

The Best of Us

Weekender

October 3, 2026

The man who can walk away from what he desires for the sake of what he must become, is a man no one can own.

Epictetus

When you fear something, learn as much about it as you can. Knowledge conquers fear.

Edmund Burke

The child who is not embraced by the village will burn it down to feel its warmth.

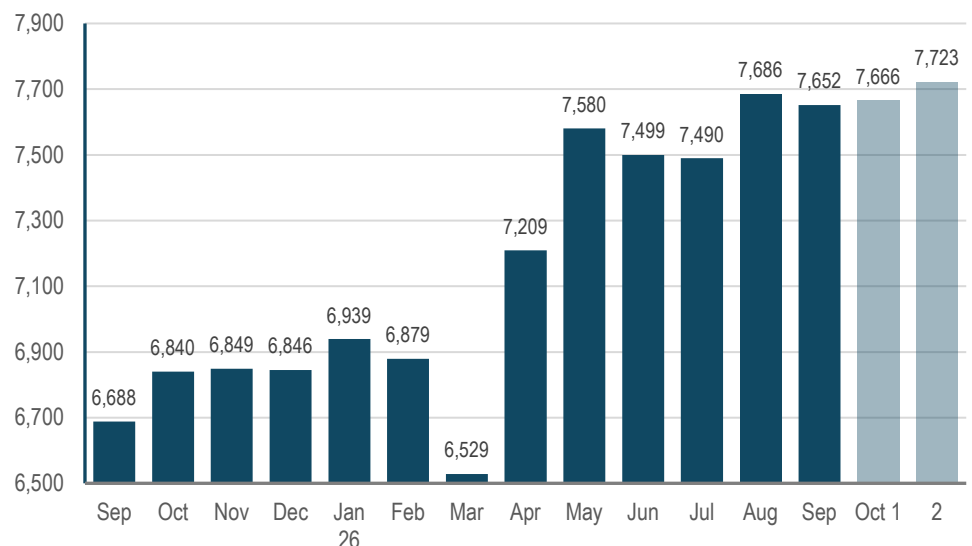
African Proverb

Good morning and welcome to the Weekender for Saturday, October 3, 2026. Equity markets, as measured by the S&P 500 index, were slightly lower by -0.3%, while the Nasdaq rose 0.5% and the Nasdaq 100 hit a record, up 0.7%.

Most weeks, our *Weekender* tells the story of the tape, which we hope is more than regurgitating news. Instead, our *Weekender* provides, in summary terms, analysis that drives our investment decisions. We try to steer clear of discrete recommendations to avoid the edges of regulatory constraints.

S&P 500 Index Levels

(Source: Bloomberg)



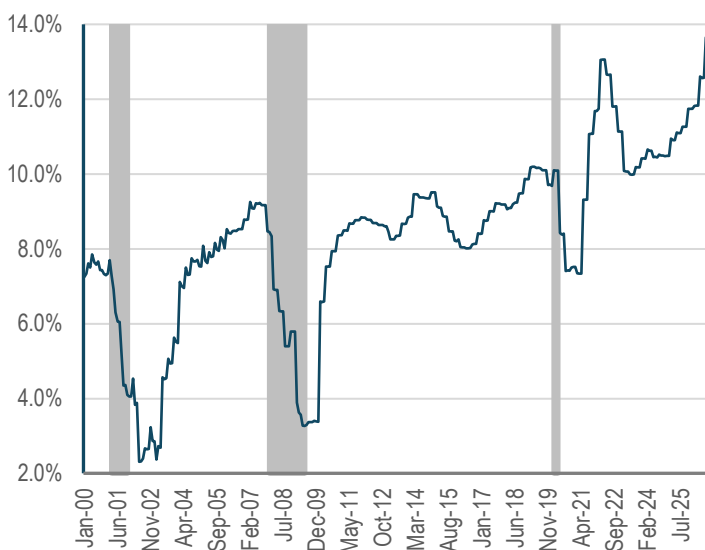
Over the past two months, cobbling together a cohesive narrative from data and expectations has proven elusive. As we prepare our positioning for the new year, this week's Weekender will provide summary answers to eight questions we believe are crucial to understand as we position for the next year and beyond. We will answer four questions in this *Weekender* and will respond to the remaining four in the next publication. Together, these questions are essential to position portfolios appropriately for the months and years ahead.

The S&P 500 is up roughly 12.8% for the year, and corporate earnings for index members are growing at a pace not seen since the post-pandemic rebound. In the last quarter alone, aggregate earnings for S&P 500 members were up 53.1% on sales growth of only 15.5%, both compared to the same period in the previous year. By any temporal comparison, sales growth was strong, and earnings growth was stunning. When earnings grow much faster than revenues, it signals margin expansion, which typically comes during strong economic recoveries after recessions. This time is different. Margin expansion has come from the insatiable demand for artificial intelligence infrastructure.

Net Margin for S&P 500 Members

January 2000 to September 2026

(Source: Bloomberg)

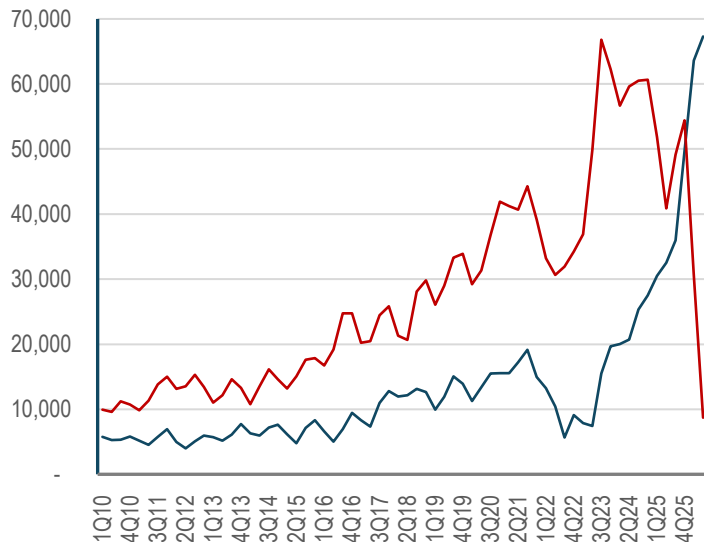


While any real detail is impossible, many market and economic pundits suggest that without artificial intelligence, the US economy would be sputtering. Demand for semiconductors exceeds supply, giving chip companies pricing power and driving record free cash flow. On the other side of the trade, hyperscalers are spending trillions of dollars investing in data center capacity to slake the thirst of artificial intelligence. Their free cash flow is crashing as investment demands empty their once copious coffers. It is impossible to know precisely how this all ends.

Hyperscaler (Red) and Semiconductor (Blue) Free Cash Flow

1Q 2010 to 2Q 2026

(Source: Bloomberg)



We believe artificial intelligence tools will keep improving, eventually eliminating hallucinations and becoming deeply ingrained in our everyday lives. But the economics of artificial intelligence will become increasingly challenging. Revenues will not be able to support the capital demands as token prices continue to fall amid competition, resulting in a wrenching reckoning at some point on the horizon.

On the fixed income side, Treasuries just suffered their worst quarter since 1994; the 10-year touched 5.34% this week, Brent crude is back above \$100, and credit spreads have begun to widen at the weak end. Those facts are not contradictory. They all support a singular narrative—the economy and corporate profits remain strong, but the price of money has changed.

Questions and “Answers”

Everything that follows in this *Weekender* summarizes our own internal musings. Our portfolio management team meets daily to address questions about markets, economics, and company fundamentals. As we prepare for potential changes as we head into the end of the year, we have concluded that knowing the answers to eight questions is critical. A summary of the answers to four of those questions is included in this *Weekender*. In the next *Weekender*, we will address the final four. If you have questions you think we missed, email me at cary@keelerthomas.com, and we will add them to our list. This *Weekender* does not intend to give investment advice. Your allocation should vary with your circumstances, risk tolerance, and planning profile. To this end, please consult a qualified financial advisor before making financial decisions.

1. What do widening spreads mean for fixed income and equities, and how do we balance them against stretched valuations?

A spread is the extra yield a borrower pays over the yield of a US Treasury of similar maturity. US government debt, don't laugh, is considered to be risk-free. It serves as the global benchmark for the return an investor should receive for taking on no risk. All other issuers carry some degree of risk, so their yields should be higher than the risk-free rate. The gap between the yield of the government bond and a riskier credit is called the yield spread.

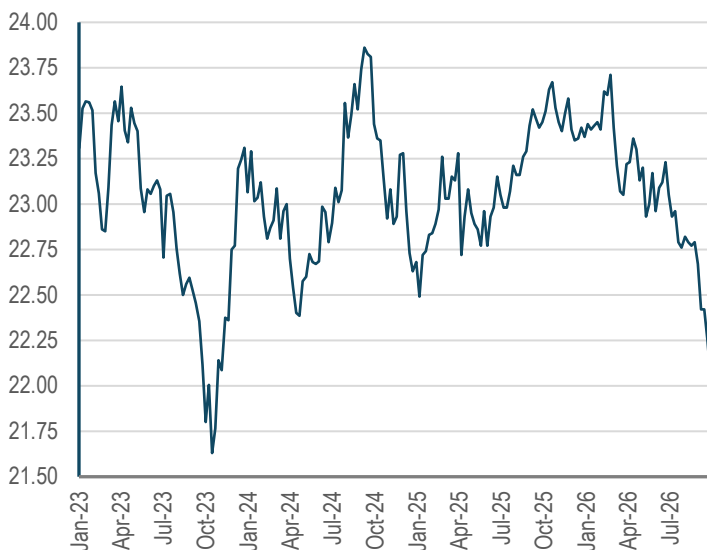
When yield spreads are tight, close to the risk-free rate, markets see little additional risk in owning fixed-income alternatives to the US government bond. In times of high liquidity, yield spreads are also tight because more money chases fewer yield-generating investment alternatives. Spreads begin to widen when risk perception heightens. Yield spreads matter right now because two things are happening at once. Treasury yields, the risk-free rate, have surged, and credit spreads, which have been very tight for years, are widening quickly. When widening happens quickly, major fixed-income traders call it a blowout.

Treasury yields are rising because inflation hasn't been tamed and credit supply exceeds demand, which reduces bond prices and increases yields. It doesn't help that the creditworthiness of U.S. government bonds is being called into question because of the burden of higher budget deficits and refinancing short-term bonds as they come due at much higher rates than when issued. Credit spreads are widening because investors perceive heightened risk on the part of the issuers, many of which are hyperscalers involved in an investment land grab for data center capacity.

Schwab US Bond Fund

1Q 2023 to 2Q 2026

(Source: Bloomberg)



For fixed income, the relationship is somewhat intuitive. Higher rates bring lower bond prices. Higher spreads bring lower bond prices. Consequently, from a total-return perspective, bond prices have been falling since the end of February. Investors who expect inflation to remain tight or spreads to continue to widen from here are selling. For investors looking for income return, it's a pretty good time to buy. It's been decades since government yields were this high.

Spreads on high-yield bonds, generally considered to be relatively risky debt, currently sit near 3.0% compared to the mid-2000s a month ago. They are still well below the long-run average near 5.0%. Investment grade has barely moved. The damage is in the tail: CCC-rated debt widened roughly 131 basis points over the past month against about 5 for BBB. The weakest borrowers are being repriced first, and a large share of this year's leveraged-finance issuance has been AI-related. Lenders are finally asking what the asset earns before the capex is spent. Spreads are a warning light, not yet a fire alarm.

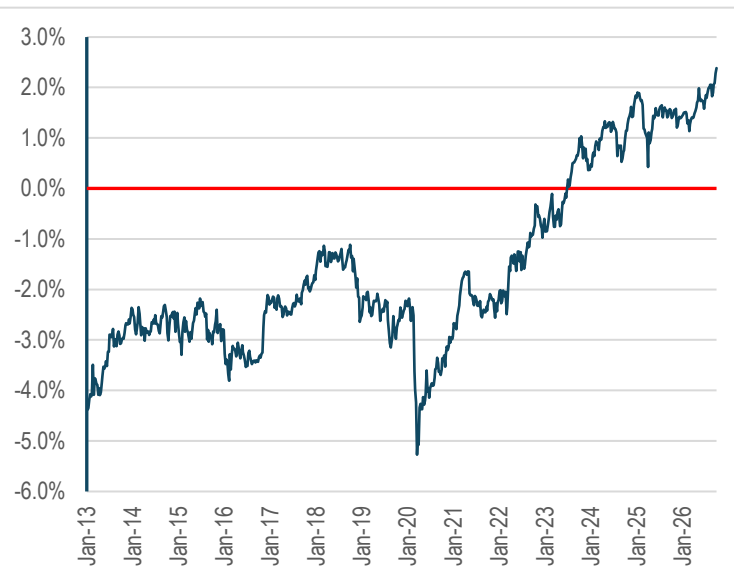
For fixed income, widening hurts the bonds you own and improves the entry point on the bonds you have not bought. All-in yields, about 5.4% in investment grade and 7.2% in high yield, are near the top of their one-year ranges. The income is real; the spread cushion is thin. You are being paid to own credit, not to reach for the riskiest credit.

For equities, spreads are the canary in the coal mine. Credit tends to crack before stocks do, and high yield has weakened while the S&P has held up. That divergence doesn't last forever; it resolves either as credit calms down or equities fall. Meanwhile, a Treasury above 5% is a legitimate competitor to stocks at 25 to 30 times earnings. You can compare bond yields to free cash flow yield. The excess yield of the no-risk US Government 10-Year bond yield has

10-Year Yield Minus S&P 500 Free Cash Flow Yield

January 2013 to September 2026

(Source: Bloomberg)



not been higher than it is today, suggesting bonds are more valuable than stocks relative to their risk.

We believe the blow-out in yields relative to the US Treasury is nothing more than a return to normal, not a harbinger of catastrophe. The adage for commodity prices goes something like, “the cure for high commodity prices is high commodity prices.” The same is true for interest rates. But for the last four years, investors have mostly ignored company fundamentals as the amorphous, unquantifiable future of artificial intelligence danced like sugar plums in their dreams. The most important part of yield spreads blowing out to normal is the prospect that similar discrimination will return to equity markets, where fundamentals will again determine value, which leads us to the next question.

2. Is the incredible AI-driven earnings growth of the last few years durable into the future?

To suggest that equities are richly valued would be tantamount to whistling past the graveyard. Certainly they are. But if the miracle of artificial intelligence yields forth a world where everyone works two days per week and plays the rest, then who cares. But maybe equities are not as expensive as we think. This is the strongest argument the bulls have, and it deserves respect. As we mentioned before, aggregate earnings growth for S&P 500 members is phenomenal. If such performance continues for a couple of years, stocks today would be considered a bargain. However, if this year represents the best things will ever get, then valuations are rich, and a market about-face is all but guaranteed. Three things underpin the durability argument.

First is concentration. Roughly half of the S&P 500’s aggregate earnings come from AI infrastructure. If you removed them from the index, earnings growth would be tepid at best. So the question of whether earnings are durable comes down to a narrower question of whether AI infrastructure is durable. Full stop. Second is energy gains. Crude and other energy prices, driven by geopolitical distress, are, with AI, driving broad aggregate earnings growth among index members. Any resolution of the current conflict would be great for consumers but take the wind out of the sails of energy earnings. Third is peak margins, which we discussed a bit at the opening of this Weekender. Peak margins are driven by two factors: incomplete reconciliation of tariff uncertainty and demand-supply imbalances in the primary and secondary value chains of artificial intelligence. The fix for high margins is economic softness, where supply exceeds demand and forces discounts that erode margins.

We believe concentration is not an outcome but an observation. Given hyperscalers’ and others’ commitment to investment spending, we expect concentration to remain high and likely increase before it cools to historical levels. A buyer strike in the fixed income market is likely to be

the proximate cause of the decline, where investors refuse to keep funding the data center build-out without higher risk-adjusted yields. Energy is an unpredictable wild card. What is predictable is that if prices stay at current levels over the next year, there will be no real growth, so earnings growth in the energy sector will flatten out. Energy prices appreciably higher than their current level are likely to jeopardize economic growth and stability. Peak margins are a useful and reliable precursor to economic recession, making them more problematic than useful.

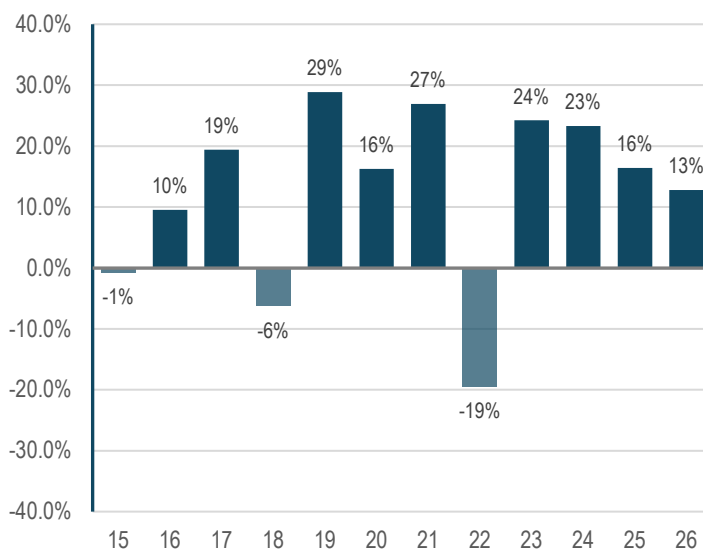
3. How do we protect portfolios in this environment — and where do we deploy?

For the last two years, a reliable market dynamic played out. If stocks wobbled, interest rates accommodated, and bonds cushioned the move. An energy shock, courtesy of the Iran War, flipped the Fed from expected cuts into a re-tightening cycle. The US ten-year bond yield has gone from 4.15% at the start of the year to above 5.3%. When stocks and bonds sell off together amid an inflation scare, duration stops acting as a shock absorber.

We believe protection is prudent. Why? Equity markets have generated remarkable returns over the past decade. From the beginning of 2015 to Friday’s close, the average annual return on the S&P 500 has been 11.8%. Compared to the long-term average of 8.5%, returns over the last decade have been remarkable. Why not keep all your chips on the table and let it roll?

Major booms are driven by at least one of four phenomena, all of which are prone to violent reversals: credit, government, technology, and real estate. We are in a unique position in financial market history: we are in the midst of dramatic excess in each area. To be candid, market excess

S&P 500 Annual Returns
January 2000 to September 2026
(Source: Bloomberg)



is rarely intractable. Instead, it is characterized by a type of “paying it forward,” where we receive unearned returns that must be normalized through a market correction before markets move forward.

Here are two approaches that can guide a prudent protection strategy.

Patience. Cash and short-term Treasuries that yield above 4% with no credit and duration risk are a legitimate holding, not a parking lot. Hold more than is fashionable and let the risk-free rate work for you. Beyond Treasuries, dip into investment-grade corporate bonds that are resilient in downturns. Focus on issuers that have pricing power, unit growth, and strong balance sheets.

Directness. Equity indices are concentrated in precisely the names likely to be hit hardest during economic retaliation. This is not a valuation concern alone. It’s also related to their business models that are so highly levered to AI infrastructure. Roughly 40% of S&P 500 companies are down on the year, and the equal-weight index badly lagged in September. Underneath the index, the dispersion is the opportunity. Add to businesses that earn their cost of capital in cash, have pricing power against an energy and wage shock, and do not need the capital markets this year. Do not add to the second derivative of the AI trade — the leveraged landlord of a data center whose tenant has not yet signed.

This type of protection will protect returns on the way down. As market recover, narrow expansions, which are the arrow of a recovery spear will pay for quality and punish leverage. Refuse to sell the bonds that just got cheaper to buy the stocks that have not. You do not have to predict the storm perfectly if the house is built correctly.

4. How fragile is real estate, and how do we feel about investing in financials?

Real estate is a broad category that includes residential, commercial, and industrial physical assets, as well as financial assets derived from those physical assets, like real estate investment trusts, mortgage-backed securities, bonds, debt, and more esoteric derivatives. Higher interest rates will always create turbulence in any asset group tied to financing. Real estate, broadly, is a prime example.

Residential real estate is caught between resilient prices and brutal affordability. The 30-year mortgage jumped to roughly 7.3% this week, the largest weekly increase in four years. Meanwhile, national home prices remain about 2.6% higher than a year ago. Homebuilder sentiment fell to 32 in September; the backlog of completed homes for sale is near levels last seen in 2009, and more builders are cutting prices and offering buydown interest rate incentives to attract buyers.

US Mortgage Rates

October 2025 to September 2026

(Source: Bloomberg)



High prices keep owners from selling, and higher rates keep buyers from buying. In the residential real estate market, volume suffers first, and the related businesses, originators, brokers, building-material suppliers, feel it long before nominal home values do.

Lumber Prices

September 2025 to September 2026

(Source: Bloomberg)



Commercial real estate has a different problem: refinancing. Values sit nearly 25% below their prior peak, CMBS delinquencies run around 7.85%, and a \$1.5 trillion wall of CRE loans matures through 2026 into 10 years above 5%. Cap-rate math works against valuations again. Office remains worst, but the stress is spreading to other leveraged property types. The one large exception is data centers —

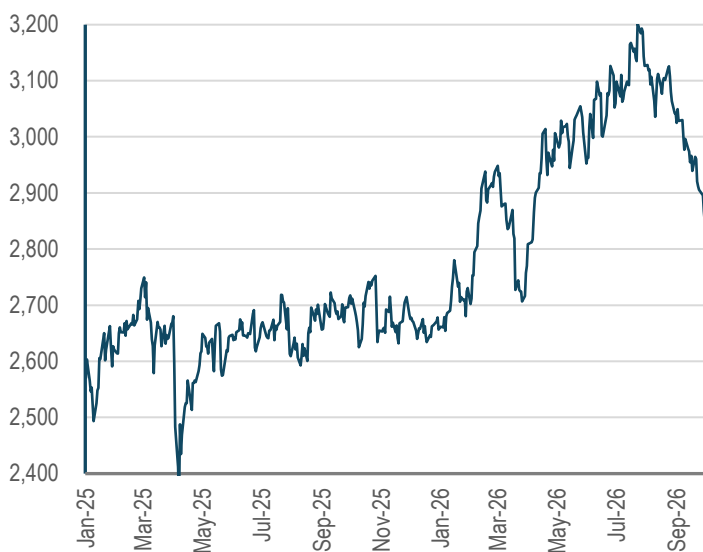
the construction market's offset and the credit market's new concentration.

Public REITs have at least marked some of this to market. The private marks have further to go, which is why we remain cautious on private-credit vehicles and BDCs heavy in real estate and sponsor-backed exposure. Office delinquencies are beginning to rise to levels not seen since 2009. The data likely underreports reality, since banks are incentivized to term out troubled office loans. Marquis properties are being pushed into the liquidation markets at pennies on the dollar. We remain very cautious on this sector and any direct exposure. Please be careful.

REIT Index

January 2025 to September 2026

(Source: Bloomberg)



Financials are not real estate, but they are the transmission mechanism for real estate assets. The exposure is concentrated, and concentration is what matters: CRE often exceeds half of loans at banks under \$10 billion, and more than 900 banks carry CRE above 300% of capital. That is where a real-estate problem becomes a financial problem. The large money-center banks, with diversified earnings and a steeper curve helping margins, are a different animal. We believe positions in money-center banks are a reasonable foundation of core equity holdings.

We do not believe opening new private credit positions is warranted. We would trim private credit as a matter of course, as we continue to expect further widening of credit spreads, and most private credit is far below investment grade. It's appropriate to own the lender only where the loan book is marked, and the funding is sticky. Own the property only where the cash yield exceeds the Treasury you could buy instead. Real estate's challenge is that structural changes in the commercial market have decreased demand, demographics are shifting away from areas that have

historically been in high demand, and money is increasingly more expensive.

One More Thing

In the spring of 1860, four men were running for president of the United States. One was a gangly prairie lawyer who, against all odds, won the sordid contest. William Seward of New York thought the Republican nomination was his by right. Salmon Chase of Ohio was certain he was the preferred candidate. Edward Bates of Missouri was the seasoned elder statesman. But the long-shot Abraham Lincoln prevailed. He believed the challenging times warranted the best minds in the country, so he filled his cabinet. When the long-shot Abraham Lincoln won instead, he did something no one expected. He surrounded himself with the very rivals who he ran against.

Seward became his Secretary of State, Chase the Secretary of the Treasury, and Bates his Attorney General. Then, as Secretary of War, he added Edwin Stanton, who had, years earlier, humiliated Lincoln to his face as legal adversaries, calling him a backwoods nobody and, by some accounts, a gorilla. Lincoln remembered the slight but gave Stanton the job anyway because Stanton was the best man for it.

In his view, the country was in peril, and he would not deprive it of its strongest men. As president at such a pivotal moment, he needed no comfort. He needed clarity of thought and persistence in action. A cabinet of allies would have ratified him. He chose a cabinet of rivals who would test him. Lincoln was once asked if he was worried that God was on his side. He responded that he was more worried about whether he was on God's side. This prominent introspection was one of his character traits. But once he decided on a course of action, his introspection ended, and resolution took over. Most leaders assemble a room of people likely to tell them how wise they are. Doers who will do as directed. Lincoln assembled a room full of people who could tell him he was wrong. Then he listened, tested the veracity of his ideas and opinions, made his own decisions, and took action.

Lincoln asked his advisors to write long memoranda, which he read and digested, then discarded what was not useful or relevant, along with any vanity. Seward, who had arrived intending to be prime minister to a figurehead, helped sharpen the language of the Emancipation Proclamation and watched as Lincoln kept the decision, and its timing, for himself. Chase built the financial architecture that funded the war, all while scheming for Lincoln's job; Lincoln kept him until the work was done, then named him Chief Justice of the United States, where his ambition could no longer reach the Treasury. Stanton reorganized a War Department that had been losing. Lincoln absorbed the competence and declined the contempt. It is hard to imag-

ine a cleaner example of separating a person's usefulness from their inconvenience.

His rivals' affection for Lincoln came much later. Seward, the rival who had expected to be President, wrote home to his wife that the President was the best of them, that there was no wiser man in the cabinet. And when the assassin's work ended his life, it was Stanton, the man who had once scorned him, standing at the bedside in tears, who gave us the sentence that has outlived every one of his earlier insults: *Now he belongs to the ages*. They did not grow to love him because he flattered them. They grew to love him because he was strong enough to use them without being captured by them, in a cause larger than their rivalry.

Another Lincoln relationship is worth setting beside the cabinet because it shows the same quality reaching across a far harder line. Frederick Douglass, who escaped from slavery, was considered the most powerful Black orator in America. For much of the Civil War, he was one of Lincoln's sharpest critics. He thought the President was too slow, too cautious, and too willing to weigh the politics of emancipation when the moral cause was clear. In August 1863, he walked into the White House without an appointment to protest the unequal pay and treatment of Black soldiers compared to their white counterparts. Lincoln received him, argued back, conceded less than Douglass wanted, but listened to him as his equal, which almost no powerful man of that era did with a Black man. Douglass left still disagreeing but deeply impressed.

Like the other rivals, Douglass took his own time to warm up to the president. The following summer, with the election in doubt, Lincoln summoned his critic and asked for his help. If peace came short of emancipation, Douglass was to organize a network to carry word behind Confederate lines so as many enslaved people as possible could reach freedom before the door closed. It is a remarkable thing to ask of a man who has been trying to defeat you. Douglass agreed.

Their last meeting was the simplest. At the reception after the second inaugural, in March 1865, Lincoln spotted him in the crowd after he had nearly been turned away at the door. He called out, in a voice the room could hear, "Here comes my friend Douglass." Then, with thousands waiting to shake his hand, the President asked his critic what he had thought of the address. Douglass tried to demur. Lincoln pressed. Douglass told him it had been a sacred effort, and Lincoln said no man in the country had an opinion he valued more.

Douglass never flattered him, not even in eulogy. Eleven years later, at the dedication of the Freedmen's Monument, he gave the most honest assessment anyone has offered: Lincoln was, in many ways, the white man's President. Slow where Douglass had wished him fast, measured where he had wished him bold. And yet, set against what

was possible, against the men around him and the country as it actually was, Lincoln had done more, and grown more, than any of them had a right to expect. That is not the tribute of a courtier. It is the tribute of a rival, and, in the end, the same verdict Seward and Stanton reached.

Lincoln's lesson to us is unburdened by complexity, which is perhaps why it is so seldom heeded. Real strength is secure enough to keep abler people close. Wisdom learns from the ones who doubt you. The surest sign of great character is that the people who started as its critics end as adherents. Remember that the measure of one's life is not the weight of loyal friends by journey's end. It is the lightness of being that comes from extending grace and goodness to critics, family, and friends as a matter of course, in pursuit of a cause that so significantly outweighs our petty grievances and hubris.

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