

MARKET SPOTLIGHT

August 2026

In our most recent quarterly update, we wrote about the growing use of leverage and speculative activity in several parts of the global equity market. At the time, we were not arguing that a correction was imminent. Instead, our point was that when investor positioning becomes crowded and leverage begins to accumulate, stock prices can reverse in a violent way. The last several weeks have provided a real-time illustration of that dynamic.

One of the clearest examples has been SK Hynix. The stock had become one of the most visible beneficiaries of the artificial intelligence capital spending cycle, particularly as investors focused on demand for memory. But after a remarkable run, the share price has fallen sharply since the end of June. The decline does not change the long-term importance of memory in AI infrastructure, nor does it mean the company's fundamentals have suddenly deteriorated in a way that matches the share price move. It does, however, reinforce a broader point: fundamentals, starting valuations, and investor positioning all work together to drive market prices in the short-term. We do our best to understand when investor positioning is stretched in one direction or another, and this is one of the clearest examples of crowding that we have seen in some time. It is fundamentals and starting valuations though that win out in the long-term, and this update seeks to provide some of thoughts around those topics.



Source: Bloomberg data from 12/31/2025 – 7/14/2026

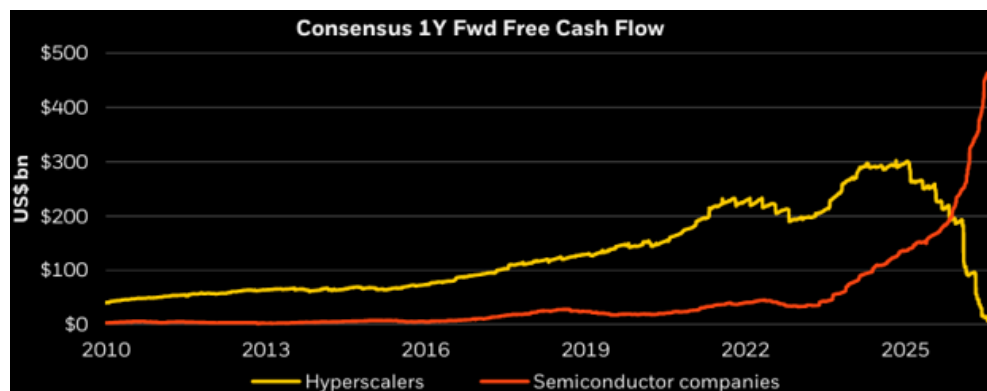
AI Optimism Meets Reality

One item we are watching closely is the changing cash flow profile of the largest technology companies. For much of the last decade, the largest companies in the U.S. equity market were unusually capital light. They generated enormous free cash flow, maintained strong balance sheets, returned capital to shareholders, and grew earnings at rates that justified premium valuation multiples. That combination was extremely powerful for equity investors, leading to double-digit returns over long stretches of time simply for holding a diversified basket of equities.

That model is changing. The largest hyperscalers are now spending extraordinary amounts of money on data centers, chips, networking equipment, power infrastructure, and related capacity. Recent earnings reports have not suggested that this spending cycle is nearing a pause. If anything, management teams appear willing to ramp spending up further, with demand for AI infrastructure still exceeding available capacity. That may be encouraging for the companies selling semiconductors, memory, power equipment, and data center services, but it creates a more complicated setup for the companies funding the buildout.

Markets appear to be starting to distinguish more carefully between the beneficiaries of AI spending and the companies absorbing the cost of that spending. In some cases, the companies providing critical inputs into the buildout have dramatically outperformed the hyperscalers themselves. That is not especially surprising. The cash flow dynamics are different. For suppliers, hyperscaler capital expenditure becomes revenue. For the hyperscalers, that same spending becomes a capital commitment that must eventually earn an adequate return on investment.

This does not mean the AI investment cycle is broken. We continue to believe the technology, if implemented correctly, is incredible and will be transformative. Early signs of productivity improvements remain encouraging. The issue is valuation and capital intensity. Investors have grown accustomed to treating the largest technology platforms as exceptional businesses with premium margins, high returns on capital, and limited incremental investment needs. If those same companies must now spend hundreds of billions of dollars to defend or extend their competitive positions, the market may need to reassess what multiple those earnings deserve.



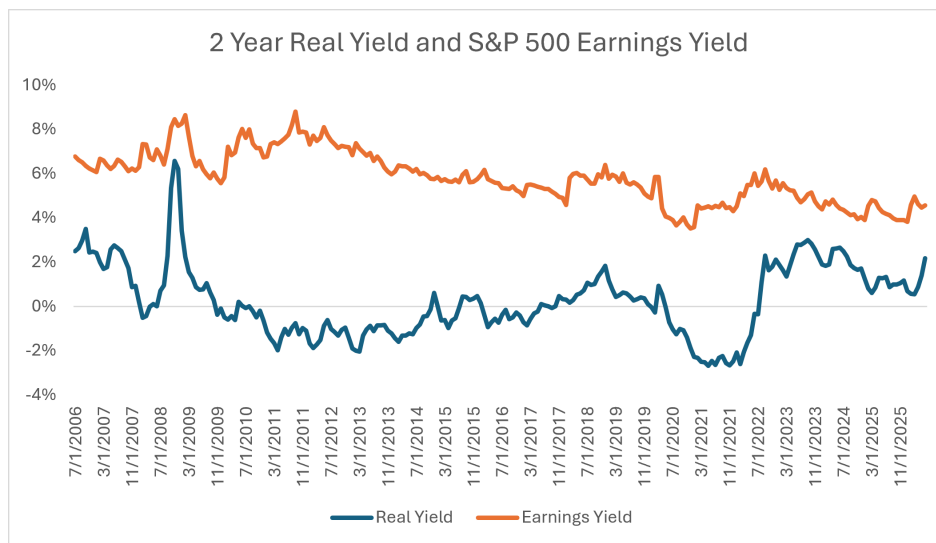
Source: Bloomberg data from 12/31/2025 – 7/14/2026

Valuations Look Less Compelling Relative to Real Yields

The valuation discussion is not limited to technology stocks or any specific equity segment for that matter. Broad U.S. equities are not cheap on absolute measures, and they are also less compelling when compared with lower-risk fixed income alternatives. One framework we find useful is comparing the inverse of the S&P 500's forward price-to-earnings ratio with the real yield available on short-term Treasury Inflation-Protected Securities (TIPS). Both assets, in different ways, should help investors preserve purchasing power over time. Equities do this through earnings growth, while TIPS do it more directly through contractual inflation adjustments that preserve purchasing power or real yields.

For years after the global financial crisis, equity investors could make a relatively straightforward argument that stocks offered a meaningful earnings yield spread over safer real yields. Real rates were low or negative, and the earnings yield on equities looked attractive by comparison which gave investors plenty of compensation for additional risk. That backdrop is no longer in place. Short-term real yields are now solidly positive, while equity earnings yields have compressed as valuations have risen. The result is that investors are receiving much less incremental compensation for taking equity risk than they did for much of the prior cycle. If history provides any lessons in this situation, equity valuations are more likely to revert to lower long-term averages than increase, which would serve as a meaningful headwind to equity investors.

This comparison is not a market timing tool. But taking all factors together, we are recommending investors allocate a larger portion of their portfolio to high quality, short duration fixed income securities to take advantage of these yields.



Source: Bloomberg data from 6/30/2006 – 6/30/2026

Portfolio Positioning: Diversify Concentrated Equity Exposure

These dynamics have implications for portfolio construction. We have maintained market capitalization weighted exposure to U.S. equities in recent quarters, in part because earnings growth remained strong and the largest companies continued to dominate index-level returns. We were not eager to fight that trend simply because market leadership was narrow. In many cases, the companies leading the market were also producing the best fundamental results.

However, as pointed out earlier, the case for a modest shift is becoming stronger. The combination of high valuations, extraordinary capital spending needs, top-heavy index concentration, and improving relative value in other parts of the market argues for a more diversified approach. Therefore, in addition to introducing more fixed income into portfolios, we recommend investors begin to tilt portfolios toward greater multi-factor exposure. Investors today can build high quality, well diversified portfolios at index-like costs using these products today, and we would be happy to discuss recommendations there further.

A broader mix of investment styles can help reduce dependence on one particular type of economic regime to deliver solid results. Quality, value, profitability, and momentum exposures will each behave differently as the cycle evolves, but in combination they provide a more balanced way to own equities that ought to perform well under multiple scenarios. This is especially important in an environment where the Federal Reserve appears hawkish and large macroeconomic risks are still present.

Closing Thoughts

The market backdrop remains constructive in several important respects. Economic growth has held up better than many expected, corporate earnings are still being supported by AI-related investment, and the broader economy does not appear to be on the edge of recession. We do not think investors should abandon equities or attempt to time every short-term rotation in market leadership.

At the same time, we think the risk and reward tradeoff has changed. The AI capital spending cycle is becoming more expensive for the companies funding it. The unwind in select leveraged trades is a reminder that strong momentum can reverse quickly. Equity valuations are less compelling when compared with positive real yields. And index concentration means that many portfolios may be more dependent on a narrow group of companies than investors realize.

Our conclusion is balanced rather than alarmist. We remain fully invested in equities relative to benchmark, but are being more selective. We believe investors should consider diversifying top-heavy equity exposure, incorporating broader factor exposure, and taking advantage of attractive real yields in short-term fixed income. Markets can continue to move higher from here, but the next phase may require a different playbook than the one that worked so well when the largest companies were capital light, valuations were easier to defend, and safe real yields were close to zero.

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