



An Unsteady Balance

Q3 2026

Bond yields spiked in the third quarter, pressuring most stock returns. Higher interest rates devalue future cash flows. The S&P 500 managed a 2% gain driven by a 17% move in the energy complex (Iran war) and a very strong rebound in software stocks, up 27%. The average S&P 500 stock was actually down 2% with small caps trailing badly, down 8%. The bond market sometimes calls the tune, and small caps are the most economically sensitive. As for the year-to-date, this remains one of the most powerful momentum markets on record with the beneficiaries of the datacenter spending boom far outpacing everything else. The S&P 500 is up just short of 12% with big contributions from tech and specifically semiconductors, up 28% and 44%, respectively.

Sick of hearing about AI? I'm growing weary of writing about it, but I'm afraid we're just getting started—so many nebulous topics, so much money. Should I write about the threat to civilization, or the political posturing? How funny—at least to me—seeing all the talking heads of AI flanking the president at their latest summit. How'd they choose the seating chart? Kinda embarrassing for the boys relegated to the ends. Regarding the meeting, I believe they agreed to avoid Armageddon. Well...that's a relief. I could try and write about the specifics of the latest models, but, honestly, I can't keep up and frankly the competition is more interesting. It's a little like the Odyssey...but longer and lacking a hero. Claude (Anthropic) slew Chat (OpenAI) who slew Gemini (Alphabet) and then all were bewitched by Muse (Meta). Muse will almost certainly be bested. More cool names and intrigue are coming and more powerful models too, given the extreme amount of investment committed. So, I should probably try and get a little more serious about this, because it is serious.

The most recent quarterly updates from the AI spenders and beneficiaries guarantees even greater spending in 2027 than in 2026, but there was less specificity and the growth is most likely slowing. Where once the hyperscalers (AMZN, GOOG, MSFT, META, ORCL) boldly raised the ante, they're not beating their chests so loudly now. There's genuine worry about the return on this gargantuan investment, as evidenced by their stalled stock prices and increasing borrowing costs. And let's be clear: we still don't know enough about the economics of AI given the primary model providers (OpenAI and Anthropic) are still private companies. What's certain is that AI's future better be bright.

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By definition, an investment that takes time to mature will have to realize its potential in the future. Investors and corporations are placing an enormous financial bet today that AI will eventually pay for itself. Every time the AI builders raise the stakes, they're very likely moving that payoff further into the future and increasing the risk that something unforeseen interferes. As Warren Buffett famously said: "Forecasts may tell you a great deal about the forecaster, they tell you nothing about the future." I have no doubt that AI will gradually weave itself into our lives, just like the internet has. But this will take time and follow an unpredictable path. The scale of the AI investment boom screams certainty; history whispers caution.

I'd love to end this piece not talking about the bond market, but like high blood pressure it needs to be addressed. Bond yields, which had been creeping up across the curve all year, spiked in the third quarter. The 10-Year US Govt yield reached over 5.2%, something it hadn't done in twenty years. Japanese and European bond markets followed similar, if not more concerning, paths. Part of this is demand for credit (primarily profligate, intractable deficit spending), part of it is inflation, and part of it is investors moving money around. No fancy AI model can tell you how much was for this reason or that. In any case, this is coarse sand in the gears of the U.S. and global economies. What's offset the interest rate drag is the positive wealth effects on consumer spending from years of strong stock market returns and the brute force of AI capital spending. It's anyone's guess how long this equilibrium will hold, but the bond market will have the final say, as it always has. And what about my guess, you might be thinking? It feels like yields want to push higher until the momentum stock trade is broken. This would be entirely normal--healthy even--and impossible to time with any accuracy.



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