

AI Enthusiasm, Market Fragility, and the Case for Quality

Market Review Commentary for the Third Quarter 2026

Key Takeaways

- ➔ Market leadership remained concentrated in AI, energy, and cyclical stocks, while quality and small caps lagged.
- ➔ In our view, rising borrowing costs and greater reliance on debt are increasing the risks surrounding the AI capital-spending boom.
- ➔ AI demand remains concentrated among a small number of companies, with long-term economics and competitive leadership still uncertain.
- ➔ We believe strong balance sheets, durable earnings, and disciplined fundamentals will be increasingly valuable as market narratives shift.
- ➔ We believe quality companies will benefit from AI as users of the technology.

Market Review

The third quarter saw a reshuffling as the narrative around artificial intelligence (AI) became more nuanced and complex. We saw large capitalization stocks outperform small caps, with the S&P 500 up 2.30% versus a 7.23% decline in the Russell 2000 Index. Within small cap, there was a clear preference for value over growth (-4.91% return for the Russell 2000 Value versus a -9.39% return for the Russell 2000 Growth).

From a sector standpoint, energy was once more a top performer within the S&P 500 boosted by high oil prices. Health care and technology also outperformed. Utilities declined the most this quarter. Within

the Russell 2000, there was some divergence. Energy was still the strongest performer because of the continued conflict from the war in Iran. Marine transportation companies also performed strongly reflecting some of the bottlenecks brought on by the conflict in the Middle East. Industrials and technology were the two weakest sectors, followed by consumer discretionary.

The third quarter can be characterized as a play in two acts—July was a strong flight to quality away from the more speculative stocks that had outperformed and August and September saw the tide swing back to the more AI-exposed and cyclical stocks. From a more granular perspective, we believe price to earnings ratios (P/Es) provide the most insight as to the drivers of performance of the Russell 2000 Index in the third quarter. Investors were clearly mindful of higher interest rates as deep-value stocks with P/Es trading between 0x-6x earnings per share performed the strongest. This is where sector preference is most prevalent as companies with P/Es in the 0x-6x range are often in energy and mining businesses.

Also, as it relates to interest rates, the recent rise in rates has important implications for the economy. The marginal cost of borrowing for U.S. investment grade companies is up 20% year-to-date. For a “junk” issue, borrowing costs have increased 18%. And worryingly, the cost of a 30-year mortgage is 14% higher this year.

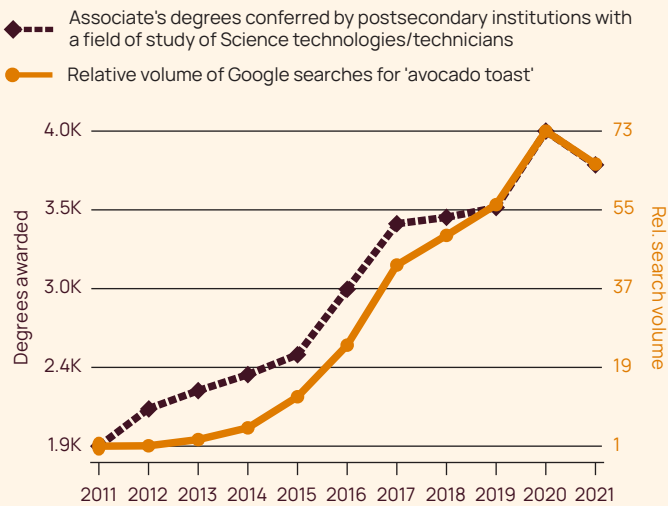
The counterpoint to this headwind is the strength of earnings. Third quarter is expected to show nearly 30% growth in earnings per share (EPS) for the S&P 500. As we see it, the sectors showing the strongest growth should be energy (with EPS more than doubling), with technology, communications, and materials up materially as well. EPS growth has been the central pillar underpinning the strong bull market.

With that performance review as the backdrop, let's answer some frequent investor questions.

1. Why is this time not different?

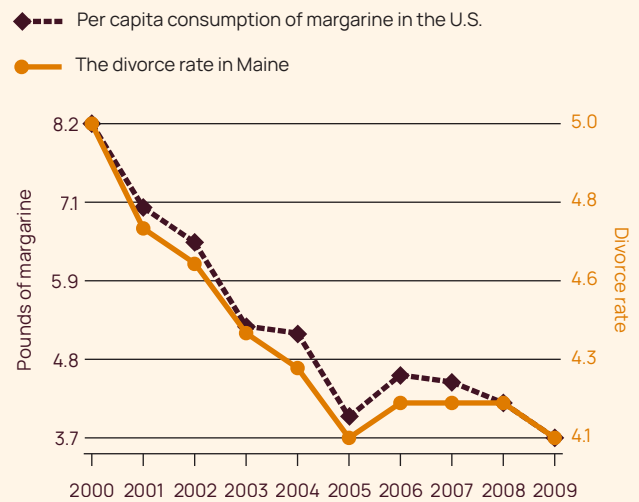
First, there is real wisdom in the saying history doesn't repeat itself, but it does rhyme. There are real limits to using analogies for different time periods. While they can teach us lessons, they are not by themselves predictive. It is rare for all the same factors to be at play at the same time when you're talking about events that are often decades apart. And correlation is not causation. There is a cottage industry of economists using correlation data to try to predict macroeconomic outcomes. Every cycle has its own unique reasons for why and when things change. It's easy to look in the rear-view mirror and proclaim the data was screaming a crisis was ahead. The challenge is the relevant data was different each time. But again, correlation is not causation, as evidenced by the charts on the next page.

Figure 1: Associates Degrees Awarded in Science Technologies Correlates with Google Searches for 'Avocado Toast'



Source: National Center for Education Statistics, Google Trends, tylervigen.com
2011-2021, $r=0.985$, $r^2=0.970$, $p<0.01$

Figure 2: Per Capital Consumption of Margarine Correlates with the Divorce Rate in Maine

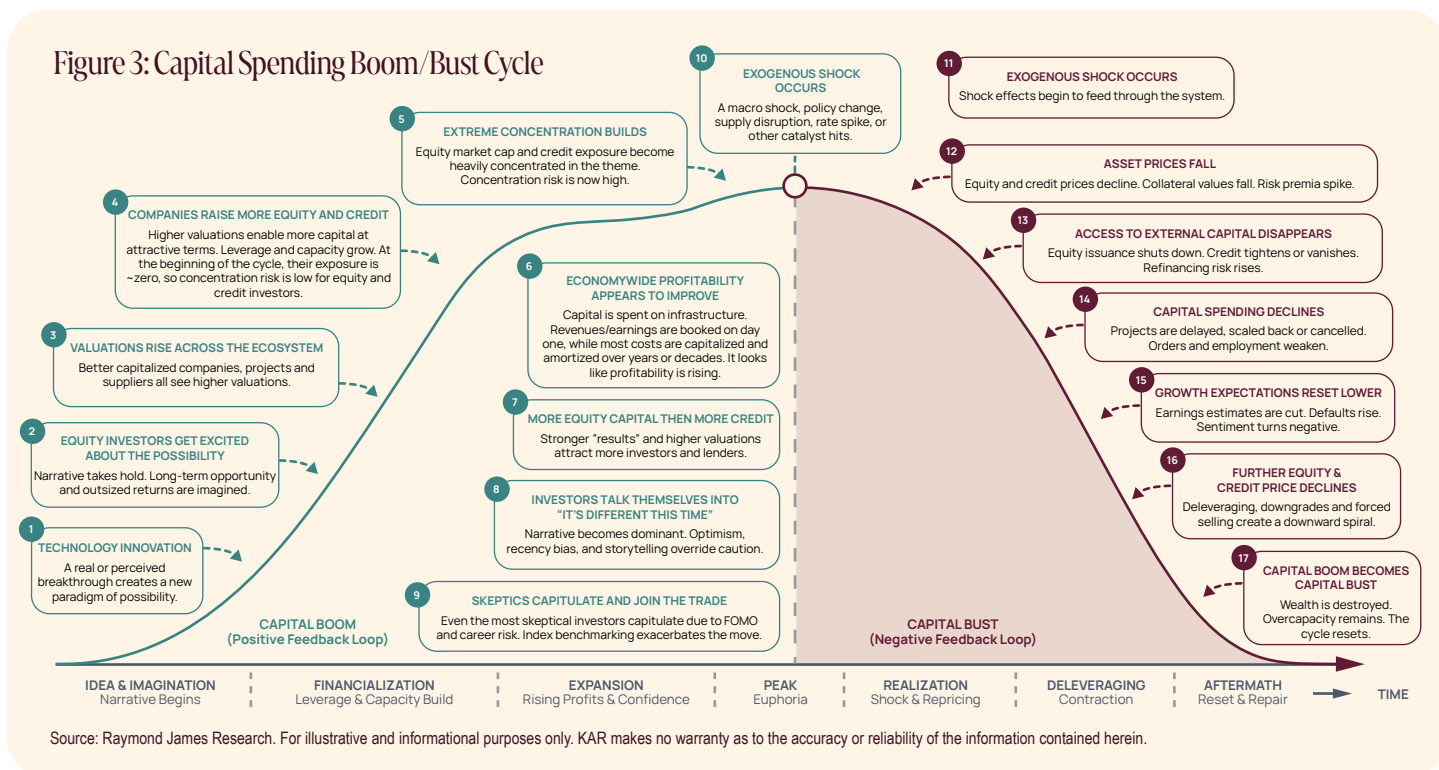


Source: U.S. Department of Agriculture, CDC National Vital Statistics, tylervigen.com
2000-2009, $r=0.993$, $r^2=0.985$, $p<0.01$

There are many meaningful differences between today and the internet boom for example. Today there is a more connected financial system, a much larger base of passive investment (which does not help with price discovery), a quicker and more robust flow of information, large scale of the AI buildout plus the depreciation of it, and a less capable and responsive government. There are enough reasons to make this time different. So, I think trying to predict any specific outcomes for technology, employment, or the macroeconomic environment is still early.

That said, what we can say is that if this AI capital expenditure cycle manages to not be overbuilt, it will be the very first in history where that has happened. The chart on the next page illustrates the cycle of asset booms.

Figure 3: Capital Spending Boom/Bust Cycle



One of the things to pay attention to is how these capital expenditure booms are financed. Initially, mega-cap technology companies were funding asset purchases from their gigantic free cash flow. Every time they announced an increase in their capital expenditure budgets, their stocks went up. It was a little confounding to watch investors cheering declining returns on capital. But there was so much conviction that the returns would more than justify the investment.

Eventually though, even the huge piles of free cash flow were not enough to fund the growth. We've transitioned to substantial debt raises in the market. We even saw Google come to market to raise equity. Prior to that, Google had been buying back its stock at a healthy clip. We've also seen an increase in complex off-balance sheet financing and special purpose vehicles to obscure the leverage in the system. I really thought we had learned our lesson in the Global Financial Crisis, but I might have been wrong. Once you are in this stage, you've created some fragility to the system. It is more vulnerable to economic shocks. And the shocks don't have to come from the industry itself; they can be completely exogenous.

To me one of the largest vulnerabilities of this capital expenditure boom is the dependence on two large, private, and unprofitable companies: OpenAI and Anthropic. According to news reports, Anthropic has solid margins on its inference compute (that is when users prompt the models and generate a response). While that is good news, it does not include the costs of revenue paid back to partners and the huge cost of training the models.

It is estimated that some 70% of AI cloud revenue is from Anthropic and OpenAI. A recent UBS report estimated that nearly half of all of Google's cloud revenue next year would be from OpenAI and Anthropic.¹ Microsoft disclosed that 70% of its AI cloud revenue was from just OpenAI.² However, the concentration is not limited to the hyperscalers generating revenue from the frontier labs. According to NVIDIA's most recent 10Q, nearly 70% of its receivables are from just five companies.³

The other unusual element of this capital expenditure cycle is how quickly the lead in usage and capabilities changes. Most of the hyperscalers funding this cycle have operated in winner take all markets, typically with strong network effects. These competitive barriers generate strong economics that allow companies to invest to harden the competitive walls around them. This time it's hard to argue that there are switching costs when you can change a model just by toggling a drop-down menu, and that many companies worried about the costs of tokens are choosing cheaper open-source models, many from China. If you think of the last two years, OpenAI, Google, Anthropic, Meta, and Microsoft were each called a leader at one point and later a laggard and back again. Meta was thought to be a distant player until the recent release of their agentic product Muse.

It must give one pause in the absence of more information on the underlying economics for these frontier labs. And that's before we get into all the recent reports on the models breaking free from their protected sandboxes to hack other companies and governments.

2. When is quality going to start outperforming?

Quality has had glimmers of a recovery this year. We saw this most notably in July, when overbuilding concerns roiled markets. We saw a drawdown in semiconductor names that had been substantial winners, and we saw by and large most of the KAR quality strategies outperform their benchmarks.

As the summer continued into September, we saw investors return to the AI and cyclical themes they had favored, though with perhaps more measured enthusiasm. This caused a reversal in quality as a positive factor in performance.

¹ Where's Your Ed At, "The AI Demand Bubble," August 4, 2026, <https://www.wheresyoured.at/the-ai-demand-bubble/>

² Bloomberg, "Microsoft's AI Sales Mostly Come From OpenAI, Disclosures Show," August 5, 2026, <https://www.bloomberg.com/news/articles/2026-08-05/microsoft-s-ai-sales-mostly-come-from-openai-disclosures-show>

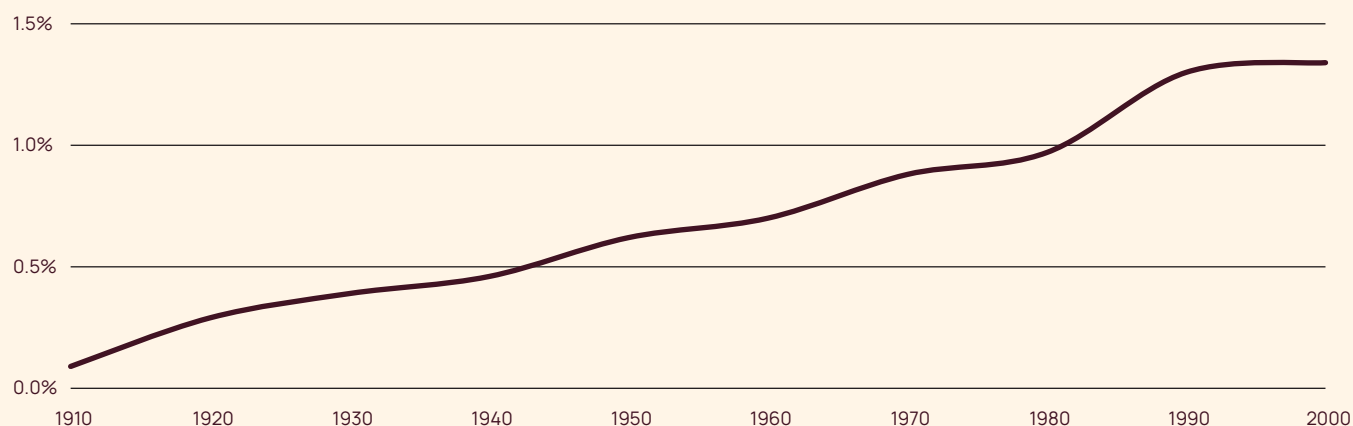
³ U.S. Securities and Exchange Commission, NVIDIA Corporation, Form 10-Q for the Quarterly Period Ended April 26, 2026, <https://www.sec.gov/Archives/edgar/data/1045810/000104581026000052/nvda-20260426.htm>

If we examine the quarter, the month of July was revealing. Investors fled at a breathtaking speed from the more speculative corners of the AI trade. The abandonment of the momentum trade tells you that there are real concerns about the foundations of AI and that everyone wants to have a sturdy chair to sit on when the music stops.

In the meantime, we continue to take advantage of the current period to upgrade portfolio quality wherever possible because we believe the usual quality premium has been replaced with AI excitement. While it is frustrating to see portfolio characteristics stay consistent or improve and not be rewarded in the market, we do believe the regression to the mean will resume.

This is not to say we are predicting the end of the AI boom nor are we questioning the utility of AI as a technology. Far from it—we are big believers that AI will completely change the nature of work and how we relate. When I think back to the early internet, there was a time when many believed that internet portals would be the way we accessed most of the web and that AOL would curate the experience for you. Or even further back, imagine being an accountant and calculating things manually. You would have trembled in fear looking at the advent of the spreadsheet. And yet, there are more accountants employed today than ever before.

Figure 4: Accountants and Auditors as % of U.S. Employment



Source: U.S. Bureau of Labor Statistics, Benedict Evans. **Past performance is no guarantee of future results.**

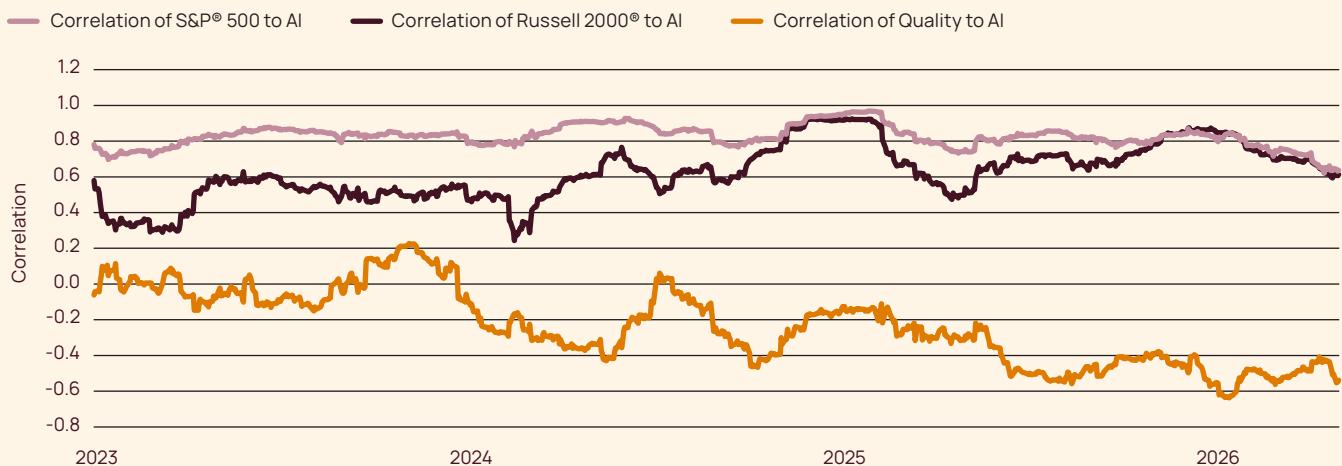
The nature of the work has changed, but it's hard to predict these things and even harder to know how the market will react.

3. Given strong balance sheets, cash flow generation, and generally healthy fundamentals, what is preventing broader investor interest in quality small caps?

It was surprising to look at attribution data from this quarter and see a mixed bag in terms of what types of stocks outperformed during the period. Return on equity (ROE), generally a measure of high quality, was influenced by what we would term lower-quality, cyclical companies generating strong ROEs as a result of strong cyclical demand. This is why we prefer to let the qualitative strengths of a business take precedence in our analysis and recognize that the quantitative metrics are the outputs of a business' strengths.

What we've seen this past quarter is investors chasing bottlenecks across energy, shipping, or AI beneficiary themes. Investors will quickly exit a stock when it reports only good, and not stellar earnings. That indicates that narrative is driving the investment and not so much a deeper analysis on the longer-term strength of a business. The swift exits are a recognition that many of these companies do not have the kind of differentiation to be durable.

Figure 5: Russell 2000®, Quality, and S&P 500® Correlations with the AI Trade

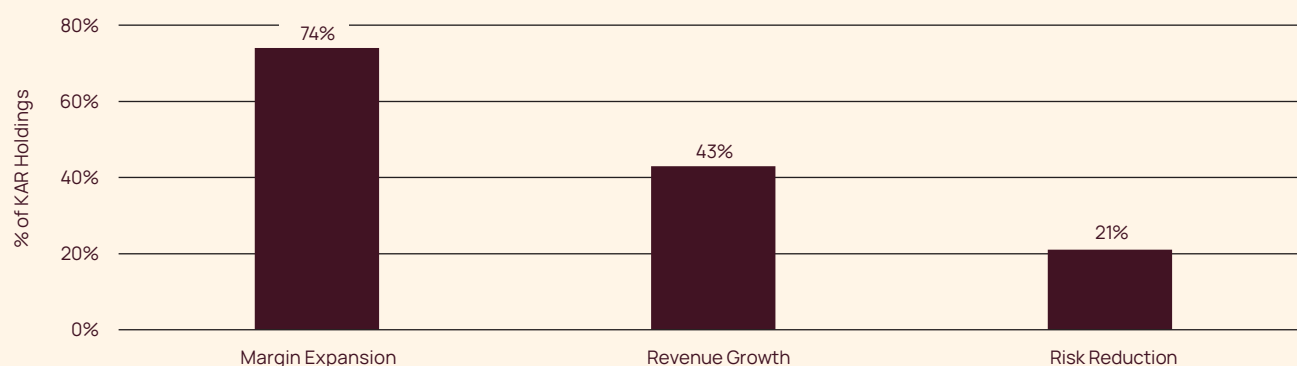


Data as of September 30, 2026. Source: Workbook price histories; GS AI Basket = GSTMTAIP; GS U.S. Quality Pair = GSPUQUAL; S&P 500 = SP50. Methodology: trailing 63 aligned daily price-return observations. The indices are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment. **Past performance is no guarantee of future results.**

By contrast, quality companies who are not direct beneficiaries of the capital expenditure or energy cycle have not had the same appeal for investors. They are continuing to generate solid growth in earnings, but

for many, they are not suddenly doubling or tripling their growth rates. It is this low earnings variability that attracts longer-term investors, but for right now, it is not as appealing. What's perhaps most interesting is that we would argue that many of our portfolio holdings will benefit directly from AI, as users of the technology, rather than suppliers. We estimate that some 80% of KAR holdings had identified specific AI initiatives with measurable objectives.

Figure 6: AI Adoption by Category (% of Combined KAR Holdings)



Data as of June 30, 2026. Includes both domestic and international companies. Holdings are credited in a category only when both of the following are satisfied: (1) the company has publicly disclosed a specific AI initiative, application, partnership, or investment, beyond generic references to 'using AI'; and (2) management has attributed a concrete, measurable financial or operational outcome to that initiative. Companies may appear in multiple categories where independent evidence supports inclusion in each. Evidence drawn from company earnings calls, press releases, investor presentations, and SEC/regulatory filings spanning 2025 through June 30, 2026. Margin Expansion: Using AI to automate tasks or drive operating leverage that flows through to P&L margins; Revenue Growth: Using AI to sell more, charge more, or win new customers; Risk Reduction: Using AI to underwrite better, prevent fraud, manage risk, or improve safety. **Past performance is no guarantee of future results.**

We saw small caps generally start to underperform as the Federal Reserve announced its most recent interest rate increase. That is a typical reaction in the market, but we believe it matters why the Fed is raising rates. In this case, the Fed sees the strength in employment and the economy as evidence that rates at these levels are not restrictive. Considering the five years that inflation has been above target and the constraint of higher oil (particularly diesel prices), it is no surprise the Fed felt compelled to act and give some indication of an additional hike this year.

A healthy U.S. economy is typically more meaningful to small cap earnings than interest rates. But to play it safe, in a higher rate environment, we believe favoring pristine balance sheets that are not subject to rising rates is another reason to focus on quality.

4. How healthy is the consumer today? What are the key indicators investors should be monitoring?

Today's consumer is still spending but is also incredibly careful with every dollar. We would guess that as long as employment remains strong, the consumer will continue to spend. Right now, unemployment is at 4.1%, the lowest level in one year.

Consumer balance sheets, despite a weak savings rate, still look benign. Revolving credit lines have stayed down, and consumer bank lending is soft, preventing overheating. The challenge is that average hourly earnings continue to trail inflation, so purchasing power is strained.

Strained purchasing power is supported by commentary from many retailers, such as Kroger, which noted customers are putting fewer items in the basket and trading down more to private label. Higher gas prices are certainly having an impact. Even luxury brands that don't deliver the perception of value have underperformed. Hermes, once a standout in luxury, has seen its stock pressured on concerns if growth can continue in a more competitive luxury market. All consumers, regardless of economic standing, have felt the strain of lost purchasing power. Consumer-oriented companies must execute at very high levels to win business. In our eyes, the metrics to watch are employment, employment, and lastly, employment.

As always, we thank you for your continued trust and confidence and we welcome any additional questions you may have.



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The S&P 500 Index is a market capitalization weighted index which includes 500 of the largest companies in leading industries of the U.S. economy. **The Russell 2000 Index** is a free float-adjusted market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. **The Russell 2000 Value Index** is a free float-adjusted market capitalization-weighted index of value-oriented stocks of the smallest 2,000 companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. All companies that have a weight greater than 4.5% in aggregate are no more than 45% of the Index and no individual company has a weight greater than 22.5% of the Index. **The Russell 2000 Growth Index** is a free float-adjusted market capitalization weighted index of growth-oriented stocks of the smallest 2,000 companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. All companies that have a weight greater than 4.5% in aggregate are no more than 45% of the Index and no individual company has a weight greater than 22.5% of the Index. The indices are calculated on a total return basis with dividends reinvested. The indices are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.