

KEY TAKEAWAYS

Equity markets remained resilient as strong corporate earnings offset higher oil prices, geopolitical tensions, and the Federal Reserve's ("the Fed") September rate hike.

Continued corporate earnings growth should help offset valuation pressure from rising oil prices and interest rates.

Midterm election years typically bring muted returns and higher volatility, yet stocks have rallied this year without a meaningful correction, potentially reflecting voter expectations of a divided government that would limit any major policy changes.

The AI investment boom continues to create significant opportunities, but the scale of investment raises questions about future returns.

Higher yields have improved opportunities in short-term U.S. Treasuries, while the incorporation of select alternative investments, where appropriate, may provide opportunities to enhance portfolio yield and diversification.

U.S. equity markets extended their gains in the third quarter, although the advance was more muted than the prior quarter's rebound, as a renewed spike in energy prices and rising interest rates offset continued strength in corporate earnings. The U.S.-Iran ceasefire collapsed during the quarter, with both sides exchanging attacks that disrupted key energy routes and intensified supply concerns. Oil prices subsequently climbed from around \$70 per barrel in early July to more than \$100 by mid-September¹. The resulting inflation concerns contributed to the Fed's decision to raise interest rates by 0.25% in September, its first increase since 2023.

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While these developments presented challenges to valuations, strong U.S. corporate earnings growth provided an important counterweight and remained the primary driver of equity performance year-to-date. As a result, the S&P 500® Index returned 2.30% for the third quarter and is now up 12.73% for the year. Outside of the U.S., markets were more mixed. Foreign developed equities, represented by the MSCI EAFE Index, gained 0.91% and are up 10.91% year-to-date, as European and Japanese markets lagged given their limited exposure to the AI investment boom and pressure from rising interest rates. Emerging markets, represented by the MSCI Emerging Markets Index, declined 0.4% as early strength faded amid a pullback in semiconductor stocks and higher U.S. rates pressured global capital flows. South Korea was a notable pullback victim as it reversed some of its strong AI-driven first half performance. Despite the modest quarterly decline, emerging markets remain up approximately 23.5% year-to-date. Fixed income markets, meanwhile, faced a difficult quarter, as concerns about increasing inflation combined with the Fed's rate hike to push yields higher. The Bloomberg U.S. Aggregate Bond Index declined 3.51% for the quarter and is now down 2.91% for the year.

¹ Price quoted is West Texas Intermediate, the primary benchmark for crude oil pricing in North America.

THE FORCES SHAPING EQUITY MARKETS

The Fed's decision to raise interest rates at its September meeting was somewhat surprising to us. As a reminder, the Fed has a dual mandate to promote maximum employment and maintain price stability. However, the primary source of renewed inflationary pressure has been higher energy prices, which are largely the result of a geopolitical supply disruption rather than excess demand within the U.S. economy. Outside of energy, underlying inflation trends have generally been more encouraging. Shelter costs, which account for roughly 35% of the CPI, continue to move lower. At the same time, the labor market remains relatively static, characterized more by a lack of hiring and firing than by significant acceleration in either direction. Historically, the Fed has indicated that it will generally look through temporary oil supply shocks, recognizing that monetary policy has limited ability to address an immediate increase in energy prices and that such shocks can ultimately reverse on their own. Given these dynamics, we expected the Fed to remain on hold in September.

"According to FactSet, S&P 500 year-over-year earnings growth accelerated from 28.8% in the first quarter to 52.3% in the second quarter, significantly exceeding the 23.1% growth rate analysts had expected at the beginning of the reporting period (note that second quarter earnings results are reported during the third quarter)."

Despite the tighter monetary conditions, U.S. equities posted a positive return for the quarter, supported by broad-based earnings growth. According to FactSet, S&P 500 year-over-year earnings growth accelerated from 28.8% in the first quarter to 52.3% in the second quarter, significantly exceeding the 23.1% growth rate analysts had expected at the beginning of the reporting period (note that second quarter earnings results are reported during the third quarter). These figures were boosted meaningfully by outsized results from Amazon and Alphabet, whose reported earnings benefited in large part from gains on their investments in Anthropic and SpaceX. Excluding Amazon and Alphabet, S&P 500 earnings still grew by more than 33.8% in the second quarter, which still compares favorably with the five-year average

earnings growth rate of 16.4% and the 10-year average of 10.3%. Importantly, earnings growth was not limited to the largest technology companies, with earnings for the 493 S&P 500 companies that are not part of the Magnificent 7 growing 31.8%. AI is becoming an increasingly important contributor to this growth. While the initial benefits have been concentrated among companies directly tied to the AI investment cycle, adoption is broadening across the economy as businesses use AI to improve productivity, reduce costs, and expand operating margins. This broader adoption is important because it suggests that the economic benefits of AI may extend well beyond the companies building the underlying technology and infrastructure. The outlook remains encouraging. Analysts expect third- and fourth-quarter earnings to grow 29.1% and 26.8% respectively, marking nine consecutive quarters of double-digit earnings growth for the index. Initial estimates for 2027 call for earnings growth of 15.2%, which remains comfortably above the 10-year average.

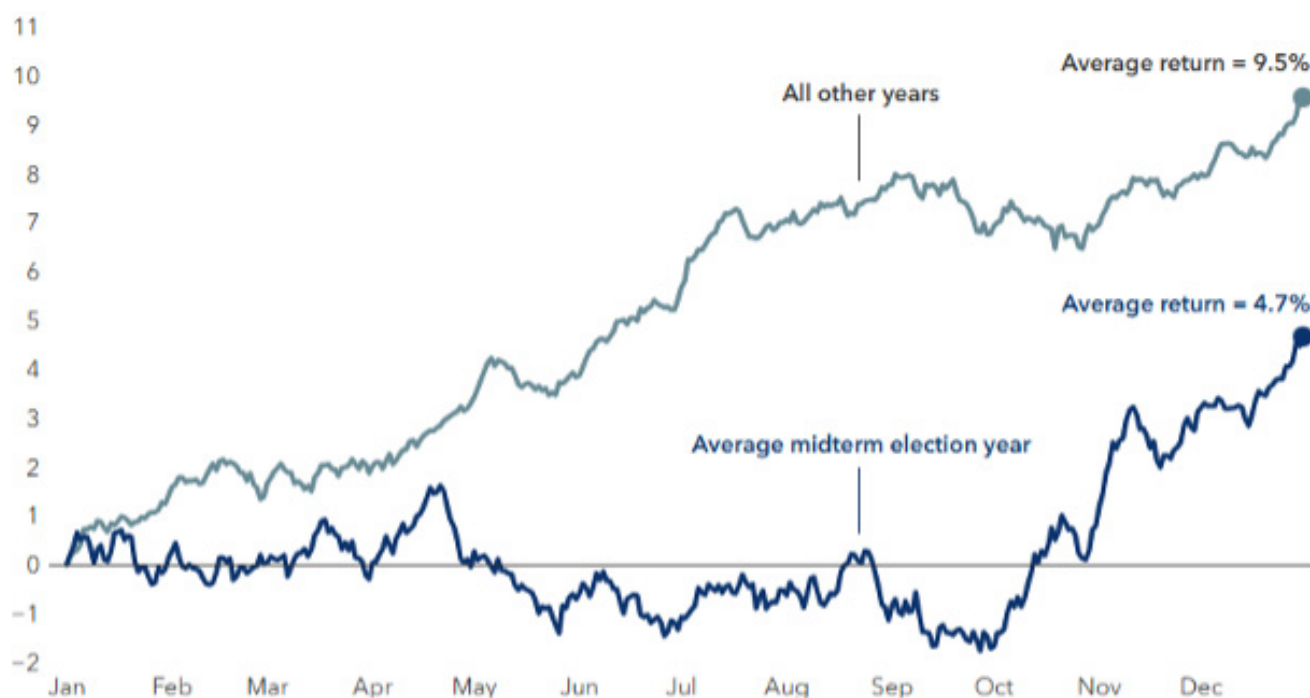
Looking ahead, the future path of oil prices and monetary policy remain important considerations for the market. So far, the impact of the disruption to global oil supplies has been somewhat contained. Coordinated releases from strategic petroleum reserves, surplus inventories accumulated prior to the conflict, reduced crude imports by China, and efforts to reroute supplies through alternative channels have helped offset a meaningful portion of the lost production and transportation capacity associated with the closure of the Strait of Hormuz. In our opinion, this has helped keep oil prices from rising even higher. However, some of these measures are temporary. If the conflict persists, inventories and strategic reserves could become increasingly depleted, while alternative transportation routes may not be sufficient to fully replace disrupted supply. This creates a risk that oil prices could move higher, potentially putting additional pressure on inflation and ultimately forcing the Fed to raise interest rates further. (Remember that higher interest rates can weigh on equity valuations because they reduce the present value of a company's future earnings.) That being said, we believe the strength and breadth of corporate earnings provide an important source of support for equity markets. While we remain mindful of the risks posed by higher oil prices, interest rates, and geopolitical developments, the primary focus remains on the trajectory of corporate earnings. If earnings can continue to grow at the rates currently anticipated, they should provide an important foundation for equities even as investors navigate a more challenging monetary and geopolitical environment.

The upcoming midterm elections will also be a focus for investors in the fourth quarter. Historically, midterm election years have followed a fairly consistent pattern: returns have tended to be more muted, volatility higher, and the market's strongest gains have often come after the election, once some of the political uncertainty has been resolved (see chart below courtesy of the Capital Group). It is also interesting to note that since 1930, the S&P 500 has never declined in the 12 months following a midterm election, with an average price return of 14% during that period. This likely reflects a rebound from the weaker performance that typically comes before the election. What makes the current cycle particularly interesting is that 2026 has not followed the typical midterm year performance script. Instead of muted returns and elevated volatility, stocks have delivered strong performance without a meaningful correction. Again, strong corporate earnings have likely been an important factor, but investor expectations surrounding the election may also be playing a role. President Trump's current approval rating and recent polling data suggest the possibility of a divided government following the election, with Democrats likely

to regain control of the House while Republicans retain a relatively narrow majority in the Senate². The deviation from the historical pattern may be attributable to the fact that investors are already anticipating a divided government and therefore placing less emphasis on the potential for significant policy changes following the election. If this is the case, then the market's performance over the next 12 months may differ from historical post-midterm patterns. Regardless of the election outcome, we believe investors should be careful not to confuse political noise that can influence markets in the short term with the fundamental factors that drive equity values over longer periods. Elections can affect expectations for taxes, regulation, and government spending, but corporate earnings, cash flows, economic growth, and monetary policy have historically been more important determinants of long-term equity returns. Investors should stay focused on the fundamentals rather than attempting to anticipate the market implications of any particular political outcome.

Political Uncertainty Has Dampened Returns in Midterm Years

S&P 500 Index average price return (%), 1931-2025



Source: The Capital Group

²Note that even if the Democrats were to gain control of the Senate by one or two seats, President Trump would still have the ability to veto any legislation. Overriding a presidential veto requires a two-thirds majority in both chambers, while most legislation in the Senate requires 60 votes to overcome a filibuster, meaning a narrow Democratic majority would still face significant constraints on its ability to enact legislation. As a result, the likelihood of major policy changes following the election would remain low.

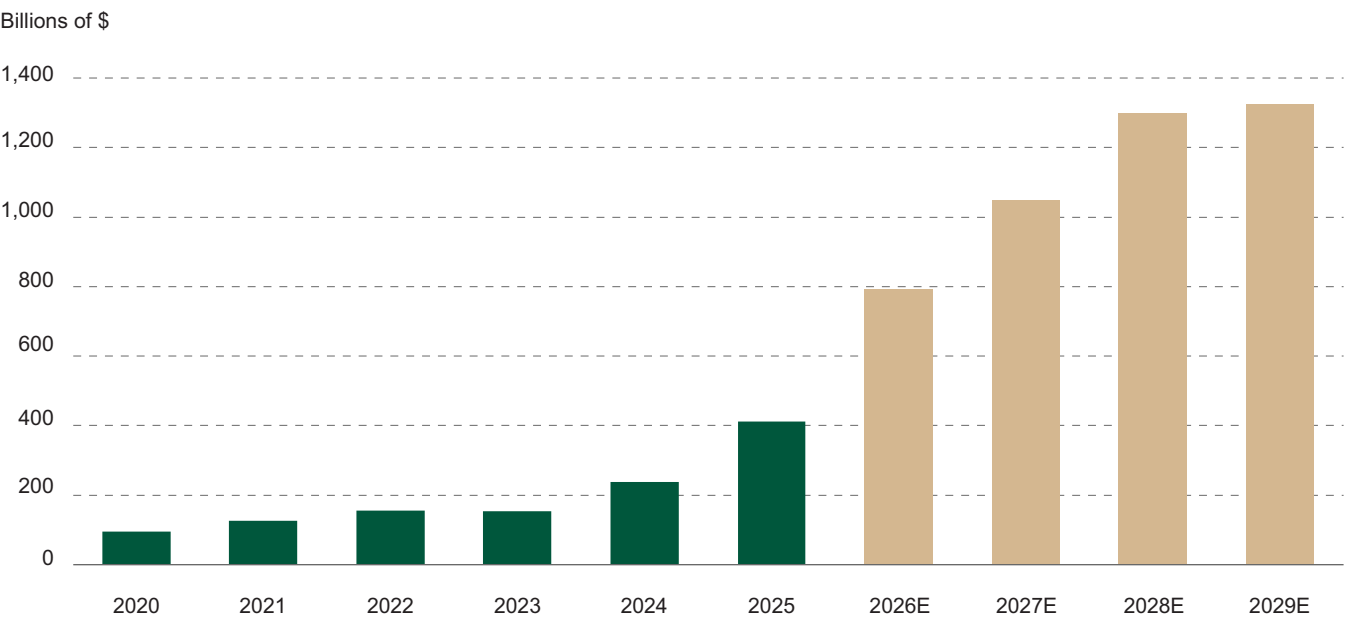
AI'S TRILLION-DOLLAR CHALLENGE: CAN RETURNS JUSTIFY THE INVESTMENT?

AI has rapidly proliferated, driving a massive wave of capital investment and contributing meaningfully to near-term economic growth. This investment cycle extends well beyond the companies that are developing AI models. To better understand the broader AI investment opportunity, it is helpful to look at the technology supply chain itself. At the top of the stack are the frontier model developers, such as Anthropic and OpenAI, which are competing to develop the most capable AI models and expand their adoption across a broad range of applications. These companies require enormous amounts of computing power to train and operate their models, creating substantial demand for the infrastructure needed to support them. Beneath them are the hyperscalers and cloud infrastructure providers that supply the computing capacity, storage, networking, and cloud platforms required to train and run those models. Supporting this cloud infrastructure is a physical supply chain that includes semiconductors, high-bandwidth memory, servers, networking equipment, cooling systems, power infrastructure, and data-center real estate.

AI spending has represented one of the largest waves of private investment in modern history, with the pace of investment expected to remain elevated for years to come. The most commonly referenced estimate for investment in AI is the projection for capital expenditures by the major U.S. hyperscalers: Amazon, Microsoft, Google, Meta, and Oracle.

Collectively, these companies are expected to have roughly \$800 billion in capital expenditures this year, an increase of 92% versus last year, with spending projected to exceed \$1 trillion next year. In fact, it is expected that the total capital spent will exceed \$6 trillion by the end of the decade (see chart below). This expenditure dwarfs the largest scientific and infrastructure projects of the 20th and 21st centuries. The Manhattan Project, in today's dollars, is estimated to have cost about \$30 billion, while the Apollo Program, during the 1960s and early 1970s, accounted for around \$250 billion. Such an outlay has understandably led to concerns around whether it will actually yield an adequate return on investment, or be known as one of the biggest misuses of capital in history. If we were to assume that the \$6 trillion of cumulative investment would generate a modest 10% return on investment, then the industry would ultimately need to produce approximately \$600 billion of incremental revenue to justify it. Notably, the software industry alone isn't large enough to cover the bill, even in a total cannibalization scenario. For perspective, one of the biggest concerns surrounding AI is its potential to disrupt existing software businesses, a risk that received significant attention earlier this year. The argument is straightforward: if AI models can automate tasks that historically required software applications and human labor, some traditional software companies could see their products become less valuable or even obsolete. According to Statista, total software revenues in the U.S. are

Combined CapEx Spending of Major Tech Companies*



Source: Bloomberg, Goldman Sachs, *Actual and projected CapEx from Amazon, Microsoft, Google, Meta, Oracle

estimated to be \$390 billion in 2026. In an extreme scenario, if frontier model developers such as OpenAI and Anthropic were to capture nearly all of the revenue currently generated by U.S. software companies, the industry would still need to grow roughly 50% by the end of the decade, simply to support the level of AI investment being contemplated.

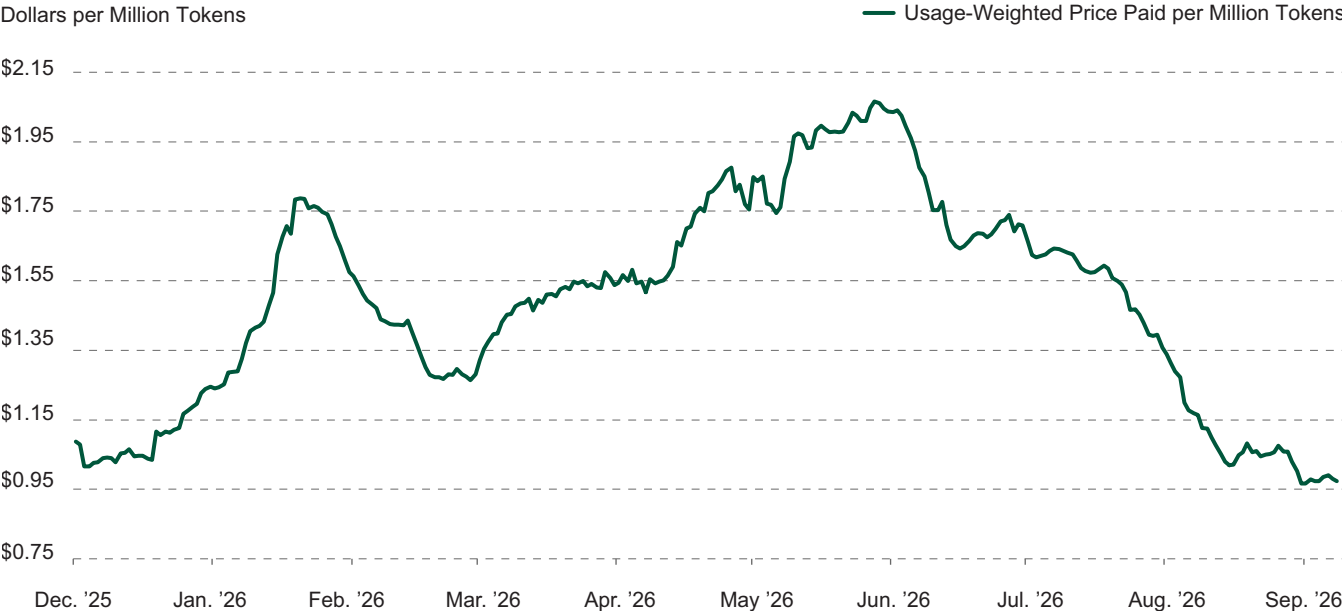
At the same time, it is important to recognize that frontier AI models are offering capabilities that go well beyond traditional software. These systems can automate knowledge work, generate and analyze content, write software, conduct research, and, increasingly, solve complex reasoning problems. The potential economic impact therefore extends well beyond the existing software market. AI could ultimately create entirely new categories of demand and increase productivity across virtually every industry.

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The growth experienced by the leading AI model developers provides some evidence that this demand is real. Although Anthropic and OpenAI remain privately held, both companies publicly share their revenue data. Anthropic reported \$11.6 billion in revenue for the second quarter (ending June), more than double its \$4.73 billion in the first quarter, and said its annualized revenue run rate reached \$65 billion by the end of July. OpenAI reported \$6.7 billion in revenue for the second quarter, an 18% increase from \$5.7 billion in the first quarter, and indicated that its annualized revenue run rate recently hit \$40 billion. There is no doubt that AI is transformative, and demand for computing power, as evidenced by these numbers, has risen exponentially. But current and planned investment spending by the hyperscalers appears to assume that such demand will continue to grow at the current pace.

Even as AI adoption gains momentum, one important counterweight to rising demand is that the price of AI continues to fall, particularly when measured on a per-token basis. A token is the fundamental unit of data (such as a word, character, or punctuation mark) that an AI model processes to understand and generate text. (One token is equal to about four characters or 0.75 words in English.) When you type a prompt into a model, such as ChatGPT, the system breaks your words into tokens before processing them. For those individuals and enterprises that pay to utilize these models, AI providers charge money based on how many millions of tokens you use instead of charging a flat monthly fee. This creates an important economic dynamic: the number of tokens being processed can rise dramatically

Prices Paid for Tokens



Source: Silicon Data LLM Token Expenditure Index

while the price paid for each token falls. Recent pricing pressure has been driven by intense competition among AI providers, rapid improvements in model efficiency, and the emergence of lower-cost alternatives developed in China. This competition has forced AI labs to reduce prices to remain competitive (see chart courtesy of Bloomberg on the previous page). As a result, investors need to watch the relationship between token volumes and token pricing closely to determine whether the frontier model developers can sustain revenue growth at current rates.

In our winter 2026 letter, we examined whether we are in an AI-driven equity bubble by comparing today's leading technology and AI-related firms with those that dominated the technology sector during the dot-com era.

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Our conclusion was that the fundamental backdrop was considerably healthier today. Valuations, corporate profit margins, and balance sheets are substantially stronger than those of the companies that characterized the dot-com bubble. While valuations and profitability among today's technology and AI leaders remain much more favorable than they were during the late 1990s, debt levels among the hyperscalers are starting to rise. The enormous amount of capital required to build the AI infrastructure ecosystem is increasingly exceeding what even these highly cash-generative companies can fund internally. As a result, they are beginning to supplement internal cash generation with debt and other forms of external financing—a potentially risky trend. The hyperscalers entered this investment cycle with some of the highest-quality balance sheets in the market, but that strength is beginning to erode at the margin, because the financial commitments being made today are increasingly certain, while the future earnings power required to support those commitments remains dependent on AI revenues continuing to grow at a very rapid pace. We therefore believe this is a situation that bears watching closely. We remain constructive on the long-term transformative potential of AI and on the financial strength of the leading hyperscalers, but the magnitude of the investment cycle raises increasingly important questions about future returns on capital. We are not suggesting that it is time to sell these businesses outright. Many remain among the highest-quality companies in the world. However, there may come a point when the combination of rising capital requirements, increasing leverage, falling AI pricing, and slowing returns on incremental investment warrants a more cautious stance.

NAVIGATING TODAY'S FIXED INCOME MARKETS

Beyond the impact of the Fed's rate hike, U.S. Treasury prices also fell during the quarter as the massive borrowing needed to fund AI infrastructure created an additional source of demand for corporate debt. As hyperscalers increasingly tap the bond market to finance their AI investments, the resulting supply competes for investor capital that has traditionally flowed into Treasuries. For many investors, these bonds are an attractive alternative, offering higher yields while being issued by highly rated companies with strong cash flows. Their appeal has been further reinforced by growing concerns over federal budget deficits and the rising amount of Treasury debt outstanding. As capital shifted toward high-quality corporate issuers and away from Treasuries, softer demand for government debt added to the upward pressure on Treasury yields.

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That said, we feel the rise in Treasury yields is creating more attractive opportunities at the short end of the curve. We continue to favor U.S. Treasuries over publicly traded investment-grade and high-yield corporate bonds, as credit spreads remain near multi-decade lows. As a reminder, credit spreads represent the additional yield investors receive for taking on corporate credit risk relative to comparable-

maturity U.S. Treasuries, which are generally considered the benchmark for risk-free rates. That additional yield is intended to compensate investors for the possibility that a company could default on its debt. At current levels, we believe spreads in both the investment-grade and high-yield markets suggest investors are not being adequately compensated for taking on additional credit risk. Within Treasuries, we also remain cautious about extending duration too far, particularly into ten-year and longer-dated maturities. Investors are currently receiving relatively little additional yield when compared to shorter-term Treasuries, while taking on significantly greater sensitivity to changes in interest rates (also known as duration risk). Longer-term yields may be vulnerable to a renewed rise in inflation, particularly if a prolonged conflict in the Middle East leads to continued disruptions in the oil supply chain and pushes energy prices meaningfully higher. In addition, persistent federal budget deficits could require increased Treasury issuance, potentially keeping long-term yields elevated and limiting the potential for price appreciation. With short-term Treasury yields having moved higher, we believe the front end of the curve offers an attractive combination of yield and limited duration risk.

The performance of bonds during the quarter also reinforced the value of incorporating alternative investments that can enhance portfolio income and diversification. Areas such as private credit and private real estate can provide attractive sources of income while offering exposure to return drivers that differ from traditional fixed income. At the same time, we view stores of value such as gold and bitcoin as complementary portfolio components. Both can serve as potential hedges against currency debasement, elevated

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fiscal deficits, and longer-term inflation risks, while also providing diversification benefits in periods of heightened macroeconomic and geopolitical uncertainty. Please be aware that investments in alternatives may not align with every investor’s financial needs or risk profile, and should be evaluated within the broader context of an individual’s overall asset allocation. However, for investors with longer-term time horizons and the appropriate risk tolerance, we believe selectively incorporating alternatives can complement traditional fixed income and provide additional sources of income and diversification across market environments.

IN CLOSING

Equity markets have navigated a challenging environment remarkably well this year, despite heightened geopolitical tensions in the Middle East, higher oil prices, and a more hawkish Fed. Looking ahead, further increases in oil prices could keep upward pressure on interest rate expectations, weighing on equity valuations. The extent of that pressure will depend largely on how oil prices evolve and, ultimately, how long hostilities in the Middle East persist. While continued growth in corporate earnings should provide an important source of support for equities, the combination of geopolitical uncertainty and higher interest rates could contribute to increased market volatility in the future. Nevertheless, we do not currently anticipate a recession, as continued investment

in artificial intelligence and the potential productivity gains it generates should help support economic growth. Against this backdrop, we believe disciplined asset allocation remains especially important. As always, a well-structured, long-term, and diversified portfolio tailored to your financial goals, risk tolerance, and investment time horizon remains the cornerstone of navigating an evolving investment environment.

We thank you for your ongoing confidence and trust. Please reach out to your relationship manager with any questions, or if you wish to discuss your portfolio allocation.

Happy fall!

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Performance numbers for the index are total return with dividends reinvested in the index.

The Bloomberg Barclays US Aggregate Bond Index provides a measure of the total return performance of the U.S. dollar denominated investment grade bond market, which includes investment grade government bonds, investment grade corporate bonds, mortgage pass through securities, commercial mortgage backed securities and asset backed securities that are publicly for sale in the United States.

Artificial intelligence (AI) is a wide-ranging branch of computer science concerned with building smart machines capable of performing tasks that typically require human intelligence. While AI is an interdisciplinary science with multiple approaches, advancements in machine learning and deep learning, in particular, are creating a paradigm shift in virtually every sector of the tech industry. Artificial intelligence allows machines to model, or even improve upon, the capabilities of the human mind. And from the development of self-driving cars to the proliferation of generative AI tools like ChatGPT and Google's Bard, AI is increasingly becoming part of everyday life — and an area companies across every industry are investing in.

Please contact us for more information on how we can assist you with your financial needs.

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