FORTIS FINANCIAL
GROUP

July 16, 2026

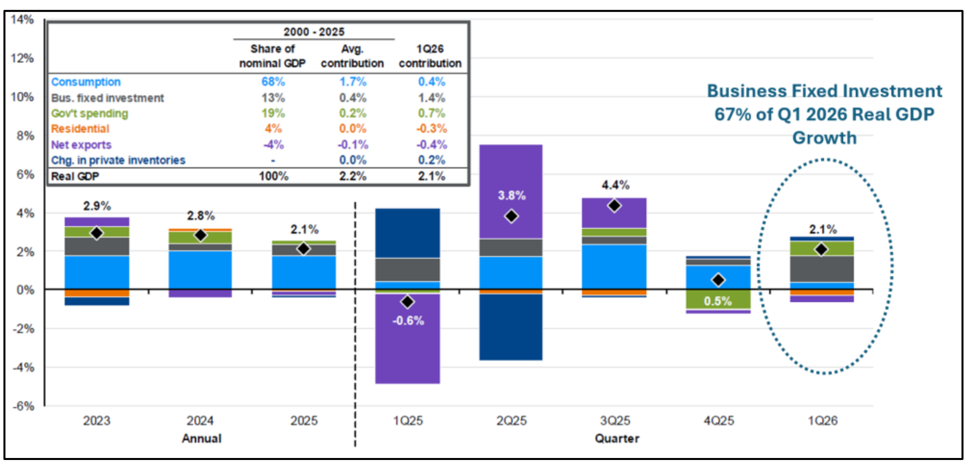
Dear Clients and Partners:

After the Iran conflict and the closure of the Strait of Hormuz drove markets to their March lows, we witnessed a strong recovery in Q2 on the back of a supposed peace deal. With seemingly endless starts and stops to the deal, the market appears to have headline fatigue and largely moved on to focus on the incredibly strong earnings growth coming from AI investment. We still think the risk is to the upside in oil prices (and by extension, inflation) given how far inventories have been drawn down. However, with "some" traffic in the Strait restored, oil futures traders are currently pricing in a more sanguine price going forward. This inflation risk shapes everything we discuss below regarding the new Fed Chairman, but first, let's discuss the AI trade, which is in the middle of an important transition.

Proof is in the Capex ROI

As the GDP report came out this last quarter, business fixed investment drove 67% of Q1 2026 real GDP growth of 2.1%, nearly four times its average contribution since 2000. Consumption has historically done the heavy lifting, but as we've discussed, the challenged consumer was largely absent from this report. Instead, business fixed investment, a proxy for AI capex and the data center buildout, is now carrying the vast majority of economic growth.

Contributors to Real GDP Growth (Seasonally Adjusted Annualized Rate)



Source: J.P. Morgan Asset Management

This massive amount of investment (>$725 billion in 2026) has led market participants to be very focused on finding where those dollars are going and where certain companies might see dramatically expanding margins due to huge supply/demand imbalances. We have seen over the past year, the AI trade has largely been a game of "find the next bottleneck." GPUs, high-bandwidth memory, power, networking, liquid cooling, semicap equipment – each took its turn as the scarce input that got bid to higher valuations. **Market participants have sold the "spenders" and bought the companies benefitting from that spend.**

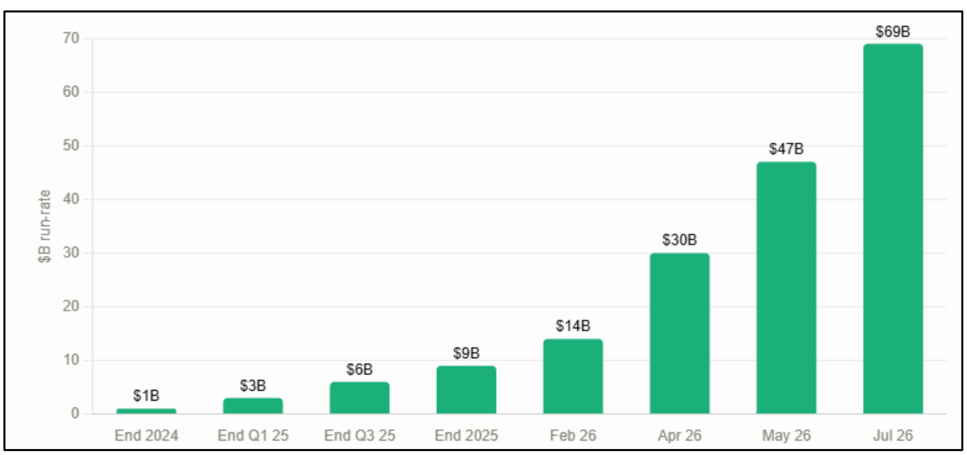
3600 136TH PL SE, SUITE 270, BELLEVUE WA 98006 | 425.453.5010 | WWW.FORTIS.CAPITAL

Semiconductor (SMH) vs. Magnificent 7 (MAGS)

Source: TradingView

The key issue of endless debate is whether the hyperscalers are actually going to see positive returns on all of their capex (now rumored to reach over $1 trillion in 2027). In our view, which has been confirmed publicly by hyperscaler management teams, the capital being deployed today will ultimately be rewarded by profits, which we believe the market will reward with higher stock prices. Berkshire Hathaway's decision to build a $31 billion stake in Alphabet, including a $10 billion private placement last month, lends further credibility to the thesis that hyperscaler capex should ultimately generate returns well above the cost of capital. Buffett has articulated a similar framework, evaluating AI infrastructure spending not on whether it looks expensive today, but on whether it produces sustained returns on capital meaningfully above risk-free rates over a long horizon. This is further demonstrated by the massive growth in revenue by Anthropic and OpenAI.

Anthropic Annualized Run-Rate Revenue



Source: Company statements via VentureBeat

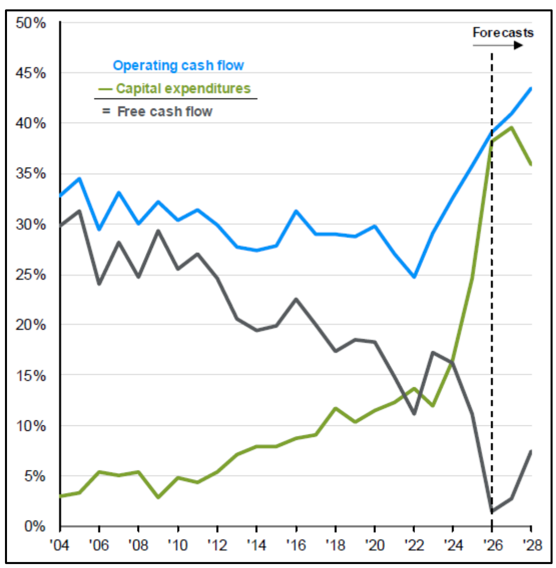
They have end customers that see substantial value in paying for their models, which require the compute capacity provided by AWS, Azure and GCP (and are still compute constrained at this point). This means the hyperscaler businesses are largely analogous to Visa/Mastercard rails, acting as the transaction network layer, which will take a toll on all future AI token spend. Regardless of which frontier models eventually win out (or even if open-source models ultimately rule the day), every end customer needs compute to process their AI requests, and the hyperscalers are some of the only parties that own this scarce resource. Given these businesses are now at some of the most attractive valuations in a decade, we believe the risk/reward in large cap tech is very favorable today despite the way the prevailing media loves to trumpet tech as being expensive.

2yr Forward P/E Multiple for MSFT / AMZN / META / NVDA

Source: Bloomberg

With regards to how the capex is funded, our observations shared in prior letters remain unchanged: this cycle remains largely self-funded. The hyperscalers' capital expenditures have surged to nearly 40% of sales, compressing free cash flow to near zero for the first time in two decades. However, that spending is being paid for out of the operating cash flow of the best businesses ever created, not with borrowed money.

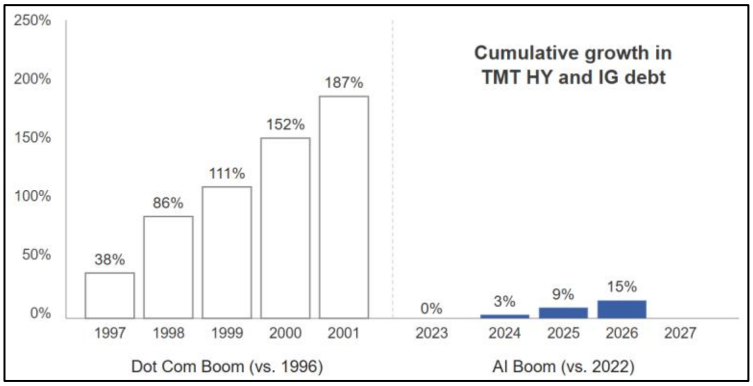
Hyperscalers' Cash Flow and Capex (% of Revenue)



Source: J.P. Morgan Asset Management

Tech debt has grown a cumulative 15% this cycle versus 187% at the equivalent point of the dot-com boom, an order of magnitude smaller. We wrote in our Q4 letter that the "debt phase" was only starting, and that remains true. The absolute quantity of debt issuance by the tech industry has grown, but relative to revenue and the overall capital base, the buildout remains comparatively self-funded, which reduces the tail risk of a credit-driven unwind even if equity valuations correct.

Cumulative Growth in TMT HY and IG Debt



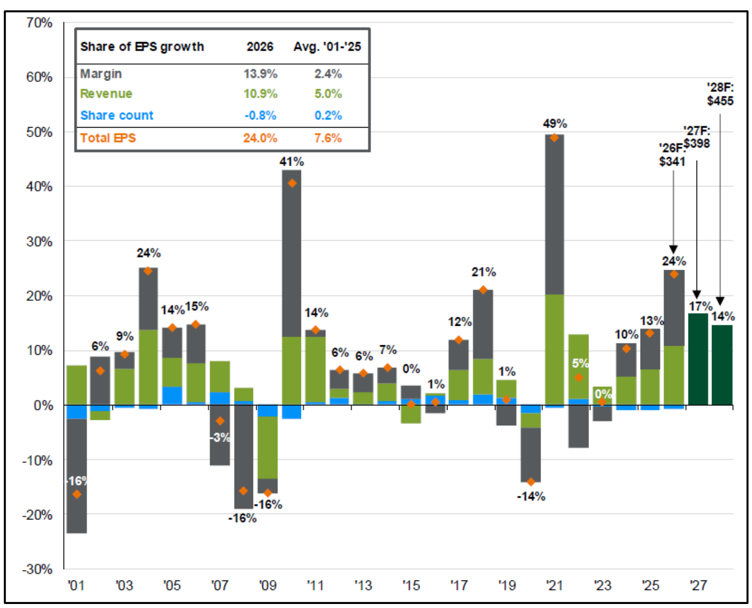
Source: Goldman Sachs

Nevertheless, the AI capex cycle has become the market's swing factor, and crowded positioning is the accelerant to material moves in both directions. However, narrative trades eventually mature into financial trades, and when they do, businesses get valued on durable earnings rather than on hype. As the market transitions to better understanding the ROI that hyperscalers are getting, we expect capital to rotate out of the more speculative areas of the buildout and back into the highest quality companies. Our focus remains on owning the companies that can turn customer demand into lasting recurring revenue and earnings, not only in tech and AI but across the rest of the sectors of the market as well.

The Bar is High for Earnings Expectations

One word of caution though. While the valuations, particularly across many of the largest constituents of the S&P500, are not demanding, we do worry that analyst earnings estimates are beginning to get a little ahead of their skis. Q2 earnings are expected to be the strongest earnings growth in decades outside of the post-COVID and GFC recession recovery (which was really just earnings getting back to where they were before a large downturn).

S&P 500 EPS YoY Growth



Source: J.P. Morgan Asset Management

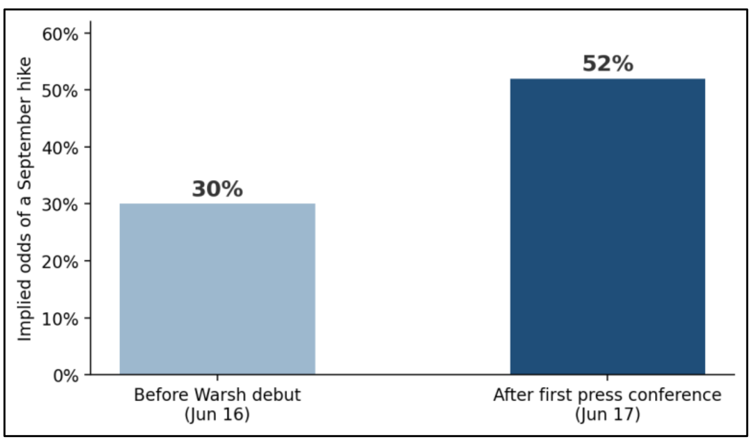
Everyone knows earnings are going to be strong, the question is whether analysts are beginning to expect too much. We saw this in June with Micron earnings as an example. Micron released what was potentially the best quarterly report we have ever seen and after an initial pop in the stock price it quickly sold off because investors wanted even more. We will see as Q2 earnings reports begin to roll in, but the bar is fairly high. We view this risk not necessarily as a long-term risk to the market but as a shorter-term risk that could cause certain areas of the market to pause their upward trajectory and consolidate as new expectations get digested. This is healthy and may present great entry opportunities for new capital.

A New Fed Chair

The other significant change this quarter came from the Federal Reserve. Kevin Warsh chaired his first FOMC meeting on June 17 and immediately reshaped how the institution communicates. The post-meeting statement ran just 130 words, less than half the length of the prior meeting's under Powell. He declined to submit his own rate projection (the dot plot showed 18 dots instead of the usual 19), consistent with his long-running critique of the Fed's forecasting record. He launched five task forces covering communication, the balance sheet, data sources, productivity and AI, and the inflation framework. His mantra: more thinking, less talking.

The committee held rates at 3.50-3.75%, but Warsh pledged to restore price stability "unambiguously and unanimously," noting the Fed has "missed for five years." With the Iran shock still working through energy prices, the market repriced quickly. We came into 2026 with markets assigning a 98% probability to one or more rate cuts this year. Following his first press conference, the implied odds of a September rate hike moved from roughly 30% to over 50%.

Market-Implied Odds of a September 2026 Rate Hike

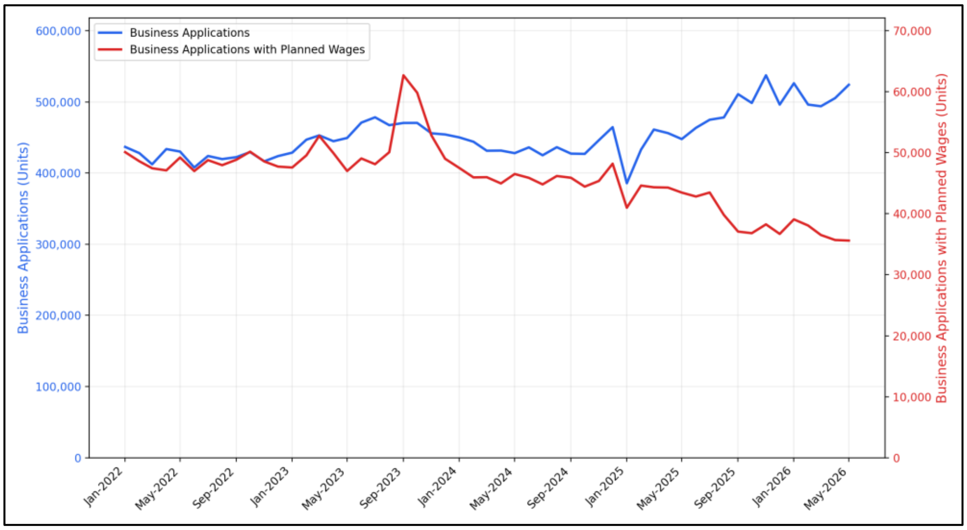


Source: CME FedWatch

Kevin Warsh served as a Fed Governor from 2006 to 2011 and was Chairman Bernanke's liaison to Wall Street during the financial crisis, before leaving the Fed in 2011 largely over his skepticism of quantitative easing. He has long been critical of the size of the Fed's balance sheet and the volume of its communication. Under Warsh, we can likely expect balance sheet runoff. Higher-for-longer US rates, rising real yields and AI-driven capital inflows have speculative dollar longs at multi-month highs and the dollar breaking out. Our view is to position for higher-for-longer, budget for more volatility around economic data, and treat anything dovish as a pleasant surprise. While we are cautiously monitoring whether this may in fact represent a wholesale regime change at the Fed, at the current time we lean towards Warsh likely being more bark than bite.

In regards to the employment side of the Fed's mandate, there is tangible evidence that grassroots demand is emerging in the real economy. As we have been saying for months, AI should lead to an explosion in entrepreneurship as the gap between ideation and execution gets narrowed significantly. We can see this playing out already as new business formation is surging. Since the launch of ChatGPT, total business applications have climbed to record levels. However, it's notable that application with planned wages (i.e., employees) have declined, likely meaning it is a wave of AI-native businesses being formed to do more with fewer people. Connecting back to the hyperscaler theme though, these are the companies that will provide the direct demand pull-through for a meaningful portion of the compute being built.

U.S. Business Applications vs. Business Applications with Planned Wages



Source: Census Bureau, Business Formation Statistics

Positioning

Putting the two themes together, we have an AI trade that is maturing from being driven by narrative to financials, and a Fed providing less transparency. Both point in the same direction: more dispersion, more single-headline volatility, and a bigger premium on owning businesses with real earnings power. In portfolios, we favor the AI value chain where ROI is visible and less speculative, we still see energy equities as under-reflecting a structurally higher oil price regime, and we see the software dispersion we wrote about in January beginning to resolve in favor of the companies proving they can upsell AI.

Conclusion

Transitions are rarely comfortable, but this is the transition long-term investors should want: the AI trade being forced to prove itself in revenue, margins and cash flow, and a central bank determined to restore its inflation credibility. Both will create volatility along the way, but both ultimately reward the same thing we have always focused on: owning the best businesses over the long haul and letting them do the work for us.

As always, we are available at your convenience.

Regards,

Your Fortis Team

Disclaimer: The views and opinions expressed in this quarterly letter are those of Fortis Financial Group ("the firm"), which is a wholly owned subsidiary of Fortis Holdings LLC. Portions of this letter may contain certain statements relating to future results regarding companies we may invest in which are forward-looking statements. These statements are not historical facts, but instead represent only our belief regarding future events, many of which, by their nature, are inherently uncertain and outside of our control. Such forward-looking statements are made pursuant to the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995.

Forward-looking statements are subject to market, operating and economic risks and uncertainties that may cause our actual results in future periods to be materially different from any future performance suggested herein. Factors that may cause such differences include, among others: increased competition, increased costs, changes in general market conditions, changes in industry trends, changes in the regulatory environment, changes in loan relationships or sources of financing, changes in management, and changes in information systems and technology.

The firm will not publicly update or correct any forward-looking statements to reflect events or circumstances that subsequently occur or of which we hereafter become aware.

This letter should not be considered an offering or solicitation to invest with the firm. Ideas and views expressed within are not recommendations to buy or sell any securities. Past performance is not necessarily representative of future results. The investment strategy of the firm is not designed to resemble returns generated by the S&P 500 or any other index mentioned herein, and strategy volatility may be materially different from that of the indices.