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Disciplined Strategic Investment Management

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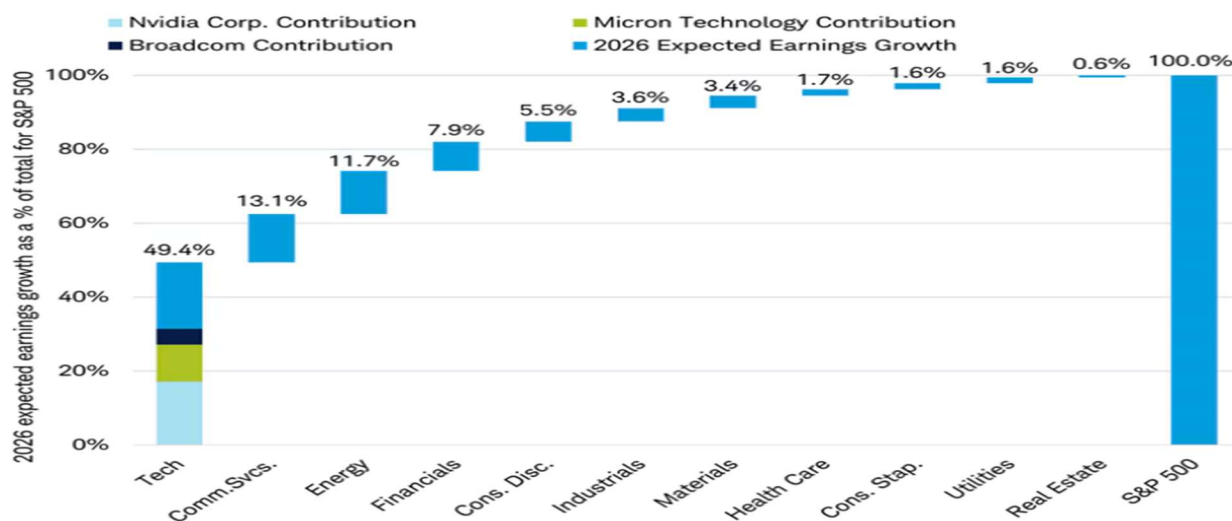
Mid-Year 2026 Market Outlook

"To focus is to ignore."

Mokokoma Mokhonoana,- South African writer, social critic and observer. (1985 – 2023)

As we cross the halfway mark of 2026, U.S. equity markets present a study in contrasts. The major indices have recovered from a sharp first-quarter drawdown to post modest gains for the year. Investors have “focused” on a handful of companies (supplying the chip and memory capacity) and have ignored the "Magnificent Seven"(down moderately ytd) and most of the remaining “old world” stocks and market sectors. These relatively few stocks have driven the lion's share of index-level performance, while the group that dominated returns in 2023–2025 has largely stalled or declined. (see chart below).

Distribution of total earnings growth in the S&P 500



Source: Charles Schwab, S&P Global, and FactSet data as of 5/27/2026.

The macro backdrop remains constructive on the surface. We anticipate that this year's growth will surpass that of 2025, as the economy has continued to pick up speed. Capital investment is rising on the back of increased industrial activity and robust investment in AI infrastructure. Federal spending has also increased, and defense spending is climbing as the U.S. works to replenish weapons deployed abroad. Exports are likewise expected to expand, driven by increasing shipments of industrial materials and supplies and greater demand for petroleum products.

Beneath this reasonably healthy macro picture, however, sits an unprecedented wave of capital expenditure on artificial intelligence infrastructure — data centers, power generation, networking gear — that has created one of the more consequential uncertainties facing equity investors today: when, and whether, those investments will translate into long term commensurate earnings.

Areas of concern or challenges:

AI - The bubble question. History offers a useful, if imperfect, guide. Housing bubbles burst when residential investment reached roughly 7% of GDP in the U.S.— this figure swiftly halved once the bubble burst. U.S. Tech-related capital expenditure peaked at 5% of GDP in nominal terms in 2000 and is now slightly higher; in real terms, the figure is now above 7%. After the dot.com bubble in 2000 the cyclical nature of the semiconductor index dropped by over 80%. Notably, in almost all the earnings bubbles we have studied historically, share prices began to fall well before analysts started revising down earnings estimates — a reminder that the market often moves ahead of the data that would ostensibly justify a peak.

Data center capex. The most consequential investment theme overhanging equity markets in 2026 is the sheer magnitude of capital being deployed into AI infrastructure. The five largest U.S. technology companies — Microsoft, Amazon, Alphabet, Meta, and Apple — are on pace to spend an estimated \$320–360 billion in aggregate capital expenditure in 2026, nearly double 2023 levels. The bulk of this is directed at data center construction, GPU clusters, cooling infrastructure, and grid power capacity. The critical uncertainty is not whether AI is transformative — it clearly is — but whether that transformation generates returns commensurate with the capital invested!

AI - We remain very optimistic about AI as it gets absorbed by other industries but far more dubious about AI as a business. In our view, model providers will ultimately resemble airlines or utility companies: vital to the world economy, but extremely commoditized, with heavy capital expenditure requirements and very thin margins, but not a clear source of monopoly power once every firm has access to it. Over the past few weeks, we've seen a decline in token pricing (cost of using AI) as increasingly cost-conscious users shift away from the most expensive frontier models.

Earnings concern. AI hardware producers are making large profits on their sales, while their customers are largely treating the same purchases as *capital expenditure*. When Nvidia sells a GPU or Micron sells a memory chip, it books a real profit. The companies buying those chips, however — even at inflated prices — do not treat the purchase as an immediate expense but as capex. The result: aggregate cash flows are unchanged, but aggregate reported earnings rise. Research estimates that the hyperscalers will hold roughly \$2.5 trillion in AI assets by 2030. Assuming a 20% depreciation rate, that implies roughly \$500 billion in annual depreciation expense by decade's end — compared with the \$405 billion in aggregate earnings the same companies generated in 2025 combined. That gap will be challenging.

New Stock issuance - IPOs and Supply flooding the market.

Investors are about to discover what happens when supply comes rushing back into a market that has spent years absorbing net buybacks. According to JPMorgan Chase & Co., IPOs, secondary offerings, and other share sales are poised to add roughly \$1.5 trillion of stock to the U.S. equity market over the next two years, even after accounting for buybacks. If realized, this would mark the strongest period of net equity issuance since at least the late 1990s.

SpaceX — Elon Musk's rocket, satellite, and AI conglomerate — recently completed the largest initial public offering in history, jumping 19% in its debut after selling \$75 billion of equity. The company went public at over 93 times sales, about 40% more expensive than the most richly valued stock (Plantir Technologies) in the S&P 500 index. In the coming months, Anthropic is set to debut with a mega IPO of its own. Meanwhile, Alphabet, Meta, OpenAI, and Oracle are selling hundreds of billions of dollars' worth of shares to help finance the enormous spending demands of the AI boom.

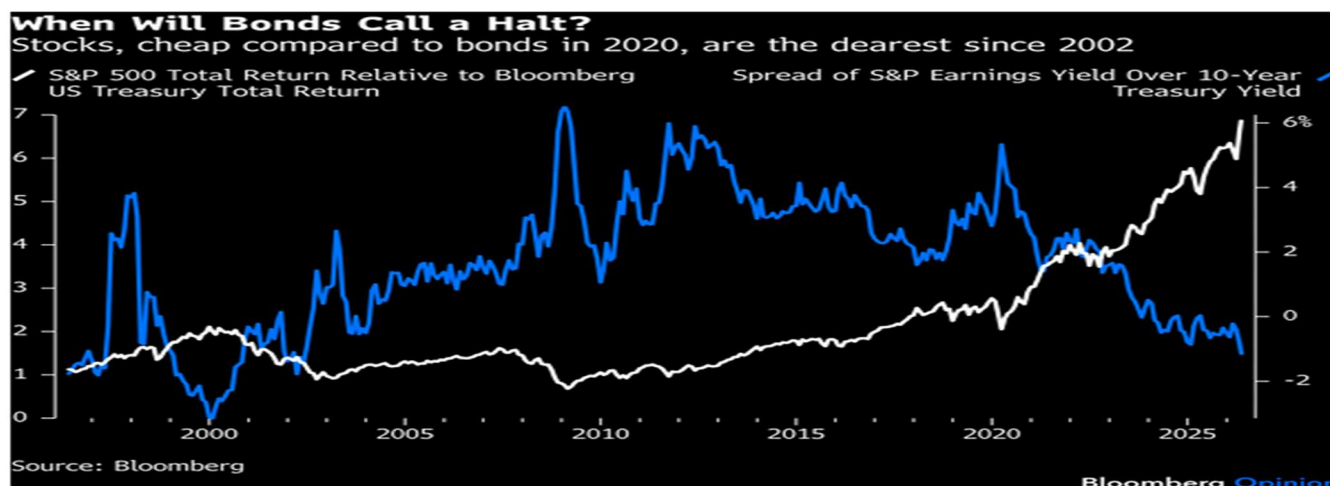
Alphabet is perhaps the clearest example of this shift. For years, Google's parent was among the largest buyers of its own stock. More recently, after loading up on debt in the U.S., Japan, and elsewhere to fund its AI expansion, the firm has now completed an \$85 billion share sale — one of the largest on record. The pivot from net buyer to net issuer, replicated across the largest companies in the index, represents a meaningful and underappreciated shift in the supply-demand balance for U.S. equities.

Bond Market Issues and Concentration Risk

S&P concentration. A relatively small subset of stocks are carrying the returns. Investors relying on passive exposure may not fully realize how concentrated their risk has become. The largest names have dramatically outperformed the broad market over the post-pandemic period, and as their market value increases, they represent an ever-larger share of whatever index they're included in. The concern is straightforward: if market tone shifts and technology stocks begin to lag the broader market, investors will experience an outsized downturn as well. ***Concentration amplifies both upside and downsides; the reward is potential outperformance, but the risk is catastrophic loss if the thesis is wrong.***

The Fed and bond market backdrop. With Kevin Warsh stepping in as Federal Reserve chairman, he faces a complex challenge managing growth and inflation. Most expect the Fed to remain on hold through year-end, though this will be data- and bond-market-dependent. It's also worth noting that Warsh will not rule unilaterally — even though President Trump may have wanted a Fed chair more supportive of lower rates. The Federal Open Market Committee is made up of 6 governors and 5 regional Fed presidents, each with their own views, institutional backgrounds, and policy preferences; “majority rule” will require more than 6 votes, though the Chair can direct the conversation and set the agenda.

Perhaps most striking: the yield on the 10-year Treasury now exceeds the earnings yield on the S&P 500 to an extent not seen since the tail end of the dot-com bust in early 2002 — a signal we view as a flashing warning light for equities. (See chart on next page). Stocks offer an inflation hedge that bonds don't, and a growth story, bonds can't match, so preferring equities to bonds on a relative basis makes sense. But if the bond market's slow-motion adjustment should speed up, equity investors will have to get more defensive.



Market Outlook and Focus: Our framework for the second half of 2026 rests on three observations:

1. **Breadth matters more than it has in years.** With the Magnificent Seven no longer reliably driving index returns, active stock selection and sector allocation carry more weight. The divergence between equal-weight and market-cap-weighted indices creates opportunity for patient investors willing to look beyond the largest names.
2. **Earnings support is real, but so is concentration risk.** We anticipate markets will continue to be supported by solid earnings, while also contending with concentration risk and the possibility that inflation disruption returns requiring higher interest rates to bring it under control.
3. **The capex cycle will eventually turn.** What investors are currently underappreciating is that this wave of data center investment will come to an end, and in turn, chip and memory stocks will come back to earth, as they have so many times in the past.

Given this backdrop, we remain well diversified, long-term focused, favoring companies with durable earnings power and strong barriers to entry, applied through a value-oriented lens.

We encourage you to reach out with any questions or concerns or to schedule a portfolio review to ensure your goals and tolerance for risk remain aligned.

Thank you for the continued trust you place in us.

Warm regards,

Brian

Brian Chait, President, July 7th, 2026

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