



TIMBER POINT CAPITAL MANAGEMENT

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AI EARNINGS GROWTH MEETS HIGHER RATES



Source: ChatGPT

Third Quarter 2026 Market & Economic Review

The third quarter offered investors an unusual combination: a resilient economy, exceptionally strong corporate earnings, an extraordinary investment cycle around artificial intelligence — yet continued inflation and interest-rate pressures.

Over the course of 2026, investors have debated whether inflation, the Federal Reserve or economic growth would ultimately dictate the direction of markets. During the third quarter, the growing force of Artificial Intelligence became impossible to ignore.

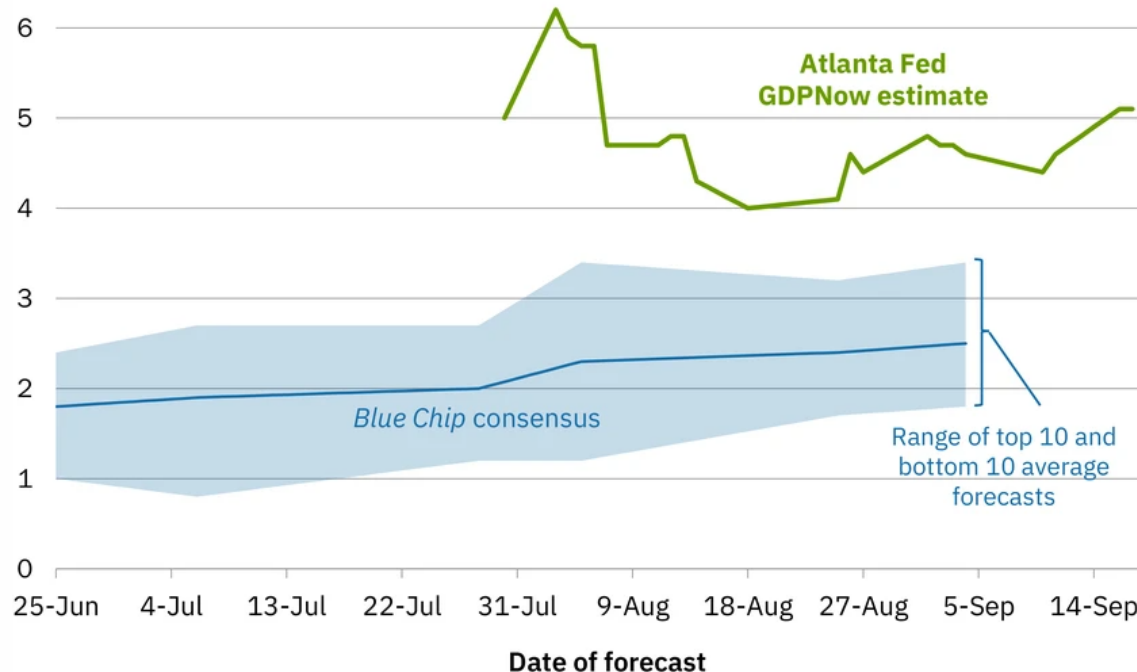
The result looked a little like an old monster movie. On one side, AI investment, productivity expectations and earnings growth continued to push markets forward. On the other, higher interest rates, inflation and an increasingly demanding cost of capital pushed back. For now, AI appears to be holding its own. But the battle is getting more interesting.

A Resilient Economy Meets Persistent Inflation

The U.S. economy continued to perform surprisingly well during the third quarter despite a more difficult financial backdrop. Consumers continued to spend, businesses kept investing and the labor market remained healthy. [The unemployment rate declined from 4.3% at the beginning of the summer to 4.1%, while the economy added approximately 80,000 jobs per month](#). Those aren't boom-time employment numbers, but they are consistent with a labor market that has cooled without breaking. That distinction matters.

The larger concern during the quarter was inflation. [Oil moved back above \\$100 per barrel](#), but the inflation problem extends well beyond energy. [More than half of the components of the Consumer Price Index are now increasing at annual rates above 3%](#), while [Core PCE increased from 3.0% in December 2025 to 3.4% in August](#). In other words, inflation isn't simply refusing to disappear. In several areas, it is moving in the wrong direction.

Evolution of Atlanta Fed GDPNow real GDP estimate for 2026:Q3 Quarterly percent change (SAAR)



Sources: Blue Chip Economic Indicators and Blue Chip Financial Forecasts

Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the Blue Chip survey.

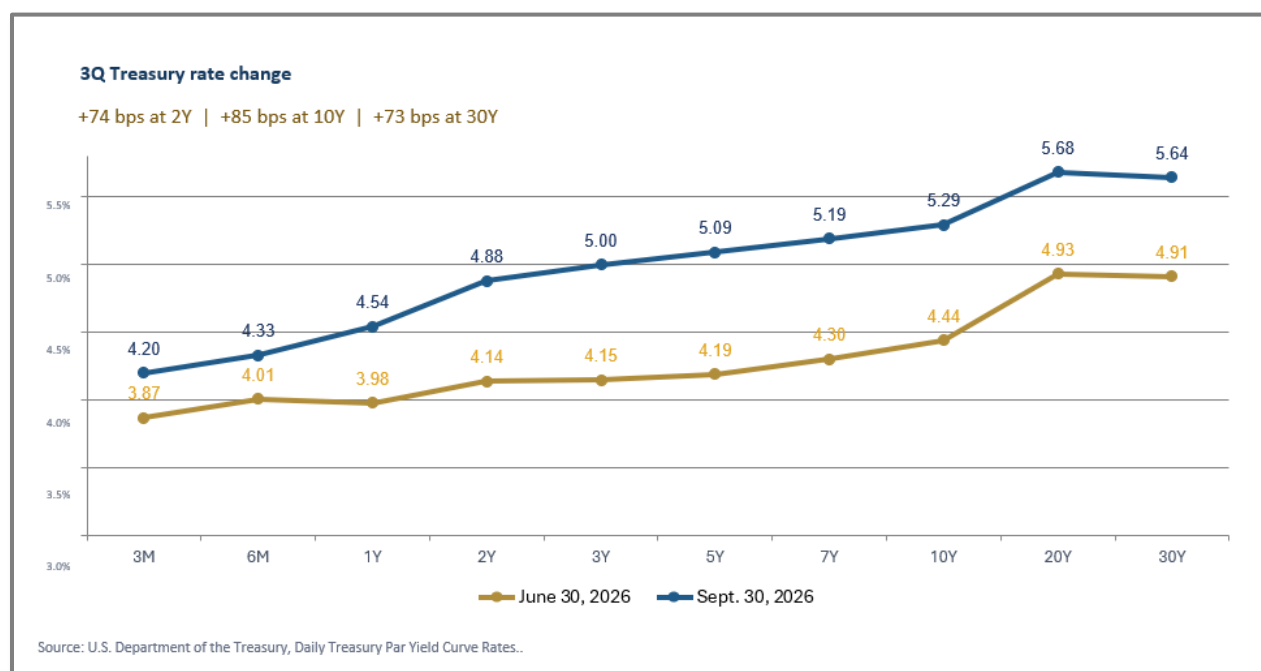
The economy has so far been strong enough to absorb higher energy prices, higher borrowing costs and tighter financial conditions. Ironically, that resilience has also made the Federal Reserve's job more difficult.

Rates Return to Center Stage

The Federal Reserve began the quarter on hold, maintaining the federal funds target range at both its June and July meetings. By September, persistent inflation and continued economic strength had changed the calculus.

On September 16, the FOMC unanimously increased the federal funds target range by 25 basis points to 3.75%–4.00%, the first Fed rate increase in more than three years. Perhaps more important than the hike itself was the message that accompanied it. The Fed's updated projections showed 16 of 18 policymakers expecting at least one additional rate increase during 2026. Markets increasingly began pricing additional tightening extending into 2027.

The bond market responded accordingly. The [10-year Treasury yield increased 85 basis points during the quarter to 5.29%, its largest quarterly increase in four years, while the 30-year Treasury finished September at 5.64%](#). Resilient growth, persistent inflation, higher oil prices, a more hawkish Fed and substantial government and corporate debt issuance all contributed to the move. Correspondingly, the Bloomberg Aggregate Bond Index posted sharply negative returns, [falling nearly 3.5%](#) for the quarter.

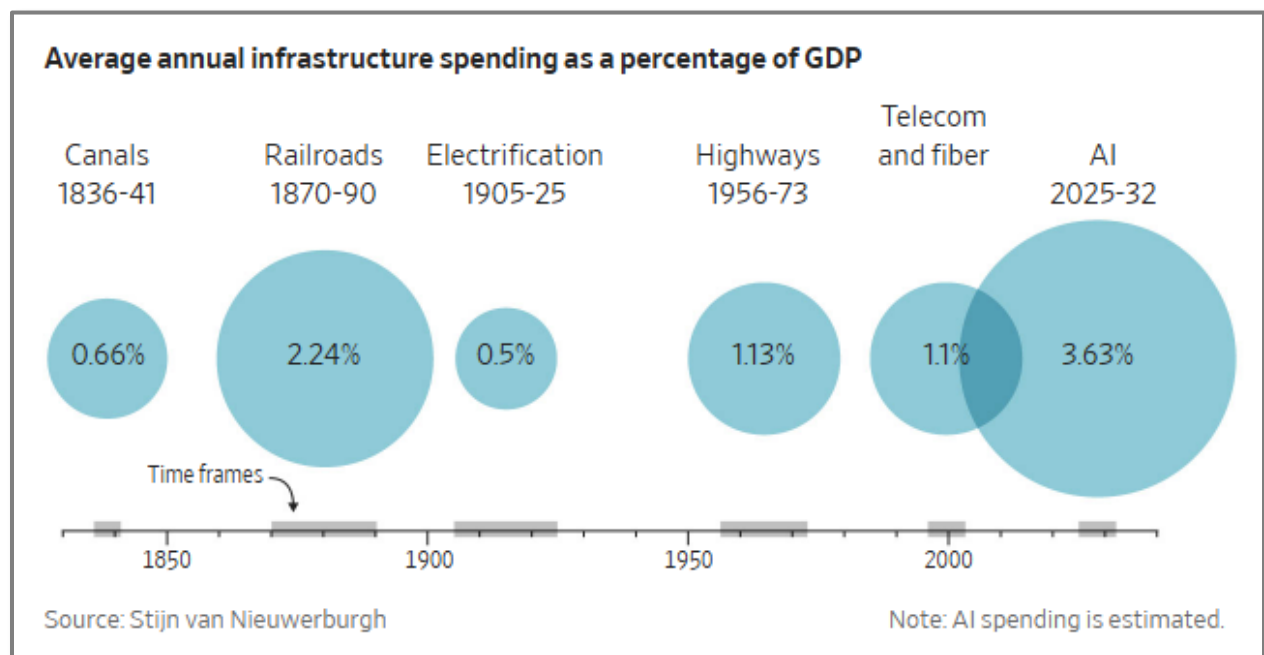


At yields above 5%, Treasuries become legitimate competition for investor capital. Financing becomes more expensive. Highly leveraged companies face greater pressure. Real estate and other rate-sensitive assets must adjust. And equity valuations face a higher hurdle rate.

AI Keeps Pushing Back

A sharp rise in long-term interest rates would normally spell trouble for growth stocks, but the traditional playbook was largely tossed aside during the third quarter. [The S&P 500 gained 2.30%, bringing its year-to-date return to 12.75%](#), while major indices reached record highs in late summer. Large-cap technology continued to lead, while the Dow and small-cap stocks lagged. A major driver of that resilience has been artificial intelligence. AI is rapidly moving beyond software and into the physical economy through enormous investment in data centers, semiconductors, power generation and related infrastructure.

It is tempting to label this another technology bubble, but we think that comparison misses an important distinction. Much of today's AI buildout is being funded by some of the world's largest, most profitable and best-capitalized companies. There is a meaningful difference between speculation around a new technology and actual investment in it — and right now, we are seeing an extraordinary amount of the latter.



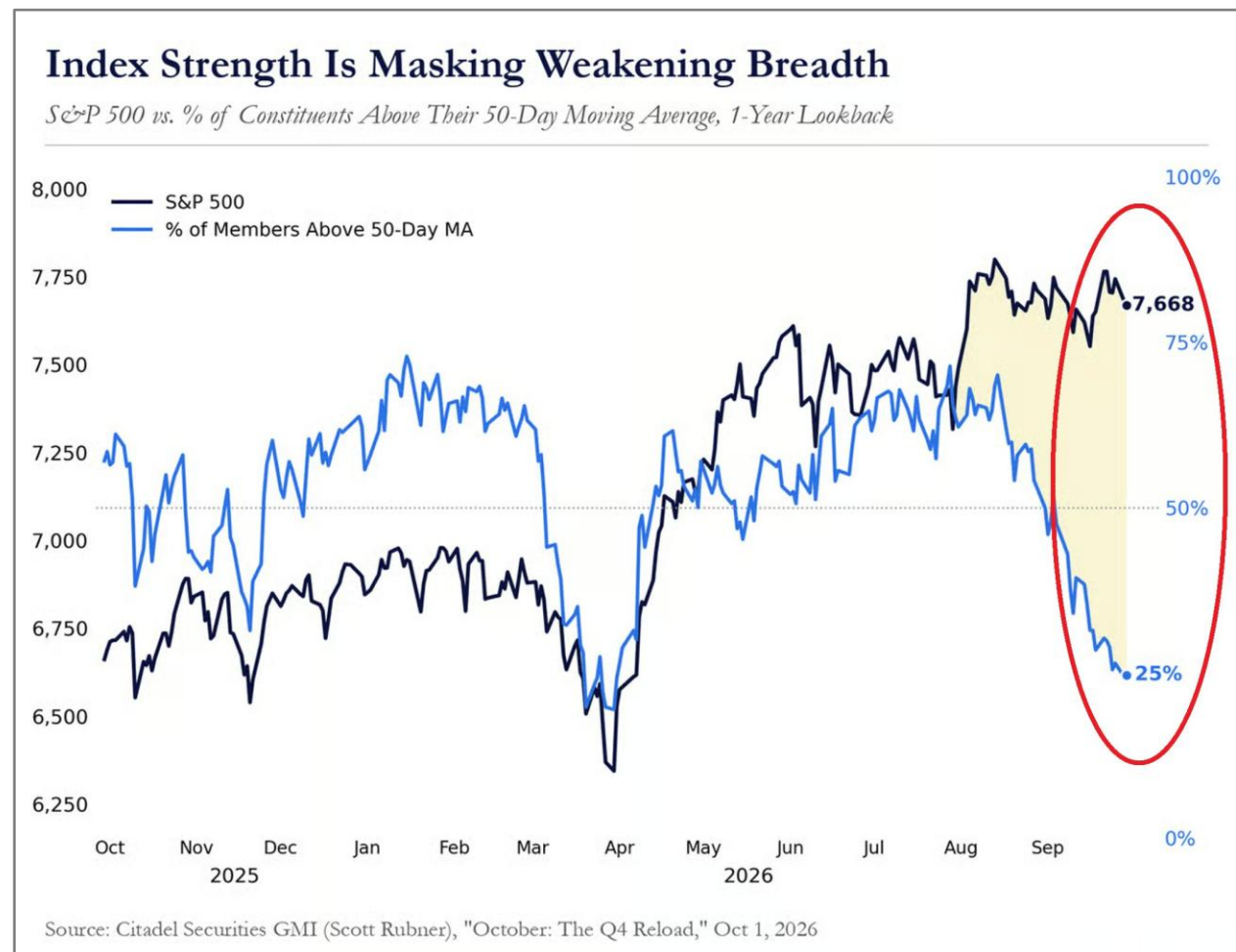
That doesn't mean every dollar will be well spent. There will be overbuilding, bad investments and companies whose valuations ultimately prove difficult to justify. That's a normal part of any major technology transition.

But the scale of the infrastructure being built and the potential productivity benefits suggest AI is much more than a temporary market narrative. There may be a bubble somewhere in AI, but we don't believe AI itself is the bubble.

AI and interest rates aren't entirely independent of one another. The extraordinary capital being deployed into data centers, semiconductors, power generation and related infrastructure is contributing directly to economic growth, while over time AI should also improve productivity and the economy's capacity to grow. In the near term, however, that investment is helping keep an already resilient economy running hot, giving the Federal Reserve less reason to tolerate above-target inflation or ease policy. There is some irony here: the same AI investment supporting equity markets may also be contributing to the economic strength keeping interest rates higher. The two monsters aren't simply fighting each other — to some extent, they're feeding each other.

The Index Isn't the Market

There is an important caveat to the relatively strong headline market numbers: market breadth deteriorated significantly during the quarter. While the S&P 500 finished September [only about 2% below its 52-week high, roughly 75% of its constituents were trading below their 50 day moving averages](#) and [42% of stocks were down more than 20% from their previous highs](#). As a result, earlier strength in the equal-weight S&P 500 and smaller-cap stocks reversed.



The conclusion was a return to a more concentrated market, with a relatively small group of large-cap growth and technology companies — many closely tied to AI — supporting the major indices. We don't view concentration alone as a warning sign; today's market leaders generate extraordinary levels of revenue, earnings and free cash flow. But breadth matters, and a healthier next phase of the bull market would likely require participation to broaden beyond the handful of companies currently benefiting most from the AI investment cycle.

Earnings Are the Equalizer

The strongest argument supporting equities today isn't simply enthusiasm surrounding AI — it is earnings. Heading into third-quarter earnings season, analysts have actually raised estimates, an unusual development as expectations typically decline as a quarter progresses. [S&P 500 earnings are now expected to grow approximately 29.5% year-over-year, which would mark the third consecutive quarter of earnings growth above 25%.](#)



That earnings strength helps explain why equities have been able to withstand sharply higher interest rates. Higher rates put pressure on valuations, but rapidly growing earnings can offset much of that impact. [The S&P 500 now trades at approximately 19.0 times forward earnings, down 12% from the beginning of 2026 and roughly in line with its longer-term averages.](#) Put simply, stock prices have risen, but earnings have risen faster.

Importantly, the earnings story is not limited to the United States. After several years of relatively subdued growth, earnings momentum outside the U.S. is beginning to improve, particularly in

Europe and parts of Asia, where easier comparisons, improving margins and a recovery in global manufacturing are providing support. Valuations also remain considerably less demanding than in the U.S., meaning international markets may not require extraordinary earnings growth to generate attractive returns. If this earnings recovery continues, it could provide another avenue for market participation to broaden beyond the U.S. and the handful of mega-cap technology companies that have dominated global equity returns.

Where We Stand

As we enter the fourth quarter, we remain constructive on the economy and investment opportunities broadly, although the balance of risks has become more nuanced. Economic growth remains resilient, corporate earnings are strong and AI-related capital spending continues to provide a meaningful tailwind. At the same time, persistent inflation and sharply higher long-term interest rates have raised the hurdle rate across nearly every asset class.

2026 4Q Key Economic and Investment Drivers

Real Economic Growth	Rising Stable Falling	Capex in AI continues to drive the economic growth trajectory in the US . We believe this trend is still in the early innings and will persist throughout 4Q and into 2027.
Inflation	Rising Stable Falling	U.S. inflation has been impacted by the Iran conflict and the resulting spike in oil prices. Yet other factors are at hand which may prevent a meaningful inflation increase.
Real Interest Rates	Rising Stable Falling	Real interest rates increased sharply during 3Q reflecting a higher cost of capital for a heavily indebted Federal government as well as faster levels of economic growth.
US Dollar F/X Value	Rising Stable Falling	The US dollar has remained relatively strong, reflecting continued global capital flows into the United States, supported by a resilient economy and attractive investment opportunities.
Taxes and Regulations	Rising Stable Falling	The midterm elections are likely to give Democrats control of the House, the Senate, or both. The resulting legislative gridlock would likely reassure investors.
P/E Ratios	Rising Stable Falling	S&P 500 earnings growth continues its rapid ascent meanwhile valuations have fallen during this market correction as the S&P 500 now trades below 19x forward earnings, which leaves room for a revaluation higher
Fixed Income Risk Premiums	Rising Stable Falling	Corporate credit spreads remain historically tight, reflecting strong balance sheets, healthy earnings and limited signs of broad credit stress. Concerns exist in CCC rated corporates and private credit.
Volatility	Rising Stable Falling	Volatility has remained remarkably muted over the past several months again showing the resilience of investors and the U.S. stock market. Periodic spikes are always a risk.

Source: TPCM

Bullish Neutral Bearish

Our probabilistic work reflects that balance. We remain constructive on equities, but see less reason for concentrated bets on any particular style or capitalization segment. Financials, healthcare and technology appear relatively attractive, while improving earnings and lower valuations are creating selective opportunities outside the U.S. The broader message is one of diversification and security selection rather than a significant tactical shift.

2026 4Q Asset Class and Sector Probabilities

Major Market Asset Class	Likelihood of Outperformance
Bonds outperform Cash	59.4
Equities outperform Bonds	51.0
Non-Traditional outperforms Equities	57.0
Non-Traditional outperforms Bonds	48.3
Europe outperforms the US	47.5
Asia outperforms the US	47.8
EM outperforms the US	53.5
Small Cap outperforms Large Cap	52.7
Mid Cap outperforms Large cap	51.5
Value outperforms Growth	53.5
Credit outperforms Government bonds	47.0

Sectors v Market	Likelihood of Outperformance
Discretionary	46.8
Energy	48.4
Financials	60.4
Health Care	54.2
Industrials	45.3
Info Tech	54.0
Materials	48.3
Real Estate	49.1
Staples	44.4
Communications	51.1
Utilities	47.9

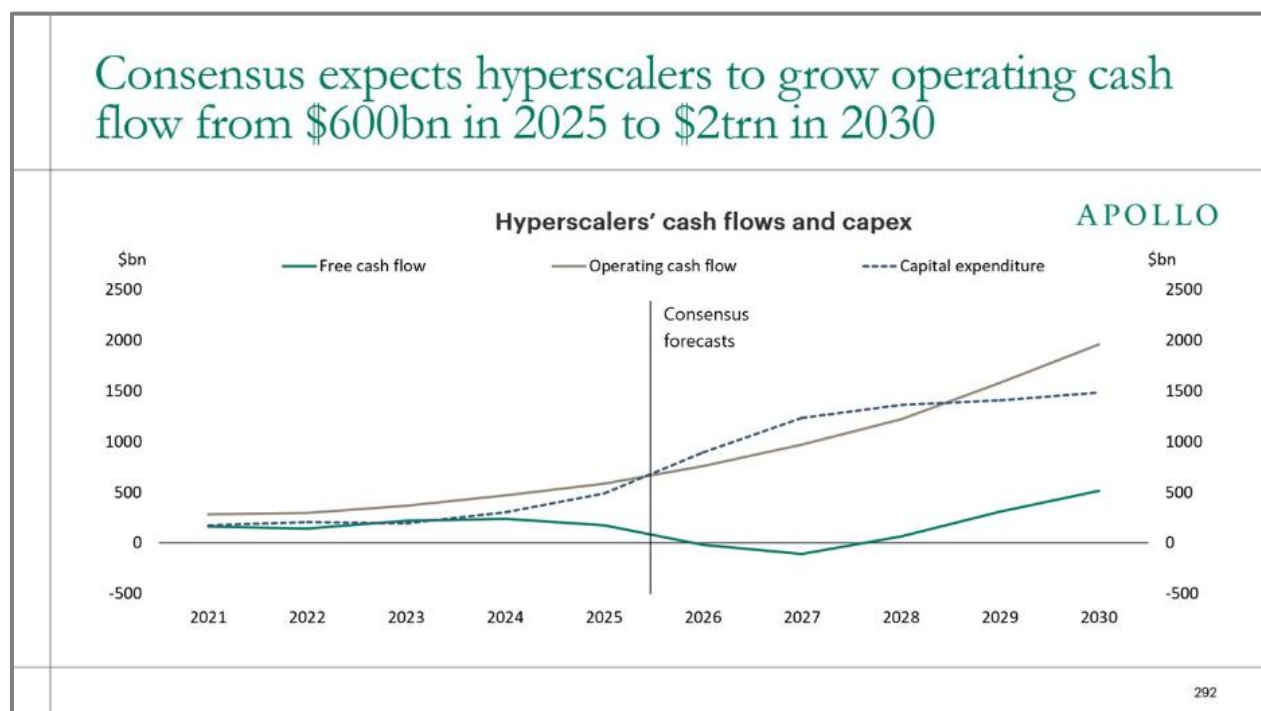
Source: TPCM

Bullish Neutral Bearish

Bonds are becoming a considerably more attractive part of that diversification. Higher Treasury yields have materially improved prospective returns and, importantly, restored some of the income and portfolio-balancing characteristics that were largely absent when rates were near zero. We favor higher-quality fixed income, while remaining more cautious on corporate credit where historically tight spreads provide limited compensation for additional risk.

We also continue to see an important role for non-traditional investments. With inflation uncertainty, geopolitical risks and changing relationships between stocks and bonds; return streams that are not entirely dependent on equity markets or declining interest rates can improve portfolio resilience.

We also expect the AI investment story to evolve. Semiconductors, hyperscalers and data-center infrastructure have been the obvious early beneficiaries. The more interesting question over the next several years will be where the productivity benefits ultimately accrue — across healthcare, financial services, industrials, logistics and the broader economy.



The continued strength in AI-related capital spending reinforces our view that this investment cycle has real economic substance and can remain an important driver of growth. At the same time, the sheer scale and pace of spending should invite some skepticism: capital investment rarely grows at this rate indefinitely, and history suggests that periods of extraordinary investment inevitably produce some excess capacity and disappointing returns. We remain constructive on AI, but increasingly believe the next phase will be about returns on investment rather than simply the amount invested.

Ultimately, our outlook remains defined by two powerful forces. AI is driving investment, productivity expectations and earnings higher, while higher interest rates are raising the cost of capital and demanding greater discipline from both companies and investors. For now, strong economic growth and earnings have been sufficient to absorb much of the pressure from higher rates, keeping us constructive. AI can remain a powerful long-term driver of economic growth while higher rates create a more demanding investment environment. Both can be true.



Written by David Cleary, CFA

David Cleary, CFA is the President and Chief Investment Officer at Timber Point Capital Management. Additionally, David serves as Chief Investment Officer of Fortis Capital Advisors. Previously he spent 23 years at Lazard Asset Management where he held a series of senior portfolio management roles over multi-asset and global fixed income strategies. Additionally, he served as the firm's global head of fixed income, a \$26 billion platform. Prior to Lazard, David worked at UBS and IBJ Schroder, mostly in fixed income asset management roles. He began working in the asset management field in 1987 upon his graduation from Cornell University, with a BS in Business Management and Applied Economics. He is a CFA charter holder.

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