

October 14, 2026

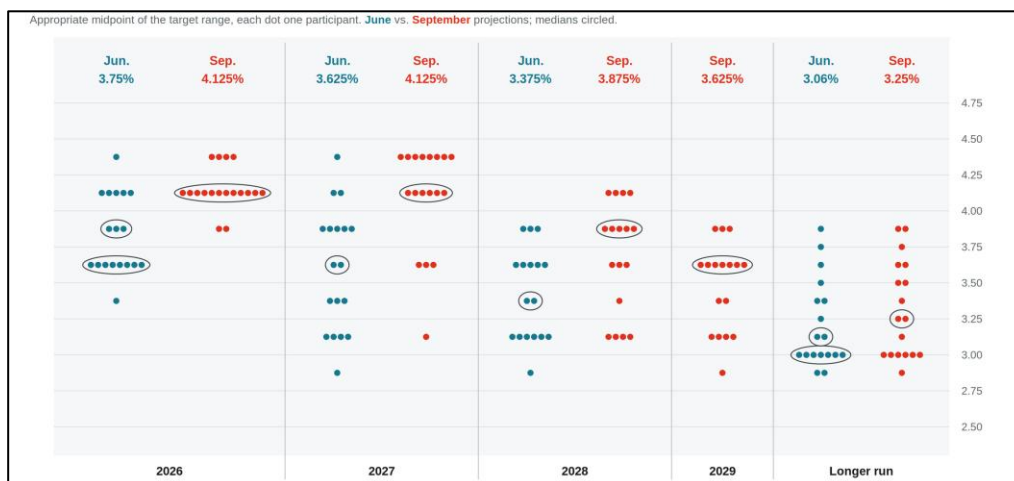
Dear Clients and Partners:

The S&P 500 gained about 2% in Q3 and set a new all-time high on October 6. However, the index does not tell the whole story. In July, the most crowded part of the AI trade went through one of the sharpest selloffs on record, and one of the best-known AI hedge funds was forced to sell its entire public stock portfolio. Meanwhile, the Fed raised rates for the first time since 2023 and the 10-year Treasury yield reached its highest level since 2002. The September CPI report, released on October 14, also came in hotter than expected and raised the odds of another rate hike at the Fed's October 27–28 meeting. This letter will focus on four areas: interest rates and where we see value in bonds, why the S&P 500's valuation has already corrected even though the index has largely traded sideways, investor positioning in the AI complex, and why we believe the AI buildout will last longer than the market expects.

Interest Rates and the Fed

In our last letter, we said our view was to position for higher-for-longer rates and to treat anything dovish as a pleasant surprise. We have kept bond duration very low vs. the aggregate for a very long time as we did not believe yields provided sufficient protections vs. the risk of capital loss. That positioning has served us well and has protected from most of this year's damage (and a lot of damage in prior years as well). After a hawkish speech at Jackson Hole in late August and a hot August inflation report, the Fed raised rates by a quarter point on September 16 to 3.75%–4.00%. It was the Fed's first rate hike since 2023 and the vote was unanimous. The Fed's median projection calls for one more hike this year and no cuts until 2028.

Fed Funds Rate Projections: June vs. September 2026 (%)



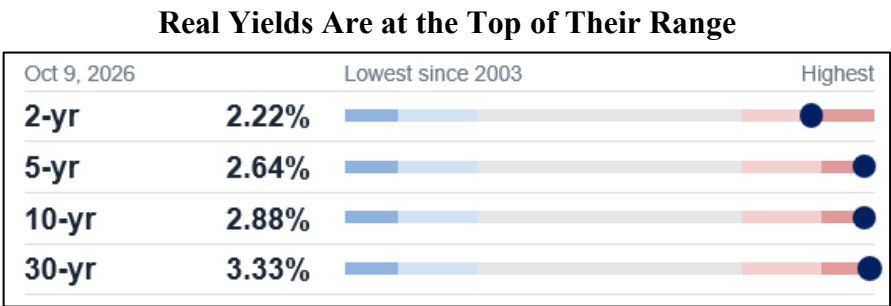
Source: Federal Reserve, Summary of Economic Projections; Fortis

The September CPI report, released on October 14, strengthened the case for another hike. Consumer prices rose 0.6% in September and 3.7% from a year earlier, slightly above expectations and the highest annual rate since May. Gasoline prices jumped 9.1% in the month and accounted for more than half of the increase. In our view, the more important detail was core inflation, which excludes food and energy. Core prices rose 0.3% for the second month in a row vs. expectations of 0.2%, bringing the annual rate to 2.6%. Over the three months through September, core inflation ran at a 3.4% annualized pace. Shelter, airfares, recreation and education were all higher, and several economists described the increase as broad-based rather than a one-off.

While inflation has dominated the headlines on rates, most of the move in yields has come from real yields (the return investors demand after inflation). The 10-year real yield, which is the yield on Treasury Inflation-Protected Securities (TIPS), climbed from about 1.9% in January to >2.8% in October, its highest level since 2008. Meanwhile, the market’s expectation for inflation over the next 10 years has remained around 2.3%. In other words, the rise in yields is mostly investors demanding a better real return, not a fear of runaway inflation. We see three forces pushing real yields higher:

- **Stronger economic growth.** A faster-growing economy raises the opportunity cost of capital.
- **Tariffs.** As tariffs shrink the trade deficit, fewer dollars flow abroad, and foreign buyers have less to reinvest in U.S. government debt.
- **Competition for long-term capital.** Goldman Sachs counts roughly \$500 billion of AI-related debt issued this year through September. Treasuries and the AI buildout are competing for the same pool of long-term savings.

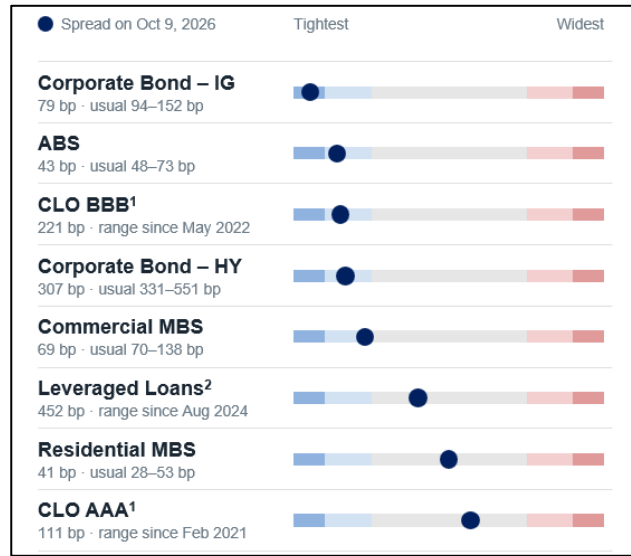
Real yields are now at the upper extreme of their range since 2003, which means that for the first time in two decades, high-quality bonds offer an attractive starting point.



Source: Bloomberg

The key question is where to take risk within fixed income. Credit spreads (the extra yield investors earn for lending to companies instead of the government) are near their tightest levels in decades for investment-grade bonds and well below normal for high-yield bonds. In other words, investors are being paid very little to take credit risk at the same time that AI-related borrowing is surging and the Fed is tightening, while Treasury yields are near the top of their 20-year range. We would rather own duration than credit, and our preferred way to own duration is through TIPS.

Where Credit Spreads Sit vs. Their Range Since 2003



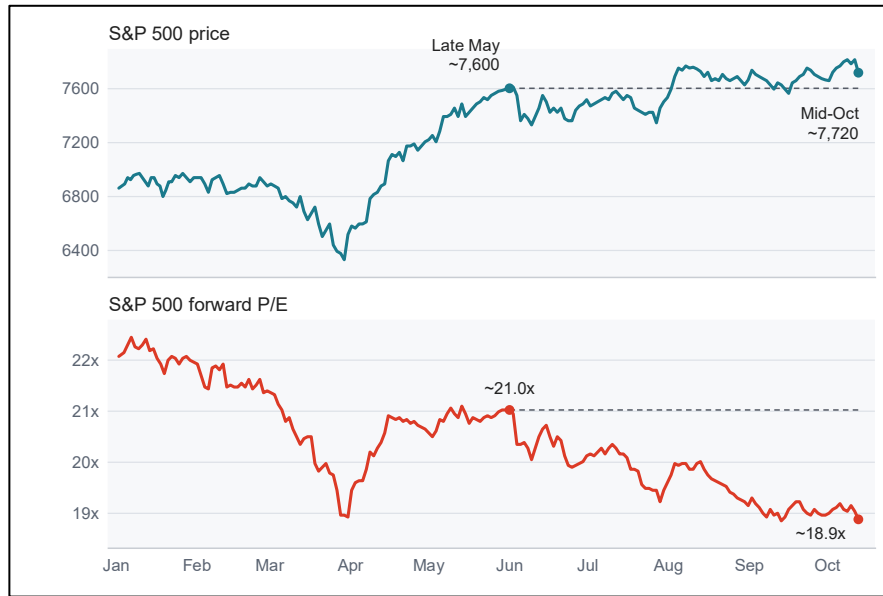
Source: Bloomberg

TIPS pay a fixed real yield (close to 3% on longer maturities) plus whatever inflation turns out to be, and they are backed by the U.S. government. A TIPS will outperform a regular Treasury of the same maturity if inflation averages more than about 2.3% over the life of the bond. That is a fairly low hurdle with consumer prices up 3.7% over the 12 months through September. Hot inflation reports like September's work in favor of TIPS holders, because the principal of TIPS are adjusted for changes in the CPI (with a short lag), while the fixed payments on a regular Treasury simply lose purchasing power. We think of TIPS today as inflation insurance bought at a discount, with the highest real yields in nearly two decades. Longer-dated TIPS would also benefit if growth slows and real yields fall. For income portfolios, we are looking to add TIPS across a range of maturities, complemented by high-quality, short-duration income and diversifying alternatives.

S&P 500 Has Corrected Through Time

While the S&P 500 has largely traded in a sideways range since late May, a correction in valuation has already taken place. It set a new record close on October 6, but that was only a few percent above its late-May level. Over the same period, its forward P/E fell from about 21x in late May to roughly 19x in early October, a decline of about 10%. How can valuations fall while prices move sideways? The answer is earnings. S&P 500 earnings are expected to grow about 32% this year, and Q3 earnings are expected to be up nearly 30% from a year earlier. In our July letter, we cautioned that the bar for earnings was high and that certain areas of the market could pause and consolidate while new expectations were digested. That is largely what happened. **The market has been correcting through time rather than through price**, meaning earnings have been catching up to prices instead of prices falling. As a result, the index is on firmer valuation footing than when we last wrote.

S&P 500 Price and Forward P/E, 2026



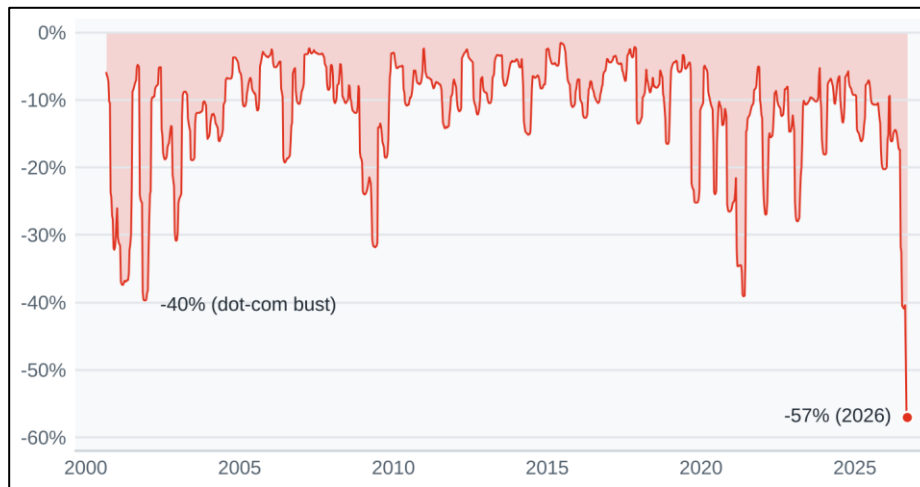
Source: Bloomberg; forward P/E on 12-month estimates, January to mid-October 2026

However, a record high for the index does not mean most stocks are at record highs. According to Morgan Stanley, as of early October, 89% of the stocks in the Russell 3000 had pulled back more than 10% since June 1, and 54% had pulled back more than 20%. In Q3, the equal-weighted S&P 500, which gives every company the same weight, fell about 2% while the regular market-cap-weighted index rose about 2%. The reason the index has stayed so calm while so many stocks have struggled is correlation, which measures how closely stocks move together. As we noted in our Q2 strategy update, the correlation between individual S&P 500 stocks and the index has fallen roughly 43% since 2023. As of October 12, options markets were pricing one-month correlation among S&P 500 stocks at the lowest level since at least 2006, according to Citadel Securities, and the S&P 500 had not had a 2% daily move, up or down, since June 5.

Volatility in AI Stocks

In our Q3 2026 letter published in July, we wrote that “crowded positioning is the accelerant to material moves in both directions.” Within two weeks of that letter, we saw exactly that. From their June highs through July 29, the Philadelphia Semiconductor Index (SOX) fell 29%, the Nasdaq-100 fell about 11% and the most volatile momentum stocks fell roughly 50%. The momentum factor (a strategy of owning recent winners and shorting recent losers) had its worst four-day decline on record, worse than anything during the dot-com bust, 2022 or COVID. Jefferies’ measure of tech momentum fell 57% over a rolling 60-day window, a deeper drawdown than in 2000.

Tech Momentum: Rolling 60-Day Drawdown



Source: Jefferies Trading Desk, through mid-September 2026

During this episode, a relatively obscure hedge fund, Situational Awareness, founded by Leopold Aschenbrenner, a former OpenAI researcher, made headlines. The fund reportedly grew to tens of billions of dollars in size in a relatively short period of time through concentrated bets in AI “picks and shovels” (power, memory chips, neoclouds and data center developers). It also reportedly ran gross leverage of nearly 4x. To put that in simple terms, the fund had roughly \$4 of positions for every \$1 of its own capital, so a 25% loss on those positions would wipe out all of its capital. In July, its holdings fell between 27% and 54%. Needless to say, margin calls from its prime brokers followed. Before the market opened on July 30, the fund sold most of its public stock portfolio in a block sale, reportedly to Citadel. Many of the stocks it was forced to sell rallied 20% or more that same day. The lesson is that leveraged speculation can turn an ordinary pullback into a violent one, as forced sellers dump shares regardless of price or fundamentals. Those spikes in volatility say more about positioning than the fundamentals, and rather than signaling the end of the AI cycle, they have historically created generational buying opportunities in the companies best positioned to benefit from the AI buildout for years to come. The bouts of selling we have seen in recent weeks may well look like one of those windows in hindsight.

The Duration of the AI Cycle: Power and Land

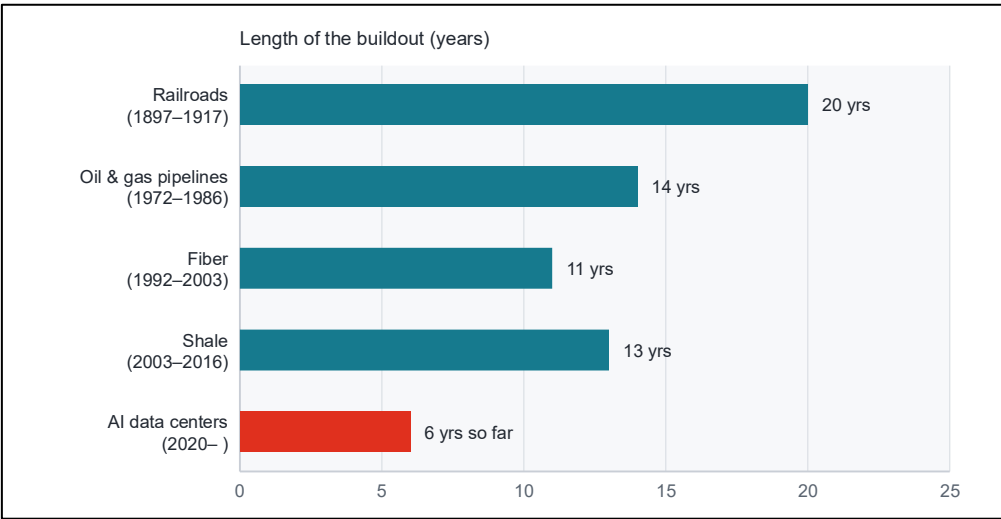
Taking a step back from the tactical and technical, as we think about the duration of this cycle and its longer-term bottlenecks, our view is that the AI buildout will last longer than the market expects. We believe the biggest barriers to accelerating the buildout are going to be power and land, and if those become even more of a bottleneck, it will only serve to extend the cycle.

Markets tend to treat capital spending booms as short cycles: a few years of heavy building, followed by overcapacity and a bust. Wall Street expectations reflect that thinking. Hyperscaler capex is expected to grow roughly 80% in 2026 to more than \$700 billion, and 2026 is widely seen as the peak year for growth (BofA, for example, expects growth to slow to about 38% in 2027). Memory chip makers earning operating margins above 70% are valued as though those margins are a cyclical peak. Just as important, the market fears the hyperscalers will run out of capital. Spending now outruns the cash their businesses generate, and they have turned to bond markets and even equity raises to fill the gap, which raises the prospect of more debt and more dilution.

In our view, today’s negative free cash flow reflects the lag between building data centers and collecting the revenue they produce, not a shortage of demand. We expect hyperscaler operating cash flow to accelerate sharply over the next two years as today’s capacity comes online, allowing them to self-fund more of the buildout than the market expects and reducing their need for new debt and equity. Much of that revenue is already under contract. As of June, cloud backlog stood at \$678 billion at Microsoft, \$514 billion at Google Cloud and \$496 billion at Amazon, up more than \$1 trillion combined in a year, and Alphabet expects to recognize about half of its backlog within 24 months. That revenue is also increasingly profitable, with Google Cloud’s operating margin rising from about 21% to nearly 36% over the past year.

History also suggests these cycles last longer than people expect. The great infrastructure buildouts of the past ran for 11 to 20 years: railroads from roughly 1897 to 1917, oil and gas pipelines from 1972 to 1986, fiber optics from 1992 to 2003 and shale from 2003 to 2016. At their peaks, those buildouts absorbed 1.4% to 2.1% of GDP. The AI data center buildout began around 2020 and only really accelerated after ChatGPT launched in late 2022. Coatue estimates that global AI data center investment will reach roughly 2.9% of U.S. GDP, more than any of the prior cycles.

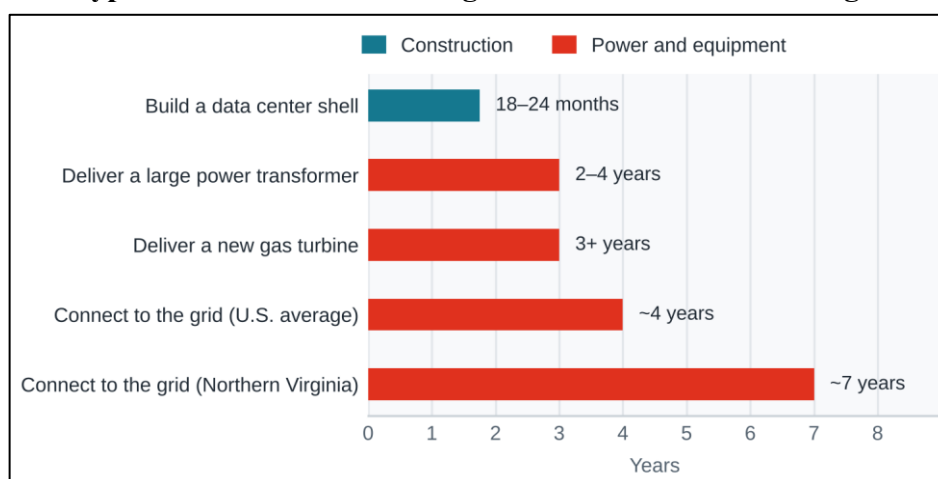
Past Infrastructure Buildouts: Length of the Buildout



Source: Coatue, Publics Update (October 2026)

More importantly, the main constraints on this cycle are physical rather than financial. The scarce input is no longer chips. It is electricity and the land to put it on. Microsoft CEO Satya Nadella acknowledged in late 2025 that the company could end up with “chips sitting in inventory that I can’t plug in.” Coatue describes the modern data center as a “token factory” whose raw inputs are land, grid connections, water and permits. As you can see in the chart below, putting up the building takes 18 to 24 months, while connecting it to the grid can take four to seven years.

Typical Lead Times: Building a Data Center vs. Powering It



Source: JLL; Siemens Energy; J.P. Morgan Asset Management; ConstructionOwners.com

Why does this matter for the length of the cycle? Capital spending cycles rarely end because demand disappears. They end because supply overshoots. The telecom bust of 2001 happened because carriers could lay fiber much faster than demand could grow into it. The difference in this cycle is that hyperscalers cannot build faster than they can secure power and land. As a result, spending that might otherwise have been crammed into two or three years is being spread out over many more. That keeps new capacity scarce, keeps utilization and pricing firm, and pushes out the overbuilding that typically marks the end of a cycle. If power and land become even more of a bottleneck, we believe the result will be a longer cycle, not a shorter one.

Another critical difference is that everyone knows about the busts of the past and talks about them constantly. This is reflected in the build-out by TSMC and the turbine providers such as GE Vernova. They could have expanded massively more than they did but they have kept their CAPEX build-out at much more reasonable levels. This likely extends the cycle as well as everyone is constrained by not only permitting, land, and power but the decisions of a few companies that have acted responsibly throughout.

Conclusion

The S&P 500 has largely traded sideways near its highs since late May, but a lot has happened underneath the index. Inflation picked up again in September, the Fed is raising rates, bond yields are near 20-year highs and the most crowded part of the AI trade went through a painful deleveraging in July and once again now in middle of October. There will be volatility along the way, but our focus remains on owning great businesses either directly or via funds and taking bond / credit duration only when/where it makes sense to do so.

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.