

Investment Update

October, 2026

2026 Third Quarter Update

Review: The most notable development in Q3 was the dramatic shift in expectations for interest rate policy and the resulting selloff in bonds. The Federal Reserve is committed to trying to keep inflation in check, and the market is now expecting at least three more rate hikes over the next year, following the one last month. The Bloomberg US Agg was down 3.5% in the quarter, and the municipal index sold off even more, down 6.3%. US stocks held up relatively well, eking out a solid 2.3% return, ahead of both developed and emerging market returns.

	3Q26	2Q26	1Q26	2025
S&P 500	2.3%	15.2%	-4.4%	17.9%
MSCI EAFE^{1,2}	0.9%	11.1%	-1.1%	31.9%
MSCI Emerging Markets²	-0.2%	24.1%	-0.1%	34.4%
Bloomberg U.S. Aggregate Bond	-3.5%	0.7%	-0.1%	7.3%
Bloomberg Municipal Bond	-6.3%	2.5%	-0.2%	4.2%

¹Europe, Australasia, Far East

²MSCI returns are in U.S. Dollars

Texas Hedge

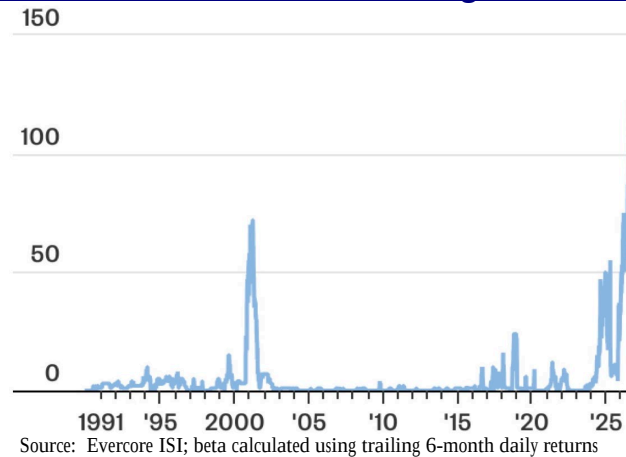
We noted in our last quarterly update that a number of highly cyclical companies tied to the AI infrastructure buildout, particularly certain semiconductor stocks, appeared to be valued based on overly optimistic assumptions. Other investors clearly noticed this as well, because semiconductors as a group were down more than 20% in July, with some of the most cyclical names declining 40-55%.

In late July, this selloff contributed to a highly-publicized blowup at a “hedge” fund that was ironically named Situational Awareness. To be fair, the firm had a number of prescient calls that had worked out well prior to that episode, but we call attention to it because it is indicative of aggressive investor behavior more akin to gambling than to prudent investing. In simple terms, hedges are traditionally structured to limit losses by minimizing risk at the portfolio level. What Situational Awareness and a number of other investors did actually increased portfolio risk because both the long and the short positions were tied to the same thesis—semiconductor and AI infrastructure stocks would win while software stocks would lose. With leverage (reportedly >4x), the portfolios were not able to withstand the decline in semiconductor stocks and rise in software stocks in July.



The market has become increasingly bifurcated over the past few years, with earnings growth and returns being driven primarily by AI-related stocks. This trend has resulted in unusual individual stock behavior, where an increasing number of S&P 500 constituents tend to move in the opposite direction of the overall index. As the following chart shows, the number of constituents exhibiting this behavior (called negative beta) is now ~120, almost 25% of the index, a level unmatched in the data going back to 1990. No one knows how long this will persist or what overall returns might be when the trend reverses. However, this trend and the Situational Awareness event are reminders that diversification and a disciplined investment approach are keys to prudent portfolio management.

Number of S&P 500 Constituents with Negative Beta, 1990-2026



Outlook: Expectations for 2026 US GDP growth are currently 2.2%, up slightly from the prior 2.1% estimate. The AI infrastructure build out continues to have a positive impact on economic growth, and aggregate consumer spending has held up relatively well, despite inflationary pressure. Two potential headwinds worth monitoring in the coming quarters are the housing market and government fiscal policy. Residential investment continues to be weak, and with mortgage rates recently hitting 7.3%, it is unlikely that the housing market sees any near-term relief. Fiscal policy is expected to turn from a positive growth driver to a negative one as many of the boosts from the budget bill were one-time in nature.

International markets were mostly weaker in Q3, and the US dollar strengthened versus most currencies due to the revised interest rate outlook. Developed international markets that are net importers of oil, gas, and refined products may be increasingly under pressure due to continued supply constraints and elevated prices due to the Iran conflict.

Strategy: Bonds have sold off over the last month due to expectations of higher interest rates for longer. As a result, there are areas of fixed income that appear to be offering very attractive returns on an absolute and relative basis. To date, this has not led to a noticeable impact on equity markets, but the upcoming earnings season and several high-profile IPOs of AI-related stocks may test investor appetites to put more money to work in equities. The conflict with Iran remains a wildcard, as elevated commodity prices have contributed to the outlook for higher interest rates and to the recent strength of US assets relative to developed international markets.