46 PEAKS
INVESTMENT ADVISORY GROUP

The Year of Living Dangerously.

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October 2026

As we head toward the closing months of 2026, it's striking how most stock markets have delivered decent positive returns year-to-date in the face of so much "danger". This year has taken the shape of a neat four-chapter story, each with a potential villain that could trip up stocks:

• The U.S. attacked Iran in late February, triggering an energy and supply-chain-related inflation spike.

• The 2nd quarter marked the "coming out" of AI, along with concerns about the future of many jobs and even long-term profitable businesses like software.

• For investors, the third quarter was notable for a new Chairman of the Federal Reserve, Kevin Warsh, who seized on the mantra that "*you only get one chance to make a first impression*". In September, the Federal Reserve raised short-term interest rates - **the opposite** of what most investors predicted when the year started.

• Now, as we look to finish the year, we're a few weeks from a mid-term election that could flip the chess board and affect the political playing field for the next 24 months.

Let's see how different investments performed this year in the face of these challenges:

	3Q	YTD
U.S. Stocks	2.30%	12.75%
Non U.S. Stocks	0.62%	12.40%
Emerging Market Stocks	-2.90%	23.08%
Real Estate (REITs)	-5.90%	3.70%
Multi-Strategy Alternatives	2.70%	7.18%
Commodities	17.90%	33.16%
Core Bonds	-3.40%	-2.85%

The first nine months of the year served as a strong reminder that **there is no such thing as a single "stock market."** U.S. Large Caps, Non-U.S. stocks and Emerging Markets have each responded differently to this year's shifting narratives. Winners and losers have flip flopped throughout the year.

Within non-core investments, Real Estate continues to be challenged by higher interest rates. Commodities, volatile as usual, have nevertheless been top performers. Alternative strategies have delivered relatively smooth and non-correlated returns. Meanwhile, **Core Bonds have had a rough year.** More on that shortly.

Through all the turmoil and uncertainty this year, the economy continues to chug along – growing at nearly 6% last quarter (2.2% after inflation). Common recession indicators are largely absent. Great, right? For some, yes. But a deeper dive reveals that the "K"-shaped economy is not healing; if anything, the divide may be widening.

Wage growth has declined closer to its long-term average of 3.3% - below the rate of inflation - meaning that workers are losing ground. Importanly, higher fuel prices hurt lower income consumers much more than higher income.

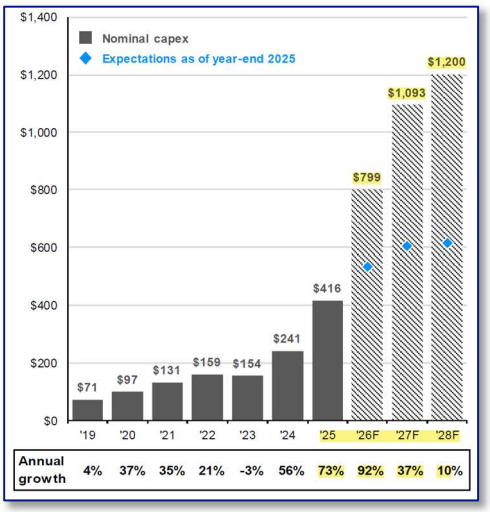
The chasm between winners and losers in today's economy is not as simple as "rich" vs. "poor". While it is obviously correlated, another element of **the "K" shaped economy is age-based**. According to the *Wall Street Journal*, from 2022 to 2025, Americans ages 75 or more saw their inflation adjusted net worth jump more than 30%. Those under 35 years old? Theirs FELL OVER 20%! These types of moves used to lead to pitchforks in the streets.

A thorn in the side of markets all year (and since 2022), has been inflation. The Federal Reserve wants inflation near 2.0%. With recent figures near 3.4%, we still have a way to go. On the bright side, inflation is poised to fade during the first half of 2027 as the war's oil related price spike will "fall off" trailing 12-month inflation numbers in the Spring of 2027. Slower wage growth may help, too.

Back to what might be called "The Person of the Year" – AI. While it's been growing for years, the rise of AI's

importance to both the economy and the investment landscape has seemingly happened at lightning speed this year. One example - The relatively unknown-until-recently companies that provide ChatGPT (OpenAI) and Claude (Anthropic) are expected to reach recurring annual revenues of $115 billion by the end of this year. That's almost as much as Microsoft gets from Windows and its Office Suite (Word, Excel, etc.), which launched in 1983!

Looking beyond the tools themselves, the AI infrastructure buildout is dominating the U.S. and global economy. A chart might help. This graph shows the amount of capital investment already and forecasted to be made by the five companies (Alphabet, Amazon, Meta, Microsoft, Oracle) known as "Hyperscalers". This year's investment is expected to be $799 Billion, 92% higher than 2025. And the next two calendar years are forecasted to **exceed $1 Trillion each!** That's a lot of money.



Stock market metrics are also eye popping – According to JP Morgan, a basket of just 42 AI stocks accounted for 60-80% of all S&P 500 earnings growth and performance since January 2024.

The business implications of AI are undeniably significant. Customer service and software development are early examples of work being quickly revolutionized by AI. While the opportunity for productivity gains is enormous, so is the potential disruption for workers and businesses.

Talk of bubbles has already started. To frame this important question, think back to the first time you used a personal computer. Or heard that unmistakable internet dial-up cacophony as you logged into AOL. Or ordered something online and wondered not just whether it would arrive, but if you just sent your credit card data out into space for thieves to exploit. For many of us, the first time we toyed with an app on a smartphone's colorful screen was another one of those moments. We suspect the first conversation someone has with AI tools such as Grok, ChatGPT or Claude, or the first time you "delegate" routine personal or work tasks to an AI "assistant", will belong on that list. For those wondering if AI is already in a bubble, that seems unlikely to us - We think it's easier to conclude that we are still in the early innings.

It's hard to compete with stories as large as the Iran war and the rise of the AI machines, but **the Bond market is giving it a shot**. In 2022 the poor performance of Core Bonds should have surprised no one. This year is another story, as markets generally expected inflation to fall and the Federal Reserve to cut short-term interest rates, pulling down bond yields. The Iran war changed that entirely. Here's the yield on the 10-year U.S. Treasury Bond from the start of the year (around 4.20%) through September 30th (around 5.25%).

We've drawn the red line at 4.75% to highlight how that level provided meaningful "resistance" for 4-5 months and once breached in August, how yields have spiked quickly – now over 1.00% higher than their level on January 1st.

When bond yields go up, prices go down. As the earlier table showed, Core Bonds were down 3.4% in the third quarter and are down 2.9% year to date. It certainly stings when a conservative part of your portfolio loses value. That's the bad news, hopefully much of which is in the rear-view mirror. With the juicy yields shown in this table, we think the future for bonds looks brighter going forward.

Category	9/30/26 Yield
10-Yr US Treasury	5.29%
US Core Bonds	5.56%
High Yield	8.35%
Leveraged Loans	8.95%

Moves of this size in interest rates and bond prices are worth exploring a little more. We've talked about two of the obvious reasons – the war in Iran and its inflationary impact. But there's likely more to it than just those factors.

Remember that chart about how much is being invested in AI? Well, that money must come from somewhere. By some estimates, the "Hyperscalers" will issue about $200

billion of bonds this year. More bond supply can put upward pressure on yields elsewhere, too.

Additionally, there's a widespread belief that some of the rise in U.S. interest rates is linked to an increasing loss in confidence in the U.S. fiscal position. It's hard to argue against that, as our leaders on both sides have zero appetite to reign in our government's spending, leading to a current annual deficit of over $1.8 Trillion.

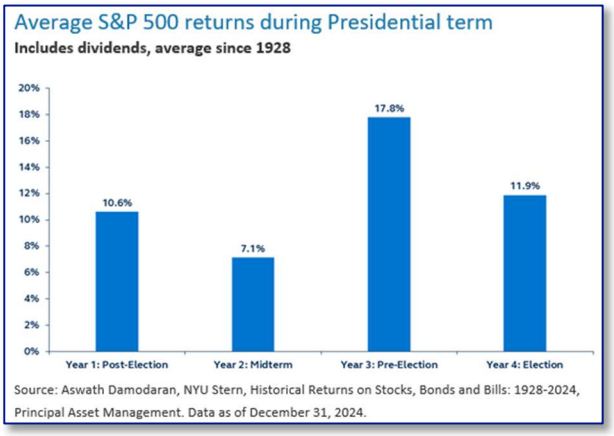
Our biggest concern with bonds and interest rates, however, is not that bond prices are down (that's water under the bridge), or that yields will go higher (they're already relatively high). No, we are more concerned that higher yields will have **the opposite of their intended effect on inflation** – fueling it rather than taming it.

Our main concern with higher rates is that inflation is both a supply and demand equation, and higher rates can cause non-AI investment to slow. Case in point – apartment construction recently fell to its lowest level since 2013, not a good thing since new apartment deliveries are already down 27% over the last year. In the end, higher rates cannot refill an oil tanker or lower gas prices, and they're likely to restrict the new supply of important sectors like housing, meaning higher rents and housing costs.

Next up on the calendar is obviously the mid-term elections. Many Americans may view this as a stressful, potentially disruptive, and maybe even dangerous development. But if history is any guide, **investors should view the upcoming election with excitement**. Even glee.

Why? Well, since 1950, there have been 19 midterm elections. One year after these elections, the S&P 500 has been higher…*<checks notes>*…*<squints and double checks them again>*…**all 19 times**. If we change our focus to full calendar years, we see in this chart that since 1928 the third year of a Presidential term has historically been the best year of the four for the U.S. stock market. By a lot.

Political historians are keen to point out that the President's Party has lost congressional seats in nearly every mid-term election since the 1940's – there **have been only three exceptions**. Investors know this and the market will not be surprised or disappointed if it happens in November. Historically, a divided government has not been a headwind to further gains.



As we reflect on the year so far, here's an interesting thought exercise…If, on January 1st, someone told you that the U.S. would attack Iran, gas prices would be near $5 a gallon, commodities would be the top performing investment category, the Fed would flip from talking about rate cuts to actually hiking rates, the yield on the 10-year Treasury would climb above 5% for the first time since 2007, and fears would grow that AI might annihilate software and many other business models, where would you expect stocks to be? Not higher, that's for sure. In fact, these are conditions for sharp declines. Yet stocks are higher. The **Year of Living Dangerously**, indeed.

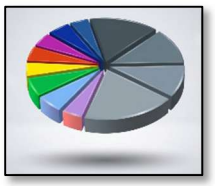
As usual, there are compelling arguments on both sides of the investment ledger. Bulls can point to strong corporate earnings, the upcoming historically favorable stretch of the Presidential cycle, the possibility that the oil-driven inflation spike fades next spring, and the prospect that a lasting resolution in the Middle East could provide a major economic and market tailwind.

Bears have plenty to work with, too. Inflation is stubbornly elevated, there's no guarantee of a successful outcome in the Middle East, oil and fuel prices may not decline much from here, interest rates spikes can be very dangerous to leveraged companies and investors, and valuations in parts of the market are lofty. Plus, it's entirely reasonable to be enthusiastic about AI's long-term opportunities and also concerned about both its disruptive impact on the economy and the investment case for spending so much money to build it.

And for bears who want to keep things simple, we turn to one of our favorite investment strategists, Ned Davis, who has a favorite two-part investment rule-to-live-by: **"Don't Fight the Tape"** and **"Don't Fight the Fed."** In this context, "The Tape" is the market's underlying strength and broad direction. As we sit here admiring the stock market near all-time highs, the

market is being held up by a handful of stocks as **60% of S&P 500 stocks are at least 20% below their highs**. Unhealthy. With the Fed raising rates, being bullish now means spitting into the wind of these two rules. Not a wise move, in our opinion.

Not surprisingly, we continue to like Alternative investments for both **their return opportunities and their diversification benefits**. One might think that rising bond yields make Alternative investments less important, but that's not the full story. The expected returns on many Alternative investment strategies are based on a "cash plus" structure, so higher short-term interest rates push up return expectations for many of these strategies.



On the diversification side, stocks and bonds are currently not diversifying each other very well since inflation is bad for both. But the risk is not just inflation, it's also sector concentration. Nowadays, Tech stocks are increasingly driving both U.S. "Growth" and "Value" styles, as well as many Emerging Markets. Add it up, and we think portfolio designers must work harder and **paint pie charts with a more colorful palette** - including exposure to inflation-sensitive assets and absolute-return strategies independent of stocks and bonds.

All this talk of Alternative investments may sound a little nerdy to some, but to us it is not an academic exercise - It's **your hard-earned retirement**. We think inflation, valuation, and concentration are bigger risks than many investors appreciate. With that in mind, we've spent considerable effort lately reviewing numerous Alternative strategies. We're pleased with the results of this process, and where appropriate, our portfolios are being updated to include what we think are some exciting strategies.

One final thought on bonds. This chart shows the trailing 10 Year performance difference between stocks and bonds. As you can see, we're currently at extreme levels of stock outperformance, due both the strong trailing returns for stocks as well as the terrible (near 1.0%) trailing ten year returns for Bonds.

Looking at this chart…what do you notice? After a peak, the black line eventually breaches below the horizontal red line. In plain English…when stocks have trounced bonds over a ten-year period by 10% or more annualized, bonds often outperform stocks the next ten years. We know the mere thought of bonds beating stocks over a ten-year period sounds impossible, especially to the "*stocks always return 10%*" and the "*buy every dip*" crowd, but it's happened before, and could again the next ten years.

For years, portfolio designers and **asset allocators suffered through the T.I.N.A. syndrome** – There Is No Alternative…to stocks. Now that bonds are offering real yields, there is. And Alternative investments continue to argue for a big seat at the table. There's a lot of uncertainty out there, and compelling arguments for both bulls and bears. One thing we know for sure - being overconfident or making bold moves in this type of environment may not be merely risky, it can be downright dangerous. We'll continue to think opportunistically and consider both sides of each argument, while emphasizing a smoother ride and true, robust diversification.

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