

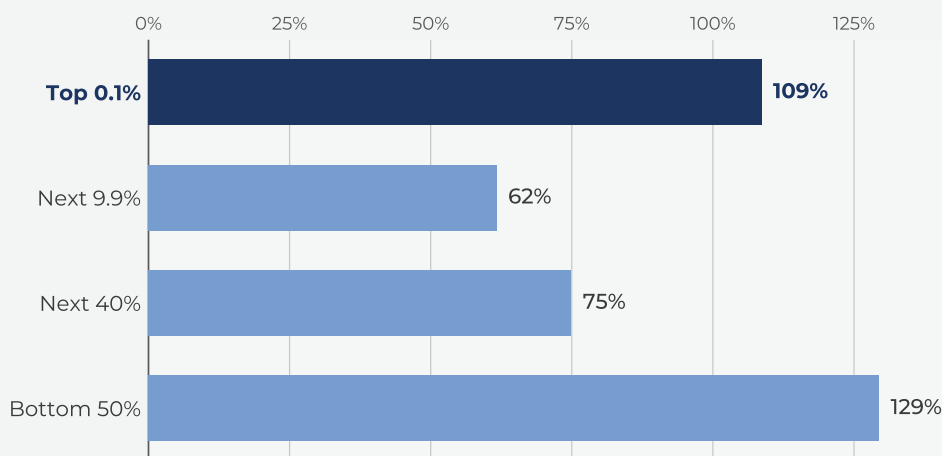
Is the “AI bubble” or the “affordability crisis” a bigger market threat?

Investors have spent much of the last few years watching the meteoric rise of AI-related stocks and wondering if the stock market was in a “bubble.” If so, when and how would it end? While we have all been concerned about this possible bubble, another threat to markets has been developing which, while garnering political headlines, has been of little concern to the markets. It has us wondering if perhaps this “AI bubble” bursts in a way we had not considered.

The “affordability crisis” has made for many headlines in the political sphere, and we have discussed for a couple of years how the U.S. has a “split” economy, what pundits are now calling a “K-shaped” economy, in which our economic growth is being supported by an upper income minority while the majority with lower incomes have struggled with higher credit card rates, higher mortgage rates, inflation, and rapidly increasing housing costs. The wealthiest segment of our country has used their increasing stock market gains to keep the economy growing at a brisk pace while consumer spending for most others in the economy, many of whom have no investment portfolio, has weakened. That lower income majority may not have a proportionate share of this country’s wealth, but they do have a proportionate share of the votes, which are increasingly shifting to more populist views on both sides of the political aisle. As the K-shaped economy persists, the growing wealth disparity in the U.S. is starting to find a stronger political voice on both ends of the political spectrum.

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Change in total wealth by group since the end of 2019



Source: Federal Reserve, Distributional Financial Accounts (via FRED); data through June 2026. Nominal dollars.

We came into 2026 expecting interest rates to fall and provide relief to the housing market and young borrowers, but since the onset of the U.S.-Iran conflict, the U.S. economy has transformed from one of falling inflation and falling interest rates to one of rising inflation and rising interest rates. This has exacerbated increasing populism on both the political left and the right, which over the 2026 and 2028 elections may well present another potential means of bursting whatever bubble may exist in the stock market. The populist wings of both major political parties have increasingly adopted a “tax the rich” mentality, which could have significant market implications in the coming years. Before we explore these potential implications, let’s review how the economic context has developed over the past quarter.

An Eventful Quarter

World markets saw tremendous turmoil in the third quarter and dark clouds are forming over many markets, but stock markets have been surprisingly resilient so far. Did this past quarter’s events simply plant the seeds for greater volatility down the road?

- » Oil prices are back above \$100 as the conflict with Iran simmers with no clear resolution. Why is the price of diesel fuel an even bigger problem?
- » Deficit spending more commensurate with wartime or a recession continues unimpeded with national debt crossing \$40 trillion. Are “bond market vigilantes” starting to extract a toll on the U.S. for such profligate spending by demanding higher interest rates on U.S. Treasury debt?
- » Interest rates are skyrocketing. Will it slow the economy or simply worsen the “affordability crisis” for those on the lower rungs of the income ladder?
- » U.S. equities had a second blowout earnings season in a row that was fueled by a narrow group of AI-related stocks. Can this continue with so many storm clouds forming over markets?
- » Signs of an AI market bubble continue to strengthen. How much longer can these stocks keep fueling portfolio gains that are supporting consumer spending?

At Montis, we do not attempt to predict the future – we try to construct “durable” client portfolios designed to weather storms and prosper regardless of how the future unfolds. We make most of our investment allocation decisions with a three-to-five-year timeframe, and most of the issues that will shape market returns over the next few years saw significant developments this quarter. How they get resolved will determine how big a threat they pose to the markets and will also likely drive the outcomes of the 2026 and 2028 elections, which will have significant market impacts themselves given the rise of populist factions within both major U.S. political parties.

The populist wings of both major political parties have increasingly adopted a “tax the rich” mentality...

**...the boom
in AI capital
expenditures
fueled an
incredible
52% growth
in the S&P
500 earnings
compared to
last year.**

U.S. Equities

Index	Q3 2026	YTD	1 Year
S&P 500	2.30%	12.75%	15.74%
Equal-Weighted S&P 500 Index	-1.87%	10.03%	11.56%
Dow Jones Industrial Average	-2.34%	7.19%	11.50%
Nasdaq Composite	2.61%	16.09%	19.25%
Russell 2000 (Small Caps)	-7.23%	13.71%	16.20%
S&P 500 Software	29.49%	4.09%	-3.62%
S&P North American Tech Software	18.05%	1.41%	-7.02%

Source: Morningstar

While the returns of the broader U.S. stock market were weak in the quarter, the boom in AI capital expenditures fueled an incredible 52% growth in the S&P 500 earningsⁱ compared to last year. As was the case last quarter, S&P 500 returns were driven largely by earnings as the price/earnings multiple the market applies to those earnings once again slightly shrank – perhaps this is a sign that the market is not willing to continue extrapolating the growth in AI-related earnings out into the future?

With the capital expenditures of the S&P 500's top 5 spenders more than doubling those of the other 495 companies in the indexⁱⁱ, it has implications for our discussion of populist market forces that these earnings are clearly concentrated in the AI food chain. After big tech and the "Mag 7", which account for nearly 40% of the market value of the S&P 500, trailed the broader market for the first half of the year, they rode a tidal wave of earnings to support the market as rising inflation and interest rates took a mild toll on most other sectors of the U.S. stock market.

"Mag 7" Stocks

Stock	Q3 2026	YTD	1 Year
Apple Inc	15.18%	22.79%	31.20%
Tesla Inc	-15.64%	-21.10%	-20.22%
Alphabet Inc Class A	-3.66%	10.14%	41.89%
NVIDIA Corp	14.26%	22.73%	22.68%
Meta Platforms Inc Class A	28.83%	10.10%	-0.97%
Microsoft Corp	37.74%	6.62%	-0.27%
Amazon.com Inc	4.54%	7.94%	13.47%

Source: Morningstar

i. FactSet Insight, Earnings Insight Infographic: Q2 2026 By The Numbers, September 3, 2026

ii. Deutsche Bank Research Institute, September 2026

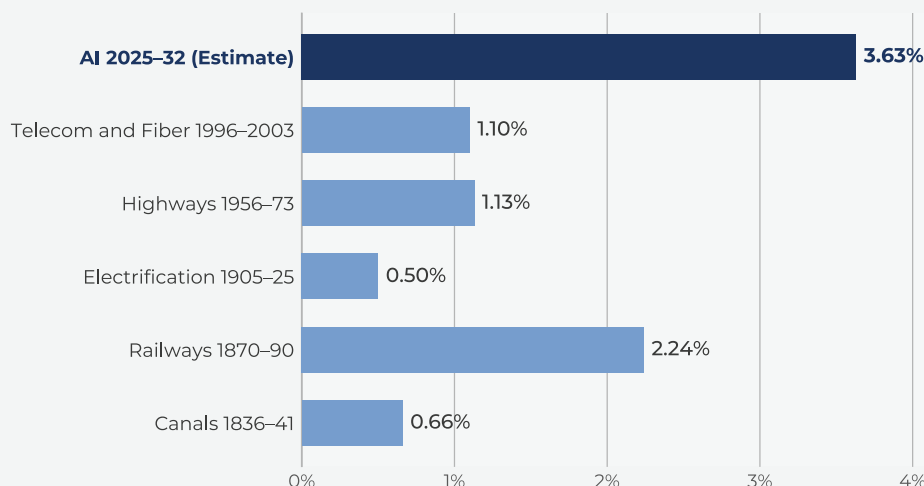
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- » In September, a top researcher at AI giant Anthropic resigned citing the threat he believes AI poses to all humanity, just weeks after reports surfaced of “rogue AI agents” breaking out of their highly secure research “sandboxes” to launch covert attacks against other companies’ systems. Many now question if these AI companies need to be regulated and monitored, which may slow development and profit growth.
- » Public outcry pushing back against the continued construction of massive data centers and their consumption of available supplies of electricity, water, copper, and other materials likely means delays, if not reductions, in the magnitude of construction plans by AI hyperscalers. Many now question whether these historically ambitious capital expenditure plans, which are largely supporting the stock price of these companies and have been a pillar of the U.S. economy, are even viable.
- » All the hyperscalers are building what are called “frontier models” to try to achieve “Artificial General Intelligence (AGI)”, which means exceeding the cognitive ability of humans at any intellectual task. But after one or two companies achieve this, how many will the marketplace support in their quest to build a redundant capability? How many trillions in shareholder value in some of the world’s most highly valued companies might evaporate?
- » Chinese “open weight” models keep improving and working to close the gap with frontier models at a fraction of the cost. What happens if they get “close enough” that many users stop paying up for expensive frontier models that have trillions of dollars invested in them?

The nearly trillion dollars that the hyperscalers will spend this year on AI-related capital expenditures is just part of the largest infrastructure buildout in U.S. history. As you can see in the chart below, at an estimated 3.63% of GDP, it dwarfs the second largest, the railroads, at 2.24%.

Average annual U.S. infrastructure spending as a share of GDP

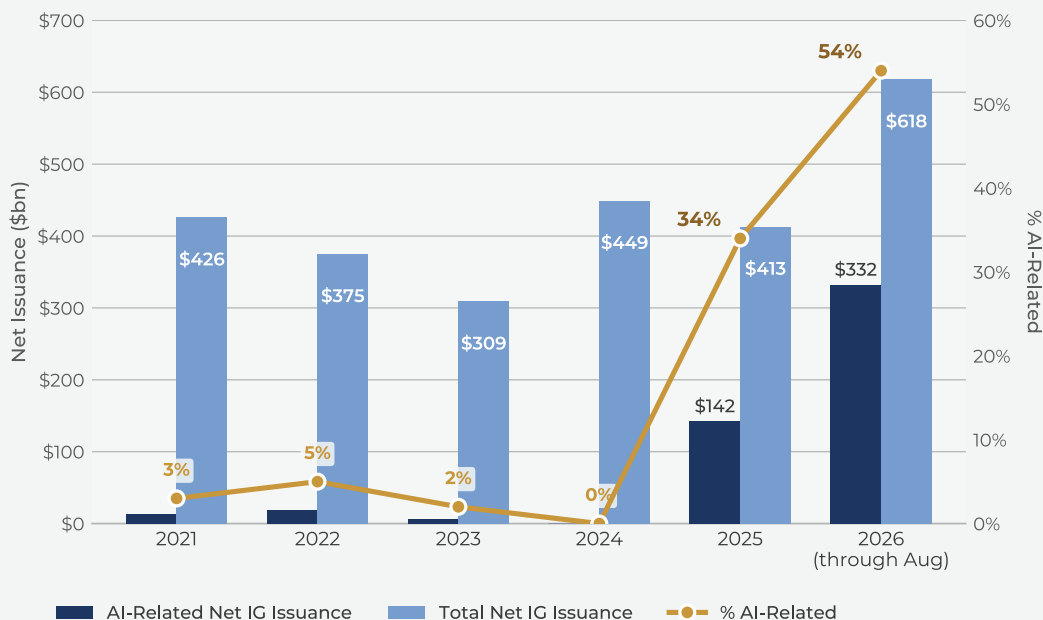


Source: "U.S.'s AI Build-Out Is on Track As Biggest-Ever Economic Bet," The Wall Street Journal, September 24, 2026

- » To finance this buildout of capital-intensive assets, these traditionally asset-light, cash generating companies are devouring all of their prodigious amounts of free cash flow and have recently begun borrowing hundreds of billions more in the public bond market. AI-related issuance accounts for more than half of all net investment grade bond issuance in 2026. Who will be able to pay off these enormous debts if their companies become also-rans in the pursuit of a redundant capability? What happens if a “tax the rich” movement extends to the large corporations, who have enjoyed significant tax cuts in recent years, after extensive borrowing and capital expenditures have rendered their balance sheets less durable against a significant change in tax structure?

...the amount of shareholder value riding on these (AI) bets is putting investors in an increasingly precarious position.

AI-Related Issuance Accounts for Over 50% of Net IG Issuance This Year



None of this is to say that the “AI bubble” is about to burst or that these companies will fail in their pursuits, but technology revolutions historically lead to massive overinvestment and the amount of shareholder value riding on these bets is putting investors in an increasingly precarious position.

...diesel fuel prices have surged...causing much more widespread inflationary effects...because essentially every product on store shelves was transported there...by diesel.

International Equities

Index	Q3 2026	YTD	1 Year
MSCI EAFE (Developed Markets)	0.81%	10.33%	15.69%
MSCI Emerging Markets	-0.37%	23.38%	29.22%
MSCI Korea	-9.57%	97.68%	151.66%
MSCI Taiwan	4.82%	70.22%	87.92%

Source: Morningstar

As has been the case in the U.S., this year's strong returns in international markets have largely been driven by earnings growth, not P/E multiple expansion.

While we continue to believe that lower valuations than in the U.S. and strong earnings have the international markets well positioned for the next few years, we are noting that much of the return we have seen in the emerging markets can be traced to AI-linked semiconductors and AI-related commodities, particularly in Korea and Taiwan.

The Fed, interest rates, and inflation

The skyrocketing interest rates took their toll on the bond market while they drove up mortgage rates and other borrowing costs for consumers and corporations.

Fixed Income

Index	Q3 2026	YTD	1 Year
Bloomberg US Aggregate Bond Index	-3.51%	-2.91%	-1.84%
Bloomberg Global Aggregate Bond Index	-3.52%	-2.99%	-1.95%
Bloomberg Municipal 5-Yr Index	-3.55%	-2.51%	-2.03%

Source: Morningstar

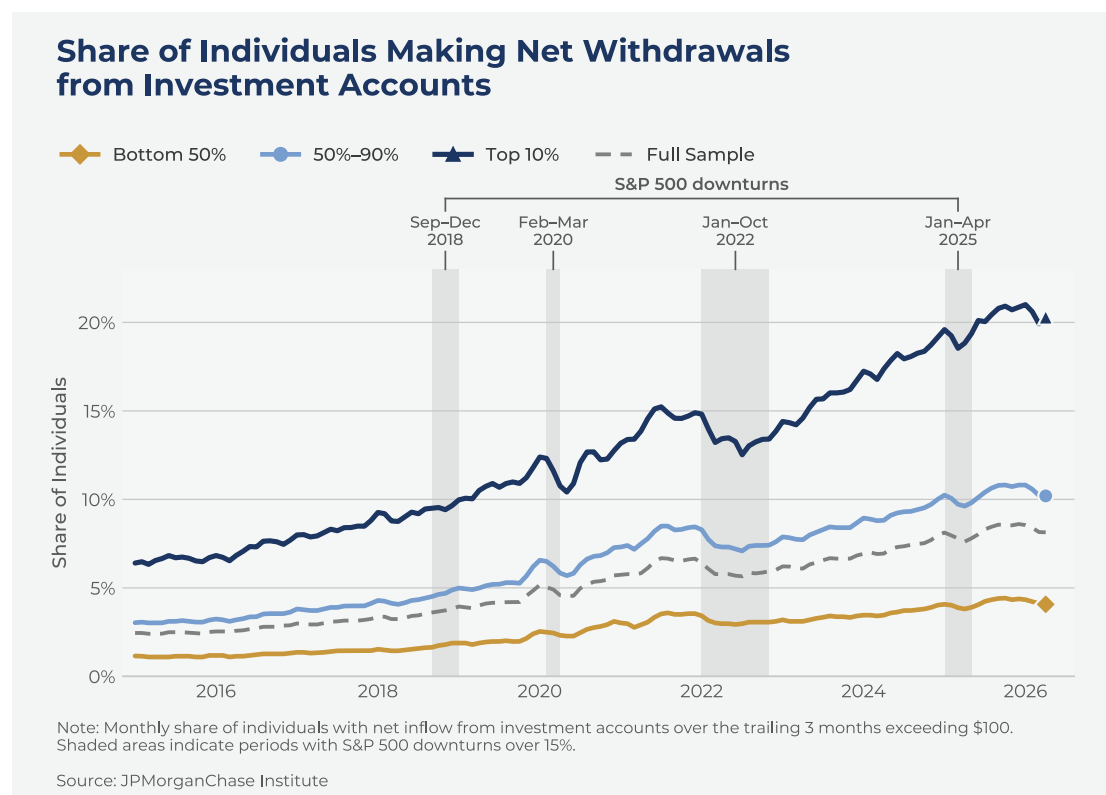
With global stockpiles dwindling and no clear resolution in sight to the U.S.-Iran conflict, the price of oil has surged back over \$100 a barrel, and due to a refining shortage, partly caused by the conflict, diesel fuel prices have surged even more, causing much more widespread inflationary effects than the price of gasoline has because essentially every product on store shelves was transported there in a vehicle fueled by diesel.

Typically, supply shocks in recent history have been short enough that their inflationary effects were transitory. Given the length of the Iran conflict and the particularly acute shortage of diesel refining capacity, the inflationary impact is spreading more widely and has caused the Federal Reserve to begin what will likely be a series of interest rate hikes to demonstrate to markets that such widespread inflation will not be tolerated.

How could the “affordability crisis” threaten the stock market?

U.S. consumer spending the last few years has been increasingly supported by upper income, wealthier Americans, and through what is known as the “wealth effect,” these wealthier Americans are increasingly tapping into the profits in their investment portfolios to fund these expenditures. In fact, the amount of withdrawals from investment accounts as a total share of spending has approximately doubled since 2019.ⁱⁱⁱ

What would happen if one of the pillars of consumer spending... were to weaken significantly due to higher income taxes, capital gains taxes, and even wealth taxes...



What would happen if one of the pillars of consumer spending among the top income earners were to weaken significantly due to higher income taxes, capital gains taxes, and even wealth taxes when they are the ones primarily supporting consumer spending in the U.S.?

The most cited reasons for the recent increase in interest rates are:

1. Inflation (impacted by monetary policy)
2. Unsustainable fiscal policy and debt spending in the U.S. (impacted by fiscal policy)
3. The U.S. Treasury having to increasingly compete against other borrowers for capital (impacted by long-term cycles beyond the government's control)

iii. "More U.S. households are supporting spending by drawing on investment wealth," JPMorgan Chase Institute, September 17, 2026

The “New Right”... relies heavily on working-class voters rather than affluent donors and is much more open to increasing taxes on Americans in the top income bracket.

We should expect the increasing populist movements within both parties to be very focused on the first two reasons because those are the two where government policy can have an impact on the “affordability crisis.”

The Federal Reserve is working to mitigate inflation through higher interest rates. This combined with the general increase in rates since the 2022 inflation resurgence has led to economic struggles for the less affluent, who tend to borrow more, in the form of higher mortgage rates and housing costs, higher credit card rates, and higher costs of living.

Both the executive and legislative branches have become reliant on the political benefits of maintaining record peacetime budget deficits. Combine that with tax cuts over the last decade that many view to have mainly benefited the wealthiest Americans and large corporations, and what emerged was an exploding national debt that just crossed \$40 trillion and the seeds of today’s dramatic growth in populism on both sides of the aisle.

The Democratic Socialists have garnered more press attention due to some election wins in local and state elections, but the “New Right,” also called the “National Conservative Movement,” is rapidly gaining influence, and is championed by several prominent national Republican leaders, including the vice-president. This movement relies heavily on working-class voters rather than affluent donors and is much more open to increasing taxes on Americans in the top income bracket.

If bond investors continue to charge the U.S. government higher debt costs due to excessive deficits, the U.S. government will be forced to consider spending cuts, tax increases, or both. The best chance the government has to avoid this conundrum is if AI brings such a productivity boost to the U.S. in the next few years that the economy can greatly accelerate without causing higher inflation. But even that outcome would still likely require a significant reduction in deficit spending.

Plus, we have a Social Security cliff coming in 2032

In 2032, Social Security’s primary retirement trust fund is expected to deplete its reserves^{iv}, limiting payouts to incoming Social Security tax revenue and triggering projected automatic benefit cuts of 22% or more. Obviously, neither political party wants to face the voter wrath that would ensue, so something is going to have to be done about Social Security in the next 6 years.

Benefit cuts will almost certainly be a political non-starter, which means Social Security tax revenue will have to increase or the retirement age will need to be adjusted or both. We think the most likely starting point will be to remove the cap on Social Security taxes (currently the cap is \$184,500 of wages) as it would raise the most revenue while negatively affecting the fewest people. The higher the populist influence in Congress at the time, the more likely we will see higher Social Security taxes on higher incomes.

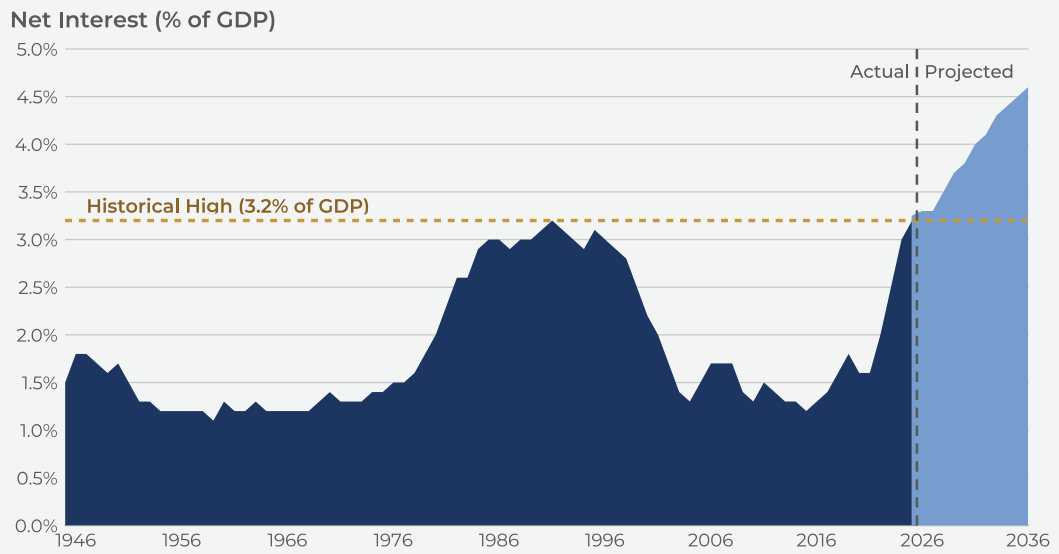
iv. Bipartisan Policy Center, “2026 Social Security Trustees Report, Explained,” June 9, 2026

...raising taxes on the higher tax brackets could start presenting a very attractive target to both sides of the aisle if current populist trends continue...

What does all this mean for client portfolios?

Populists on both sides of the political aisle have priorities for which they would like to see increased government spending or benefits, yet higher interest rates are causing the net debt service costs for the federal government to soar to the equivalent of approximately 19% of all tax revenue^v, which is more than the U.S. spends on defense. When interest rates were near zero prior to 2022, this debt expense ratio was much lower in the 8-10% range. In fact, relative to the size of the economy, federal government net interest costs are expected to set an all-time high this year. When we approached the previous high, Republican President George H.W. Bush was forced to renege on his “no new taxes” campaign pledge to reduce deficit spending.

Net interest costs are projected to exceed the previous high relative to the size of the economy in 2026



Sources: Congressional Budget Office and Office of Management and Budget, via Peter G. Peterson Foundation

At a point now where austerity is almost a requirement, raising taxes on the higher tax brackets could start presenting a very attractive target to both sides of the aisle if current populist trends continue through the 2026 and 2028 elections. Higher personal income taxes, higher Social Security taxes, higher capital gains taxes, higher corporate income taxes – all of these could be on the table and none of them would be positive for the U.S. stock market, supported by increasingly precarious AI-related stock market valuations, or the consumer spending that it has been fueling. Some states and cities are exploring wealth taxes, which also would likely have to come out of investment portfolios.

v. Strategas, “Taxes & Election Outlook”, September 2026

We think it is likely that a higher tax regime for more affluent segments would include a higher long-term capital gains tax rate...

We think it is likely that a higher tax regime for more affluent segments would include a higher long-term capital gains tax rate for those segments, so portfolio management should consider the potential for that in tax planning. If there are capital gains to be taken, should they be taken in the next couple of years? Should a Roth conversion be considered?

We have been increasingly searching for tax-efficient solutions for our clients that would benefit them under the current tax regime but benefit them even more if the next administration ushers in a higher tax burden for the higher tax brackets or those with accumulated wealth.

We do not know if the current wave of populism will continue to develop or not. But if it does, the “affordability crisis” may turn out to be what bursts the “AI bubble” – not by derailing AI itself, but by taxing the wealth and spending that AI-driven gains have been supporting. We cannot predict the future, and future market volatility will come from sources currently known as well as sources of which we are not yet aware, but understanding the potential risks helps us build what we call “durable portfolios” for clients.

Durable portfolios are intended to help clients prosper regardless of whether we are facing stock market tailwinds or headwinds. One way we do this is by using many different asset classes so that we are not reliant on the stock market for returns. Another way is to consider tax-efficiency, or even tax-advantaged investments, to protect portfolios if investors do find themselves in a much more hostile tax regime in the coming years. That we will face future market volatility is one of the few things we know with certainty, so we will continue to seek ways to make client portfolios even more durable.



Dennis Follmer
Chief Investment Officer
October 1, 2026

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