



Dear Client:

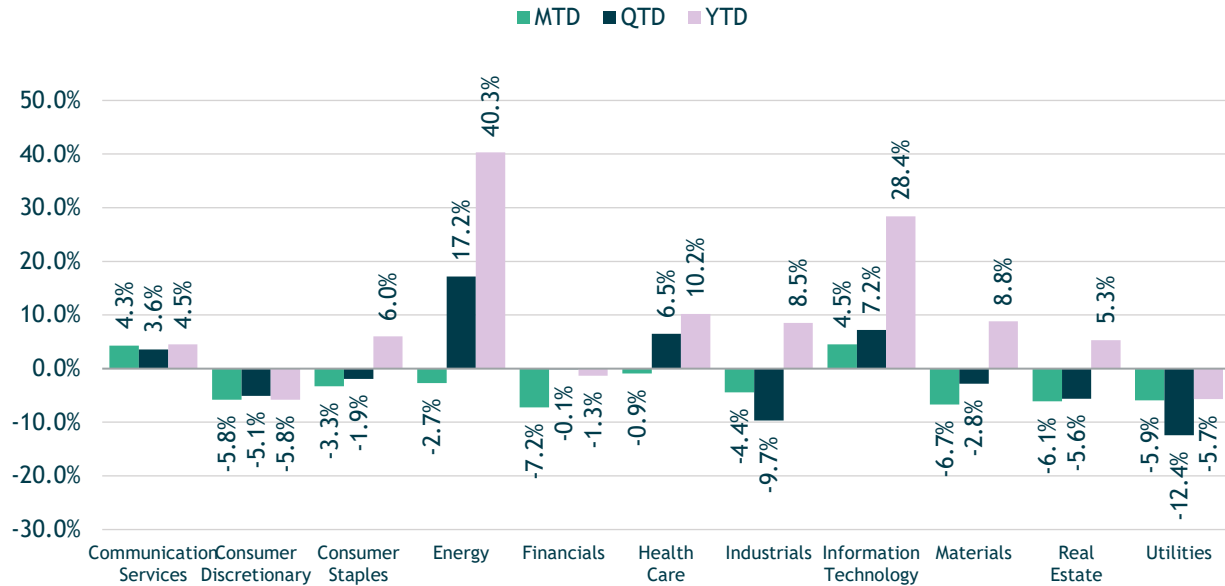
Market Recap

On the surface, the third quarter looks unremarkable. The S&P 500 returned 2.3% in the third quarter and is 12.7% higher for the year. Beneath that modest move in equity markets, however, was a bond market that took over the narrative. The Federal Reserve raised interest rates for the first time in more than three years, long-term Treasury yields pushed to levels last seen two decades ago, and oil rose by more than a third as the war with Iran reignited. The artificial intelligence trade completed a full round trip, dropping sharply to begin the quarter and regaining those losses by quarter's end.

The quarter's internal story was one of divergence. The Nasdaq Composite gained 2.6% and set a record above 27,244 in late September. The Dow Jones Industrial Average, by contrast, fell 2.3%, and September was particularly unkind to the blue-chip index, which dropped 4.1% in the month. It was a particularly difficult quarter for small-cap stocks as the Russell 2000 Index fell 7.2%. International equity markets fared worse in large part thanks to a stronger dollar during the quarter. European equities (MSCI Europe TR) fell 1.6% in USD terms and -0.9% in local terms and emerging-market stocks (MSCI Emerging Markets TR) dropped 0.4%. Japanese stocks (MSCI Japan TR) were the top performing major equity market with a return of nearly 6% in USD terms in the quarter, with much of the return attributable to the Yen rallying versus the US dollar (2.5% local).

Sector returns paint an interesting story. As yields surged in September, the financial sector fell more than 7%, its worst month since early 2023, while energy rode the oil shock higher and technology benefited from AI optimism. The market began the year broadening out beyond Mag 7 and AI-adjacent equities but spent much of the third quarter re-concentrating in the same. The market-capitalization-weighted S&P 500 Index was flat during September whereas the equal-weighted version (which would reflect a broadening of the market) fell 4.8% -- and the former is now ahead of its equal-weighted counterpart for the year. The dispersion between winners and losers widened considerably, and this can be seen in the chart below. Just two of the 11 economic sectors have year-to-date returns higher than the S&P 500's 12.7% return.

S&P 500 Sector Returns (as of 9/30/2026)



Source: Morningstar Direct. Data as of 9/30/2026.

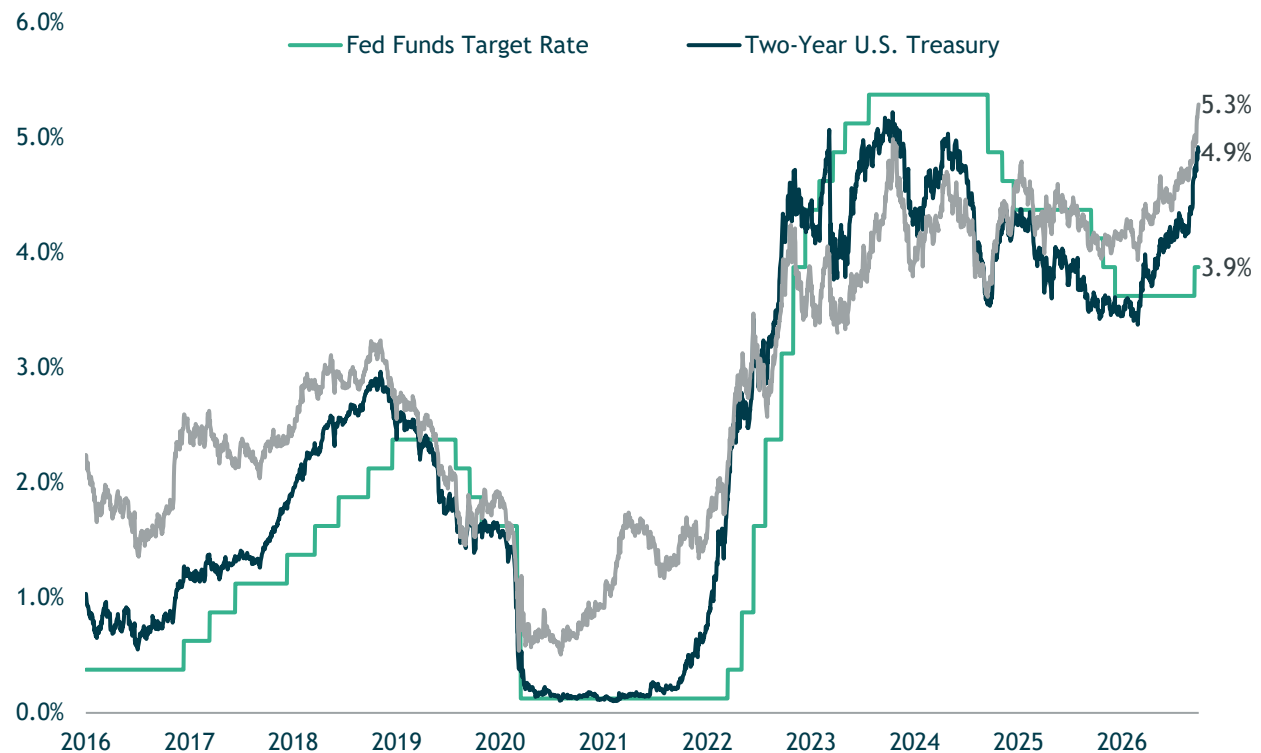
The U.S. economy continues to grow and outpace expectations. The labor market stumbled somewhat over the summer, gaining only a combined 52,000 jobs over June and July. August saw a clear improvement with payrolls rebounding by 162,000 against expectations of roughly 55,000, while the unemployment rate held at 4.1%. Economic growth was revised higher for the second quarter, moving up to 2.2% from 1.5%. It was also higher for the first quarter of 2027, moving to 2.5% from 2.1%. The economy continues to grow at a healthy clip, powered in no small part by the largest capital-spending boom in modern history. That resilience is welcome news for earnings but complicates the outlook for interest rates.

The Fed Hikes: Warsh Draws His Line

On September 16th, the Federal Open Market Committee raised the federal funds rate by a quarter point to a range of 3.75%-4%. It was the first increase in more than three years, and it partially reverses the easing cycle of late 2025. Contrary to many expectations prior to his appointment, Fed chair Kevin Warsh has taken a hawkish (“inclined to fight against”) stance on inflation and has departed from the Trump Administration’s desire to lower rates. Hawkish comments appeared in June, then there was a split Fed vote: 9 to hold and 3 to hike. Then, in his August Jackson Hole speech,

Warsh gave a blunt declaration on inflation that the Fed had “work to do.” He followed this up with the Fed’s first hike in three years.

Fed Funds Target Rate vs. U.S. Treasury Yields



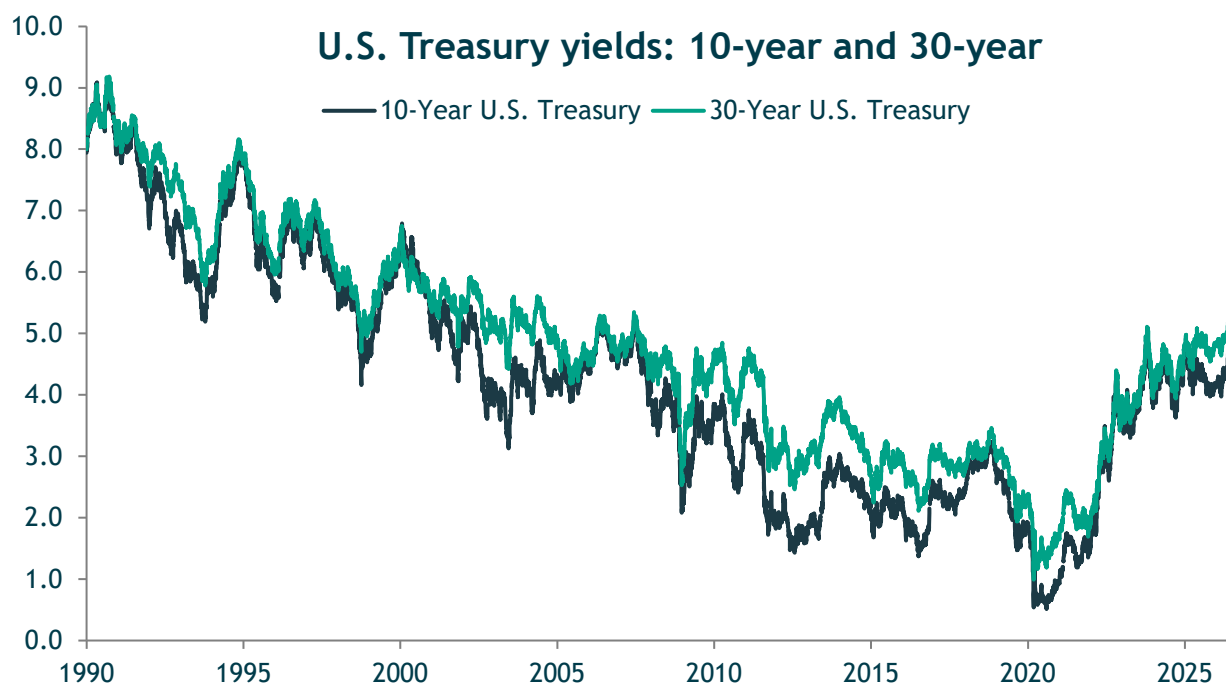
Source: Bloomberg LP. Data as of 9/18/2026.

The vote deserves as much attention as the hike. In July, the FOMC was divided with 3 dissents calling for a hike. However, the September hike passed twelve to zero. Warsh inherited a divided Fed and was able to produce a unanimous hike within four months of taking the reins (and he did so over the explicit objections of the White House). Whatever one thinks of the decision, the headline is that the Fed has asserted its independence from politics and united around the view that the inflation fight is unfinished.

The Bond Market: The Repricing of the Long End

The 10-year Treasury Bond yield ended the quarter at 5.29%, a rise of 0.82% from where it started the quarter at 4.47% and within sight of its 2007 highs. The 30-year closed at 5.63%, a level last seen in 2002, and up 0.67% from 4.96% for the quarter. These are whopping increases and largely explain

the generally horrible quarter for bond holders. Despite the weakness in bond prices, one survey of market participants suggests we may see further increases before the year ends: a majority of respondents to a late-September Bloomberg poll expect the long bond to trade above 6% before year-end. Overall, the bond curve steepened for the quarter, with long maturity rates rising more than short maturity rates.



Source: Federal Reserve Economic Data (FRED), Federal Reserve Bank of St. Louis. Daily constant-maturity yields; blanks are market holidays.

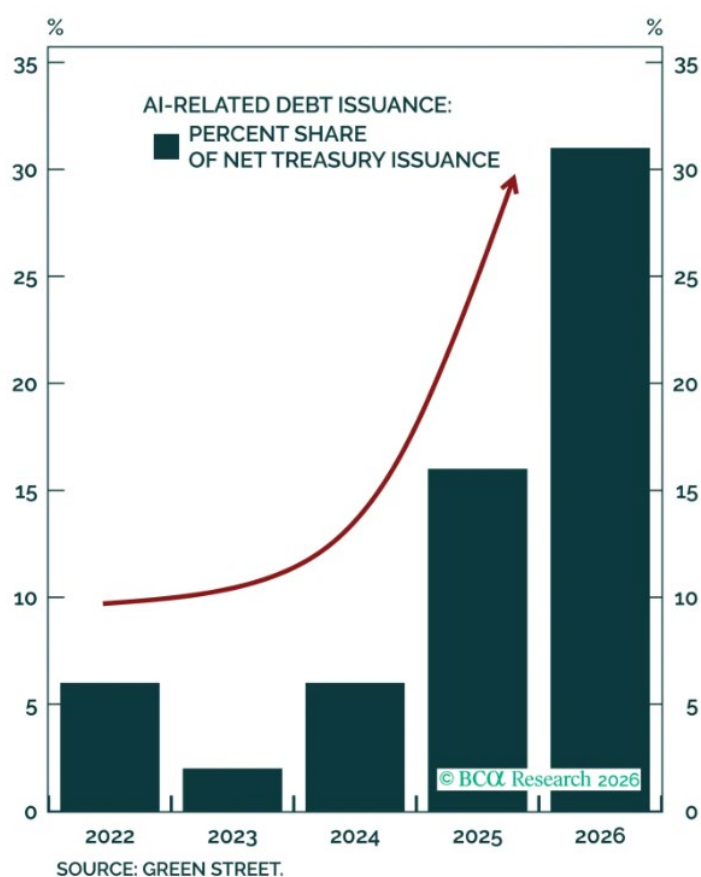
The federal deficit for fiscal year 2026 is running at around \$2 trillion (slightly more than 6% of GDP). It doesn't matter what political party is in charge, there is no desire from Washington to curb deficit spending. To finance these deficits, the Treasury's issuance calendar remains fully booked well into the future. With no end in sight to government spending, the bond market's reaction has been somewhat predictable – an increase in long maturity rates. But I'm not convinced that the move higher in rates is only about the expected inflation government spending signals.

The strength of the U.S. economy is currently driven by corporate capital spending ("CAPEX"). In effect, we're witnessing something akin to an arms race amongst the companies -- the so called "hyper-scalers" -- who stand to benefit most from the infrastructure their spending is building. In a future where compute-power will be everything, these companies fear being left behind if they have insufficient access to compute-power to run their internal applications (Meta and Google/Microsoft)

or to run their B2B sale of infrastructure applications (Microsoft, AWS, Google Cloud). To that end, the major technology platforms are deploying roughly \$600 billion of CAPEX this year, the overwhelming share of it into artificial intelligence infrastructure.

For several of these “hyper-scalers,” the funds required for this buildout exceed their free cash flow from operations, which requires them to choose between drawing on cash, issuing equity, or issuing debt to finance future spending. Several have pivoted to the bond market for financing, and the result is a massive increase in the supply of corporate debt -- issued, in this case, by companies with largely strong financials and future growth prospects.

The hyperscalers and others in their ecosystem have issued an enormous amount of debt in the AI race. To put it in perspective, AI debt issuance has ramped up from 5% of net Treasury issuance a year ago to over 30% this year (see BCA chart below). Every investor dollar absorbed by hyperscaler debt is money not bidding for Treasuries -- which should then force the yield needed to clear Treasuries higher.



For bond portfolios, the short and middle of the yield curve now offer Treasury yields near or above 5.0% without the price sensitivity of long maturity Treasuries. Short and intermediate duration is where the *taxable* bond portion of your portfolios is largely positioned. There may be a case for extending duration in portfolios if rates climb even higher, but for now I'm comfortable with our current positioning.

While this quarter's rise in rates resulted in poor quarterly returns for most bond, including our flagship bond funds (the PIMCO Multisector Bond ETF lost 2.71% and the PIMCO Income Fund lost 3.95%) the decline in bond prices leaves our bonds portfolios with compelling yields to maturity: PYLD at 7.04% and PIMIX at 7.20% as I write this on 10/13/2026. The yield to maturity ("YTM") provides a guide to the return one can expect from a bond. A bond return includes both the income it pays and its price change if held to its \$1,000 maturity value. Of note, these YTM assume no defaults in the portfolio, but historical evidence suggests that an investor's return on a bond fund, including defaults, will line up closely with the YTM at the time of investment. At today's bond prices, that YTM is 7%+. This bodes well for future returns on our bond portion of portfolios.

The rise in rates may also present a headwind for returns from dividend paying stocks. Investors in dividend paying stocks are often attracted to the competitive income they pay and the potential for that income to increase over time. With the 10-year Treasury yield landing below 3% from years 2011 to 2022, dividend paying stocks offered investors an attractive alternative. Now that investors can get 5.25% yields on the 10-year Treasury bond, there's a compelling income-alternative to dividend paying stocks. While it's possible that investors in our Dividend Payers portfolios will face headwinds if rates remain elevated or increase from here (a distinct possibility), it's my belief that higher interest rates are already priced into the Dividend Payers stock portfolios, which would explain our portfolios largely negative returns this past quarter.

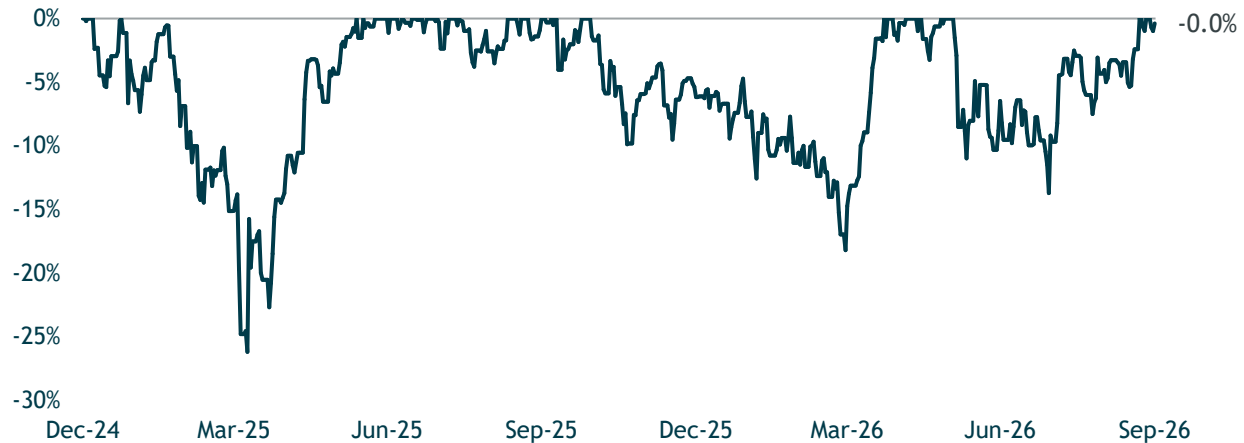
The AI Trade's Round Trip

The artificial intelligence trade traveled a real arc this quarter -- from unraveling in July to a sharp revival in September. The crowded trade and excess leverage used by inexperienced retail investors and a few well-known AI hedge funds, resulted in a sharp drawdown in July, with small losses quickly cascading into larger losses as margin calls forced holders of AI-related stocks to sell. There was a momentary shift in sentiment as the same investors who had previously rewarded ever-larger capital-spending commitments by the hyperscalers abruptly began punishing them. Alphabet fell

more than 7% on results that beat expectations, selling off because its CAPEX guidance jumped and its free cash flow turned negative for the first time since its 2004 listing. Meta was treated similarly after their results. Technology stocks slid into their second correction of the year (see chart below).

S&P 500: Technology Drawdown

S&P 500 Sector: Information Technology, Drawdown %



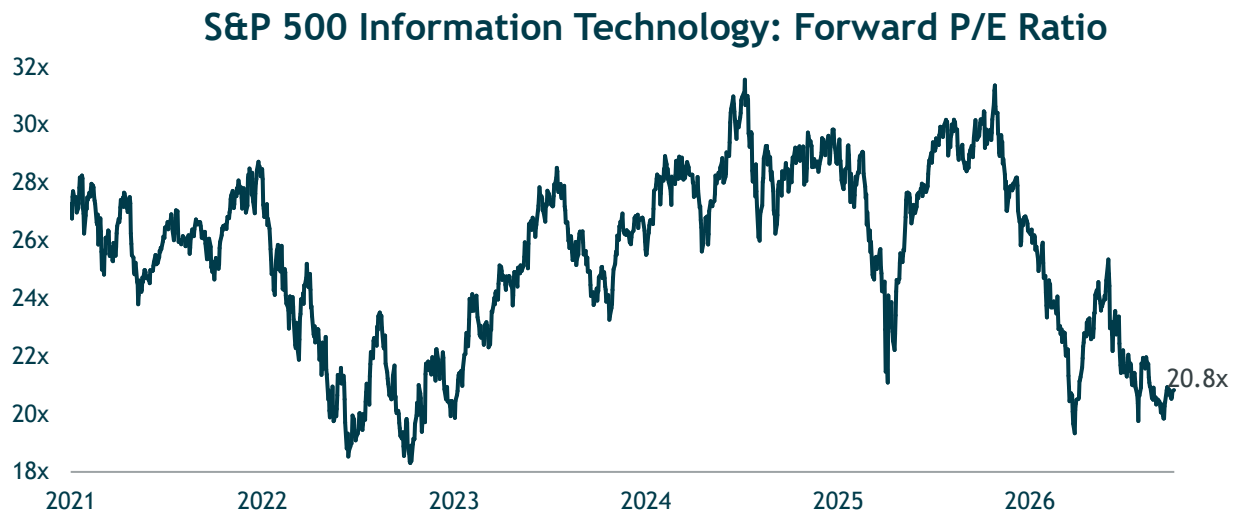
Source: Morningstar Direct. Drawdown is the percentage decline from the running peak of daily total return.

Yet despite two corrections in nine months, technology stocks managed to end the quarter up 28.4% for the year (behind only energy stocks). After bottoming in late-July, technology stocks rebounded 16.2% into the end of the quarter. NVIDIA's late-August results reminded investors of just how significant the current spending is. The poster child for the AI trade reported revenue of \$96 billion, up 106% from a year earlier, and did so with guidance well above expectations. The stock's nearly 9% surge pulled the entire complex higher and did so against the headwind of rising long-term rates, which historically induces compressed valuations.

Where does all this leave the equity market? Current earnings are real, and the spending on AI infrastructure is real. The financing of the spending has become a market force. Third-quarter earnings for the S&P 500 are expected to grow roughly 29% year-over-year, which would mark a third consecutive quarter above 25%, with the growth led by the sectors at the center of this story -- technology and communication services.

Tech earnings are expected to come in at 65% year-over-year growth for the third quarter (according to FactSet data). As a result, using Q3 earnings and current prices, the forward price-to-earnings multiple for the sector sits at roughly 21X, which means investors are paying \$21 for every \$1 of

forecasted earnings. At a 21X multiple, the sector sits well below its five-year average PE, which ranges between \$30 and \$36 depending on the barometer one uses, a stat that might surprise many but reflects just how fast earnings are growing, as well as investor apprehension that today's earnings aren't likely to continue in perpetuity.



Source: Bloomberg. Market-holiday gaps in the data column are interpolated as the midpoint of adjacent observations.

Looking Ahead

The fourth quarter is here with a full calendar. Midterm elections come November 3rd. The Federal Reserve meets the week before midterms (October 27–28th) and again in early December. Third-quarter earnings season begins this week (as I write) amidst that 29% growth expectation. The continuing budget resolution that passed without much fanfare in early September averted a government shutdown but only funds the government through December 11th.

As for the midterms, all 435 House seats and a third of the Senate are up for grabs -- putting the control of both the House and Senate in play. Betting markets currently have the odds favoring Democratic control of both branches, and the odds of a Democratic sweep continue to build. In an age of populism, it would not be surprising for voters to turn over the incumbents. Whatever the fate of the House or Senate, markets have historically been comfortable with divided government and the resulting gridlock, which tends to limit legislative change and, by so doing, limits investor uncertainty, typically good for markets.

With ballooning government debt and the long end of the yield curve now central to the investment outlook, this election's most important market consequence may be what it signals about the nation's fiscal trajectory. I'll be watching the bond market's reaction more closely than the stock markets. As many of you know, my long-standing view is that portfolios should not be positioned on political predictions. Vote at the polls, not in your portfolio.

The market enters this quarter betting on an October rate pause and a December rate hike. The softer late-September inflation data took some of the urgency out of an October hike. And the proximity of the midterms argues against a potentially politicizing move. So, I don't see the Fed pivoting to ease rates any time soon. This Fed has signaled its priority is inflation and acted on it with a hike.

Our portfolio allocations have not changed meaningfully over the last few years. However, should interest rates continue their climb, it may make sense to increase portfolio bond allocations, especially for clients invested in our more conservative portfolios. If rates continue their ascent, it may also make sense to shift some of our slow-growth equity allocation into fast growth equities. While the economy remains strong, I'm comfortable maintaining our current bond positioning. Bottom line - nothing firm yet, but these ideas are percolating.

Zooming back out, nominal economic growth (unadjusted for inflation) is running around 6%, inflation is stuck near 3%, a united Fed is hiking rates, and the Treasury and AI hyperscaler debt are competing for capital. Add all that up and it's not surprising that rates are touching multi-decade highs. I don't think anything is broken. The U.S. economy is simply strong enough to handle a higher cost of capital without tumbling into a recession, and markets are now repricing this new normal.

I thank you for your continued trust and partnership.

Best,

Kelly D. Kane, ChFC®, CFP®

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