



Charts and Smarts®

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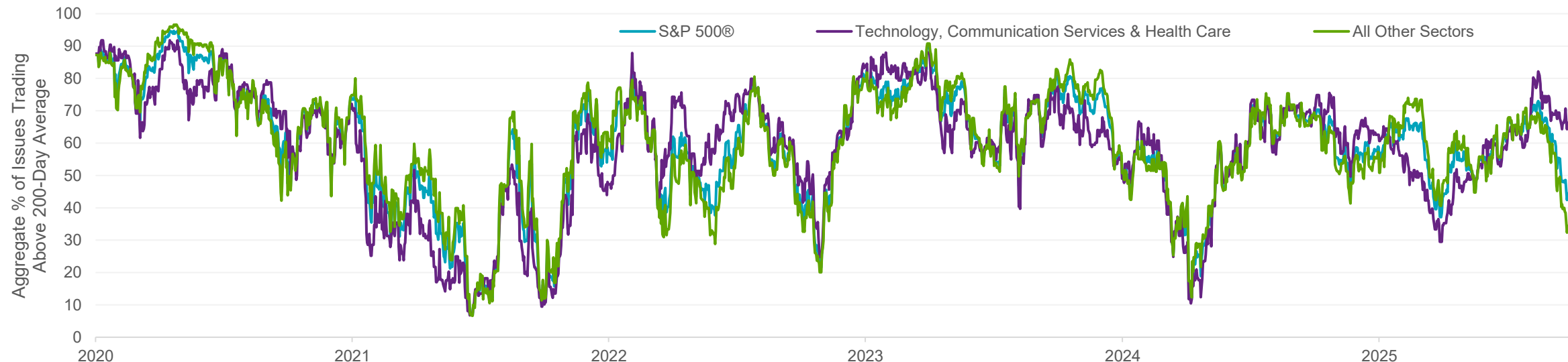
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The Bear

S&P 500® breadth (12/31/20–10/9/26)

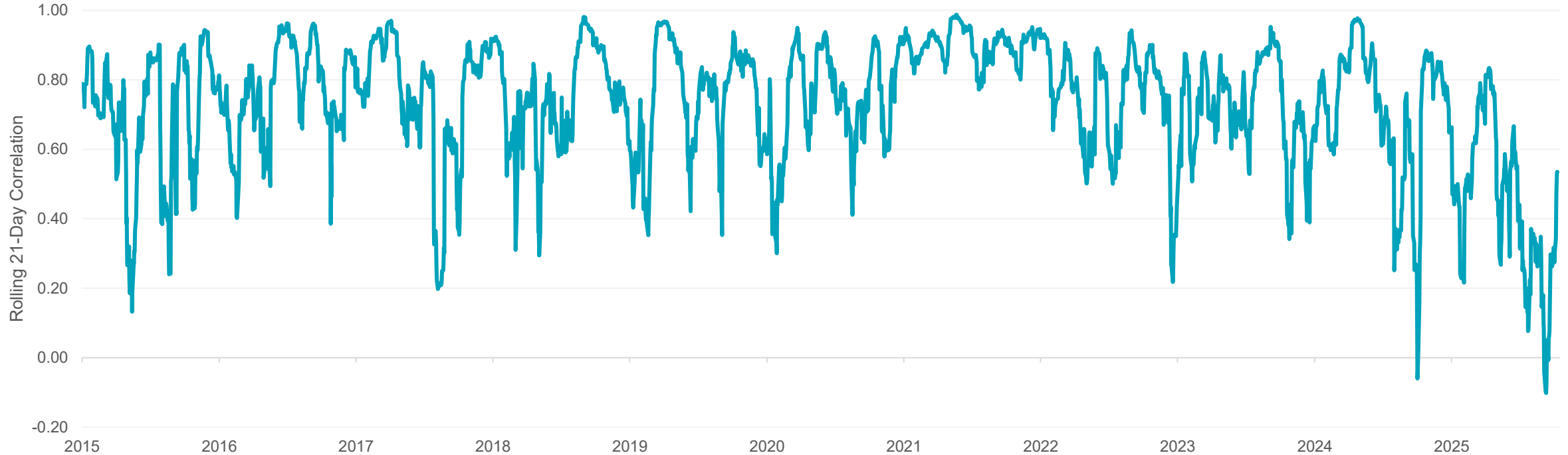


While equities have been resilient in the face of an eye-watering selloff in the rates market that only accelerated in the month of September, the mega cap-led rally has resulted in familiar concerns about deteriorating market breadth. At least once a year, markets become myopically focused on narrow breadth signaling an unsustainable advance that is bound to end with a correction. Welcome to the 2026 rendition. Indeed, breadth that has narrowed sharply over the past month or so as the percent of issues trading above their 200-day moving average has plummeted across defensive and cyclical sectors. But breadth isn't the panacea that investors would like it to be, and as we've pointed out on myriad occasions over the past few years, breadth tends to follow price, not the other way around. More importantly, breadth is by no means narrow if you know where to look – namely within tech and healthcare. Aggregating tech, communication services, and healthcare reveals breadth remains healthy in these sectors as equal-weighted tech and healthcare sit at or near all-time highs. The narrowing in breadth has played out exactly where one would expect to see it against a backdrop of sharply higher yields and persistent input cost pressures. It's been a painful couple of weeks for defensives and cyclicals, but participation has arguably become so bad its good. Across these sectors we've seen growing evidence of a washout developing as the percent of issues trading above the 20- and 50-day averages has collapsed with new 20-day lows spiking, cleaning the slate for a renewed broadening. And that's precisely how these episodes of falling breadth tend to play out – breadth tends to follow price as a narrow, but advancing market draws inflow, thereby expanding breadth as investors rotate to laggards. A classic 'heads I win, tails you lose' dynamic appears to be setting up as any renewed AI skepticism likely prompts a rotation into those laggards while any calming in rate vol and a compression in long yields likely unlocks a more powerful catch-up rally across cyclicals and defensives. Tech looks likely to remain leadership, but the case for a broadening beta catch-up trade looks to be growing stronger.

Source: Portfolio Analysis & Consulting; Bloomberg.

Golden

Magnificent 7 correlation with Philadelphia Semiconductor Index (4/4/15–10/9/26)

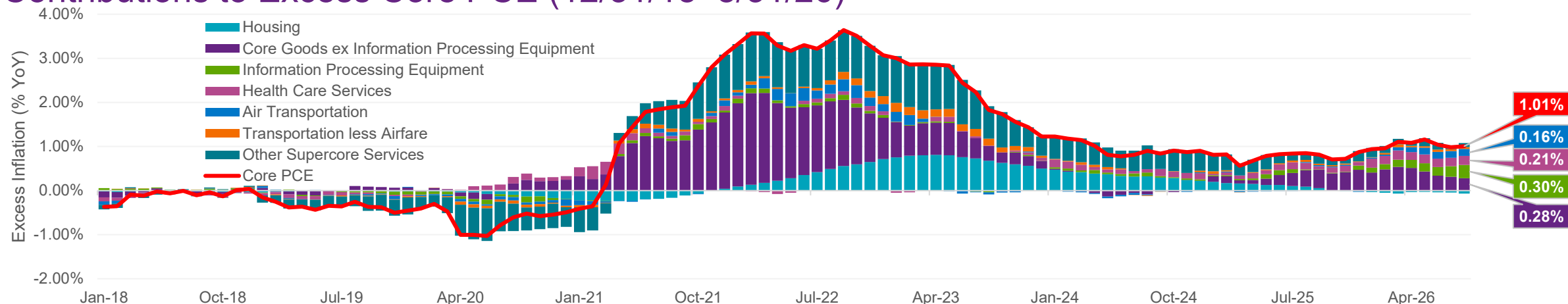


Through three quarters of 2026, the market has been defined by either-or price action. AI has become an on-off switch defining the broader trend of the market. When the AI trade kicks into gear, it vacuums up capital from the rest of the market and fuels a strong but narrow rally higher leaving nearly all other corners of the market starved of capital. And when the AI narrative pendulum swings back in the other direction, those flows predictably rotate back into the laggards within cyclical and defensive sectors. The result has been a high dispersion market that has seen intra-market correlations plummet. That same dynamic has been playing out even within the tech sector itself. While a chart showcasing the cash flow transfer from hyperscalers to semiconductors made the rounds over the summer, one needs to look no further than the market itself to see the either-or dynamic in action as the 21-day correlation between the Magnificent 7 and Philadelphia Semiconductor Index plummeted into negative territory at the lowest level on record in early September. But the rally through September was defined by a resynchronization of the two sectors. The extreme all-or-nothing price action appears to be behind us as the AI trade seems to be homogenizing to a degree. While a broadening catch-up trade may tap the brakes on tech leadership in the short run, a reunified AI trade throughout the tech complex would provide a powerful tailwind to headline equity indices into year end against a backdrop of cleaner positioning, robust fundamentals, and healthy skepticism that has kept sentiment in check.

Source: Portfolio Analysis & Consulting; Bloomberg.

Hopefully

Contributions to Excess Core PCE (12/31/18–8/31/26)

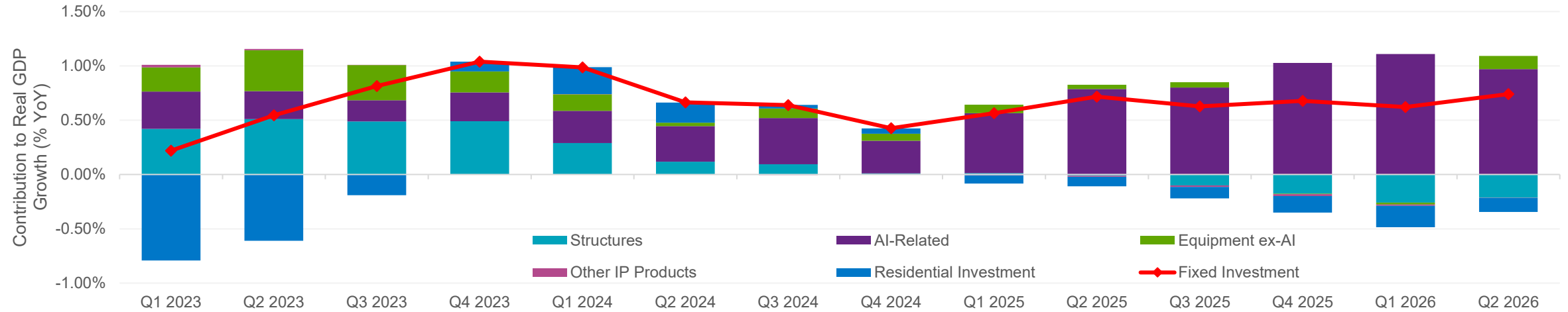


For much of this year, we've been highlighting the growing wedge between core CPI and core PCE as the gap between the two measures, which has historically seen core CPI running about 30 basis points (bps) above core PCE, has inverted to the most extreme degree since 1983 with core PCE running nearly 1% above core CPI. Revisions and methodology changes to financial services and information processing equipment have helped to compress that wedge down to 56 basis points – a smaller, but still historically significant inversion. Yes, inflation prints have been firmer than hoped for much of this year, but our read of the wedge suggests that core PCE has overstated the stickiness of those prints relative to both core CPI and underlying inflation trends. While energy passthroughs to both food and core prices remain a risk, the stickiness in supercore services prices has been the key force behind the Fed's hawkish pivot this year. But parsing through the drivers of that stickiness in supercore services and core goods paints a more encouraging picture of the inflation outlook. The AI buildout is indeed having a material impact as information processing equipment is contributing 30 basis points of the overshoot of core PCE to the Fed's 2% target, and while the capex cycle may continue to provide upside pressure to those prices, much of that impulse occurred early in the year and has since moderated. Excluding information-processing equipment, core goods are contributing an incremental 28 basis points to the core inflation overshoot which should continue to unwind as tariff effects roll off. And looking at supercore services, 21 basis points are a function of acyclical healthcare factors which policy rates are ill-equipped to address, while another 16 basis points are a function of airline fares, which reflect the immediate pass through of energy costs. In short, the overshoot appears to be more a function of idiosyncratic factors as opposed to a broad-based cyclical inflationary impulse. More importantly, wages and unit labor costs continue to soften and inflation expectations remain largely well-behaved suggesting there's little urgency for aggressive tightening. Continued shelter disinflation through mid-2027 and fading tariff effects will help to meaningfully close the gap while any softening in energy prices and stabilization in AI-related goods could provide a meaningful boost to the disinflation process into next year. If the Fed is tightening on risk management grounds, as the latest minutes suggest, the improving inflation outlook continues to bolster the case for a recalibration in policy as opposed to a renewed tightening cycle.

Source: Portfolio Analysis & Consulting; Bloomberg. Core PCE is personal consumption expenditures less food and energy. Core CPI is consumer price index less food and energy. Excess inflation defined as current contributions to core PCE relative to a regression of 2014-19 contributions consistent with 2.0% Core PCE.

Just One Thing

Real private fixed investment contributions to real GDP growth(Q1 2023–Q2 2026)

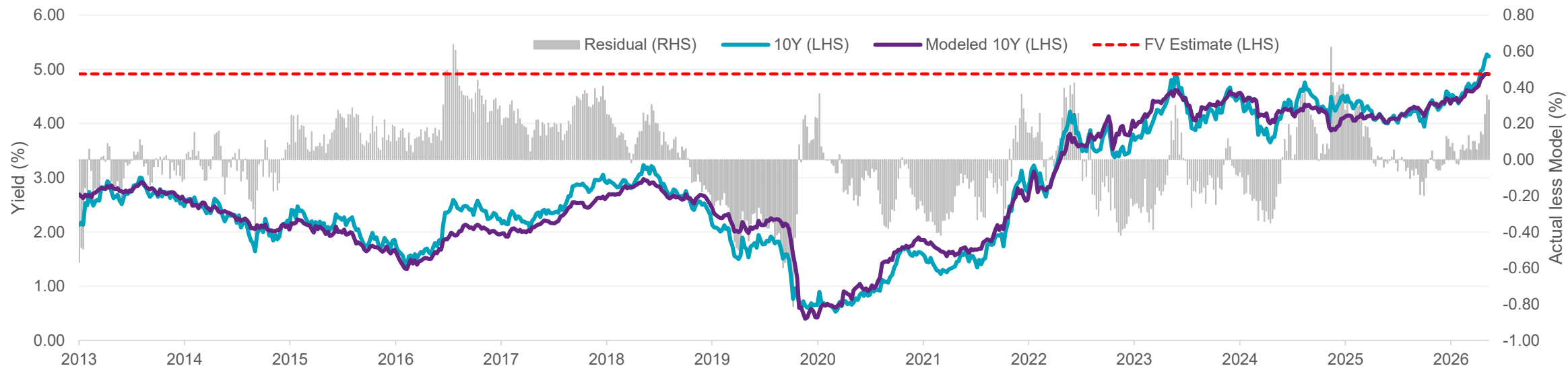


Over the past year, we've written ad nauseum about our Ho-Hum Growth view of the macro backdrop, and it doesn't look like we'll be dropping the routine anytime soon. Nominal growth has been undoubtedly strong, accelerating from an annual pace of 4.8% a year ago to 6.3% through the second quarter. Real growth, however, has remained relatively stable, cooling modestly from 2.4% to 2.2% over that time. That's certainly not terrible, and good enough to continue supporting healthy top line revenue growth and strong earnings growth after a healthy dose of margin expansion. But from our perch, the setup into 2027 continues to look fairly ho-hum, and perhaps even more so than this year. The housing market can't lift off the mat, with the latest surge in rates simply keeping it in the penalty box longer. Manufacturing activity has bounced, but sentiment appears to be getting ahead of itself with PMIs running well ahead of actual output while much of the rebound continues to appear more a function of an inventory restocking cycle than a true cyclical acceleration. And fiscal headwinds continue to mount at all levels of government which is likely to weigh on consumption and appear poised to moderate back down towards softer income growth. It's no surprise at this stage that the AI infrastructure buildout has been a key driver of growth over the past six quarters, providing a nearly 90 basis point boost to real growth. As we discussed last month, AI investment doesn't appear to be letting up anytime soon with 2027 consensus capex estimates for the hyperscalers pushing up over \$1T, up from about \$800B in 2026. But GDP growth is a flow measure, and 2026 is shaping up to be the peak in the growth rate for capex as it surges nearly 90% versus 2025 spend. Following consensus estimates, capex growth is set to moderate to about a 37% pace. To be sure, that still translates to about a 40-basis point contribution to real GDP growth, but without a commensurate reacceleration in other areas of the economy or real measurable output gains from AI implementation in the next year, growth looks set to potentially moderate further next year. AI capex will continue to provide powerful support for the economy, but at the margin it's beginning to shift to a robust floor under activity as opposed to the lone source of a growth impulse. In short, with so many of the pillars of growth within the economy on ice and the AI growth impulse set to slow sharply, the Ho-Hum economy looks set to continue through 2027. Growth is fine, but both the consensus and the Fed appear to be overly sanguine on the outlook.

Source: Portfolio Analysis & Consulting; Bloomberg. AI-Related includes information processing equipment, software, and research and development. Equipment ex-AI represents all other components of equipment investment. IP Products is intellectual property products. GDP is gross domestic product.

Steam Engine

10Y yield vs regression (5/31/13–10/9/26)



One of these days, we'll be able to write about more than rates and AI. But that day is not today. The painful rate selloff accelerated over the course of September, surging 54 basis points on the month, and widening by 65 basis points (bps) from the local lows at the end of August. Much of this selloff has been justified by the fundamentals as evidenced by the steady march higher in our fair value model estimate of the 10-year yield, which is a simple regression of the 10-year yield against a group of measures covering inflation expectations, growth expectations, short rates, global rates, and futures positioning. But over the past few weeks, the fair value estimate has flatlined around 4.90% even as the 10-year yield continued to march sharply higher. While the model is by no means infallible, it has an R2 of 0.95, suggesting it does a very good job explaining moves in the actual 10-year yield. Most importantly, while deviations between the prevailing 10-year yield and the fair value estimate are normal, extreme overshoots on the order of 30-40 basis points tend to indicate unsustainable moves where technicals may be playing a greater role. And just as we've seen with other momentum trades of late, including precious metals at the start of the year and the AI trade over the summer, large overshoots don't tend to simply stabilize, they usually reverse sharply. When that reversal begins is anyone's guess, but in addition to the model overshoot a few indicators suggest we may finally be getting close. The October 10-Year auction was impressively strong, pricing nearly 2 basis points below its when-issued yield on the back of the highest bid-to-cover ratio since 2014 and the lowest allocation to primary dealers on record suggesting strong demand for price-sensitive buyers seeking attractive value with high carry. Implied rate volatility has also finally spiked after a long and steady slog higher, suggesting we may be getting close to the washout stage. And perhaps most importantly, yields have been unable to sustain upward momentum of late despite hawkish Fed speak, renewed upside in crude prices, and an upside surprise on September CPI. The overshoot appears to have finally arrived, and signs of selling exhaustion are beginning to seep into the price action. Place your bets accordingly.

Source: Portfolio Analysis & Consulting; Bloomberg. FV model is a simple regression model of 5Y5Y forward inflation breakevens, 3m3m OIS (overnight index swap), JPMorgan US Forecast Revision Index, Bloomberg Global Treasury ex US Index yield, net noncommercial 10Y Treasury Note futures positioning.

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NIM-10152026-puaf9gml
Exp. date: 5/31/2027
PAC98-1026