

October 6, 2026

Dear clients and friends,

Washington has tried to talk the bond market down. On September 8th, Treasury Secretary Scott Bessent told an audience at Southern Methodist University, “I have asymmetric information. I am the house now. Bet against me if you want.” Interest rates continued to climb, and two weeks later Bessent acknowledged on CNBC, “I can’t set the equilibrium price.” His former mentor, Stan Druckenmiller, put it best in *The Wall Street Journal*: “The long-term Treasury yield is the most important price in the world. It is also the only fiscal disciplinarian the U.S. has left.” Druckenmiller added that if the 30-year bond must yield 5.5% to attract buyers, “That isn’t a crisis. It is an invoice.”

Rising yields have already sent their invoice to the owners of bonds. A bond’s price moves in the opposite direction of its yield, and duration measures the severity of this inverse relationship. A bond or bond fund with a duration of six years, for example, would lose roughly 6% of its market value if yields rose by one percentage point, all else being equal. The longer the duration, the more severe the price swings (in either direction). Since December 31, 2025, Treasury yields have risen by roughly a full percentage point across most of the curve. The 2-year yield climbed from 3.47% to 4.88%, the 10-year from 4.18% to 5.29%, and the 30-year from 4.84% to as high as 5.69%. Year to date through September 30th, the 2-year Treasury returned 0.30%, the 10-year lost 5.30%, and the 30-year lost 8.06%. The Bloomberg U.S. Aggregate Index, the benchmark for most core bond funds, fell 2.91%, and the Bloomberg Municipal Bond Index fell 4.18%. Most of the damage came in the third quarter, as core bonds fell 3.5% and municipal bonds fell 6.3% in those three months alone, erasing gains from the first half. There is a silver lining. The Aggregate Index now yields 5.56%, and its real yield after inflation, 3.12%, is above its long-term average of 2.48%. The starting yield has historically been the best

single guide to a bond's future return, so today's buyer of high-quality bonds is being paid far more for lending money than buyers were only a few years ago.

Why does this matter to an owner of stocks? As Warren Buffett wrote in *Fortune* in November 1999, near the peak of the last technology frenzy, interest rates “act on financial valuations the way gravity acts on matter: The higher the rate, the greater the downward pull.” When rates rise, the present value of earnings expected far in the future shrinks the most, and businesses that depend on capital markets to fund their losses become the most vulnerable. Businesses with internally driven earnings built on the qualities we seek¹ can fund growth from their own cash flow rather than from debt and are less exposed to rising interest rates.

Nowhere is this more relevant than in today's AI trade. Joachim Klement, a securities strategist at Panmure Liberum in London, recently told MarketWatch that if the artificial intelligence boom implodes, he would favor two basic positions: “cash and fetal.” It is a funny line that makes a serious point. Klement believes an AI “reality check” could take the S&P 500 Index down roughly 35% by the end of next year. We make no such forecasts, but it is worth describing plainly what an investor owns when buying the Index today, and why we have chosen a different path.

The engine of this market is capital spending. Alphabet, Amazon, Meta, Microsoft, and Oracle spent roughly \$416 billion on capital projects, mostly data centers, in 2025. The consensus estimate for 2026 is \$799 billion, followed by roughly \$1.1 trillion in 2027 and \$1.2 trillion in 2028. For the first time in at least two decades, these companies are on track to spend essentially all of the cash their businesses generate, leaving little or no free cash flow for their owners. The gap is being filled with borrowed money. At the center of the buildout sits Nvidia. Increasingly, Nvidia is financing its own customers. Critics call this circular finance: a

¹ These include Hamilton Helmer's *Seven Powers*: scale economies, network effects, counter-positioning, switching costs, branding, cornered resource, and process power. We also seek proven management with the right incentives, high and sustainable margins, free cash flow growth, high returns on capital, attractive reinvestment opportunities, and financial strength – purchased at a reasonable valuation.



supplier provides the money a customer uses to buy the supplier's products, the sale is recorded as revenue.

Much of the buildout's risk has moved off balance sheets and into special purpose vehicles, or SPVs. Risk that cannot be measured has not been removed.

We also question who will ultimately earn a return on this investment. Through the lens of Hamilton Helmer's *Seven Powers*, which we use to judge the durability of the businesses we own, frontier model companies, including OpenAI and Anthropic, have a moat problem. Switching costs are low, since developers can change models with a few lines of code. Scale economies are being competed away by rivals spending just as heavily, new competitors offer models at a fraction of the price, and capable open-weight models are freely available. A technology can transform the world without enriching the people who build it. Warren Buffett once observed that a far-sighted capitalist at Kitty Hawk would have done his successors a huge favor by shooting Orville down, because the airline industry went on to destroy enormous amounts of capital while changing the way the world travels.

We have seen this pattern before. In 1999 and early 2000, telecommunications equipment makers lent their customers money to buy their gear, the industry laid enough fiber-optic cable to circle the globe many times over, and Cisco briefly became the most valuable company in the world. The internet changed everything, just as its promoters said it would, yet many of the investors who financed it lost most of their money. From its peak in March 2000, the S&P 500 Index fell 49% over the next two and a half years, and the technology-heavy Nasdaq fell far more. The Federal Reserve was raising interest rates then, too.

During the third quarter, U.S. large-cap stocks as measured by the S&P 500 Index gained 2.3%, yet the average stock fell 1.9%. After contributing just 1% of the Index's return in the first half of 2026, the Magnificent Seven have now delivered 34% of its year-to-date return. The rally has narrowed again, and as we cautioned in July, the equity portion of our clients' portfolios should be expected to trail the S&P 500 Index during periods like this.



Inflation is rising again, the Federal Reserve raised its policy rate for the first time since 2023, the European Central Bank raised rates in June and again in September, and the Bank of Japan lifted its rate to its highest level in 31 years. Brent crude traded above \$100 per barrel before ending the quarter at \$98, and diesel, which moves nearly everything Americans eat and buy, set a record national average of \$6.53 per gallon in September. Federal debt has crossed \$40 trillion, and net interest on that debt topped \$1 trillion in just the first eleven months of fiscal 2026, more than the United States spent on defense over the same period. Europe faces its own reckoning. France's 10-year yield hit 4.96%, its highest since 2002, and Britain's 30-year yield topped 6% for the first time since 1998.

Our focus remains on high-quality bonds and on attractively valued stocks of companies with internally driven earnings that can compound value for years to come. We look for management teams that lead sustainable businesses and allocate capital as if it were their own. When a speculative cycle ends, prices tend to reconnect with normal earning power, and patient owners are often handed opportunities that were unavailable at market peaks. Maintaining a long-term view and managing through what we would characterize as speculative cycles is difficult and increasingly rare. As fiduciaries, we will continue to do what we believe is right for our clients.

We welcome the opportunity to discuss these observations and your portfolio with you. Please email info@sapphirefiduciary.com, call (502) 509-2568, or visit sapphirefiduciary.com to schedule time with us.

Sincerely,

A handwritten signature in black ink that reads "Paul Stropkay". The signature is fluid and cursive, with the first name "Paul" and last name "Stropkay" clearly distinguishable.

Paul Stropkay, CFA



Sources

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