



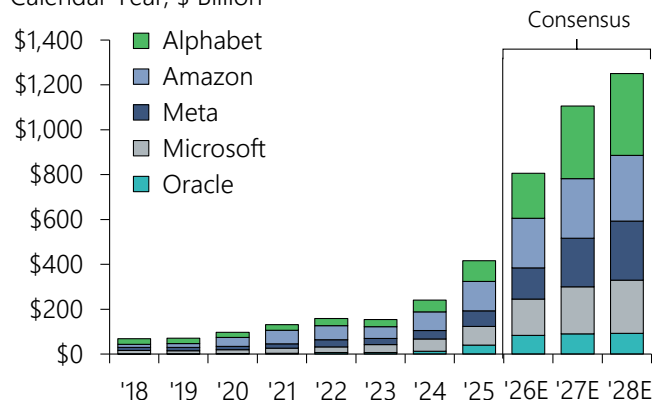
Key Points

- Energy Prices Surge Again; Refining Squeeze Pushes Diesel to Record Highs
- AI Build-Out and Wealth Effect Keep U.S. GDP Growth Resilient, for Now
- China Leans on Fiscal Stimulus Again; Property Drag Still Outweighs AI
- Bank of Japan Quickens Tightening, Now Eyeing Upside Inflation Risks Too
- Bond Yields Reset Higher, Offering Opportunities Amid Rising Market Risks
- Broadening Potential Beyond AI Favors Diversified, Quality Equity Portfolios

In Focus: We Believe Anticipated Productivity Gains Justify Trillions in AI Investment

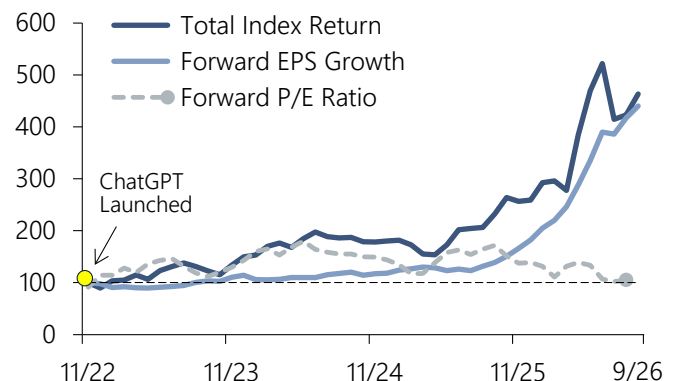
1 Hyperscaler Capex Forecasts Keep Climbing

Hyperscalers' Total Capital Spending
Calendar Year, \$ Billion



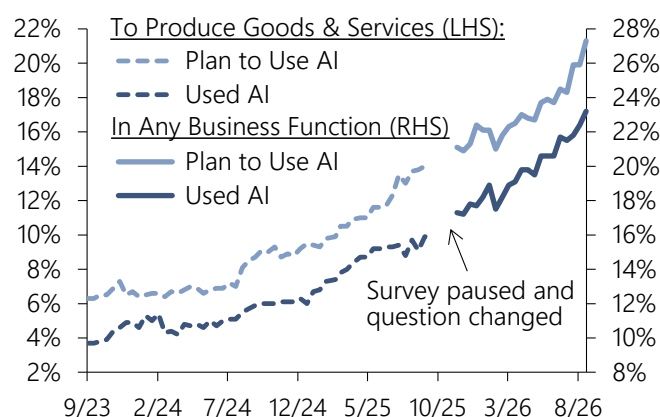
2 Chip Rally Driven by Stellar EPS Growth

Philadelphia Semiconductor Index
Indexed, 11/30/22 = 100



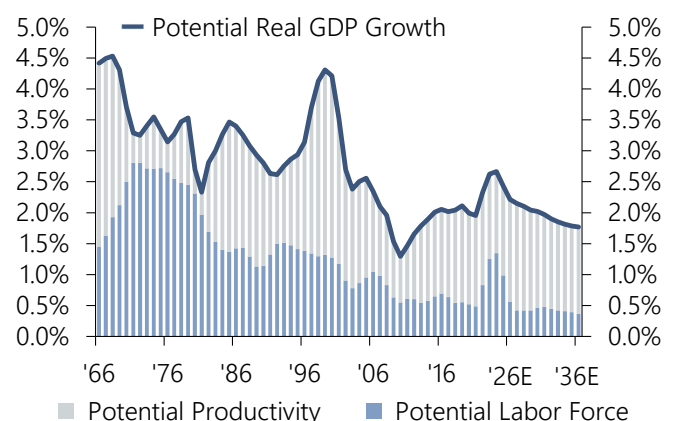
3 AI Adoption Broadening but Still Early

Percentage of U.S. Businesses Using AI or Plan to Use AI



4 AI-Led Productivity Must Carry U.S. Growth

U.S. Potential Real GDP Growth

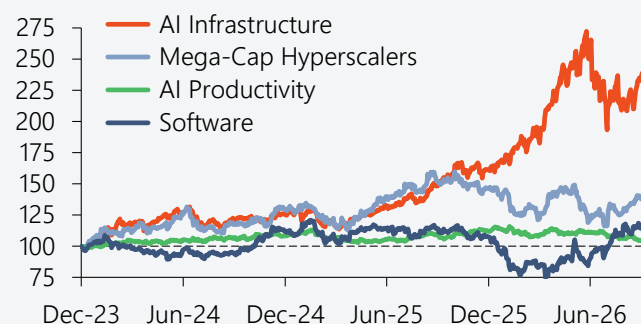


From Building AI to Putting It to Work

When OpenAI released ChatGPT in November 2022, few investors anticipated how quickly an “AI chatbot” would reshape corporate spending priorities and equity market leadership. The race to build AI capability has since become the dominant driver of global investment, and the stocks of companies supplying AI’s “picks and shovels” (semis, networking equipment, compute, and power generation) have outperformed the broad market by a wide margin. We believe the fundamentals largely justified this outperformance, but the easiest gains from the investment theme are likely behind us.

AI Infrastructure Has Led Since Mid-2025

Performance of AI-Related Portfolios
Relative to Equal-Weight S&P 500, 12/31/23 = 100



Source: Goldman Sachs, 9/30/26

Unlike prior tech “manias,” earnings have largely kept pace with equity returns. Around 95 percent of the AI infrastructure group’s return over the last four years, as represented by the Philadelphia Semiconductor Index, is explained by the growth in forward earnings and cash flow, which is very different from the dot-com bubble, when valuation expansion did most of the heavy lifting. Capital expenditures by the five largest hyperscalers are expected to climb from \$158 billion in 2022 to roughly \$800 billion in 2026 and \$1.1 trillion in 2027, with much of it flowing to a small set of dominant suppliers.

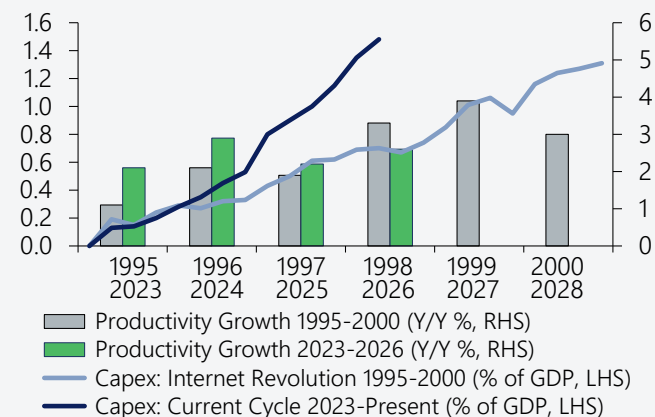
So, is the spending justified? To date, largely yes. It has been funded mostly by hyperscaler cash flows and has generated real earnings. However, the burden of proof is rising. Capital expenditures are consuming a growing share of operating cash flow, and debt and vendor financing are playing an ever-increasing role. Around 45 percent of the S&P 500 Index’s value is estimated to be tied to the AI build-out. The enormous investment must ultimately produce a return, which depends on the next phase—adoption by consumers, businesses, education, and the public sector across the global economy.

Some of the early evidence of potential returns comes from historical revenue acceleration at frontier AI labs, primarily driven by software coding; rapid adoption of personal agents like Muse and Instinct; and early signs

of use cases in healthcare, finance, engineering, energy, and elsewhere. Industry analysts estimate that frontier AI labs’ revenue needs to surpass \$180 billion, or add \$80 billion in incremental revenue, by the end of 2026, just to keep the AI trade intact. Zooming out further, Goldman Sachs estimates that more than a trillion dollars in AI application-layer revenues are needed to justify cumulative AI capex in 2026 and 2027.

U.S.-China strategic competition adds another layer of urgency, as Washington, D.C., like Silicon Valley, views AI leadership as vital to future technological, economic, and geopolitical primacy. The AI build-out ranks among the largest infrastructure investments in U.S. history, rivaling the 19th-century railroad build-out, the early-20th-century electrification, and the late-1990s telecom boom. Given the scale of this spending, there is likely to be some overbuilding. Still, history shows that excess capacity can be valuable. Much of the fiber-optic cable laid in the late 1990s sat dark after the dot-com bust, yet that cheap bandwidth later became the basis for broadband, streaming, cloud computing, and mobile internet.

AI Productivity May Align With Internet Path



Source: Citi Research, 10/4/26

Having said that, we do not believe today’s build-out is analogous to the fiber overbuild. In the 1990s, telecom carriers borrowed heavily to build capacity far ahead of demand, whereas today’s build-out is funded largely by the operating cash flows of highly profitable companies, and demand for compute continues to outstrip supply. We believe the investment will prove worthwhile, as AI offers one of the few credible offsets to slowing labor force growth and aging populations across the U.S. and the developed world by improving productivity.

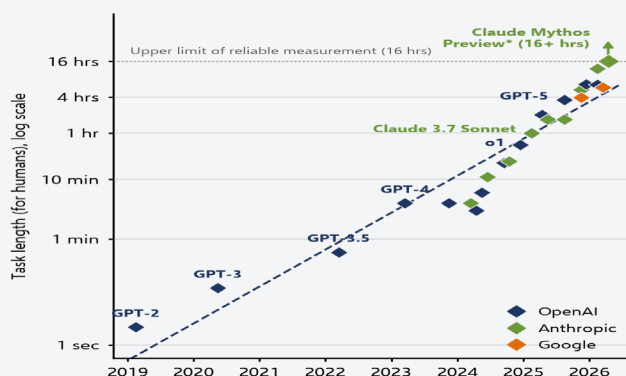
If the last four years were about building AI’s capability, we believe the next several will be about deploying it, led by agentic AI—systems that perform multistep tasks on a user’s behalf rather than simply answering queries. Consumer adoption may have reached its tipping point. Meta’s Muse, launched in early September, has reached more than 5 million downloads in three weeks. Google,

OpenAI, and others are expected to launch their own personal AI agents soon. Muse works across apps and keeps running even after the app is closed. Its insights into what users buy and cancel could meaningfully lift Meta's advertising yield. Start-ups such as Instinct are pursuing similar concepts, and in enterprise markets, coding agents from Anthropic, OpenAI, and others have become the first agentic applications to achieve broad, paying adoption.

Agents are far more compute-intensive than chatbots: a single task can involve dozens of model calls and long context windows, agents run continuously in the background, and Muse's free tier alone allows 100 million tokens per week. As a result, compute will shift further toward inference, increasing demand for memory and the processors that orchestrate agent workflows. While we expect the AI infrastructure trade to continue, we are becoming more selective. Capex growth will inevitably slow from 2026's breakneck pace. Thus, we favor firms with persistent bottlenecks and pricing power (leading-edge foundry, high-bandwidth memory, optical and electrical interconnect, and power) over layers prone to commoditization or reliant on external financing.

Agents also upend business models built on consumer friction. Citrini Research characterizes these as rents on tedium, inertia, attention, and information asymmetry: the subscription no one bothers to cancel or the policy renewed without shopping. Agents will wait on hold indefinitely, ignore ads, and compare every option, thus harming subscription lifetime values and intermediary take rates while favoring direct providers. The clearest winners, in our view, are those that build and improve agents, supply the infrastructure on which they run, and have end-market product/service leadership that agents are likely to interact with.

AI Task Horizons Doubling Every Six Months



Source: METR, 9/30/26

Earlier this year, investors sold the equities of security software and infrastructure providers, as well as application vendors, driven by fears that agents would erode seat-based pricing models. We view it, for the most part,

as an overreaction: AI agents are software's newest and most voracious users, and each needs somewhere to run, data to act on, permissions to operate within, and monitoring to keep them in check.

Hyperscaler platforms such as Microsoft and Alphabet monetize agent activity based on consumption. Security vendors such as CrowdStrike and Palo Alto Networks must protect a new class of non-human identities; early consumer agents have already been steered by malicious instructions. Observability platforms such as Datadog benefit as agents generate more logs and traces, and companies like ServiceNow aim to be the control tower governing agents across the enterprise.

We own leaders across every layer of the AI stack. In compute, Nvidia is the architect of AI data centers, with a software ecosystem and rack-scale design as valuable as its processors; Broadcom has become the principal partner for hyperscalers designing custom accelerators; and TSMC manufactures nearly every leading AI accelerator. In capital equipment, ASML's monopoly in EUV lithography and Applied Materials' breadth across new transistor architectures, advanced packaging, and DRAM make both companies vital to the production of each new generation of chips.

Perhaps the most dramatic re-rating has occurred in memory. High-bandwidth memory has transformed Micron and SK Hynix from commodity cyclical into strategic suppliers, as accelerator performance is increasingly constrained by the "memory wall." In networking, Arista, Credo, Coherent, Semtech, Tower Semiconductor, and Ciena address bandwidth bottlenecks—from switching and cabling to optics and links between data centers—that intensify as clusters scale to hundreds of thousands of accelerators.

Power has become the binding constraint on the AI build-out. As a result, we have focused on technology and product leaders across power generation and power management, which we believe are well-positioned to benefit from demand that should remain strong over the next several years.

In summary, AI spending has so far been justified by the earnings it is generating for many firms. Within AI infrastructure, we favor firms with durable competitive moats that provide sustained revenue visibility. We also see opportunities in infrastructure software, and in the platforms that enable AI agents, rather than in the intermediaries those agents are increasingly able to bypass. Beyond tech, there are compelling investment opportunities in healthcare, financials, industrials, and other sectors as AI adoption reshapes businesses across the economy. The first phase of AI rewarded those who built the technology. The next phase may well reward those who put it to work.



Global Macro Developments

Energy Prices Spike as Fragile U.S.-Iran Truce Collapses Yet Again

Energy prices have surged again after the U.S.-Iran memorandum of understanding signed in June quickly unraveled. The reinstated U.S. blockade of Iranian exports, along with expanded hostilities that include Houthi attacks on Saudi Arabia's Red Sea route, has again disrupted Middle East oil flows and pushed Brent oil prices to above \$100 per barrel. The larger pressure point, though, is refining. Ukraine's broadening strikes on Russian refineries and idled capacity in the Persian Gulf have driven diesel prices to record highs ahead of winter (Exhibit 1). Energy markets have proven adaptable, with inventories, new supply, decreased Chinese imports, and demand destruction absorbing much of the hit. But these buffers are thinning, and new refining capacity cannot be readily added. Therefore, the outlook remains highly uncertain. A new U.S.-Iran agreement could send prices sharply lower while a prolonged stalemate could drive them higher still. On balance, we now expect oil prices to settle within an uncomfortable but tolerable range of \$80 to \$100 over the coming months, with oil product prices remaining elevated.

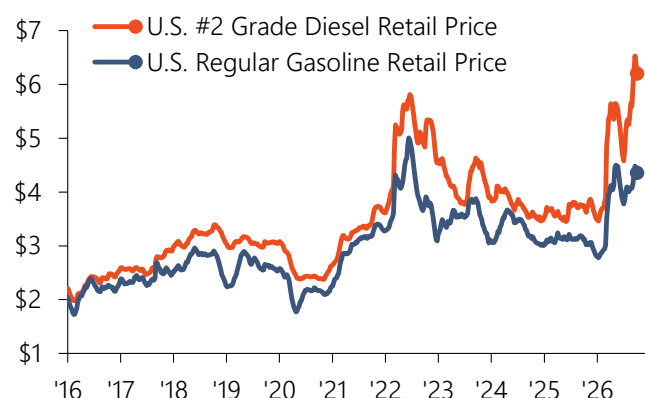
Central Banks Tighten Into Supply Shocks That Higher Rates Cannot Fix

Persistent inflation, driven largely by supply-side factors of late, is prompting central banks to tighten (Exhibit 2). Higher rates cannot ease supply constraints; they can only weaken demand. For that reason, policymakers have historically looked through the typically transient effects of supply shocks, provided that long-term inflation expectations remain well anchored. But amid elevated geopolitical uncertainty and overlapping shocks, including renewed energy pressures, they have begun to hedge, especially as resilient economic growth reduces the cost of doing so. As Chicago Fed President Austan Goolsbee recently observed, "supply shocks have come more frequently, hit harder, and lasted longer," weakening the argument for looking past them. Year to date, central banks have raised rates by 100 basis points in Australia, by 50 basis points in the Euro Area, Japan, and South Korea, and by 25 basis points in the U.S., with others expected to follow. Policymakers have a long history of fighting the last battle. Having been slow to respond to post-Covid inflation, they now risk overtightening to address issues higher rates cannot fix.

Powered by AI Build-Out, U.S. Growth Defies Energy Shock and Higher Yields

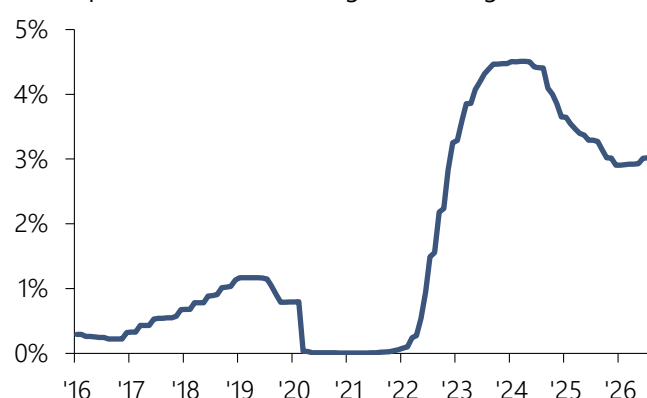
Buoyed by the aggressive AI build-out and positive wealth effects, the U.S. economy has proved incredibly resilient amid the energy shock and surging bond yields. As of print, the Atlanta Fed's GDPNow model forecasts 3.7 percent annualized real GDP growth for the third quarter, versus the upwardly revised 2.2 percent (from 1.5 percent) posted in the second quarter. Yet, inventory accumulation accounts for roughly two percentage points of that estimate. Final sales to private domestic purchasers, regarded as a better measure of underlying demand, have grown at a 2.9 percent annual rate since year-end 2024, above the 20-year average of 2.4 percent (Exhibit 3). Excluding AI-linked capital investment, Oxford Economics estimates that growth would have

Exhibit 1: U.S. Diesel and Gasoline Retail Prices
Per Gallon



Source: U.S. Energy Information Administration, 10/5/26

Exhibit 2: Average Central Bank Policy Rates
Developed Markets, GDP-Weighted Average



Source: FactSet, IMF, 9/30/26



been just 1.7 percent, before accounting for significant knock-on effects. AI capital investment is expected to continue surging, but its lift to growth will wane, leaving non-AI investment and consumer spending to pick up the slack. Investment is broadening, and the consumer has been strong. Yet, both are increasingly vulnerable to rising rates, and any reassessment of AI returns would simultaneously hit capital investment and wealth-effect-driven consumer spending.

U.S. Consumer Spending Strong, but AI-Driven Wealth Effect Can Cut Both Ways

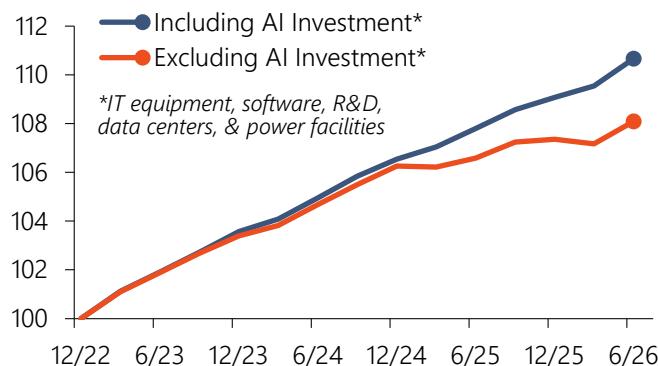
Real personal consumption expenditures (PCE) have held up well despite an affordability crisis and weak sentiment (Exhibit 4). After rising 3.8 percent annualized (2.5 percent year over year) in the second quarter, real PCE is poised to grow 3.3 percent annualized in the third quarter. Tax refunds softened the blow from higher energy costs, and low- to middle-income households are trading down and saving less to make ends meet. But higher-income households remain the key driver of spending growth, due to a wealth effect powered by the AI-driven surge in stock prices. Evercore ISI estimates that positive wealth effects, accruing predominantly to the top quintile of households, accounted for about half of the year-over-year increase in real consumer spending in the second quarter. Because the wealth effect works with a lag, the firm expects it to add 129 basis points to year-over-year spending growth in the third quarter and 117 basis points in the fourth quarter, assuming the market is flat through year-end (Exhibit 5). That leaves spending reliant on equity gains, especially in 2027, and vulnerable to an AI-driven market correction.

U.S. Labor Market Stays Balanced, Sustaining Spending Without Stoking Inflation

Over the past two years, U.S. nonfarm payroll growth has averaged about 47,000 a month, near the estimated breakeven pace, while private labor demand has been flat since 2022 (Exhibit 6).

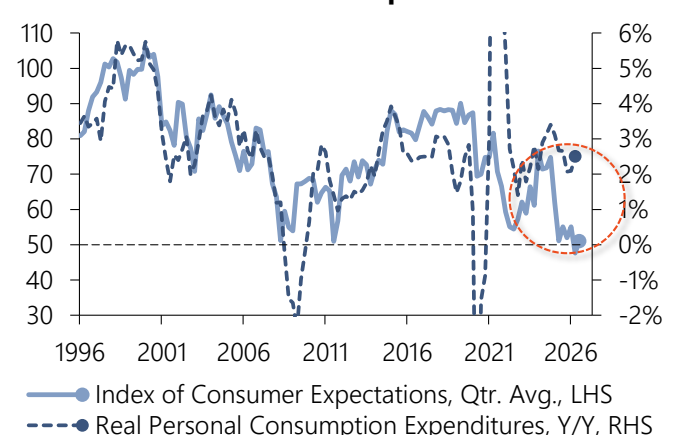
Exhibit 3: U.S. Private Domestic Demand

Final Sales to Private Domestic Purchasers
Indexed, 12/31/22 = 100



Source: Bureau of Economic Analysis, Oxford Economics, 9/30/26

Exhibit 4: U.S. Consumer Expectations vs. PCE



Source: University of Michigan, Bureau of Economic Analysis, 9/30/26

Exhibit 5: Wealth Effect's Contribution to PCE

Contribution to Real PCE Y/Y Growth

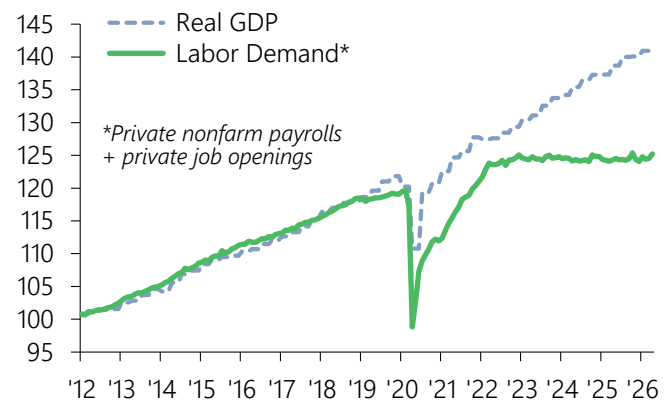
	Chg. In Wealth	2026:Q1	2026:Q2	2026:Q3	2026:Q4
2025:Q4	+\$1.8T	+4bp	+5bp	+6bp	+4bp
2026:Q1	+\$0.8T	-4bp	-10bp	-13bp	-15bp
2026:Q2	+\$12.8T		+34bp	+81bp	+106bp
2026:Q3E	+\$2.1T			+2bp	+4bp
2026:Q4E	+\$1.0T				-3bp
Cumulative Impact		+102bp	+120bp	+129bp	+117bp

* Assumes the stock market is flat in the fourth quarter of 2026

Source: Evercore ISI, 9/28/26

Exhibit 6: U.S. Real GDP vs. Labor Demand

Indexed, 12/31/11 = 100



Source: Bureau of Labor Statistics, Bureau of Economic Analysis, 10/2/26



Nonfarm payrolls expanded by just 29,000 in September, well below the consensus of 90,000. Downward revisions to July and August payrolls brought the three-month moving average to 51,000, in line with the ongoing trend. Job gains were concentrated in healthcare, construction, and manufacturing, the latter two sectors bolstered by AI-related investment, while jobs in AI-exposed information and financial activities continued to decline. Even though the economy is operating near full employment—the unemployment rate remains in the low-4 percent range—the labor market is not a source of inflationary pressure. Average hourly earnings growth cooled to 3.0 percent year over year, its slowest pace since May 2021. Still, low layoffs and steady job gains have helped sustain consumer spending. Overall, the job market remains fairly balanced, without the overheating that would justify aggressive monetary tightening.

Growth Now Hinges on AI Delivering Productivity, Not Jobageddon

Much of the outlook hinges not only on the continued build-out and adoption of AI but also on its promise of higher productivity, without triggering a “jobageddon”—a delicate balance must be struck. Potential GDP growth is the sum of labor force growth and productivity growth. Due to an aging population, falling birth rates, and stricter immigration policies, the Congressional Budget Office forecasts that labor force growth will continue to decelerate, placing the onus on productivity to fuel GDP growth (Exhibit 7). Excluding AI’s unknown benefit, it estimates that potential GDP growth will decelerate in the decade ahead, as shown in the front-page exhibit. Estimates of AI’s productivity lift to GDP growth vary widely, with the median estimate at about 0.4-0.5 percentage points per year over the next decade. An acceleration in productivity growth and AI-led innovations could trigger a virtuous feedback loop of higher capital investment and consumer spending, offsetting demographic headwinds. At least that is the bull case.

Fiscal Policy Will Rescue China’s Economy Again as Structural Headwinds Persist

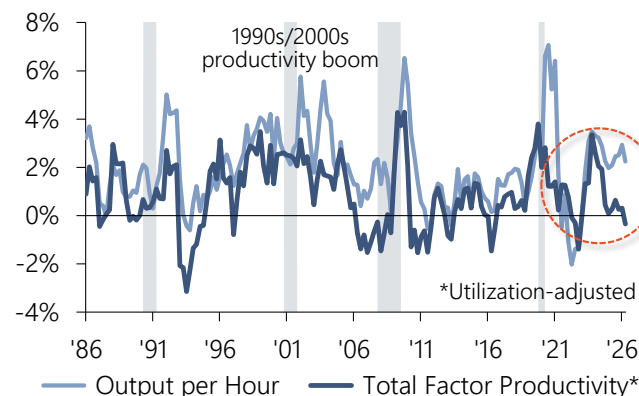
We expect 2026 real GDP growth to be near the lower end of the government’s 4.5-5.0 percent target range and forecast 2027 growth of 4.0-4.5 percent. Despite still-robust exports, China’s economic momentum remained weak in July and August, as soft household consumption and the ongoing property-market correction continued to hamper growth (Exhibit 8). Yet we expect growth to accelerate in the coming months, buoyed by faster government bond issuance, with third-quarter growth dictating the pace of stimulus through year-end. For 2027, our forecast for slower growth largely reflects China’s persistent structural headwinds. While high-tech and AI investment is growing rapidly, it is not yet large enough to offset the property downturn. As for U.S.-China relations, the recent meeting between Presidents Trump and Xi extended the trade truce but produced no broader agreement. We expect this fragile stability to persist, marked by managed competition and targeted decoupling in critical sectors through export controls.

Euro Area Economic Momentum Builds Just as Inflation Forces the ECB’s Hand

The Euro Area economy has proved more resilient than expected, with the first-order effects of the energy shock milder than feared. Excluding Ireland, real GDP grew at an annualized rate of

Exhibit 7: U.S. Productivity Growth

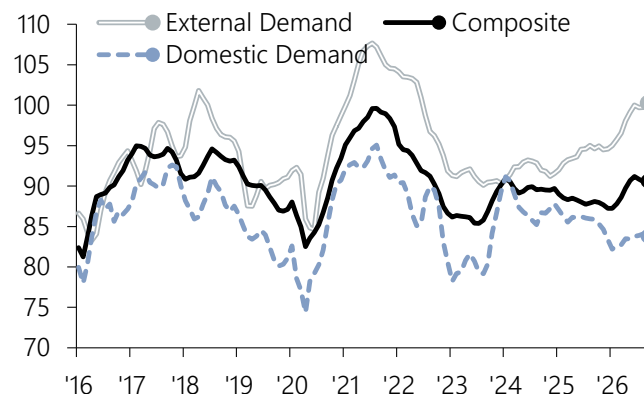
Y/Y Percent



Source: Bureau of Labor Statistics, San Francisco Fed, 9/30/26

Exhibit 8: China Cyclical Momentum Index

Three-Month Moving Average



Source: China International Capital Corporation, 10/7/26

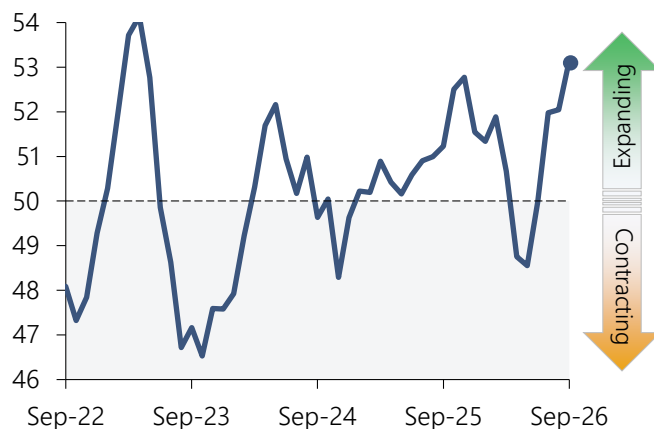


1.2 percent in the second quarter, and consensus forecasts similar growth in the third quarter. Economic momentum improved toward quarter-end, with the composite PMI rising to 53.1 in September, a 41-month high consistent with annualized growth of 1.6 percent (Exhibit 9). Yet inflation also accelerated, rising to 3.8 percent year over year in September, up from 3.2 percent in August (Exhibit 10). As a result, euro short-term rate futures are pricing in about three more European Central Bank rate hikes by mid-2027 (Exhibit 11), and rising bond yields are putting further pressure on already modest economic growth. German fiscal stimulus is a cushion, and an AI build-out is a source of upside. Still, economic growth will likely hover around 1.0 percent over the coming year, with downside risks if Middle East energy disruptions persist.

Bank of Japan Quickens Tightening with More Balanced View of Inflation Risks

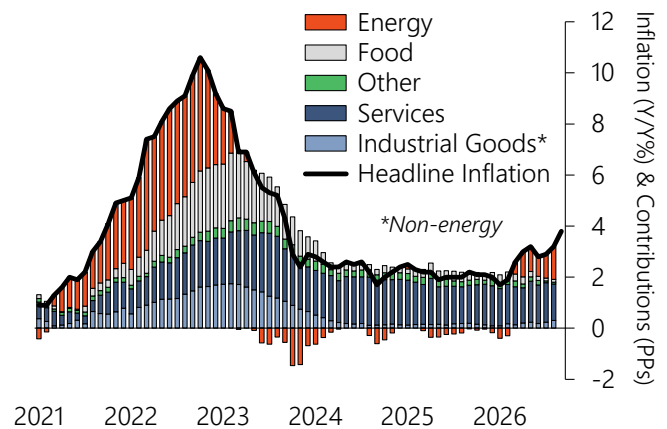
The Bank of Japan (BoJ) raised its policy rate again in September to 1.25 percent, accelerating a tightening cycle that began in 2024. The BoJ has long focused on guarding against downside price risks and ending deflation. Yet, given increasingly entrenched inflationary pressures and still-accommodative financial conditions, it is now also accounting for upside risks (Exhibit 12). Persistent yen weakness, which prompted the first coordinated U.S.-Japan intervention in 15 years, also contributed to the shift. Still, fiscal policy may pull in the opposite direction, with record fiscal 2027 budget requests and a food tax cut scheduled for April 2027, leaving the BoJ to go it alone in containing inflation. Despite the turbulent global backdrop, real GDP grew at a 1.4 percent annualized rate in the second calendar quarter, and survey data point to continued growth in the third quarter. We expect 0.5-1.0 percent real GDP growth in calendar 2026, but the renewed surge in oil prices skews risks toward higher inflation and weaker growth.

Exhibit 9: Euro Area Composite PMI



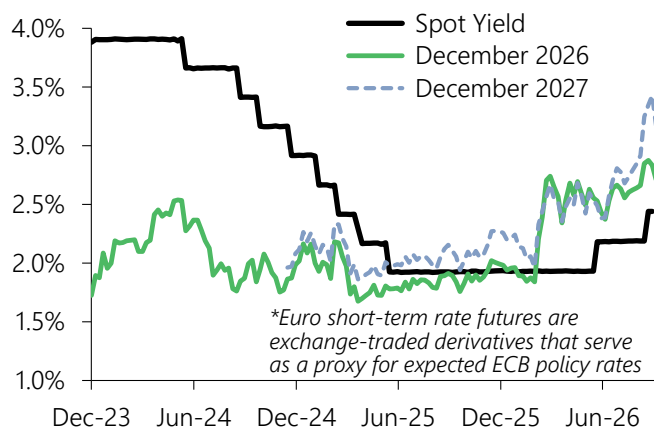
Source: S&P Global, 10/5/26

Exhibit 10: Euro Area Consumer Price Index



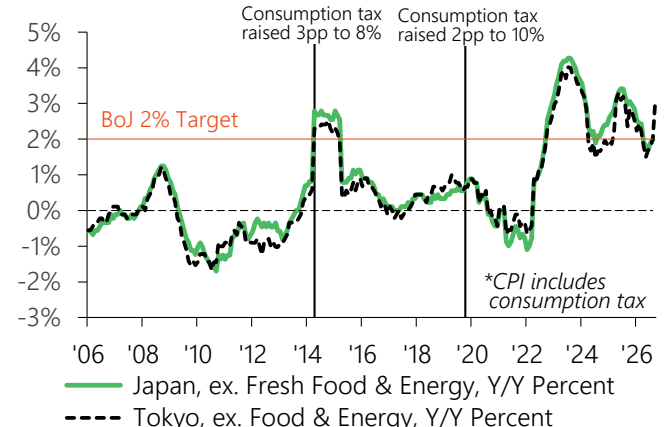
Source: Eurostat, 10/2/26

Exhibit 11: Euro Short-Term Rate Futures



Source: FactSet, 10/2/26

Exhibit 12: Japan Core Consumer Price Index



Source: Ministry of Internal Affairs and Communications, 10/2/26

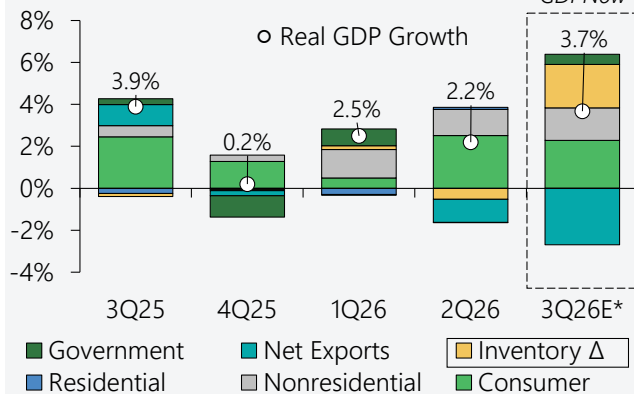
United States: Other Notable Data Points

U.S. Economy Shrugging Off Energy Shock

U.S. Real GDP

Contribution to Q/Q Annualized Percent Change

*Atlanta Fed's GDPNow

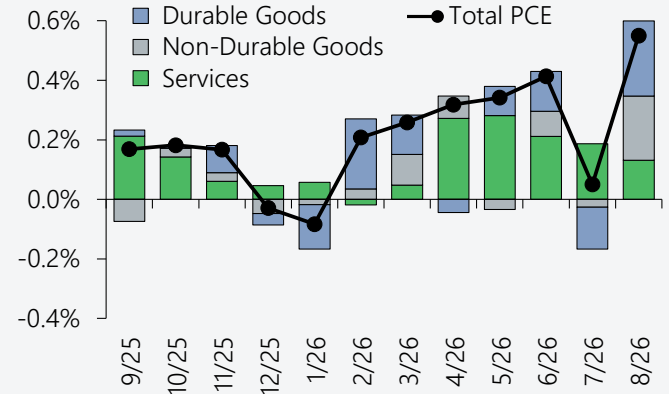


Source: Bureau of Economic Analysis, Atlanta Fed, 10/6/26

Consumer Spending Buoyed by AI Wealth Effect

U.S. Real Personal Consumption Expenditures

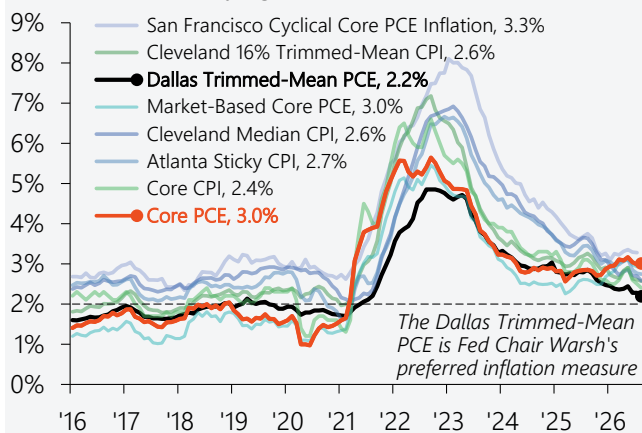
Contribution to M/M Percent Change



Source: Bureau of Economic Analysis, 9/30/26

Most Other Inflation Gauges Are Below PCE

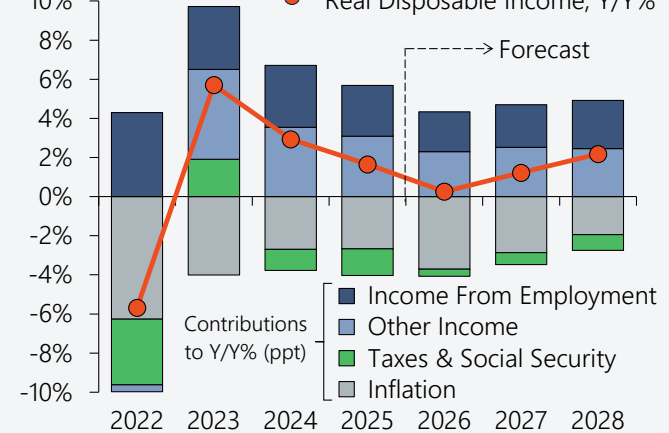
Measures of Underlying U.S. Consumer Inflation



Source: BLS, BEA, Regional Fed Banks, 9/30/26

Easing Inflation Should Revive Real Incomes

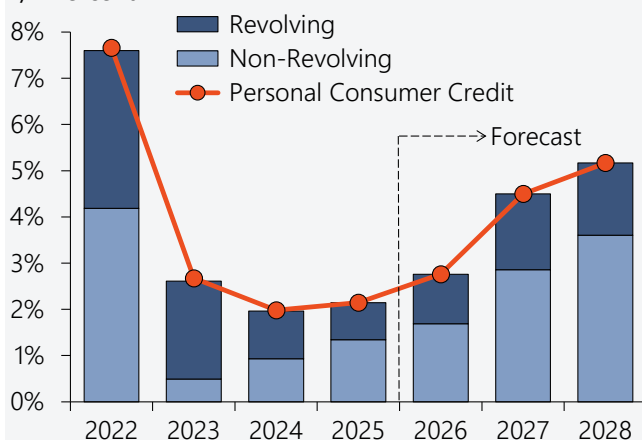
Real Disposable Income, Y/Y%



Source: Oxford Economics, 9/30/26

Consumer Credit Growth Expected to Pick Up

Y/Y Percent

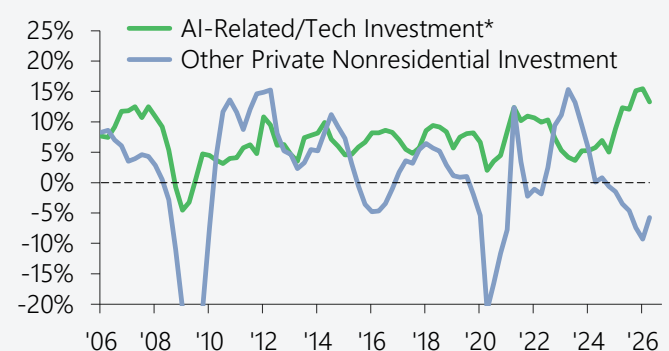


Source: Oxford Economics, 9/30/26

Fixed Investment Needs to Broaden Beyond AI

U.S. Real Business Investment

Y/Y Percent



*Software, computers, communication equipment and facilities, electricity infrastructure, and data centers

Source: Oxford Economics, 9/30/26



Fixed Income: Environment and Strategy

The End of Cheap Money—Treasury Yields Reset Higher Across the Curve

U.S. Treasury yields increased considerably across much of the curve year to date, led by 2- to 5-year maturities, as investor expectations shifted from interest rate cuts to hikes amid multiple supply shocks and term premiums expanded. The curve also flattened, notably between 2s and 10s, with the spread narrowing 29 basis points through the end of September. The third quarter, in particular, saw a marked rise in yields, with most of the increase occurring in September as the Federal Reserve (Fed) hiked rates and markets priced in higher real yields (Exhibit 13). With federal debt now exceeding \$40 trillion, investors have also grown increasingly concerned about fiscal sustainability and the growing Treasury issuance. Meanwhile, the enormous capital needs of the artificial intelligence build-out are competing with government borrowing for a finite pool of savings, adding upward pressure on yields. After more than a decade of artificial suppression under zero-interest-rate policies and quantitative easing, rates have normalized.

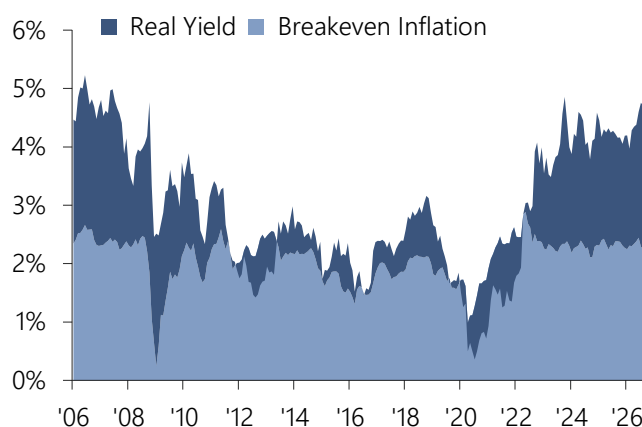
The Fed's First Hike in Three Years: Recalibration or New Tightening Cycle?

In a unanimous decision, the Fed raised the fed funds rate by 25 basis points in September, its first hike in three years, to a target range of 3.75-4.00 percent. We had expected it to remain on hold, but a rebound in oil prices and robust economic activity prompted it to nudge rates higher. At the post-FOMC-meeting presser, Fed Chair Kevin Warsh repeatedly characterized the rate hike as removing a “dose of accommodation” rather than tightening. He may have couched the wording for President Trump's sake. Still, Fed watchers worry that the expression “removal of accommodation,” or a variant, has historically signaled a tightening cycle, not one or two hikes. Compared with the FOMC's dot plot, which implies just one more 25-basis-point hike, fed funds futures now price in about three more hikes through mid-2027. We expect the Fed to raise rates once more in 2026 but to remain data-dependent. Barring another shock, inflation should trend toward the low 2.0 percent range in 2027, providing the Fed with some breathing room.

Disinflation Ahead Favors a Fed Pause in 2027 and Shorter Maturities

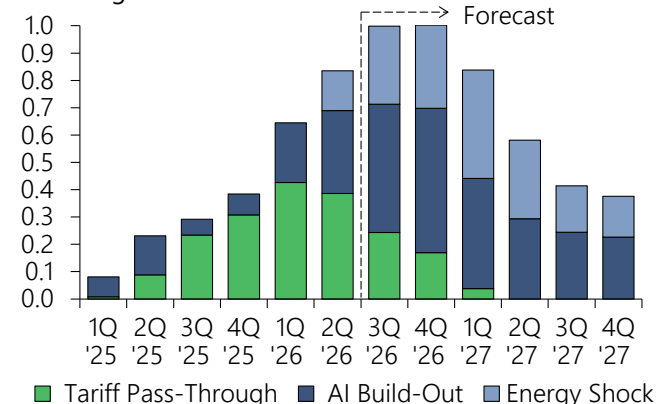
Warsh claimed the rate hike was intended to support a timelier return to the Fed's 2.0 percent inflation goal, though the median FOMC projection pushed the return to 2.0 percent from 2028 to 2029. While consumer inflation may stay “sticky” through year-end, it is poised to decelerate meaningfully in 2027 as the effects of tariffs, the U.S.-Iran conflict, and the AI build-out roll off year-over-year measures (Exhibit 14). Again, barring another shock, hardly a given these days, we estimate that core PCE inflation will steadily ease to 2.3 percent by year-end 2027, down from 3.3 percent at year-end 2026. Although inflation would remain above the Fed's target, this trajectory suggests a pause next year rather than more rate hikes, especially if the Fed expects inflation-busting, AI-led productivity gains. As stated, markets are pricing in a more aggressive rate path, setting up possible relief at the front end of the curve. So, we favor shorter maturities

Exhibit 13: 10-Year Treasury Yield Breakdown



Source: FactSet, 9/30/26

Exhibit 14: Contributions to Core PCE Inflation
Percentage Points



Source: Oxford Economics, 9/30/26



for their attractive yields and remain cautious on longer durations amid continued volatility.

Financial Conditions Remain Easy, but Tight Spreads Offer Little Margin for Error

The slightly positive real fed funds rate suggests a neutral-to-mildly restrictive monetary policy stance. Still, owing to a robust stock market and tight credit spreads, broad financial conditions are accommodative, supporting Warsh's view. Investment-grade corporate bond spreads have widened slightly but, underpinned by strong earnings and healthy profit margins, remain near all-time tights (Exhibit 15). The higher all-in yields have also drawn steady demand from yield-sensitive buyers. But these easy financial conditions rest on elevated asset prices and investor optimism rather than on the policy rate itself and can tighten abruptly if sentiment sours. With spreads this tight, there is little cushion for bad news, and conditions can reverse far faster than the Fed can respond. We thus maintain a defensive, up-in-quality stance and are underweight lower-rated credits. We also are cautious on technology-sector bonds, where we expect heavy new issuance to resume in the coming months to fund large-scale capital spending.

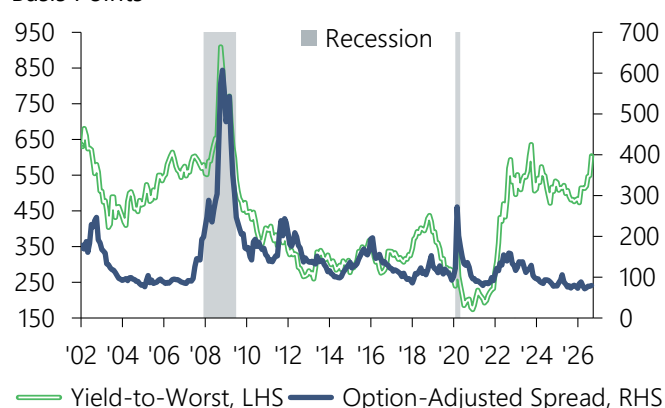
Mortgage Duration Extension Drives Losses, but Opportunities Are Emerging

Mortgages were among the hardest-hit sectors in the quarter, as a sharp rise in yields weighed on performance. The average mortgage rate climbed above 7.0 percent, lengthening duration as negative convexity became more pronounced. As mortgage rates increased, borrowers had less incentive to refinance or prepay, extending the expected life of outstanding mortgages and boosting sensitivity to rate movements. As shown in Exhibit 16, mortgage spreads also widened by approximately 20 basis points as investor sentiment softened and valuations adjusted to the higher-rate environment. Higher duration, increasing rates, and wider spreads led to a negative return of more than 4.0 percent for the sector. Importantly, much of the duration extension has been absorbed, positioning the sector to benefit from improved convexity as rates stabilize or fall. We are seeking opportunities to capitalize on this phenomenon, but rate volatility will be a headwind. Emphasis on structure will be necessary to mitigate risk.

Taxable Fixed Income Strategy

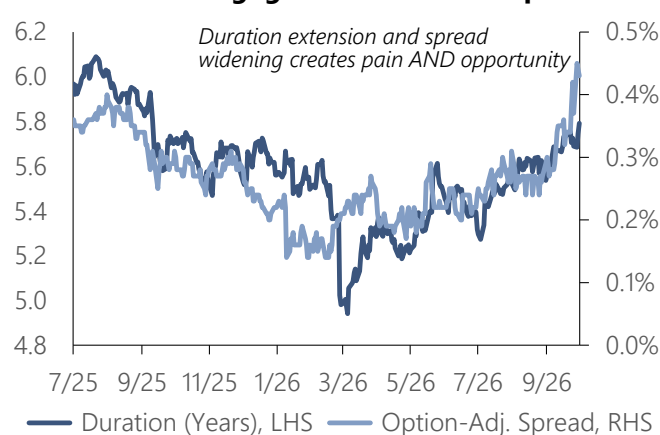
In the current environment, we favor shorter maturities, particularly the 2-year sector, where breakevens are exceptionally attractive. It is unusual to find an investment where generating a negative total return over a one-year horizon requires such a significant move in yields. With 2-year Treasury yields near 5 percent, yields would need to rise above 10 percent over the next 12 months to produce a negative total return, providing a substantial cushion against rate volatility. We reiterate our positive view on banks, given their benign underlying credit risks, and utilities, which continue to benefit from rising energy demand. Overall, portfolio durations remain modestly longer than benchmarks. Our focus remains on generating a meaningful income advantage, which we believe will be the primary driver of long-term outperformance. Attractive income, disciplined risk management, and careful security selection provide a durable foundation for returns while allowing us to capitalize on market dislocations.

Exhibit 15: U.S. Aggregate Corporate IG Index
Basis Points



Source: Bloomberg, 9/30/26

Exhibit 16: Mortgage Durations and Spreads



Source: Bloomberg, 9/30/26



Rising Rates Drive the Weakest Tax-Exempt Bond Quarter Since 1981

Tax-exempt yields rose sharply in the third quarter as sticky inflation and the Federal Reserve's first rate hike since 2023 pushed rates higher. AAA General Obligation yields rose 94-126 basis points across the curve, with the 10-year and 30-year yields reaching their highest levels since 2008 and 2011, respectively, before finishing September at 4.10 and 5.13 percent. Tax-exempt municipals lagged Treasuries, pushing the 10-year yield ratio from 66 to 78 percent. Credit spreads were stable for bonds rated single-A or better, while BBB spreads tightened about 10-15 basis points and high-yield spreads tightened more than 30 basis points on average.

The Bloomberg Municipal Bond Index returned -6.3 percent, its weakest quarter since the third quarter of 1981, including -4.4 percent in September, the weakest month since September 2008 (Exhibit 17). Longer maturities and lower coupons fared worst; bonds with 4-5 percent coupons returned -10.5 percent, versus -5.0 percent for 5-6 percent coupons. Secondary market selling, driven by tax-loss harvesting, added to the pressure late in the quarter. Bids-wanted volume averaged \$2.3 billion per day in September, more than double the second-quarter average, and reached \$3.8 billion on September 30, the highest daily total since March 2020. Quarterly issuance of \$163 billion brought year-to-date supply to \$458 billion. Combined mutual fund and ETF inflows totaled about \$21 billion for the quarter and \$78 billion year-to-date, though long-term mutual funds (excluding exchange-traded funds) saw net September outflows.

Higher Starting Yields Point to Stronger Forward Income

The quarter's losses were painful, but they also provide attractive investment opportunities. The Bloomberg Municipal Bond Index yield-to-worst ended the quarter at 4.78 percent, up from 3.60 percent at the start of the year. AAA yields of 4.10 percent at 10 years and 5.13 percent at 30 years translate to taxable-equivalent yields of roughly 6.93 and 8.67 percent for top-bracket investors (Exhibit 18). Because income is the primary driver of returns over a full market cycle, higher starting yields provide a larger cushion. At today's yield and duration, index yields would need to rise by more than 60 basis points over the next year before income is fully offset. Heavy October supply should give way to reinvestment demand in November and December.

Tax-Exempt Fixed Income Strategy

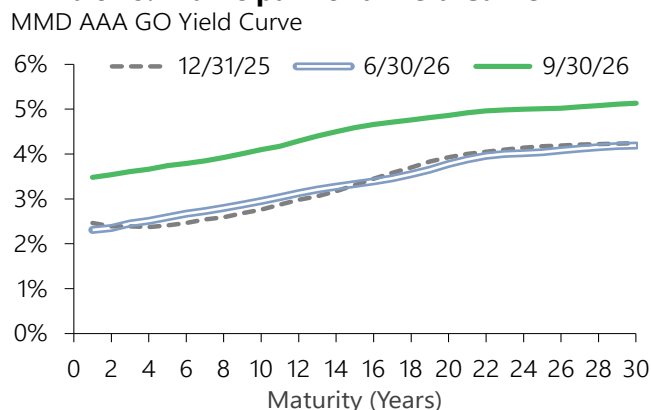
We are using volatility to lock in higher income and raise portfolio yields and coupon rates. Our preference for premium coupon structures was rewarded during the quarter, and we continue to favor coupons of 5.0 percent and higher. We are also using tax-loss swaps to replace lower-coupon holdings with higher-coupon bonds at higher yields where permitted. We continue to favor housing and transportation bonds, notably airports, and bonds subject to the alternative minimum tax for clients who are not subject to it, while remaining selective in hospitals. With BBB spreads tighter, we favor bonds rated single-A or better and continue to seek short- to intermediate-term calls. Duration remains longer than benchmarks, positioning portfolios to benefit as yields stabilize and income compounds at higher levels.

Exhibit 17: Municipal Bond Index Returns,%

	QTD		YTD		QTD		YTD
Muni Bond	-6.35	-4.18		GO Bond	-6.30	-4.40	
3-Year	-2.09	-0.81		Revenue Bond	-6.40	-4.11	
5-Year	-3.55	-2.51		Electric	-5.93	-3.90	
7-Year	-4.67	-3.87		Hospital	-7.41	-4.71	
10-Year	-6.07	-5.04		Housing	-7.42	-4.93	
20-Year	-9.04	-5.01		Transport	-6.32	-3.83	
Long	-8.68	-5.02		Education	-6.69	-4.61	
AAA	-6.72	-4.72		Water & Sewer	-6.59	-4.41	
AA	-6.24	-4.19		Leasing	-6.72	-4.57	
A	-6.27	-3.90		Special Tax	-6.62	-4.28	
BBB	-6.63	-3.46		Tobacco	-3.69	-0.91	

Source: Bloomberg, 9/30/26

Exhibit 18: Municipal Bond Yield Curve



Source: Refinitiv, 9/30/26



S&P 500 Rose Modestly in 3Q, but Breadth Narrowed to AI Infrastructure, Again

The S&P 500 Index returned 2.3 percent in the third quarter, bringing the year-to-date gain to 12.7 percent (Exhibit 19). On average, the equity market has traded sideways leading up to the midterms, and returns in August and September are historically the weakest of the year. On top of that, valuations came under increased pressure from a renewed surge in oil prices and soaring bond yields. Investors flocked to the perceived safety of AI infrastructure stocks as the quarter progressed, discarding almost everything else, especially bond proxies and rate-sensitive stocks. Only 22 percent of S&P 500 constituents outperformed the broader index in September, down from 37 percent in August and 61 percent in July (Exhibit 20). Since high-beta and momentum factor indices now overlap heavily with AI infrastructure, they underperformed in July after a significant rally but led again in August and September (Exhibit 21). But this was not a “risk-on” rally. Bond proxies, the usual risk-off trade, offered little refuge as yields surged, so investors piled into stocks with high earnings visibility and relative insulation from macro pressures.

Exceptional Earnings Have More Than Offset a Valuation Reset in U.S. Equities

The S&P 500 Index’s year-to-date return of 12.7 percent reflects a remarkable 31.2 percentage-point contribution from higher forward earnings estimates (and dividends), partly offset by an 18.5 percentage-point drag from valuation compression. The index now trades at roughly 19.1 times next-twelve-month earnings, down from 23.2 times in October 2025 but above its 20-year average of 16.7 times (Exhibit 22). That multiple remains inflated by high-growth mega-

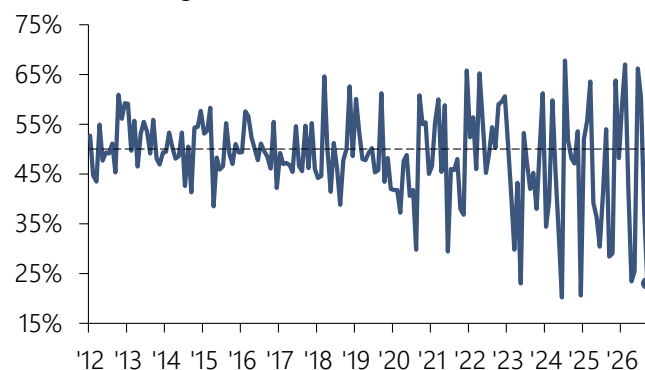
Exhibit 19: S&P 500 Index Performance

Total Returns, %	Jul-26	Aug-26	Sep-26	3Q26
Energy	12.6	7.0	-2.7	17.2
Information Technology	-3.4	6.2	4.5	7.2
Health Care	2.4	4.9	-0.9	6.5
Communications Services	0.6	-1.2	4.3	3.6
Financials	6.2	1.3	-7.2	-0.1
Consumer Staples	2.1	-0.7	-3.3	-1.9
Materials	-1.7	6.0	-6.7	-2.8
Consumer Discretionary	0.8	0.0	-5.8	-5.1
Real Estate	2.5	-1.9	-6.1	-5.6
Industrials	-3.0	-2.6	-4.4	-9.7
Utilities	-2.2	-4.8	-5.9	-12.4
S&P 500 Index	-0.1	2.7	-0.3	2.3

Source: FactSet, 9/30/26

Exhibit 20: U.S. Equity Market Breadth

Share of S&P 500 Constituents Outperforming Index
Based on Rolling One-Month Returns



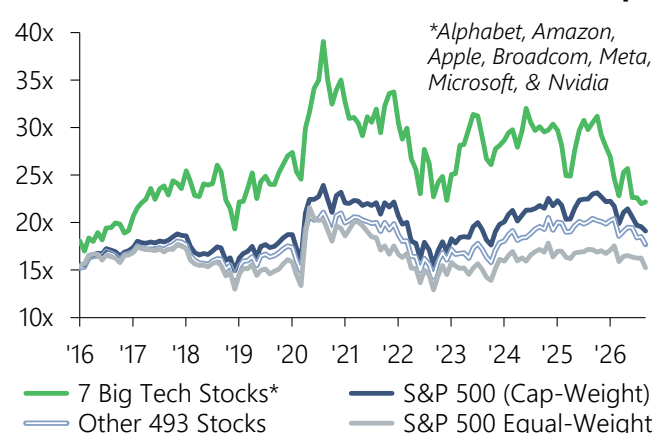
Source: FactSet, 9/30/26

Exhibit 21: S&P 500 Factor Performance

Total Returns, %	Jul-26	Aug-26	Sep-26	3Q26
Quality FCF Aristocrats	1.1	3.6	-0.2	4.4
Pure Value	4.5	1.7	-4.6	1.3
GARP	2.4	0.1	-5.1	-2.7
High Beta	-10.1	4.6	3.1	-3.1
Dividend Aristocrats	1.6	1.4	-6.0	-3.2
High Dividend	3.8	0.2	-7.6	-3.9
Low Vol., High Dividend	3.4	0.6	-7.7	-4.1
Low Volatility	1.9	-1.8	-5.4	-5.3
Momentum	-11.0	2.3	3.2	-6.1
Quality	-6.1	0.9	-1.4	-6.5
Pure Growth	-12.4	2.2	2.2	-8.5

Source: FactSet, 9/30/26

Exhibit 22: S&P 500 Index Forward P/E Multiple



Source: FactSet, 9/30/26



cap AI stocks, even after meaningful compression in their own valuations. The S&P 500 Equal-Weight Index trades at around 15.3 times forward earnings, below its 20-year average of 16.2 times. While multiple expansion is possible, earnings growth should remain the primary driver of equity returns. Bottom-up consensus estimates forecast S&P 500 earnings growth of around 34 percent year over year in calendar year 2026, 15 percent in 2027, and 17 percent in 2028. Importantly, earnings for the index excluding the seven largest technology stocks are estimated to grow nearly 16 percent in 2027, narrowing the gap with Big Tech.

Midterm Noise Should Fade; Year Three Has Historically Been the Strongest

Prediction markets currently imply more than a 90 percent probability that Democrats will win the House of Representatives and a 65 percent chance they will take the Senate, up significantly from 42 percent in June and 27 percent in September 2025. A Democratic sweep could spark a sell-off in AI-related stocks, but we expect any weakness to quickly fade as investors recognize the practical limits of new legislation. With tariffs, trade, and deregulation firmly in the Trump administration's hands, policy uncertainty will likely persist regardless of the election outcome. A looming federal debt-ceiling fight and shutdown brinkmanship are another potential source of volatility, though they are unlikely to do lasting damage to markets. While the S&P 500 Index has historically traded sideways into the midterms, it has posted its strongest gains in the third year of the presidential election cycle (i.e., the 12 months following the midterms), producing a median return of 18.1 percent (Exhibit 23). Seasonal and presidential-year patterns are no guarantee, but we expect market participation to broaden as the earnings growth advantage of the megacap AI leaders continues to narrow relative to the rest of the market in 2027.

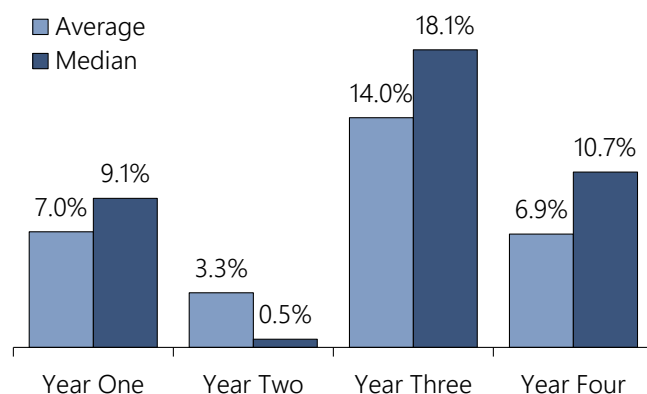
Yield Curve Flags Slowdown Risk; Stocks Can Weather a Measured Tightening

The U.S. Treasury yield curve has flattened in what is known as bear flattening, in which yields on shorter-dated bonds increase more than those on longer-dated ones. It normally emerges as investors price in rate hikes and persists throughout a tightening cycle. Historically, it has often signaled that an economic slowdown is looming. Again, we do not believe the Fed is embarking on an aggressive tightening cycle, and with the U.S. economy less sensitive to interest rates than it once was, it can likely absorb a rate adjustment without major disruption. Higher rates are an incremental headwind for equity valuations, and stocks have often wobbled early in rate-hiking cycles, but strong AI-led earnings growth should remain a significant offset. Indeed, rate hikes are not a death knell for equities. Bear flatteners have been the weakest yield-curve regime for stocks, yet the S&P 500 Index has returned about 0.3 percent per month on average since 1940 and has risen in roughly 57 percent of months (Exhibit 24). Looking ahead, we expect the Fed to pause next year, a prospect that could catalyze shares.

Global Equity Strategy

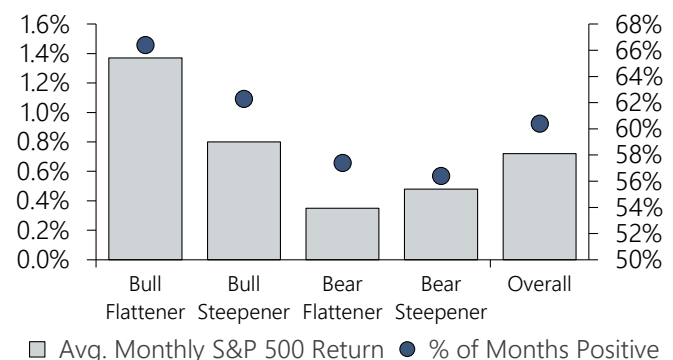
Equity portfolios remain well-diversified amid a complex economic and geopolitical backdrop, with the range of potential outcomes for the U.S. and international economies especially wide.

Exhibit 23: S&P 500 Gains by Presidential Year
Since 1929



Source: FactSet, 9/30/26

Exhibit 24: Returns by Yield Curve Backdrop
S&P 500 Average Monthly Performance During the Periods of Each Yield Curve Shift (1940-8/31/2026)



Source: BofA Research, 9/28/26



Across sectors, we continue to favor companies with strong, sustainable earnings growth—a particularly valuable trait in an inflationary environment—and valuations that can withstand higher-for-longer interest rates. Accordingly, we are cautious on consumer-oriented groups, as persistent inflation continues to squeeze consumers' wallets.

Higher interest rates have prompted investors to return to a familiar playbook: buying large-cap technology and AI stocks, which are viewed as relatively insulated from rising rates and oil prices. However, we believe this crowding is creating opportunities elsewhere. Following recent corrections, the risk-reward profile has improved in several of our preferred investment areas, including financials, industrials, and healthcare. The valuations of small-cap stocks are also increasingly attractive. Selectivity remains essential, however, as speculative companies, many of which lack earnings, continue to make up a significant share of small-cap indices. For the market to broaden sustainably, investors likely need greater confidence that interest rates and oil prices are approaching a peak. Some resolution of the Iran conflict may also be necessary to reignite the broader market participation that was gaining momentum earlier in 2026.

Dividend-paying stocks have been among the biggest casualties of the renewed AI/momentum trade and higher interest rates, which have diminished the relative appeal of dividend income to some investors. While a broader market may be needed for the style to regain momentum, its defensive characteristics remain an important part of the investment case, as dividend payers have historically provided resilience during periods of market stress. To the extent that inflation remains persistent, our investment focus must remain on companies that offer visible growth, strong free cash flow generation, and solid balance sheets. Those attributes could become increasingly valuable if higher rates materially slow the economy, ultimately putting pressure on the AI/momentum trade itself.

In international portfolios, we remain positive on equities in China, South Korea, Taiwan, and India. Chinese stocks outperformed in the third quarter after lagging in the first half, with the MSCI China Index returning 3.7 percent, compared with 2.0 percent for the MSCI World Index and -0.2 percent for the MSCI Emerging Markets Index (Exhibit 25). The market rallied in July on a rotation out of AI trades, then gave back some gains as bond yields and oil prices rose. Still, the index is down 11.7 percent year to date in U.S. dollar terms. We are maintaining our China weight, supported by expected improvement in economic momentum and by attractive valuations. As shown in Exhibit 26, the index trades at about 10.2 times forward earnings, 1.1 points below its 10-year mean. We favor a diversified mix of companies with structural growth, improving fundamentals, and attractive dividends. In South Korea and Taiwan, our holdings are focused on AI-related semiconductors, defense, internet, batteries, and financials. In India, we favor the domestic consumption theme, as resilient spending despite energy and fertilizer shocks should support growth of about 7.0 percent in fiscal year 2027.

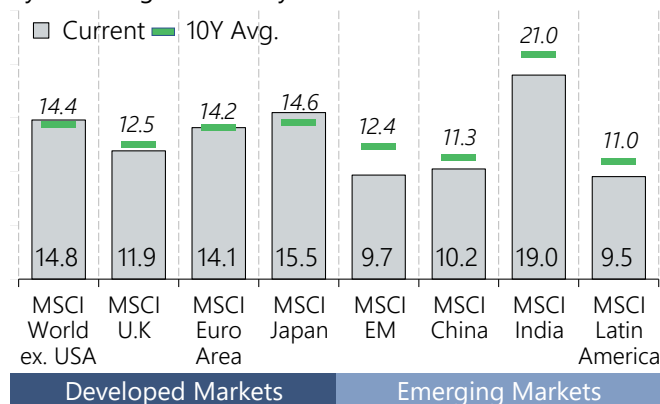
Exhibit 25: MSCI Index Total Returns

Total Returns in USD, %	1Q26	2Q26	3Q26	YTD
MSCI Brazil	19.2	-8.1	8.4	18.7
MSCI Taiwan	9.1	48.9	5.0	70.7
MSCI China	-8.9	-6.6	3.7	-11.7
MSCI Malaysia	2.5	-1.7	2.0	2.7
MSCI World Index (DMs)	-3.5	13.9	2.0	12.1
MSCI South Africa	-3.2	-1.7	1.4	-3.6
MSCI Emerging Markets	-0.1	24.1	-0.2	23.7
MSCI Mexico	7.7	3.1	-5.0	5.6
MSCI Thailand	15.7	8.6	-5.0	19.3
MSCI India	-18.1	10.2	-5.5	-14.7
MSCI South Korea	16.7	87.6	-9.4	98.3

Source: FactSet, 9/30/26

Exhibit 26: NTM Price-to-Earnings Multiples

By MSCI Region/Country

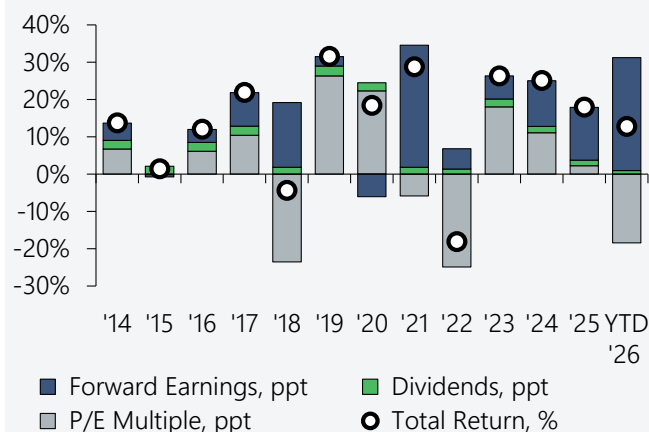


Source: FactSet, 9/30/26

Global Equities: Other Notable Data Points

Earnings Driving Gains as Multiples Compress

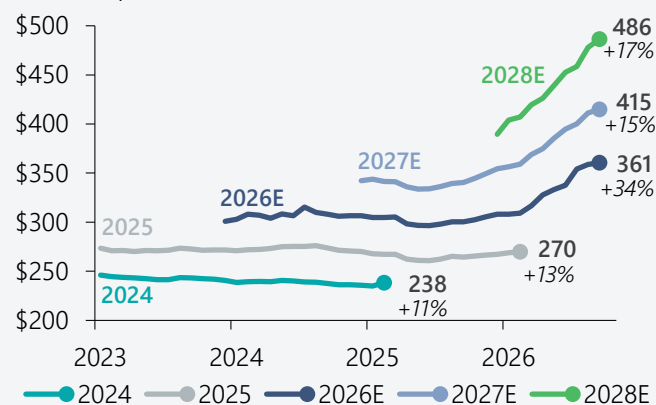
Contribution to S&P 500 Index Total Returns



Source: FactSet, 9/30/26

Consensus Earnings Estimates Continue to Climb

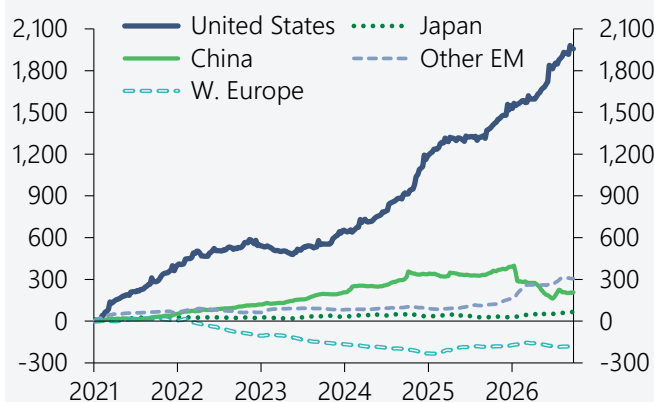
S&P 500 Consensus EPS Estimates
Bottom-Up, Calendar Year



Source: FactSet, 9/30/26

Investors Keep Piling Into U.S. Equity Funds

Global Equity Mutual Fund and ETF Flows
\$ Billions, Cumulative



Source: EPFR, 9/30/26

U.S. Equity Risk Premium Approaching Zero

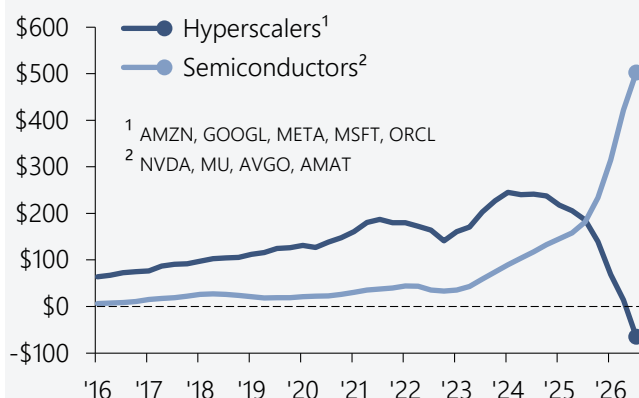
U.S. Equity Risk Premium



Source: BofA Research, 9/30/26

Hyperscaler Cash Burn a Boon for Chipmakers

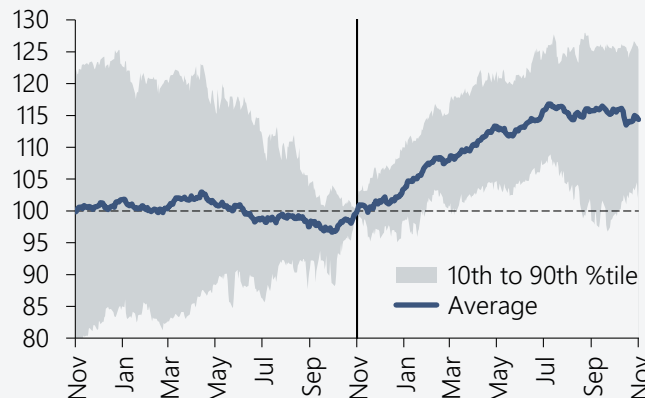
Consensus 12-Month Forward Free Cash Flow Estimates
\$ Billion



Source: FactSet, 9/30/26

Stocks Typically Rally After Midterm Elections

S&P 500 Performance Before & After Postwar Midterms
Midterm Election = 100



Source: FactSet, 9/30/26

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