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INVESTMENT ADVISORS

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INVESTMENT REVIEW AND OUTLOOK

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Amidst a challenging geopolitical environment, the stock market made modest progress in the quarter. The S&P 500 had a total return of 2.3%, but there was considerable variability under the surface. The S&P Growth Index returned 3.4% while the S&P Value Index gained 0.9%. Smaller and mid-sized stocks lagged significantly, and the Russell 2000 Index had a return of -7.2%. There were many pockets of weakness in the quarter: of 11 S&P industry sectors, 7 had negative returns. Outside of the U.S., the MSCI All-Country World Index returned 0.9% with 9 of 15 major international markets showing negative returns.

Two notable developments in the quarter were the increase in interest rates and the rise in crude oil prices. With the resumption in hostilities in the Persian Gulf, the spot price of U.S. crude oil rose from $71 per barrel to $88 per barrel or a gain of 24%. Interest rates rose significantly with the yield on the 10-year U.S. Treasury bond increasing from 4.2% to 5.1%. When interest rates rise, bond prices fall, and the Bloomberg Aggregate Bond Index returned -3.5% in the quarter. While the increase in crude prices is easily explained, the factors leading to the rise in global interest rates are more complex. There is no single factor driving the increase in rates, but rather a confluence of: 1) a strong U.S. economy which is being heavily driven by capital spending that in turn is leading to record levels of borrowing by corporations; 2) persistent levels of inflation which remain above the Federal Reserve target of 2% (the year/year increase in the Consumer Price Index was 3.4% for the month of August); 3) large federal deficits which require significant borrowings by the U.S. Treasury. The Congressional Budget Office projects a fiscal 2026 federal deficit of close to $2 trillion; annual interest costs on U.S. national debt are now exceeding $1 trillion. In addition, the Federal Reserve, at its most recent meeting, raised the benchmark Federal Funds rate to 4% in September. This action was taken largely in response to persistently high inflation levels.

Given the foregoing, as well as the unsettled geopolitical environment, it is not surprising that equity returns were modest in the quarter. As has been the case over the past few years, the leadership of the stock market in the quarter was fairly narrow: the energy sector returned 17% followed by technology (+7.2%), health care (+6.5%) and communication services (+3.6%). As noted above, the remaining 7 S&P sectors all posted negative returns.

Headlines and the Bottom Line

As noted, there was no shortage of negative headlines during the quarter. In addition to the developments discussed above, the U.S. economy has demonstrated uneven growth: spending by upper income consumers continues to rise and Bank of America estimates that consumers in the top 40% of

incomes accounted for 80% of total consumption in the first 6 months of the year. Although overall consumer spending remains resilient, several industries continue to lag due to the impact of higher interest rates and energy prices as well as weakness among low-end consumers. Construction of new homes declined 1.2% in the month of August compared to the prior year. Sales of new automobiles are expected to decline 2.4% in 2026 according to Cox Automotive Forecast. Affordability continues to be a limiter when it comes to new home and car purchases.

Despite the negative news flow, the U.S. economy continues to show robust economic growth; nominal GDP growth, which is not adjusted for inflation, rose 8% in the second quarter according to the Bureau of Economic Analysis (BEA). The unemployment rate in the month of September was 4.2% which most economists regard as full employment. The stock market has recently reached all-time highs as measured by the S&P 500 Index.

How can it be that "the bottom line" of the economy is doing so well at a time of fraught geopolitics, decade-high interest rates and elevated crude oil prices? There are a multitude of considerations. We have earlier written about the strong capital spending cycle in the U.S. which is heavily influenced by investments in Artificial Intelligence (AI). In recent quarters the capital spending component of GDP growth has been estimated to be at least one third of overall growth according to the BEA. In the U.S., the impact of increase in crude oil prices have been mitigated by improvements in energy efficiency and the low price of natural gas which is both an energy source and an important feedstock for the chemical and fertilizer industries. Innovation has been and continues to be an important driver of economic growth, and employment in these industries has grown faster than the overall rate of job growth and now accounts for one third of U.S. employment, according to the Bureau of Labor Statistics.

Of course, every economy is cyclical, and the U.S. will inevitably be subject to the forces of both growth and contraction. At the present time however, the U.S. economy is proving to be remarkably resilient.

(Almost) Found Money

An old saying goes that "there is no free lunch" and that is certainly true throughout the business world. On Wall Street, while there are no free lunches, there are occasionally opportunities for financial gain that come at little cost. A prominent example of this is the tax differential between short-term capital gains (securities sold in less than a year) and long-term capital gains (securities sold that have been held greater than a year). While short term gains are taxed as ordinary income with a maximum federal rate of 37%, long term capital gains are taxed at a much lower rate of either 15% or 20% (depending on other income considerations). In the case of investments, an extra day can translate into significant savings.

While there are no "sure things" when it comes to investments, there are periods when conditions are more favorable for certain asset classes. Since the summer of 2020 the yield on the 10-year U.S. Treasury bond has risen from a low of 0.55% to the current level of 5.3%. Today, high-quality corporate fixed income securities (which yield a premium to Treasuries) with maturities of 3-5 years are yielding between 5% and 6%. With inflation averaging 3.4%, bonds provide a real (after inflation) return to investors. While no investment is without risk, default rates on investment grade bonds have been extremely low and focusing on maturities of 3-5 years minimizes the impact of volatility should interest rates rise further. Similarly, tax-exempt bonds also offer attractive after-tax yields.

As our clients know, we do not attempt to divine the direction of markets, the economy or interest rates. We acknowledge that there are significant forces placing upward pressure on the level of interest

rates. However, an essential responsibility that we have for our clients is to take advantage of investment opportunities when they arise. We view that as the case with fixed income at the present time.

On Guard

Ongoing risks and concerns, be they economic, geopolitical or market related, are always top of mind for us. In recent years, the geopolitical "worry list" has been longer than usual. The geopolitical environment is quite complex and volatile. In addition to the Mideast and Ukraine, Russia continues a pattern of "gray zone" tactics (cyber-attacks, sabotage of critical infrastructure and drone intrusions) against several of our NATO partners.

On the economic front, growth remains strong, but we are mindful of the outsized role played by the AI infrastructure buildout.

In a world that we would characterize as having elevated risks and uncertainties, our focus on more conservative, income-producing investments appears appropriate.

As always, we welcome your comments and questions.