TIMESSQUARE CAPITAL MANAGEMENT, LLC

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TSCM: Inside the Investment Room

TSCM: Inside the Investment Room is a bulletin offering the Firm's perspectives on current market developments.

Navigating Higher Rates & Weaker Dollar: Defense, Discipline, and the Durability of AI

In this edition of *Inside the Investment Room*, we examine how higher interest rates and a weaker dollar could reshape sector leadership. From defensive healthcare and industrial positioning to rate-sensitive financials, consumer pressure points, and questions surrounding the sustainability of AI infrastructure spending, the current environment reinforces the importance of balance-sheet strength, pricing power, and disciplined stock selection.

Markets remain highly differentiated as investors navigate higher rates, currency shifts, and evolving capital needs. In this environment, the team is seeking high-quality businesses with recurring demand, pricing power, and strong balance sheets, while remaining selective across more rate-sensitive areas. AI remains a powerful structural growth driver, though attention is increasingly shifting toward the economic returns needed to sustain elevated investment.

Executive Summary

The investment backdrop remains highly sensitive to the path of interest rates and the dollar, creating meaningful dispersion across sectors and individual companies. The team continues to favor businesses with recurring demand, pricing power, and strong balance sheets, while maintaining a defensive posture toward rate-sensitive areas such as early-stage biotech, housing-related consumer exposure, and leveraged businesses. At the same time, AI remains a powerful structural growth theme, though attention is increasingly shifting toward the economic returns required to sustain elevated infrastructure spending. Across portfolios, disciplined stock selection and balanced positioning remain critical as the team evaluates opportunities across multiple macro scenarios.

22

AVERAGE YEARS OF EXPERIENCE

18

INVESTMENT PROFESSIONALS

Sector Perspectives — Takeaways

Technology

Technology fundamentals remain broadly resilient, but the sustainability and economics of AI infrastructure spending are becoming increasingly important to the investment debate.

- Software companies generally have manageable currency exposure and relatively low capital intensity, limiting direct sensitivity to higher rates.
- Semiconductor companies remain heavily influenced by AI infrastructure demand and are increasingly trading as a group when investors reassess valuations or capital spending expectations.
- The central question is shifting **toward whether large AI customers can generate sufficient economic returns on current infrastructure spending**, making future disclosures from major AI platforms important indicators of cycle durability.

Financials

The outlook for financials depends less on the absolute level of rates than on the shape of the yield curve and the broader risk environment, reinforcing the team's balanced positioning.

- A **higher long-term rate/weaker-dollar scenario** could favor fintech, alternative asset managers, and select value-oriented financial companies.
- A more **hawkish Federal Reserve and higher short-end rate environment** would weigh more heavily on commercial real estate and other rate-sensitive businesses, though share-price reactions to recent rate moves have been notably more muted than in 2022–2023, and banks have generally held up better than the stereotype implies.
- Portfolio construction remains intentionally balanced across real estate, fintech, alternative asset management, and brokerage exposures to avoid making a concentrated macro bet.

Energy

Energy remains relatively well positioned in an inflationary or commodity-supportive environment, while materials exposure still requires selective portfolio attention.

- Energy companies can benefit from stronger commodity pricing and continued capital investment across production and infrastructure.
- Pricing power and funded customer capital expenditure remain important supports for select energy infrastructure businesses.
- Materials remain the most exposed area of the portfolios under this scenario and a key focus for further idea generation, with precious metals volatility a larger consideration in mid cap than in small cap following the recent benchmark rebalance.

Industrials & Infrastructure

Quality industrial businesses with recurring demand, pricing power, and underlevered balance sheets remain preferred as higher rates pressure more cyclical and housing-sensitive areas.

- Waste businesses stand out defensively, supported by the least revenue variability in the group, non-exportable oligopoly market structures, and margins that more than compensate for relatively high capital intensity.
- Housing-related businesses remain vulnerable as elevated mortgage rates reduce turnover and remodeling activity, while for engineering and construction the greater concern is multiple contraction rather than end demand.
- Select niche industrial companies continue to screen well given strong pricing power, healthy balance sheets, and diversified end-market exposure.

Consumer

Consumer fundamentals remain mixed, with healthy underlying demand offset by pressure from higher rates, import costs, and sensitivity in big-ticket spending.

- Housing-linked businesses remain among the most exposed as higher financing costs weigh on remodeling and discretionary project activity.
- A weaker dollar creates additional pressure for import-heavy businesses, particularly where companies have limited ability to pass rising costs through quickly.
- Defensive businesses with contractual pricing, recurring demand, and low leverage remain preferred as consumer-sector performance continues to lag the broader market.

Health Care

Healthcare remains relatively defensive at the demand level, though higher rates create meaningful dispersion between profitable commercial businesses and capital-dependent early-stage biotechnology companies.

- The portfolios remain tilted toward **commercial, profitable, or near-profitable healthcare companies**, limiting exposure to the most rate-sensitive areas of biotechnology.
- Earlier-stage biotech remains the primary vulnerability in a rapid rate shock, as companies with greater external funding requirements face higher capital costs.
- Biopharma M&A remains an important structural support as large pharmaceutical companies look to replenish pipelines ahead of the 2028–2031 patent-cliff period, potentially offsetting some financing pressure from higher rates.

Key Macro Trends

- **Higher Rates Are Multi-Dimensional:** The investment implications depend heavily on whether higher rates are driven by long-end inflation expectations or by a hawkish Fed, and on whether the backdrop is risk-on or risk-off.
- **Defensive Quality Matters:** Recurring revenue, contractual pricing, low leverage, and resilient end-market demand are becoming increasingly valuable portfolio characteristics.
- **AI Economics Under the Microscope:** The AI infrastructure cycle remains intact, but investors are increasingly focused on whether unprecedented capital spending can generate sustainable returns.
- **Currency Creates Sector Dispersion:** A weaker dollar can benefit exporters and companies with foreign revenues while pressuring import-dependent consumer and distribution businesses.
- **Capital Availability Remains Selective:** Higher rates increase financing sensitivity for early-stage biotech and more leveraged businesses, while well-capitalized companies may gain strategic flexibility. Capital access for AI infrastructure spending has so far remained ample; the more relevant debate is whether that spending earns an adequate return.

The Bottom Line

The current environment reinforces the value of scenario-based investing rather than making broad directional macro bets. Higher rates and a weaker dollar can create very different winners and losers depending on the yield curve, balance-sheet structure, pricing power, and capital needs of individual companies. Against this backdrop, the team remains focused on high-quality small and mid cap businesses with durable demand and financial flexibility, while remaining selective in more rate-sensitive areas such as early-stage biotechnology, housing-related consumer exposure, and highly valued AI beneficiaries. As macro uncertainty persists, disciplined fundamental research and thoughtful portfolio balance remain central to identifying opportunities and risks beneath the market surface.

Performance*	2Q	YTD	1 Yr	3 Yr	5 Yr	10 Yr	Since Inception	Inception Date
U.S. Small Cap Growth (Gross)	24.21	16.17	23.19	15.10	5.04	11.99	9.96	9/30/00
U.S. Small Cap Growth (Net)	23.92	15.61	21.99	13.97	4.00	10.89	8.87	
Russell 2000 Growth	*25.71*	*22.18*	*38.74*	*18.42*	*5.56*	*11.96*	*7.10*	
U.S. Mid Cap Growth (Gross)	18.43	9.51	10.34	13.80	7.31	13.85	10.36	9/30/00
U.S. Mid Cap Growth (Net)	18.20	9.08	9.47	12.91	6.47	12.95	9.48	
Russell Mid Cap Growth	*14.55*	*7.27*	*6.17*	*15.59*	*6.02*	*13.04*	*10.49*	
U.S. Focused Mid Cap Growth (Gross)	19.71	20.86	21.23	21.39	13.70	16.61	14.30	8/31/05
U.S. Focused Mid Cap Growth (Net)	19.47	20.36	20.22	20.36	12.67	15.51	13.11	
Russell Mid Cap Growth	*14.55*	*7.27*	*6.17*	*15.59*	*6.02*	*13.04*	*10.49*	
International Small Cap (Gross)	11.22	6.41	9.74	14.42	2.68	7.11	8.47	3/31/12
International Small Cap (Net)	10.99	5.97	8.82	13.38	1.70	6.08	7.43	
MSCI EAFE Small Cap	*9.02*	*7.65*	*17.39*	*15.70*	*5.35*	*8.63*	*8.31*	
Global Small Cap (Gross)	14.49	9.24	14.16	15.18	5.30	-	7.43	12/31/17
Global Small Cap (Net)	14.27	8.81	13.26	14.25	4.42	-	6.50	
MSCI World Small Cap	*15.06*	*16.63*	*30.15*	*17.58*	*7.46*	-	*8.97*	

*Composite performance as of 06/30/26.
See important disclosures on the following page.

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