



The Balancing Act

In this edition of Strategy Insights, we examine the key forces shaping markets and portfolio positioning as investors balance AI-driven growth opportunities against rising economic and geopolitical risks.

Our outlook characterizing 2026 as the “show me” year has largely delivered. Investors have been shown tangible evidence that artificial intelligence (AI) can improve productivity, support earnings growth and reshape business investment. The challenge is no longer to prove that AI-driven transformation is underway; rather, it is to determine whether the benefits are broad, durable and timely enough to justify the expectations already embedded within current asset prices.

In this edition of Strategy Insights, we analyze the balancing act of key market drivers – AI investment, debt and interest rates, geopolitical and inflation risks and the U.S. midterm elections – and provide our perspectives on portfolio positioning for the path ahead.

While we continue to see opportunities supported by the AI innovation cycle and economic productivity, the range of possible outcomes remains unusually wide. Ultimately, we believe markets are grappling with whether an increasingly uncertain macroeconomic backdrop can support the expectations built around AI-driven growth and investment.

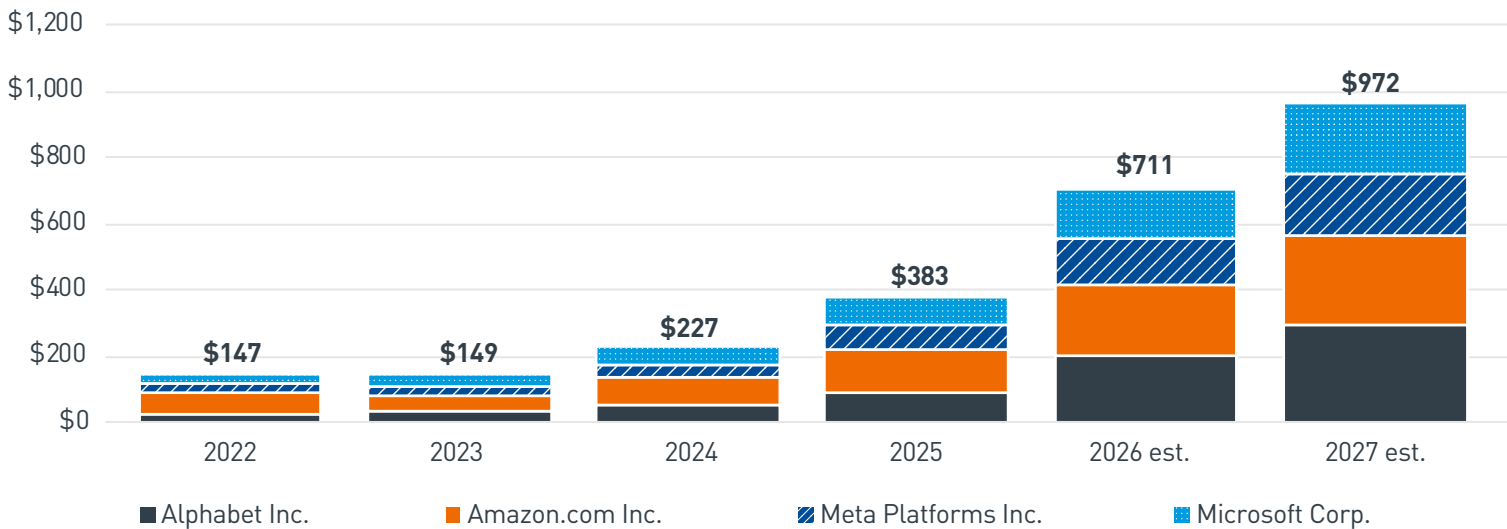
Artificial intelligence: Where we stand

We believe it is important for investors to separate AI as a transformative technology from the risks associated with the breakneck pace of AI capital spending. While the AI-related innovation and infrastructure buildout continues to be a major driver of markets and corporate earnings growth, investors have shifted their focus from rewarding AI investment announcements to expecting measurable earnings and productivity gains.

In our view, future returns will become increasingly dependent on the durability of return on investment and widespread enterprise adoption. According to consensus estimates, the four largest hyperscalers – Alphabet Inc., Amazon.com, Inc., Meta Platforms, Inc. and Microsoft Corp. – are expected to spend more than \$700 billion and nearly \$1 trillion in AI capital expenditures (capex) in 2026 and 2027, respectively (Figure 1).

Figure 1. Largest Hyperscalers’ Capex (\$B)

Signs of exuberance raise concerns about AI capex sustainability



As of 9/30/2026. Source: FactSet®. FactSet® is a registered trademark of FactSet Research Systems Inc. and affiliates.

While the hyperscalers’ balance sheets remain financially strong, net cash flows (operating cash flows minus capex) are declining and AI-related revenues remain below break-even levels on those capex investments (**Figure 2**). There are emerging signs that return on AI investment is improving, but investor skepticism about earnings durability has pushed valuations and earnings multiples for some Technology companies to their lowest levels in more than a decade.

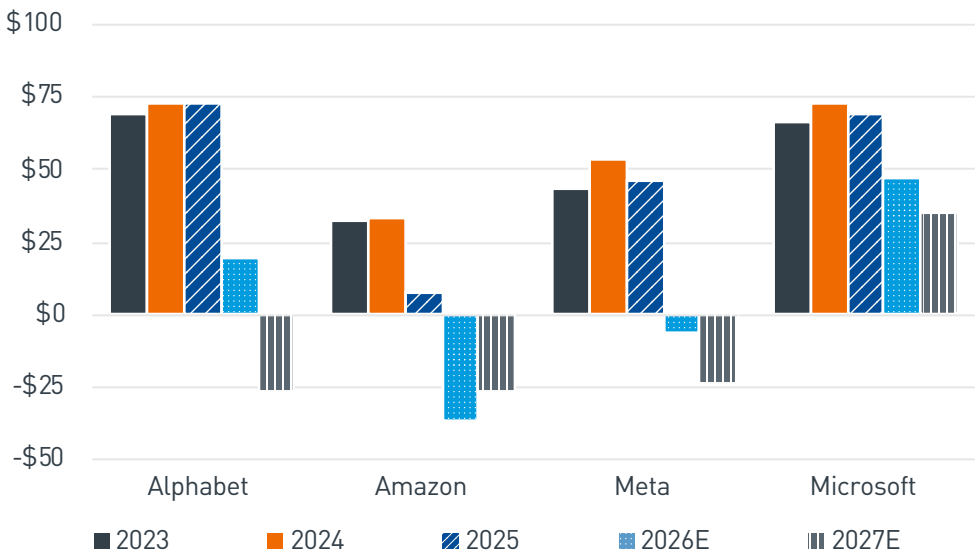
At the same time, the financing backdrop for the AI buildout has become less supportive as the need for external financing has increased. Renewed market volatility is leaving investors less willing to lean into risk assets as yields rise and inflation remains elevated. Higher interest rates have also raised the cost of capital across markets. AI-related companies are beginning to face a more challenging environment than they did during the early stages of the AI investment cycle from late 2024 through first quarter 2026, when capital was abundant and interest rates were lower.

Any signs of a pullback in capex spending would likely represent a near-term risk to the earnings trajectory for the AI ecosystem, although such a development would help alleviate concerns about an “AI bubble.” Supply bottlenecks in component inputs, power, memory semiconductors and labor will likely help to moderate the pace of AI capex, but questions remain about the impact of regulatory and local opposition to new data-center development or a possible slowdown in frontier model development.

AI innovation has been extraordinarily fast paced, making estimates of the appropriate or sustainable level of AI capex difficult to determine. As projections for future capex investment reach unprecedented proportions, however, the risk of an eventual overshoot becomes an increasingly important consideration.

Figure 2. Largest Hyperscalers’ Net Free Cash Flows (\$B)

AI investment continues to outpace monetization



As of 9/30/2026. Source: FactSet®.



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Climbing debt, rising interest rates

Current fiscal deficit dynamics point toward a self-reinforcing cycle in which rising debt levels lead to higher interest costs and borrowing needs. As such, the 10-year U.S. Treasury's recent rise to the highest level since 2007 may not be a short-term phenomenon. We believe the combination of record corporate borrowing and elevated government debt and fiscal deficit levels is contributing to higher interest rates and inflation. The near-term outlook suggests these pressures are likely to persist.

The structure of the Treasury market has shifted since the era of low interest rates in the aftermath of the 2020 recession. A notable change has been the decline in foreign ownership of U.S. Treasuries, which peaked in 2021 (**Figure 3**). Since the start of the Iran conflict on February 28, 2026 foreign ownership has declined by approximately \$200 billion. For context, from March 2021 to November 2022, a period that included the start of sanctions against Russia following its invasion of Ukraine, it took more than 18 months for ownership to decline by \$200 billion.

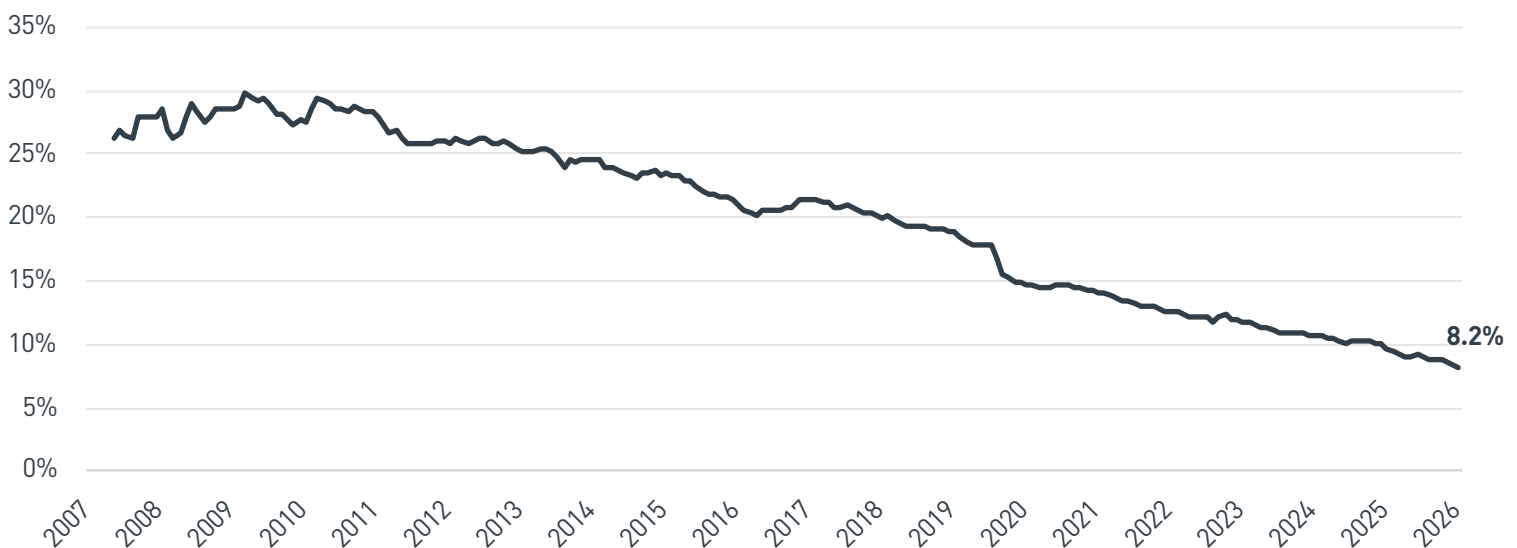
Today, Treasury markets are increasingly dependent on private-sector buyers, including hedge funds that are typically more interest rate-sensitive. Concurrently, rising interest costs are becoming an increasingly significant

component of federal spending. As government refinancing occurs at today's higher yields, the interest expense associated with servicing the debt is projected to consume an increasing share of the federal budget. With a federal debt level approaching \$40 trillion, this feedback loop creates upward pressure on Treasury issuance precisely when investors are demanding greater compensation to own longer-dated government debt.

For inflation, the implications are equally important. While cyclical inflation pressures may ebb and flow, persistent deficit spending continues to support aggregate demand at a time when labor markets remain relatively tight and economic growth remains resilient. Meanwhile, elevated energy prices, particularly for oil, gasoline and diesel, are increasing transportation and production costs across the economy, while periodic supply-chain bottlenecks continue to constrain the flow of goods and key inputs. Together, these forces create a challenging backdrop in which both demand-side and supply-side inflation pressures remain elevated. We believe the result is a greater risk that inflation proves more persistent than markets currently expect, maintaining upward pressure on bond yields and borrowing costs and creating a more volatile investment environment for multi-asset investors.

Figure 3. Foreign Ownership of U.S. Treasuries

As global interest rates rise, U.S. Treasuries become less attractive for international investors



As of 9/30/2026. Source: Bloomberg, L.P.

Geopolitics and inflation

As of this writing, the U.S.-Iran conflict has entered its eighth month and recently expanded beyond the blockade in the Strait of Hormuz to impact alternative shipping routes in the Red Sea. Global energy supply remains significantly impacted by the conflict – tracked tanker crossings through the Strait of Hormuz remain low – but crude oil has made its way through the Persian Gulf via pipeline bypass and U.S. naval escorts of tankers. Even with improving oil flows, energy markets are likely to remain disrupted for as long as a diplomatic solution remains elusive.

Crude oil prices are below their April highs but hover near \$100 per barrel, which is a significant premium to pre-conflict levels. Gasoline prices have risen with crude oil prices but are currently below the peak levels reached in 2022. Increasing energy prices feed directly into headline inflation via index weightings to gasoline, diesel and other fuels. This phenomenon has been reflected in inflation readings, which have risen back above 3% year-over-year growth since the conflict began.

Ongoing military conflicts have curtailed the ability to refine oil in the Middle East and Russia, significantly impacting the supply of diesel and other distillates. In contrast to gasoline, diesel prices are near record highs, surpassing 2022 levels



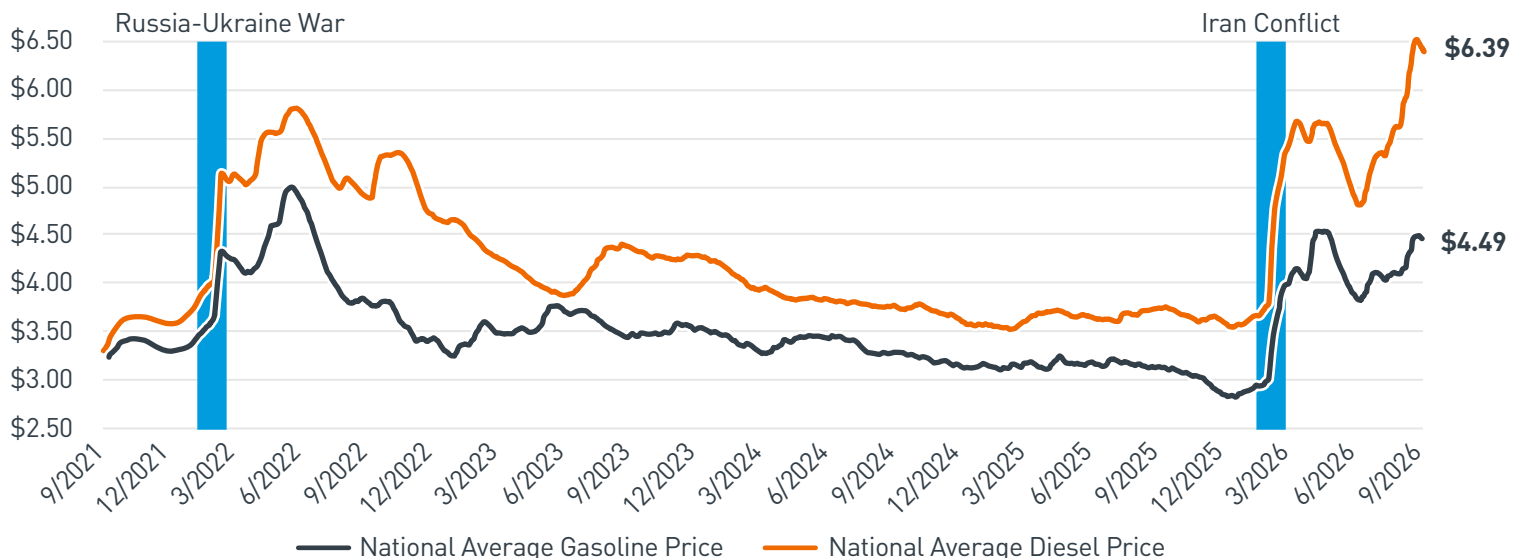
Consumers have been impacted by higher gas prices, but thus far, there has been limited pass-through of elevated energy prices into core inflation.

(Figure 4). In response to the supply limitations, the diesel crack spread, or the profit margin refiners earn from processing crude oil into diesel, is also just below all-time highs.

The tight supply of refined products such as diesel and jet fuel can also exert broader inflationary pressure, as the use of these products in transportation, farming and construction ultimately contribute to food, goods, distribution and travel costs. Consumers have been impacted by higher gasoline prices, but thus far, there has been limited pass-through of elevated energy prices into core inflation. However, the longer diesel prices stay near record levels, the greater the likelihood that rising inflation pressures will pass through into core inflation and increase the risk that elevated inflation becomes more entrenched.

Figure 4. U.S. National Average Gasoline and Diesel Prices (\$/Gallon)

Gas prices have risen but remain below 2022 levels, while diesel prices are above 2022 levels due to limited refining capacity



As of 9/30/2026. Source: Bloomberg, L.P.

Midterm elections: Policy matters more than politics

As the November 3 U.S. midterm elections approach, we expect investors to contend with a growing volume of political headlines. That said, we expect the forward path of energy prices, inflation, interest rates and bond yields to ultimately matter more for markets than the balance of power in Congress.

Still, a shift in congressional control is increasingly possible. The Kalshi-implied odds of Senate control shifting to the Democrats rose from 48% to 62% throughout September, while the probability of the House changing hands rose above 90%.

Energy prices remain one of the most consequential potential drivers of election and market outcomes. The standoff in the Strait of Hormuz, coupled with significant disruptions to global refining capacity, has kept fuel prices elevated, with diesel near \$6.50 per gallon and approximately twice its level one year ago. Elevated energy costs are contributing to inflation pressures and weighing on affordability, which remains central to both the economic backdrop and election narratives.

Rising interest rates add to the price pressures felt by voters. Long-term interest rates, such as the 10-year U.S. Treasury yield, have climbed to levels not seen in about 20 years. Following the Federal Reserve (Fed)'s rate increase in September, Chair Warsh described the monetary policy action as "removing accommodation," which signaled the potential for further tightening. We believe markets continue to underestimate the possibility of additional rate increases.

After Election Day, investor attention is likely to shift from campaign outcomes to policy implementation, and we are closely monitoring the bond market's response, in particular. The persistent U.S. fiscal imbalance could place renewed upward pressure on long-term interest rates regardless of which party controls Congress, and the continued tapping of debt markets by large corporations could add to this interest rate pressure.

Outlook: The balancing act

Domestic economic growth remains healthy, but we believe investment risks are building. We maintain a slight preference for equities over fixed income as AI-related spending continues to be a major driver of earnings. The Atlanta Fed's GDPNow estimate suggests the U.S. economy is growing at an approximately 4% annualized pace for the third quarter of 2026. Recent data indicate that input-cost pressures are increasing, which complicates the Fed's fight against inflation.

We continue to believe that international diversification is important for investors. In Europe, fiscal stimulus is supporting growth even as higher energy prices and bond yields raise costs. We also favor select emerging market exposures, including innovation-led economies in Asia and commodity exporters in South America that stand to benefit from natural resource demand.



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Risks

There are several risks to our outlook for the remainder of 2026: high energy prices, excessive reliance on debt and initial public offering markets, rising bond yields and government borrowing and the uncertainty surrounding the U.S. midterm elections.

Record diesel prices and volatile oil prices could keep inflation elevated and hurt energy importers in Europe and much of Asia while benefiting commodity exporters. Additionally, reliance on debt financing extends into fixed income markets, where global yields have been climbing sharply. Continued moves higher in interest rates could pressure stock valuations downward and strain emerging markets that depend on foreign funding or carry dollar-denominated debt. We view small-capitalization stocks as particularly vulnerable, as they tend to carry higher levels of floating-rate debt.

Government debt adds further pressure on yields. The U.S. is running substantial budget deficits, which require the government to borrow by issuing Treasury securities. Global corporations and governments are also adding to the growing supply of debt. So far, strong growth is helping to mitigate these concerns but borrowing demands on the capital markets are likely to continue growing.

Finally, the U.S. midterm elections add policy uncertainty and contribute to potentially elevated market volatility. Prediction market odds have risen in favor of the Democrat party gaining control of both the House and Senate, although a high degree of uncertainty remains. While stocks have historically performed well in the year after midterm elections, that pattern may depend on whether the underlying risks discussed above remain contained.

Portfolio positioning

We maintain our slight overweight to equities, while acknowledging that risks are becoming more balanced. The fundamental backdrop remains supportive, and we do not expect a significant slowdown in AI-related spending this year.

We favor a diversified portfolio. Within equities, we emphasize targeted areas with more attractive valuations and across a broad set of geographies. Within fixed income, we prefer shorter-maturity holdings, which can preserve more value than long-term bonds when yields rise.



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