Stephens
Investment Management Group

The following contains a brief discussion of the equity markets from Chief Investment Officer and Senior Portfolio Manager, Ryan E. Crane.



THIRD QUARTER 2026
MARKET OUTLOOK

MARKET OVERVIEW

After last quarter's momentum-driven tape and massive run in semiconductors, this quarter was a bit more complicated from a macro standpoint and less one-sided from a factor view. Only weeks into the quarter, one of Bloomberg's most read stories was about chip stocks being in a "bear market." They rallied back some before the end of the quarter, but it was quite a different environment from the feverish performance chasing of Q2.

The macro backdrop was complicated by the ongoing conflict with Iran and the mixed state of the Straights of Hormuz. Higher energy prices, especially diesel, caused concern for consumer spending and seemed to be driving higher (short-term) inflation. Newly installed Fed Chairman, Kevin Warsh, implemented a 25 basis point hike in September, to deal with inflation concerns, and perhaps to establish credibility early on.

Long term rates had already been moving higher, even in the face of some unusual intervention by Secretary Bessent and the Treasury Department. Our opinion is that long-term inflation expectations haven't changed all that much, but nominal growth has accelerated, and a massive amount of debt issuance (tied to AI capex plans) has crowded out other investments and driven yields higher. It's unclear that hawkish Fed Funds action will have any impact at all on inflation.

For the last few years, the 5% level (for the 10y Treasury) has been the pain point for equities. Large cap equities weren't hurt much by rising yields - even with the 10-year yield rising nearly 82 basis points this quarter to finish at 5.28%, the S&P 500® Index managed a return of 2.30%. The impact became more pronounced down cap. Small- and mid-cap indexes were in negative territory.

OUTLOOK

In the mid-1990s, when I was a young man working as an equity analyst at my former employer, I had a nickname: "crane.com." I don't mind admitting that I was a nerd or geek or whatever the most appropriate term is. I suppose that it's entirely likely that I still am one.

I earned that name because I was quite experienced in navigating the internet back before it was a popular thing. In college, a great deal of my disposable income went to an extra phone line and the fastest modem on the market. Moving around the internet in those days meant dial-up connections to a large network, then moving around using FTP, Telnet, Kermit, and other obscure protocols, just to connect with Unix and Linux based machines in faraway places. There were no search engines, no HTML, no world wide web. Yes, I was a verifiable nerd.

That hobby of mine served me very well as an investor in Internet companies – I understood the technology better than most of my peers. Navigating that investment landscape thirty years ago has really helped me in this AI-driven market. There are so many parallels. I'd like to share one with you.

The Internet existed for quite a while before it became usable to the average person (non-nerd). A catalyst which made it accessible to the masses was America Online (AOL). There were competing platforms like Prodigy and CompuServe, but AOL quickly became the leader. It was the way that nearly everyone accessed the Internet. It was how you sent mail, checked news, chatted with people, played games. It was all there in one place. In 1998, there was a hit movie called "You've Got Mail" based on relationships made and managed on AOL. When people thought of the Internet, they thought of AOL. In many people's minds they were one and the same.

What a stock it was! AOL had something like a 100x return from 1995 to 1999. It was a must-own position for large cap or technology investors. At the time, the dialogue among large cap growth managers was centered around the idea that the only thing that mattered was your relative bet in AOL. Sound familiar?

Despite it being the stock to own, interestingly, AOL doesn't exist today (for the most part, there is still an email business left over). AOL was a walled garden application that curated information for you and presented the Internet, or rather, portions of the Internet to you. For many consumers it was a complete solution, offering dial-up access, email, and the AOL application. But eventually content on the Internet exploded, and other tools came along to manage it (things like Google and Hotmail). AOL customers started ditching the closed system, to instead embrace the wonders that were emerging on the Internet on their own, with a free browser, free email, and free search. What was once daunting and technologically challenging and needed a one-stop solution, was now broadening into countless use cases, a much more robust ecosystem, and entirely different business models. No one needed AOL anymore.

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Is Anthropic or OpenAI at risk of the same fate as AOL? Both have been great one-stop-shop solutions, just like AOL was. Sign up, download the app, pay $20 a month, and then "You've got AI." But also just like AOL, it is a closed system. You're stuck with the weights they assign to the model, the guardrails they put in, the biases they believe are necessary, not to mention being locked into their tokens and their pricing.

It's getting easier to go your own way these days. It's not yet trivial to set up your own AI, but it's also not unapproachable either. There are many open-weight (and some open-source) models. You can run it locally on your own hardware or find a partner who will gladly host it for you and integrate it into your workflow. You're not paying for tokens, since you own (or lease) the computer. If you need bleeding-edge frontier capabilities, then maybe this isn't for you. But if being only 3-6 months behind the frontier is acceptable, then it could be a much cheaper solution, and one that won't freak out your network security team or your compliance people.

Let me be clear, this is not my base case (that Anthropic or OpenAI go the way of AOL), but it is certainly not impossible either. The technology around AI is changing fast, and the way people use it might be changing faster.

Which brings us to Muse. Meta Platforms launched Muse just recently, and it is seeing faster user growth than even ChatGPT did at its onset. It's already been so disruptive that Amazon had to temporarily block it. Last month, it didn't exist. Now it's transforming e-commerce. I've got my Muse looking for the best deal on tickets to a concert I want to see in a few weeks and scanning for news on my daughter's field hockey endeavors. If you give it access, it will renegotiate your wireless contract, plan meals and do your shopping for you, analyze your credit card bill, figure out the optimal way to use airline miles, just to name a few. Our big takeaways with respect to Muse: 1. It's changing e-commerce, and there will either be share shifts or margin compression or both (and that's deflationary), 2. It's driving a lot of incremental web traffic, and a new ecosystem of managing people vs. bots is emerging, and 3. We're going to need more compute.

In other AI-related news, a weird thing happened recently, where a former Anthropic employee resigned and then posted a scary message about how AI is "gambling with our lives" and "could kill all of us by the end of the decade." I'm not saying this was a psyop or coordinated campaign, but I'm also not saying that it wasn't. Coincidentally, just days after his post, Anthropic CEO, Dario Amodei published an essay titled "We Must Pace the Frontier," arguing that the security and safety risks are real, and that the prudent thing to do is to slow the pace of improvement. OpenAI's Sam Altman joined him in this argument, even though they are direct competitors.

OpenAI and Anthropic seem to be begging for government intervention and regulation. I find that a little peculiar and a lot revealing. Of course, both companies have the option to internally manage these risks. They are welcome to go as slowly as they choose - by all means, please pace the frontier if that's what you think is right, Mr. Amodei. My cynical take is that while they compete with one another, they are implicitly revealing that the scariest competition comes from these much less expensive, open-weight models. Wouldn't it be convenient if the government somehow restricted these models coming from China? I don't want to stretch too far and try to connect this back to my AOL thesis, but in my mind, it might indicate that even they believe they need external help from the government in order to succeed. Maybe it's just coincidence.

For the record, I think the dystopian, Terminator-style threats to humanity are probably overstated. I do think that hackers and fraudsters may have the upper hand for a while. The cybersecurity risks which we've been quite vocal about seem to be very real and near term. Frontier models are very capable at breaking into networks. In my opinion the cyber security risks are still underappreciated.

I don't say any of this to be bearish on AI. I'm still as excited as ever. It's just a reminder that the entire AI landscape will almost certainly continue to evolve at an alarming pace. That's good news for active managers. Even if OpenAI or Anthropic stumbles, I believe the long-term opportunities are still so good that they're impossible to measure.

It's not hard to see what a valuable tool AI can be and will be. I don't know how to discount the probability of AI somehow being a threat to humanity, but it seems very clear that it will be a threat to the status quo of the global economy and the geopolitical landscape. The first country to achieve AGI or SI or whatever we are calling it now, will have a potentially huge advantage, economically, scientifically, and militarily. In terms of AI development, I think we are effectively at war with China. Not a kinetic war, but with so much at stake, the spending is on par with wartime spending (although admittedly it's not constrained to government spending, the hyperscalers are doing that themselves).

In addition to this AI spending war, it turns out we are also involved in an actual kinetic war, too. The Iranian conflict doesn't seem to have an easy offramp. The extra complication of shipping oil through the Straits of Hormuz only adds to the economic implications.

Consider that:

- We are at war with Iran.
- The conflict with Iran has created oil shortages.
- We are at war of a different sort with China - a race to develop super intelligence.
- Companies are also facing competitive threats and disruptions from AI, so many of them are investing or spending at an increased rate, simply to help ensure their survival.

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All of these things are inflationary. On top of that, it's worth pointing out that historically, long-term interest rates have been somewhat correlated with nominal GDP growth. Growth seems to be accelerating (in part due to AI). Nominal GDP growth in the most recent quarter was 6.6%. With a few assumptions and digging into the Atlanta Fed's GDPNow data, it looks like they're forecasting 3.7% real GDP growth, but 6.2% nominal. Does that mean the yield on the 10-year treasury should be closer to something in the 6s?

Another reason long-term rates might be higher is not just that the AI-related spending is inflationary in itself (it surely is), but also that the hyperscalers (and others) are issuing massive amounts of debt to pay for the expansion of compute capabilities. Econ 101 – when the supply of something goes up, and demand is left alone, the new equilibrium will be at a lower price. For bonds, a lower price means a higher yield. If the industry needs $1 Trillion to fund capex next year, some of that will come from cash flow, but there's going to be a lot of new debt. Solve for the new equilibrium.

The Fed's decision to raise the Fed Funds rate in September might have been an effort to regain or maintain credibility (especially when the notion of fiscal dominance is back in vogue). I appreciate the need to at least appear to be dealing with inflation, but I'm not sure raising rates cures any of these drivers of inflation. Higher short-term rates won't solve either war problem. It won't help with energy prices. I don't think it will change AI-related business strategy. The demand for better AI and more AI seem pretty unaffected by rates. It will make borrowing more expensive however, which for many consumers is an avenue of inflation.

In prior commentaries I've referred to work by economist, John Cochrane on neo-Fisherianism – the idea that lower rates drive lower inflation and vice versa. He published this just recently. Many of you know I'm a huge fan of Cochrane, and especially his work on inflation. I find it particularly interesting that economist and Jefferies Chief Market Strategist, David Zervos, referred to Dr. Cochrane's work on this subject in early September. I've known David for years, and when I had asked him about neo-Fisherian ideas in the past, he was wholly dismissive. I'm not sure what's changed for him. But he did change jobs. Just days after publishing this note contemplating cutting rates to lower inflation, he announced that he is "pausing" his role at Jefferies and is accepting an appointment to the Treasury Department as Counselor to the Secretary (Bessent). Hmmm.

Secretary Bessent also recently gave such a position to Judy Shelton, a former economic advisor to President Trump, and a staunch critic of the Federal Reserve. She has long advocated for "hard" money and has even argued for a return to a currency somehow pegged to gold. Here's an intriguing tweet from her a couple years ago:



I have no idea where this all goes. Zervos has called me an inflationista, and maybe I am. I've been worried about inflation for a very long time. If you've been reading these commentaries for a while, I'm sure you're tired of hearing about it from me. My current take is that the forces driving near-term inflation will not be tamed by higher short-term rates, but rather will be made worse. The long-term inflation pressure I worry about stems from government spending and government debt.

While the race to develop AI is inflationary now, longer term, I still firmly believe that AI will be a powerful deflationary force. Muse and some of these agentic tools will help accelerate that – it takes very little effort to unleash a team of bots to go get the best pricing and even negotiate on your behalf. We are only just beginning to understand the productivity benefits of AI, and they span across just about every field and every industry you can imagine, and that is with today's capabilities - the improvements have not stopped.

Putting it all together, I would point back to the long-term trends we mentioned last quarter: AI is transformational, inflation seems set to continue (whether measured correctly or not), and the political environment here, and globally, is rapidly evolving as well. The status quo is not safe. And crane.com is even more excited today than he was in the late 90s.

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