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Bond Yields Rise to 2 Decade Highs
Equities are Running on One Engine

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The third quarter saw a continuation of the stock market rally, but at a slower pace, while the bond market decline picked up steam. That decline notwithstanding, I have chosen to put a relatively small portion of assets (roughly 10%) into long U.S. Treasury bonds. I have purchased bonds in the 20-year range because their yields are slightly higher than the 30-year long bond. That also reduces the volatility of the position compared to the normally higher yielding 30-year bond. That reduced volatility would be important if interest rates continue to rise, as I suspect they may.

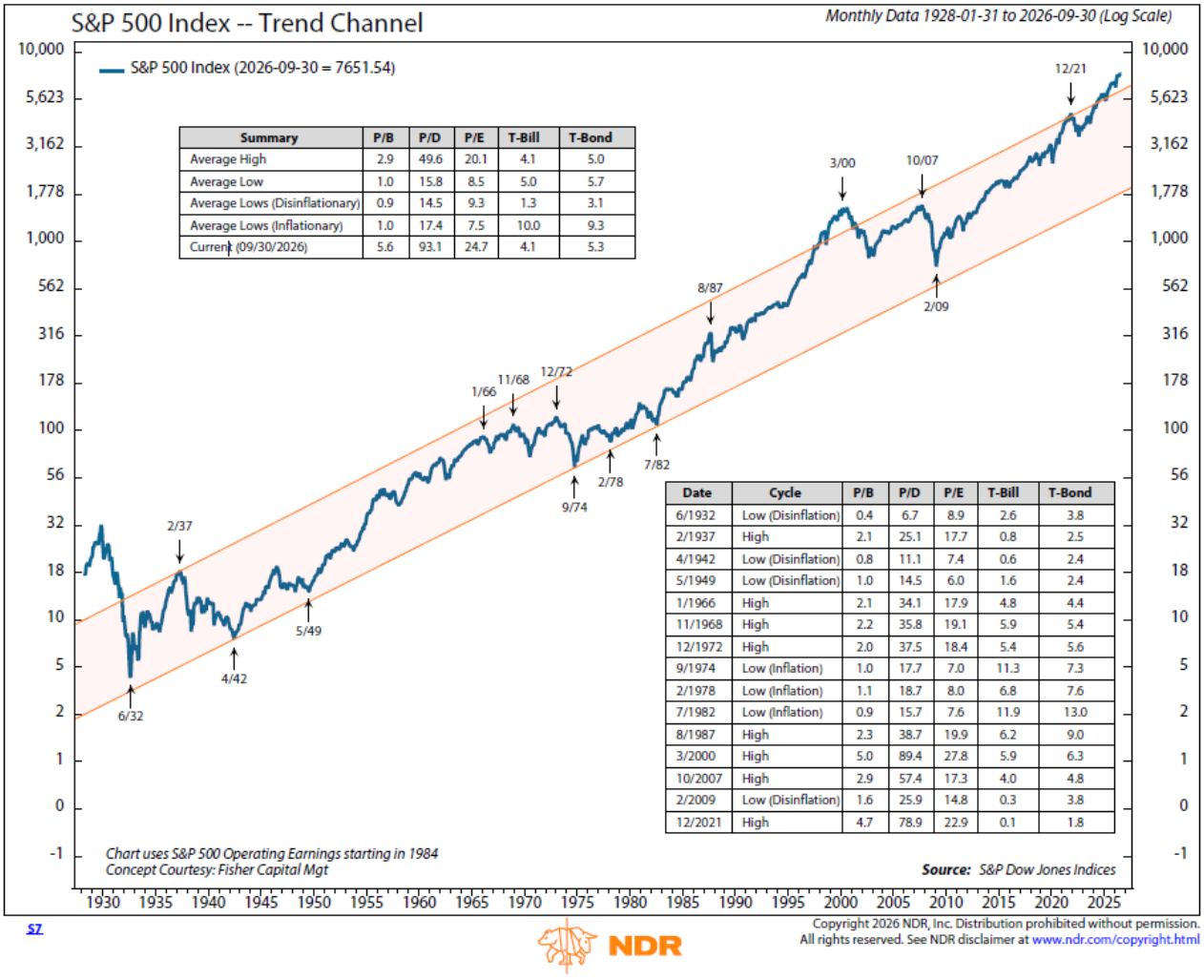
Fixed Income Portfolio Decisions

I have written frequently about how I use valuation to make purchase and sale decisions with equities. I will discuss current equity valuations later in this commentary. Valuation can provide helpful guidance in making fixed income decisions as well. It has helped greatly through the extremely weak bond market environment throughout the 2020s. Initially, I employed very short maturity paper, despite minimal yields, because long rates were similarly well below historically normal yield levels, and in an expected period of rising rates, longer maturities were almost certainly going to experience negative total returns. That is what happened. In fact, the total return for the Bloomberg Aggregate Bond Index from August 2020 through the end of this year's third quarter was a negative 4.1%, by far the worst extended period in U.S. history. Even minimally positive short rates, therefore, were clearly preferable. As rates across the yield curve began to rise, I gradually began to extend maturities, while still keeping them under one year. Once short yields rose above the historic average of about 3.75%, extending new purchases out closer to one year became more rewarding. We still had a maturity ladder that provided frequent opportunities to extend out further if yields continued to rise. It has taken several years, but longer yields have only recently risen above the historical average level around 4.9%. Although I expect that rates are likely to continue higher eventually, when I could get from 5.5% to 5.7%, I thought it worth putting a small amount of the fixed income portfolio portion in the 20-year range. Should rates continue to rise to even higher yields, it will likely make sense to increase the portion of the portfolio in the longer maturity category. On the other hand, should bond markets rally from here and rates decline for a while, we will at least have some of the assets earning a historically attractive long-term rate.

Equity Valuations

With the major equity markets arguably at their most expensive ever in terms of the most commonly used valuation measures, it is critically important to evaluate the desirability of portfolio equity exposure. Let me review data I have used for many years to evaluate levels of equity valuation attractiveness.

The graph below is from the outstanding data analysis firm Ned Davis Research.



Summary	P/B	P/D	P/E	T-Bill	T-Bond
Average High	2.9	49.6	20.1	4.1	5.0
Average Low	1.0	15.8	8.5	5.0	5.7
Average Lows (Disinflationary)	0.9	14.5	9.3	1.3	3.1
Average Lows (Inflationary)	1.0	17.4	7.5	10.0	9.3
Current (09/30/2026)	5.6	93.1	24.7	4.1	5.3

Date	Cycle	P/B	P/D	P/E	T-Bill	T-Bond
6/1932	Low (Disinflation)	0.4	6.7	8.9	2.6	3.8
2/1937	High	2.1	25.1	17.7	0.8	2.5
4/1942	Low (Disinflation)	0.8	11.1	7.4	0.6	2.4
5/1949	Low (Disinflation)	1.0	14.5	6.0	1.6	2.4
1/1966	High	2.1	34.1	17.9	4.8	4.4
11/1968	High	2.2	35.8	19.1	5.9	5.4
12/1972	High	2.0	37.5	18.4	5.4	5.6
9/1974	Low (Inflation)	1.0	17.7	7.0	11.3	7.3
2/1978	Low (Inflation)	1.1	18.7	8.0	6.8	7.6
7/1982	Low (Inflation)	0.9	15.7	7.6	11.9	13.0
8/1987	High	2.3	38.7	19.9	6.2	9.0
3/2000	High	5.0	89.4	27.8	5.9	6.3
10/2007	High	2.9	57.4	17.3	4.0	4.8
2/2009	Low (Disinflation)	1.6	25.9	14.8	0.3	3.8
12/2021	High	4.7	78.9	22.9	0.1	1.8

Current computations are as of the end of September. The graph shows all the major peaks and troughs of the S&P 500 since 1928. The initial market peak in the lower left-hand corner of the graph represents the top of the market before the crash that led to the Great Depression in the 1930s. The ultimate decline to the trough in 1932 was 89%. That decline is not

included in the computations I performed from all the dated peaks through 2007. To have included that decline would have skewed the average decline so much as to overemphasize the dangers of the average decline. I have also omitted the minor decline from year-end 2021, which was about 22%, but from which stocks quickly rose to even higher valuation levels–again, not a typical decline.

It is noteworthy that nearly a century of data conforms quite neatly to the outlined trend channel. The price-to-book value, price-to-dividends, price-to-earnings, Treasury bill and Treasury bond levels are listed for each dated market peak and trough in the table in the lower right corner of the graph. The average of each individual measure of the dated market peaks is shown across the top line in the table in the upper left corner of the graph. Similarly, the average of the dated market troughs is displayed on the next lower line in the same table.

The bottom line in the upper left table gives the end-of-third-quarter levels for the price-to-book value, price-to-dividends and price-to-earnings ratios, plus the yield on Treasury bills and long U.S. Treasury bonds. It is noteworthy that the end-of-quarter price-to-book value and price-to-dividends ratios are higher than at any of the earlier market peaks. The price-to-earnings end-of-quarter ratio is well above the average of the market peaks and above all but one of the seven individual prior peaks. The only P/E ratio above the current reading was in March of 2000, which marked the beginning of the nine-year period in which the S&P 500's value was cut by more than half.

The appendix describes the aftermath of each peak — how far the Dow Jones Industrial Average descended in what period of time, how many years of prior gains were wiped out and how long it took to get back to the prior peak and exceed it. The average decline from the listed peaks to the ultimate troughs was 40.0%. The declines took prices back to a level first reached on average 9.0 years earlier (ranging from 1 to 15 years). The dated high levels were not permanently exceeded for 9.8 years on average (ranging from 4 to 16 years). The longest such expanse of time before permanently exceeding a former high in this country was the 25 years from 1929 to 1954. The longest in any industrialized country was in Japan, which only in 2025 exceeded its 1989 peak more than 36 years later.

What registers strongly with me is that every market peak, even at smaller valuation excesses than today's, has been severely punished despite the positive news and investor sentiment that accompanied each peak. Of course, we can't know whether current market prices are near a market peak or whether prices will continue to climb. Unless this market rally is different from its predecessors, however, we can expect that the ultimate market decline will take away years, possibly several, of prior price gains and will leave valuations much lower than today's. Could AI so change society and economic and securities market precedent that valuations rise to permanently higher levels or that aggressive earnings growth eventually justify

current valuations without a serious price decline? While always possible, history demonstrates conclusively that dramatic earnings growth has never before normalized valuations from levels even close to current extremes. And despite a series of life-altering inventions or developments, such as the harnessing of electricity, the invention of railroads, air transport, radio, television, the computer and the internet, each of which led to significant stock market euphoria and frequently bubbles, markets always eventually reverted to normal or below-normal levels of valuation. Such a valuation unwind is, therefore, highly likely in this instance as well, even if the current rally should extend further.

Other Variables

Positives – Despite rapidly rising interest rates, domestic manufacturing statistics remain strong, only partially attributable to inflation. And despite persistent inflation, the U.S. consumer continues to spend. Most importantly, the development of AI has led to surging corporate earnings in a relatively small portion of the U.S. economy.

Negatives – Negatives, however, outnumber the positives.

War – No clear exit appears likely from the violence in the Mid-East. Because of its effect on oil supply and prices, continued fighting would make it very difficult to reduce either domestic or global inflation. In recent weeks, The Wall Street Journal reported that oil company executives claim that an oil crisis is already here, and those corporate leaders find it difficult to envision oil prices coming back down quickly.

Low Insider Buying – It is always encouraging to see senior executives buying more of their own company's stock. Unfortunately, we're not seeing that now. Insider buying is at a two-decade low. The number of financial executives buying their own stock fell to the lowest level in almost 23 years during the third quarter. The overall market showed about 20% more selling relative to buying than its historical norm.

Debt – Inflation is not the only factor pushing interest rates higher. Worldwide debt has been growing for years. Ned Davis Research warns of the risk of another European sovereign debt crisis with France in the most imminent danger. Last month, Goldman Sachs reported that in the U.S., Japan and Germany, longer maturity bond yields have climbed to the highest level in decades. Their report stated: "While some of the factors driving yields higher may dissipate, Goldman Sachs Research expects the fiscal concerns pushing up interest rates to persist."

Rising interest rates around the world typically influence U.S. rates as well. One of my favorite economic commentators, Mohamed El-Erion, wrote last month that investors should expect the sell-off of global government bonds to continue, pushing yields higher, with many already at multi-decade highs amid mounting concerns over inflation and central bank rate

hikes. He sees "reliable buyers and holders" of U.S. Treasuries coming under pressure. "China, for geopolitical purposes, is no longer willing. Japan and the Gulf countries have domestic issues." He sees three G7 countries — the U.K., Japan and France — particularly vulnerable to sovereign debt problems. Clearly, debt has become and may continue to become even more expensive.

I have written for years about the destructive power of debt when it fails to produce adequate growth. The most recent dramatic example of destructive debt in this country was the collapse of the real estate market that precipitated the financial crisis of 2007–09. Many homebuyers purchased their homes with very large mortgages relative to equity. When prices declined, the equity disappeared and all that remained was debt.

As Reuters reported recently, from World War II until the late 2010s, the U.S. economy in general grew faster than federal debt. That relationship changed due to government spending used to counter the 2007–09 financial crisis and the Covid-19 pandemic. Recent tax cuts exacerbated the deficit. The U.S. annual deficit is now close to 6% of GDP, a level historically only reached in response to serious economic distress. Economists generally believe a 3% deficit level to be manageable. Unfortunately, U.S. borrowing costs are now above the country's longer-term rate of growth.

Several areas of debt are starting to ring alarm bells. Private credit markets have recently experienced record default rates. The New York Fed reported this past quarter that Americans are falling behind on their debt payments at rates not seen since the Great Recession. The report also highlighted that a record number sought debt consolidation services in the first half of 2026. Debt collection lawsuits have spiked, and personal bankruptcies are on the rise. Americans' savings rates have declined dramatically, and mortgage delinquency rates are again increasing.

Investor enthusiasm is seen at both the retail and institutional levels. Margin debt is hitting record highs on both an absolute and percentage of GDP basis. J.P. Morgan Chase CEO Jamie Dimon adds that there is a lot of margin debt that we don't see, because it's called other things, like leveraged ETFs.

Ray Dalio, the founder of Bridgewater Associates, one of the world's largest hedge funds, recently stated: "I am confident that the government’s financial condition is at an inflection. If this is not dealt with now, the debt will build up to levels where they can't be managed without great trauma." On debt growth's current trajectory, he sees a debt crisis in as early as one year and as late as five.

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Fed Actions – A major determinant of the progress of the economy and the bond market will be the actions of the Federal Reserve. Inflation has been stubbornly strong, with the CPI year-over-year reading rising to 3.7% after September's increase. That makes it highly probable that the Fed will raise rates at least once more before year-end. Inflation fears also intensified in September with the New York Fed's monthly survey of inflation expectations rising to its highest level in 3½ years. Consumers expect inflation to rise to 3.9% over the next 12 months, almost double the Fed's 2% target. Fed officials consider expectations a key driver for inflation, and such expectations may complicate the Fed's decision-making should they need to consider providing assistance to a weakening housing market.

The Fed also sees threatening inflation in the producer pipeline, which implies upside risk to consumer prices and/or downside risk to corporate profit margins. Market prices are showing an expectation of two rate hikes by mid-year 2027 and three by December 2027. If realized, corporate profits will be squeezed by higher borrowing costs.

AI Domination – Without a close second category, companies connected with technology and AI have dominated economic growth and corporate profits in the last few years. Currently, 10 giant AI-related companies comprise almost 40% of the weight of the S&P 500. Such concentration has historically been a significant danger sign.

The Wall Street Journal, not given to hyperbole, published a cautionary editorial last month. In part, they wrote: "Hype about new technologies is an inevitable human temptation, and sometimes it pays off, but eventually investors demand returns on capital….The sheer quantity of capital that has flowed into tech suggests that if and when investors decide a large scale reappraisal is required, it is likely to be bloody. All the more so since much of this investment has been financed with debt, especially via opaque private-credit markets. Credit can turn a technological reappraisal into a financial panic or worse."

Despite Wall Street's broad excitement about the prospects for AI, a few respected voices can be heard issuing sobering messages. And when equity valuations are as extreme as they are today, I pay extra attention to respected analysts who lean against Wall Street's perennial bullishness.

Michael Burry made a fortune betting against the U.S. housing market before its collapse, which precipitated the financial crisis of 2007-09. He now expects that "the bubble in AI may burst sooner than later." He has increased the leverage in his short positions against some key AI stocks.

Market legend and GMO co-founder Jeremy Grantham, who accurately forecasted the dot.com bubble at the end of the 1990s and the housing bubble before the 2007-09 financial

crisis, has offered an even more dire warning about the boom that has exploded on the enthusiastic expectations for AI. In a recent interview, he said: “This is, I think, the biggest investment bubble in American history,” warning of the possibility of a 70% market decline. We can all hope that his concerns are far less accurate than his earlier market and economic forecasts, but they certainly should be considered.

Summary

In my more than half century in this business, I have studied carefully both retail and institutional investors’ tendency to push enthusiasm and pessimism to extremes that are ultimately punished severely. As the outstanding Ned Davis Research study described earlier reveals, valuation extremes clearly characterized all the major stock market peaks and troughs of the past century. That point notwithstanding, we only know the exact market peaks and troughs after the fact. Excesses in either direction can become even more extreme.

In the current instance, the potential for AI is huge. Throughout history, major technological breakthroughs have similarly projected magnificent prospects. Even when these prospects have been realized, however, the accompanying stock market advances and their far-above-normal valuations in the early development stages have always ultimately reverted to or below historically normal levels. We can’t know whether this year’s early-October high is the peak of this advance or whether we will see new highs. In either case, today’s valuations argue that we will ultimately experience stock prices at some future time well below the current level. For the opposite to occur, the unprecedented would have to prevail. I have spent a career advocating choosing the frequently precedented option over the unprecedented. Today, the high-quality fixed income option offers better than normal returns with the prospect that yields may become even more attractive.

Appendix

While the graph shown above shows the S&P 500, my original study used Dow Jones Industrial Average figures for stock market performance. The appendix shows market results in terms of the Dow. The two market indexes, though not identical, typically are quite similar. Because the dated peaks and troughs on the graph are end-of-month figures, some of the more detailed performance dates may differ slightly.

2/1937 The Dow declined 49.1% initially from 3/10/37 to 3/31/38, then ultimately 52.2% to 4/28/42. The 1942 trough took prices back to a level first reached in 1927 (15 years). The 1937 peak was not reached again until 1945 (8 years) and was not permanently exceeded until 1949 (12 years).

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1/1966 and 11/1968 The Dow declined 25.2% initially from 2/9/66 to 10/7/66. It never regained the former high before declining 35.9% from 12/3/68 to 5/26/70. The 1970 trough took prices back to a level first reached in 1959 (11 years). The 1966 peak was not permanently exceeded until 1982 (16 years).

12/1972 The Dow declined 45.1% from 1/11/73 to 12/6/74. The trough took prices back to a level first reached in 1958 (16 years). The early 1973 peak was not permanently exceeded until late 1982 (10 years).

8/1987 The Dow declined 36.1% from 8/25/87 to 10/19/87. The trough took prices back to a level first reached in 1986 (1 year). The 1987 peak was not permanently exceeded until 1991 (4 years).

3/2000 The Dow declined 37.8% from 1/14/00 to 10/9/02. The trough took prices back to a level first reached in 1997 (5 years). The 2000 peak was not permanently exceeded until 2011 (11 years).

10/2007 The Dow declined 51.1% from 10/9/07 to 3/5/09. The trough took prices back to a level first reached in 1996 (13 years). The 2007 peak was not permanently exceeded until 2013 (6 years).

12/2021 The Dow declined 21.9% from 1/3/22 to 9/30/22. The trough took prices back to a level first reached in 2019 (3 years). The peak was last exceeded on 12/13/23 (almost 2 years).

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