Offense, With Insurance

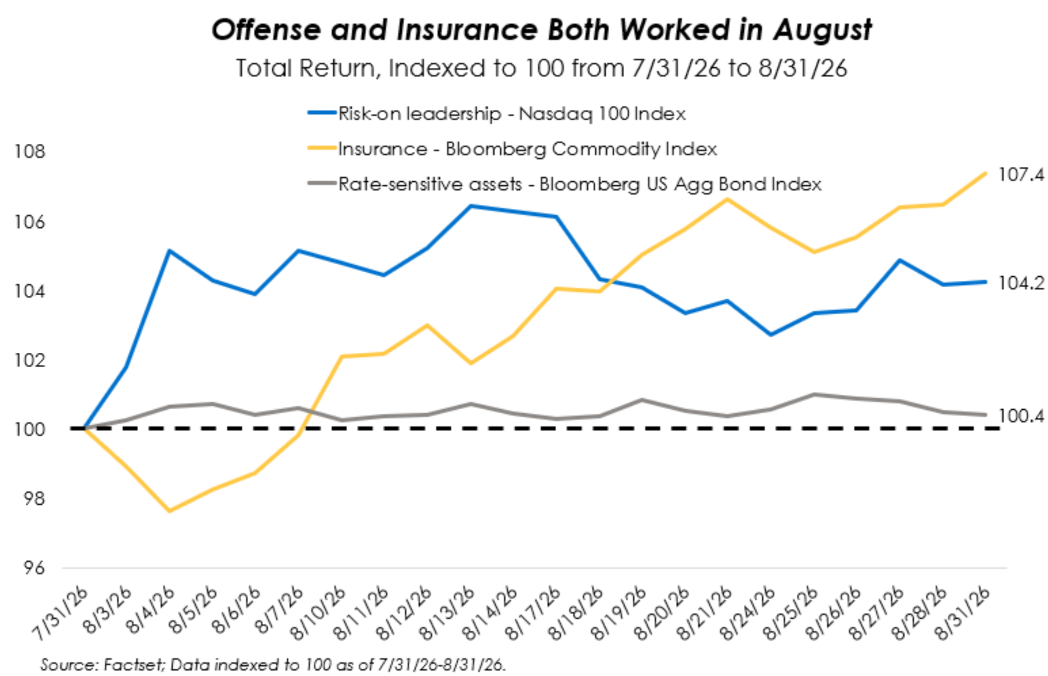
"There are old investors and there are bold investors, but there are no old bold investors."

– Market Adage

Most people don't buy insurance because they expect something bad to happen tomorrow. We buy it so we can keep moving forward without one unexpected event derailing the plan. The same idea applies to portfolios: taking risk is necessary to participate in long-term growth, but taking risk without protection can leave investors exposed when conditions change.

August was a good example. Markets were generally constructive, and investors were rewarded for playing offense. AI-related growth leadership remained strong with outperformance in the Nasdaq. Emerging Market equities participated as well, and the S&P 500 reached a new record high intramonth. Sentiment was helped by benign inflation data, exceptional 2Q earnings growth, and continued enthusiasm around robust AI-driven capital spending and financing activity.

However, August was not simply a one-way risk-on month. Commodity strength suggested that investors were also maintaining insurance against several risks that remained firmly in view, including geopolitics, inflation uncertainty, fiscal concerns, and pressure from rising rates. To that point, traditional rate-



sensitive assets were positive but lagged in the month as yields remained a key pressure point. In short, investors were willing to lean into opportunity, but they were not willing to abandon protection entirely.

The same "Offense, With Insurance" dynamic was visible beneath the surface of the economy. The macro backdrop remained solid, but uneven. Corporate activity continued to support the cycle, while consumer-related data looked more fragile.

On the corporate side, the data remained encouraging. AI-driven CAPEX growth continued to look exceptional, corporate profit growth forecasts remained robust, and layoff activity remained very benign. Credit conditions also continued to support the corporate resilience story, with improving lending standards, strong corporate bond issuance, and historically tight credit spreads.

Corporate Strength	Consumer Fragility
AI-driven CAPEX growth remains exceptional	Consumer sentiment remains depressed
Corporate profit growth forecasts remain robust	Core retail sales are softening
Jobless claims remain benign and unemployment is low	Hiring trends are subdued, with muted job gains
Lending standards are improving, corporate bond issuance is strong, and credit spreads remain tight	Housing activity remains weak and pressured by rising rates

Source: Yellow Cardinal Research

Those are not typical recessionary signals. They suggest that the corporate side of the economy still has momentum, helped by nominal growth, strong investment trends, and healthy access to capital. Earnings growth has been exceptional, even as markets remain mindful that the trajectory may be closer to a peak than a new acceleration phase. Forecasts still point to strong profit growth, but the pace is expected to slow into 2027.

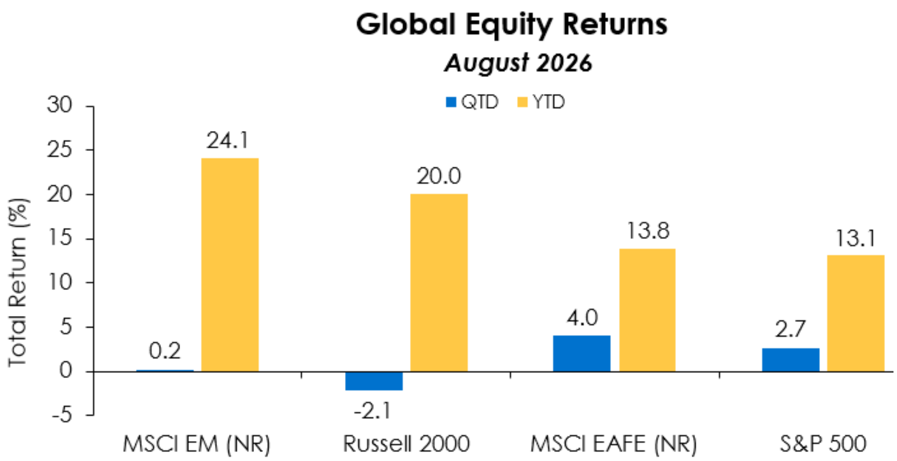
The consumer side of the ledger was more cautious. Consumer sentiment remained depressed, core retail sales showed signs of softening, hiring trends were subdued, and housing activity remained weak. Importantly, the labor market was not breaking, but the "no-fire, no-hire" backdrop leaves the consumer more vulnerable if labor conditions soften further. To be clear, households are still spending, but with less cushion.

Policy added further complexity. Benign inflation data earlier in the month supported the idea that the Fed could remain patient, but the Fed Chair's message at Jackson Hole leaned more hawkish, recognizing that the level of inflation remains too high. The recently strong August labor report also supported that message.

Taken together, August did not present a bearish macro picture. Growth remained solid, corporate activity was strong, and market technicals were generally healthy. But the backdrop was not clean enough to justify ignoring risk. The better interpretation is that August rewarded investors who stayed invested, but also reinforced the importance of maintaining protection.

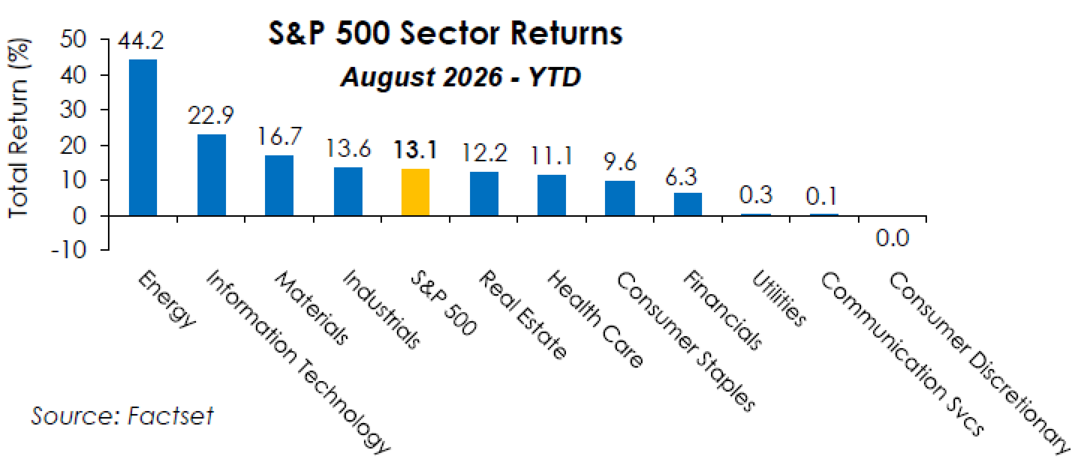
Commodities posted another month of strong returns on the back of higher prices in Agriculture, Precious Metals, and Energy. Stocks also delivered solid returns – especially those levered to robust AI-related CAPEX spending – as a result of strong earnings growth. Meanwhile, Bond returns were only marginally higher as rates remained elevated due to strong nominal growth, high levels of AI-related bond issuance along with ongoing deficit concerns.

Stocks



Source: Factset

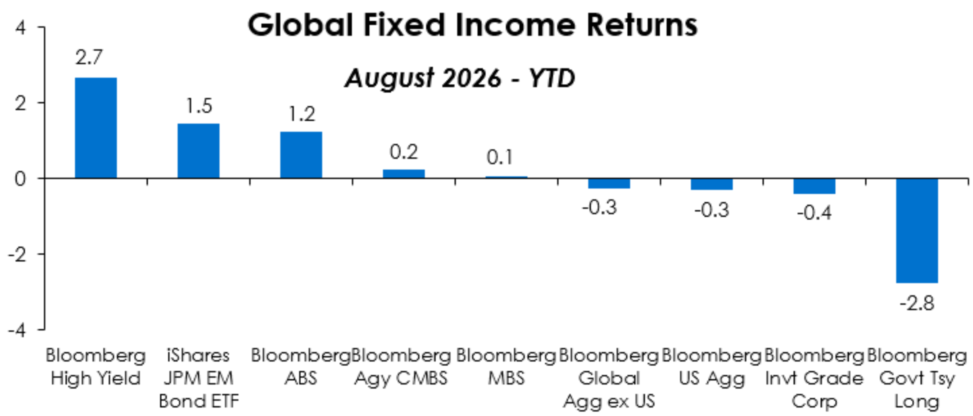
Emerging markets (MSCI EM) bounced back in August following a weak start to the third quarter – helped by dollar weakness and a resurgence of AI-related enthusiasm. Developed markets (MSCI EAFE) also benefitted from the weaker dollar and solid performance from value oriented sectors such as Energy, Materials, and Healthcare. U.S. large caps (S&P 500) posted solid returns on robust earnings growth, due to continued AI-related infrastructure spending. Lastly, after delivering very strong second quarter and year-to-date returns on accelerating earnings growth, U.S. small caps (Russell 2000) posted softer results thus far in the third quarter. From a sector perspective, market rotation remains evident. Cyclical growth sectors – namely Technology – outperformed in August while more cyclical value sectors outperformed year-to-date including Energy, Materials and Industrials. Eight sectors have posted positive returns for the year thus far.



Source: Factset

Bonds

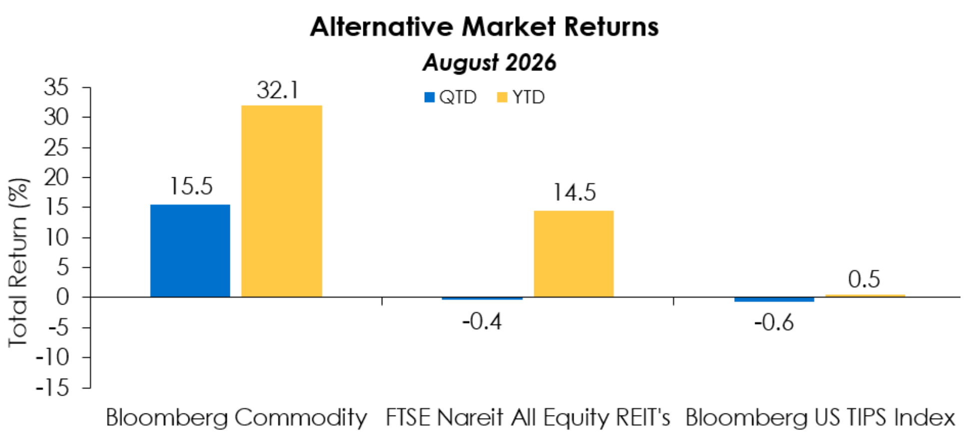
Policymakers remained on hold at their July meeting with the federal funds rate unchanged at 3.50%–3.75%. The last updated June “dot plot” implies one 25 bps rate hike by the end of 2026 followed by cuts in ’27-28. This compares to a more restrictive forward curve with around two to three hikes now priced in by year end ’28. So far, new Fed Chair Kevin Warsh emphasized the Fed’s resolve to tame inflation, while indicating a preference for reduced forward guidance to increase policy flexibility. Investors viewed this as a “hawkish hold” though markets are sensitive to the recently delivered strong August employment report making September a live meeting dependent on the upcoming inflation data. For the month, Bonds posted marginally positive returns while delivering mixed results year-to-date. Inflation concerns continue to partly offset the benefit of tighter spreads and carry. High Yield and Emerging Market Debt performed best due to their higher starting yields. Meanwhile, long-dated U.S. Treasuries have lagged with the back up in rates due to strong economic growth and lingering inflation concerns.



Source: Factset

Alternatives

Commodities were the best-performing asset class for the month, continuing their strong year-to-date run. Energy, Agriculture, and Metals prices have all moved higher due to strong demand and supply disruptions. REITs were down for the month but have delivered strong returns year-to-date. Finally, Treasury Inflation-Protected Securities (TIPS) marginally outperformed nominal Treasuries amid choppy inflation expectations – rising earlier in the year followed by weakness in May and June before bottoming out and gradually rising since then.



Source: Factset

Market Outlook

"There are two kinds of people in this world: those who believe there are two kinds of people in this world and those who are smart enough to know better."

– Tom Robbins (1980)

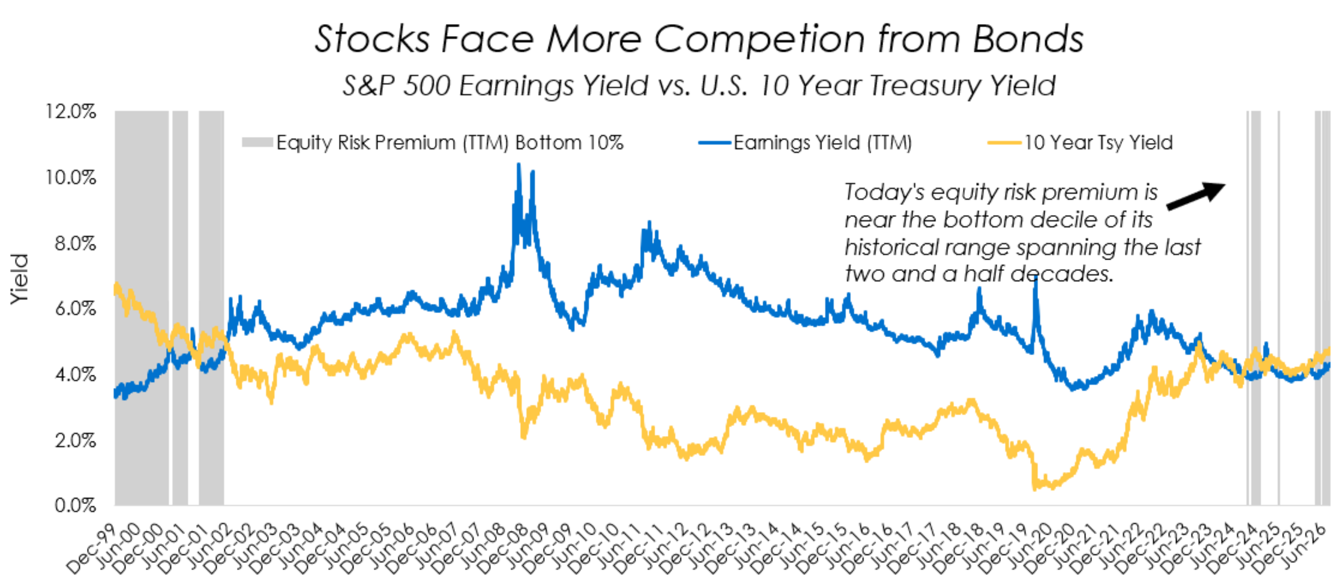
We came into 2026 with the tactical vantage point that this year would require the awareness of more nuanced views and the avoidance of oversimplification. Below is a framework for how we began the year comparing the generalized consensus view to the more nuanced views that were lying just below the surface. As we turn into the back half of 2026, we think it will continue to require more of a chess-than-checkers mentality. The backdrop remains full of crosscurrents:

2026 - The Year of the "Definitely, Maybe"

	Generalized View	Nuanced View	
Consumer	*"The consumer remains resilient."*	*High-income consumers maintain strong spending power from the wealth effect*	*Low and middle-income households struggle from affordability pressure*
Labor	*"It's a no-hire, no-fire labor market."*	*Structural tightening results from aging demographics and immigration policy*	*Structural loosening results from AI productivity initiatives*
Profits	*"Profits are solid."*	*Earnings growth is improving for the small and mid-caps*	*Earnings growth is leveling off in the larger cap companies*
Fed	*"The Fed is getting more accommodative."*	*Lowering interest rates loosens policy to improve affordability as inflation cools*	*A new Fed chair is often tested by the market resulting in a tightening of financial conditions.*
Policy	*"Fiscal stimulus will be a tailwind."*	*Midterm election years often coincide with accelerating economic growth resulting from policies of the incoming Administration*	*Midterm election years tend to usher in above average intra-year volality as markets "buy the rumor and sell the news"*
Markets	*"The AI story is early innings."*	*AI promises to be a transformative application*	*Leading edge AI stocks might be pricing in a lot of the good news*

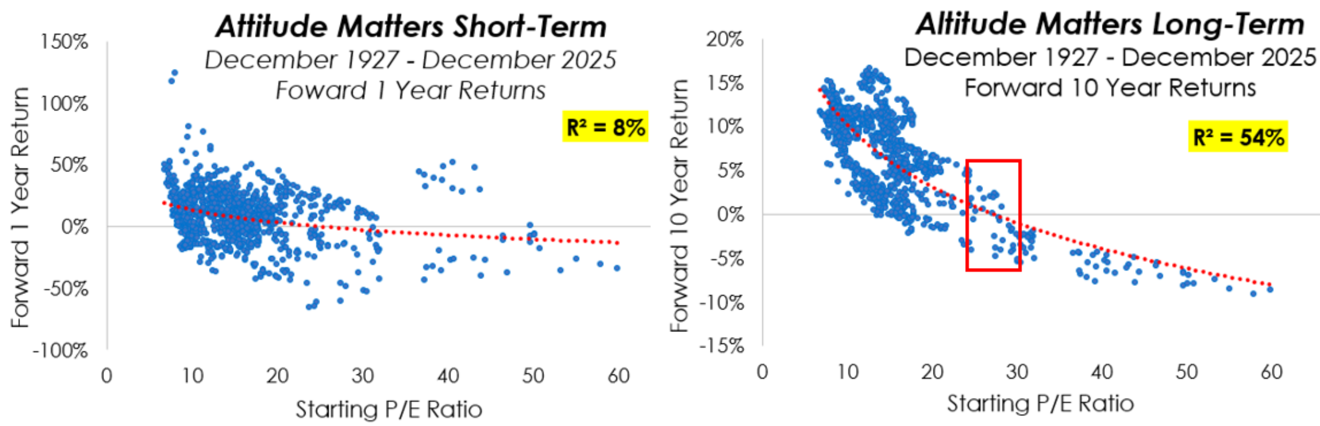
- Economic growth has been resilient – helped by the wealth effect of the high-income consumer – but is also shifting towards CAPEX-driven demand as consumer vulnerability has increased.
- The labor market remains stable with hiring gains low but firing impacts limited. This is a key variable for the consumer's resilience and ability to spend.
- Earnings are exceptional with growth well above average and still expected to be superior down market cap. Having said that, the market seems to be looking ahead to a peak in the earnings growth rate as we move into next year.
- Fed direction is more uncertain as the new Fed Chair is less willing to provide guidance and policymakers are grappling with uneven inflation data (oil prices are volatile and realized inflation continues to trend above target). Recently, market's are anticipating a more hawkish Fed as a result of a strong August labor report.
- AI remains the dominant theme in the market but separating the economic story from the investment story should remain top of mind. As a result, market rotation seems to be the new trend.

The chart below illustrates that elevated Treasury yields have narrowed the valuation cushion for stocks – increasing competition for equities and raising the bar for future earnings growth. The equity risk premium, measured as the S&P 500 trailing earnings yield less the 10-year Treasury yield, has narrowed as Treasury yields have risen and equity valuations have remained elevated. That doesn't mean equities can't perform, especially if earnings growth remains strong. But it does mean the hurdle rate is higher. In a world where high-quality bonds and high income producing stocks offer more meaningful yields, investors may become less forgiving when stocks with especially high valuations leave less room for disappointment.



Source: Factset; Equity Risk Premium Bottom 10% is the bottom 10% of observations that resulted in the lowest equity risk premium defined by the difference between the S&P 500 earnings yield (the inverse of the Price to Trailing Twelve Month Earnings ratio) and the US 10 Year Treasury Yield over the range from 12/31/99-Current.

<u>This also parallels into our strategic frame which requires the discipline to "keep the main thing the main thing".</u> As much as we opine on the factors that influence the shorter term setup, the fact remains that starting valuations tend to be the most influential factor for long-term returns. In short, what you see is what you get. In the past, we've described this as, <u>"Attitude matters in the short run, but Altitude matters in the long run."</u>



Source: PE ratios were calculated monthly based on the value of the S&P 500 and trailing 12-month S&P 500 Normalized Earnings. Normalized Earnings were calculated by determining the constant long-term growth rate that best fit actual S&P 500 earnings. This process is meant to smooth out short term fluctuations in earnings caused by the business cycle. Forward returns are price appreciation only and do not include dividends. Historical S&P 500 data was gathered from Robert Schiller's website (http://www.econ.yale.edu/~shiller/) and Factset.

Please see the charts above for context. In the short run (chart on the left), S&P 500 returns measured over a one-year period have very little to no relationship with the starting price-to-earnings valuation multiple. Investor opinion – driven by a number of factors – can shape popularity for markets and drive short term results that can be both expected and unexpected. However, the chart on the right shows that the S&P 500 returns measured over a longer ten-year period have a much more important relationship with the starting price-to-earnings valuation multiple. We think remembering this concept is an important step to maintaining discipline as a long-term investor.

<u>The combination of the above argues for flexibility in the short run and discipline in the long run.</u>

So what are the implications and key takeaways for portfolios?

- **Think chess, not checkers.** Nuanced markets can produce multiple paths to the same outcome, so short-term decisions require flexibility.

- **Balance offense and defense.** Earnings growth, CAPEX, and broadening leadership support offense, while sticky inflation, Fed uncertainty, and elevated valuations argue for defense.

- **Use diversification as a "twofer."** Diversification can provide both risk reduction and upside optionality if market leadership continues to broaden.

- **Be willing to look different.** Long-term discipline may require going against the grain, especially when concentration risk is high.

- **Mind the pendulum.** When leadership becomes crowded and the risk/reward becomes less favorable, reducing exposure to the most concentrated areas can create room for better opportunities elsewhere.

From a portfolio positioning perspective, we continue to emphasize the importance of diversification and balance. We remain on the lookout for opportunities to selectively rebalance – taking profits in equities a couple of times in the prior quarter and reallocating the proceeds to underweighted areas like bonds and alternatives (where applicable). See more specific detail below:

Within equities, our positioning incorporates balance geographically and within our US Large Cap exposure especially (away from the top of the market). Our bias has generally been to have more exposure to less expensive areas (down market cap). As such, we've maintained a larger OW in Cyclical Value and Defensive sectors, combined with a smaller sized cap bias along with a modest OW in Small Caps. We remain UW the most concentrated and expensive larger cap Cyclical Growth areas.

Within fixed income, we remain biased toward the higher quality US Core Fixed Income segment – where we're slightly longer in duration for diversification purposes. We've maintained an EW to International Fixed Income, where the end of negative interest rate conditions has led to more attractive opportunities. Maintaining a higher quality bias means that we still remain UW the most expensive part of the bond market – High Yield – where (still) tight spreads have made the risk/reward less attractive in our view.

Within alternatives, we remain fairly balanced though slightly overweight in Diversified Alternatives and Commodities. Last year, we adjusted our mix in this area in order to provide greater insurance against market volatility by emphasizing income and short exposure – areas that can benefit from choppy market conditions like what we've experienced episodically this year.

Thanks for giving this a read.