



1492

CAPITAL MANAGEMENT

DISCOVERING OPPORTUNITY

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IDENTIFY THEMES | FUNDAMENTAL ANALYSIS | TARGET VALUATION | GROWTH STRATEGY | VALUE STRATEGY | CORE ALPHA STRATEGY

1492 Vantage Point Quarterly Newsletter

Welcome to 1492 Capital Management's newsletter for the third quarter of 2026. In each quarterly newsletter, we provide our perspective on the most recent quarter, preview what lies ahead, and offer a bit of market trivia.

Our corporate slogan is "Discovering Opportunity," which is our daily focus for our clients with our small cap and wealth management portfolios. 1492's time-tested strategies are based on a three-step process of identifying investment themes from hundreds of meetings annually with company executives, extensive tire-kicking of the business fundamentals, and a rigorous valuation methodology.

"Small Caps Kryptonite - Higher Rates and Oil Create Large Divergence"

If an explosive, broad-based rally defined the second quarter, the third quarter was a fascinating study in contradictions. The economy remained resilient, and corporate earnings remained strong. The S&P 500 and Nasdaq Composite continued to advance even as the Federal Reserve delivered its first interest rate increase in more than three years. Treasury yields surged to levels not seen in more than two decades (small caps' Kryptonite). Oil prices climbed sharply, and small cap stocks suffered a meaningful correction. The headline indexes finished the third quarter modestly higher as the S&P 500 returned 2.3%, and the Nasdaq Composite gained 2.6%. The major benchmarks reached record levels in August and early September, but the quarter belonged to a very small group of stocks. At quarter end, 83% of S&P 500 members were trading more than 10% below their 52-week highs, and 42% were down more than 20%. The Russell 2000 gave back roughly half of its second quarter gain. It was a good quarter to own a handful of mega-cap technology names and a poor one to own almost anything else.

Three developments defined the quarter. First the Iran ceasefire that we flagged as our first risk last quarter collapsed. Both sides exchanged attacks that disrupted key energy routes, which sent Brent crude up 42% for the quarter to \$103.53 per barrel with the Strait of Hormuz still blocked. Second the Federal Reserve reversed course and hiked rates for the first time since 2023 while Treasury yields surged to levels not seen in over two decades. Lastly the AI trade whipsawed with a violent July semiconductor crash, a recovery in large cap AI leaders, and a September debate over "AI doomsday" that dominated the headlines. The most important takeaway is that **the Q3 correction was much broader than the headline indexes suggest**. The Russell 2000's 7.2% decline was particularly noteworthy because small caps had been one of the major winners of the first half of 2026. The sharp increase in Treasury yields and the resulting increase in the cost of capital primarily drove the quarter's reversal. Small companies are simply more sensitive to interest rates. We continue to believe that the recent small cap weakness should be viewed differently from a deterioration in the underlying long-term opportunity. The valuation gap between large and small companies remains significant, but the catalyst for small caps will likely require some stabilization in interest rates.

The Fed's rate-hiking cycle and the pending Anthropic IPO amidst the AI doomsday narrative are likely to take up most of the oxygen in the room, but the mid-term election is less than a month away, which has its own implications for the markets. Please read on to see our unique views of what's on tap for the rest of 2026, themes we're investing in here at 1492, and key market drivers.

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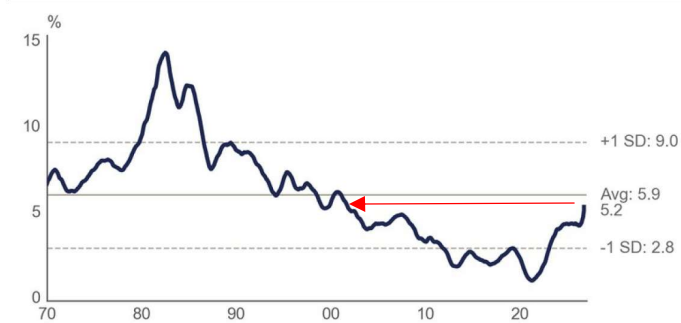
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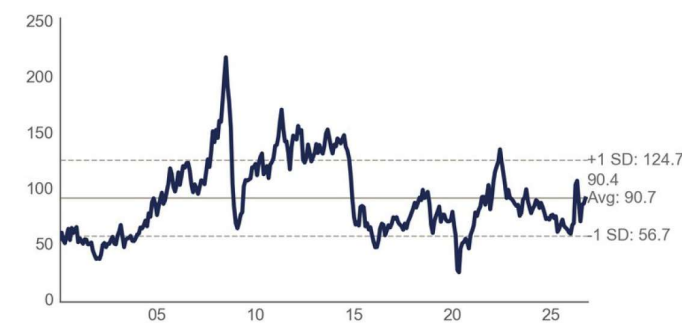
“Small Caps Kryptonite - Higher Rates and Oil Create Large Divergence”

If an explosive, broad-based rally defined the second quarter, the third quarter then was a fascinating study in contradictions. The economy remained resilient, and corporate earnings remained strong. The S&P 500 and Nasdaq Composite continued to advance even as the Federal Reserve delivered its first interest-rate increase in more than three years. Treasury yields surged to levels not seen in more than two decades (small caps' Kryptonite) as shown in the chart below on the left. Oil prices climbed sharply, and small cap stocks suffered a meaningful correction. The price of oil continues to make headlines because every news show loves to lament about the price of gas at the pump. However, if you look at the chart below on the right, which shows the price of oil in 2026-dollar terms over the past 25 years, it sits at the average price over this period, which is less than half the price from the peak in 2008.

10 Year Treasury Yield



WTI in 2026 Dollars



The headline indexes finished the third quarter modestly higher, with the S&P 500 returning 2.3% and the Nasdaq Composite gaining 2.6%. The major benchmarks reached record levels in August and early September, but the quarter belonged to a very small group of stocks. At quarter end, 83% of S&P 500 members were trading more than 10% below their 52-week highs, and 42% were down more than 20%. The Russell 2000 gave back roughly half of its second-quarter gain. It was a good quarter to own a handful of mega-cap technology names and a poor one to own almost anything else. The chart below left shows the performance for the September quarter, which had a definite skew to “Value” and “large caps”, whereas the year-to-date chart on the right shows that same skew to “Value” but a bit more even performance for small caps.

Total Returns by Style - 3Q26

	Value	Blend	Growth
Large	2.6	2.3	0.9
Mid	-2.0	-3.0	-5.8
Small	-4.9	-7.2	-9.4

Source: Bloomberg, FactSet, Seaport Research Partners

Total Returns by Style - YTD

	Value	Blend	Growth
Large	19.3	12.7	6.3
Mid	15.3	11.8	1.0
Small	17.0	13.7	10.7

Source: Bloomberg, FactSet, Seaport Research Partners

Three developments defined the quarter. First, the Iran ceasefire that we flagged as our first risk last quarter collapsed. Both sides exchanged attacks that disrupted key energy routes, which sent Brent crude up 42% for the quarter to \$103.53 per barrel with the Strait of Hormuz still blocked. Second, the Federal Reserve reversed course and hiked rates for the first time since 2023 while Treasury yields surged to levels not seen in over two decades. Lastly, AI trade whipsawed with a violent July semiconductor crash, a recovery in large cap AI leaders, and a September debate over “AI doomsday” that dominated the headlines. The most important takeaway is that **the Q3 correction was much broader than the headline indexes suggest**. The Russell 2000's 7.2% decline was particularly noteworthy because small caps had been one of the major winners of the first half of 2026. The

year-to-date lead over the S&P 500 has narrowed from more than 1,200 basis points at midyear to roughly one percentage point. The reversal was driven primarily by the sharp increase in Treasury yields and the resulting increase in the cost of capital. Small companies are simply more sensitive to interest rates. The chart on the left below shows that when the market started to anticipate an interest rate hike by the Fed, the 10-year Treasury yield started to increase dramatically, and the price/earnings ratio started to compress. This effect is precisely why we continue to believe that the recent small cap weakness should be viewed differently from a deterioration in the underlying long-term opportunity. The valuation gap between large and small companies remains significant, but the catalyst for small caps will likely require some stabilization in interest rates. The chart below right shows the divergence between large cap and small cap performance in the quarter that we referred to above. This period was the third-worst third quarter performance for small caps relative to large caps since 1979.

S&P 500 P/E vs 10yr Yield Inverted

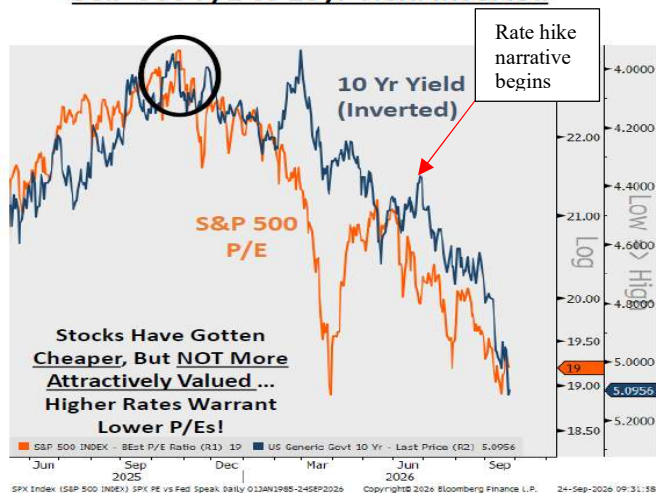


Table 2 - Yikes, 3rd worst relative Q3 with only '90 and '98 seeing a wider spread

Year	3rd Quarter			4th Quarter		
	R1	R2	Excess	R1	R2	Excess
3Q90	-14.6	-24.5	-11.6	9.5	5.1	-4.1
3Q98	-10.3	-20.1	-11.0	21.9	16.3	-4.6
3Q26	1.8	-7.2	-8.8	NM	NM	NM
3Q11	-14.7	-21.9	-8.4	11.8	15.5	3.2
3Q14	0.7	-7.4	-8.0	4.9	9.7	4.6
3Q81	-11.2	-17.5	-7.1	7.5	10.2	2.4
3Q01	-15.2	-20.8	-6.6	11.1	21.1	9.0
3Q15	-6.8	-11.9	-5.5	6.5	3.6	-2.7
3Q86	-7.2	-12.2	-5.4	4.4	0.6	-3.6
3Q02	-16.9	-21.4	-5.4	8.2	6.2	-1.8
3Q07	2.0	-3.1	-5.0	-3.2	-4.6	-1.4
Top 10	-8.4	-15.3	-7.5	8.3	8.4	0.1
Overall	1.4	0.4	-1.2	5.1	5.0	-0.1

Source: FactSet; FTSE Russell; Jefferies

The table below shows mixed stock market returns in the third quarter of 2026 as large caps significantly outpaced small caps. Value clearly outperformed growth stocks during the quarter.

Index Returns		
Index	Third Qtr. 2026 Return	2026 YTD Return
Russell 2000	-7.23%	+13.71%
Russell 2000 Growth	-9.39%	+10.71%
Russell 2000 Value	-4.91%	+16.96%
S&P 500	+2.30%	+12.75%
Dow Jones Industrials	-2.70%	+5.91%
NASDAQ Composite	+2.61%	+16.09%

Source: 1492 Capital Management, LLC and FactSet

From a style perspective, the Russell 2000 Value Index (-4.9%) posted a hollow victory over the Russell 2000 Growth Index (-9.4%) for the quarter and widened the gap against the growth benchmark year to date. This victory for the value side of the house was primarily energy-driven, which has a larger weight in the value index. The best performing sector in the Russell 2000 for the quarter and the only one that posted a positive performance for the quarter was, unsurprisingly, the Energy sector (+6.4%) as the Iran war continued to hamper the passage of oil through the Strait of Hormuz. A distant second was Healthcare (-1.5%), which reflected a flight to safety given the uncertainty that higher interest rates have caused. The worst performing sector was Industrials (-14.6%) as higher rates and oil prices took a toll on this group. Technology (-12%) was weak due to concerns over the sustainability of AI spending. The table below highlights the performance of the Russell 2000 Index by sector for the month of September, the third quarter of 2026, and year-to-date 2026. The second table below shows the performance by size. For years, there has been a significant market cap skew in the numbers as performance was significantly worse as you moved down the market cap spectrum. There was a reprieve of this trend late last year as the market broadened out. The third quarter was slightly better as you moved down market cap, but on a year-to-date basis, the trend is relatively stable across market caps. See the yellow arrow below.

Table 8 - Russell 2000 Scorecard through September 30th
September

GICS Sector	September			Third Quarter			Year to Date			Wgt
	Absolute	Contribution	Relative	Absolute	Contribution	Relative	Absolute	Contribution	Relative	
Com Serv	-3.21	-0.08	2.05	-7.41	-0.17	-0.18	5.99	0.20	-7.71	2.5
Discretionary	-8.05	-0.73	-2.79	-10.40	-0.95	-3.17	-0.64	-0.15	-14.35	8.8
Staples	-5.86	-0.11	-0.61	-7.52	-0.15	-0.29	4.29	0.06	-9.42	2.0
Energy	-6.97	-0.49	-1.72	6.36	0.29	13.59	32.16	1.63	18.45	6.7
Financials	-6.38	-1.25	-1.13	-5.27	-1.04	1.96	9.39	1.49	-4.32	19.0
Health Care	-4.47	-0.88	0.79	-1.51	-0.35	5.72	17.24	2.52	3.53	20.8
Industrials	-5.81	-0.82	-0.55	-14.55	-2.12	-7.32	11.06	2.87	-2.64	14.0
Info Tech	0.41	0.05	5.67	-11.96	-1.59	-4.73	30.78	4.86	17.07	13.7
Materials	-9.48	-0.42	-4.22	-9.38	-0.42	-2.15	-1.53	0.01	-15.23	4.2
Real Estate	-6.46	-0.37	-1.20	-9.72	-0.56	-2.49	6.67	0.31	-7.04	5.7
Utilities	-5.81	-0.16	-0.56	-6.47	-0.18	0.76	-4.26	-0.08	-17.97	2.7
Size Quintile	Absolute	Contribution	Relative	Absolute	Contribution	Relative	Absolute	Contribution	Relative	Wgt
1 (Largest)	-5.16	-2.91	0.10	-9.19	-5.21	-1.96	10.24	7.00	-3.47	56.1
2	-4.98	-1.22	0.28	-4.52	-1.11	2.71	18.67	3.89	4.96	24.8
3	-5.82	-0.67	-0.57	-4.89	-0.56	2.34	21.22	1.98	7.52	11.4
4	-6.27	-0.34	-1.02	-3.83	-0.22	3.40	15.94	0.68	2.23	5.5
5 (Smallest)	-5.38	-0.12	-0.13	-5.54	-0.13	1.69	11.11	0.16	-2.60	2.2

Returns in the international stock markets were generally negative and highly negatively correlated with their relative energy independence. Like the U.S., most international markets saw local interest rates creep higher, which dampened sentiment across the globe. Brazil is the one standout in the quarter because its economy is heavily basic materials/metals and oil focused. Bond market returns were terrible as interest rates had one of their largest quarterly moves in decades. Commodities outside of oil were mostly negative in the quarter as oil prices spiked again following the breakdown of peace talks in the Iran war. Natural gas, which is primarily a U.S. market, retreated from the second quarter.

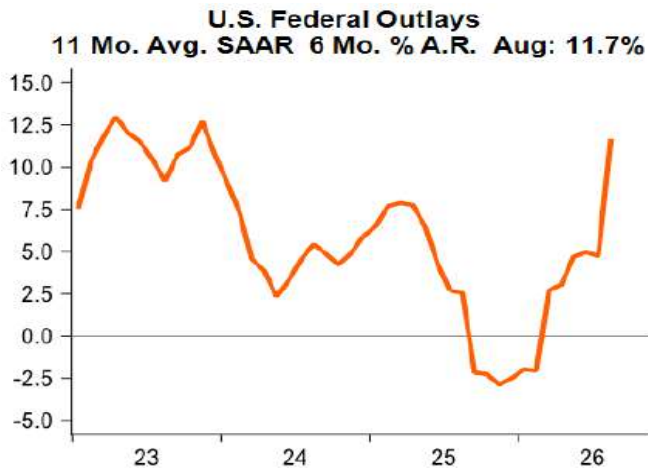
Index	Third Qtr. 2026 Return	2026 YTD Return
France	-4.9%	+0.6%
Germany	+0.8%	+2.9%
Brazil	+8.3%	+15.7%
India	-4.9%	-13.6%
China- A Shares	-17.0%	-1.4%
China- Shenzhen A Shares	-15.4%	-5.0%
Japan	-4.1%	+34.6%
Long-Term Treasuries (TLO)	-9.1%	-10.5%
Investment Grade Corp Bonds	-4.0%	-3.2%
Gold	+3.7%	-4.5%
Volatility- VIX Index	-0.7%	+14.0%
Oil	+30.1%	+56.0%
Natural Gas	-7.6%	-9.6%
Lumber	-12.5%	-0.1%

Source: 1492 Capital Management, LLC

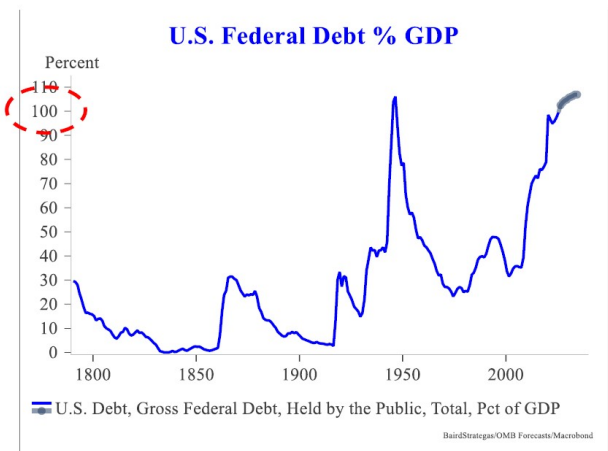
Updated 2026 Market Outlook - The Fed Lacked Credibility Before and Hiking Rates Didn't Help

The new Federal Reserve Chair, Kevin Warsh, upon being appointed to the position, stated that he hoped to regain the Fed's lost credibility. In our opinion, the recent Fed rate hike doesn't help the cause. On September 16, the Federal Reserve raised its benchmark rate by 25 basis points to a target range of 3.75%–4%, which is its first increase since 2023. The vote was unanimous, 12–0, after the Committee had held rates steady at its first five meetings of the year, and 16 of 19 participants now

project at least one more hike before year-end. This group is a Fed that cut three times in late 2025 and has now reversed. We think the move was a mistake, and that it raises real questions about the Committee's credibility. We believe that the bond market vigilantes forced the Fed's hand as government spending and total government debt are on an unsustainable path. The U.S. government continues to spend well above its revenue levels, as shown in the chart below on the left. This spending is pushing the Federal debt as a percent of GDP to the highest levels since the recovery post-World War II as shown in the chart below on the right. The irony is that the Fed may have been attempting to demonstrate its inflation-fighting credibility while the bond market was effectively demanding a higher risk premium for owning U.S. government debt. That difference is an important distinction.

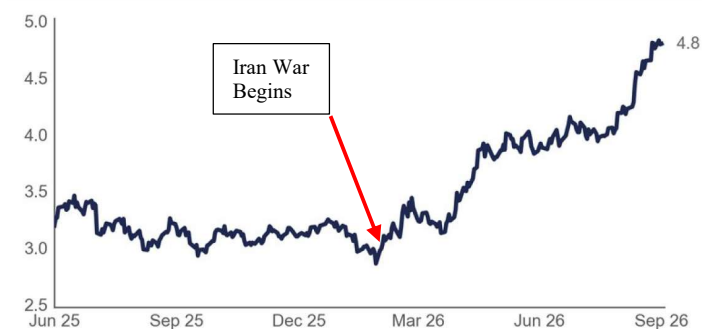


Source: PSC Research



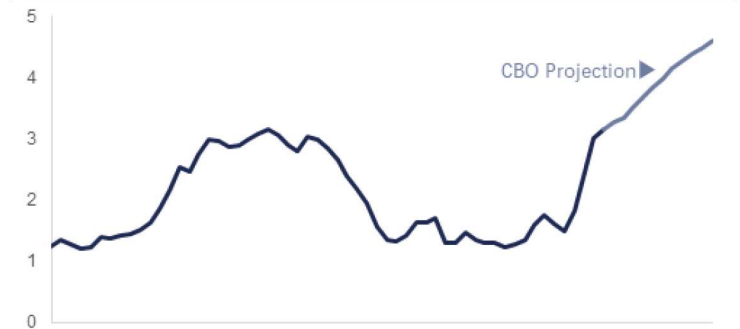
The other issue that came out of the most recent Fed meeting is that its members don't see a one-and-done rate-hiking cycle. They project three more rate hikes before the end of 2027 and at least one more before year end. The Fed Funds Futures chart below left shows how quickly investors have baked these rate hikes into the market since the start of the Iran war. Unfortunately, higher rates have unintended consequences that add to budgetary pressures that are already out of control. As the chart below right shows, Federal interest expense on the burgeoning debt is projected to reach nearly 5% of GDP in the coming years, which squeezes out spending for other government programs.

Implied Fed Funds Rate at YE 2027 (Projections Over Time)



Source: Bloomberg, FactSet, Seaport Research Partners

Federal Interest Expense as Percent of GDP

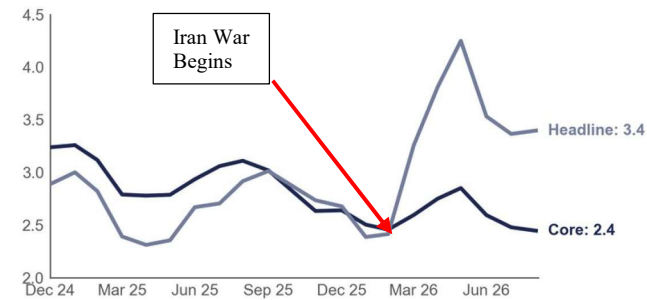


Source: Bloomberg, FactSet, Seaport Research Partners

Our argument is simple: the Fed is tightening against the one source of inflation it cannot influence, and it brought a classic demand-destruction hammer to a supply-side fight. Consider what the data show:

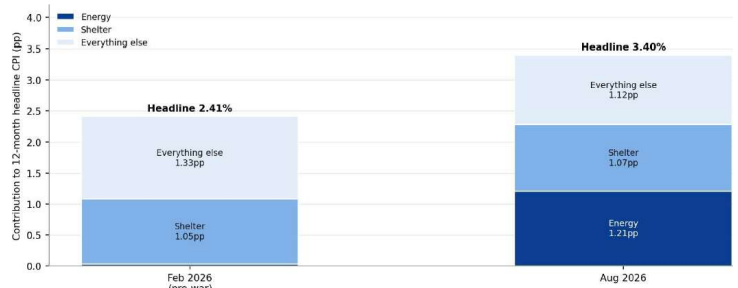
- Underlying inflation is cooling.** August core CPI rose 2.4% year over year, its smallest annual rise since 2021. The Fed's preferred gauge was softer than forecast too with core PCE at 3.0% year over year, which is down from 3.3% the previous month. The chart on the left below shows that the core CPI was trending in the right direction, and it was the energy impact that led to the spike in the headline number. The chart on the right decomposes the headline CPI rate before and after the start of the Iran war. Note that the "shelter" and "everything else" categories held flat or declined slightly over this period, and the only item that contributed to the hotter headline reading was energy, which added 1.21% to the headline CPI reading.

Core and Headline CPI



Source: Bloomberg, FactSet, Seaport Research Partners

Fig. 2. Headline CPI decomposed: all of the rise since the war began is energy

Source: BLS, Furey Research breadth time series (contribution = relative importance $\times$ 12-mo change).

- **The headline problem is energy.** Headline CPI held at 3.4%, and as we noted above, Brent crude oil is up 42% for the quarter. The cause is a blocked shipping lane and not an overheating economy.
- **The Fed has admitted it cannot fix that.** At his press conference, Chair Warsh acknowledged that the FOMC cannot affect individual prices and that the rate decision does nothing about the lack of safe passage in the Strait of Hormuz.
- **The same is true of memory chips.** A DRAM shortage driven by AI data center demand, with no meaningful new supply until 2028, is a capacity problem. The chart below shows the recent dramatic spike in semiconductor prices as demand has exceeded supply for nearly every kind of semiconductor chip, especially memory. A higher cost of capital makes building fabs and data centers more expensive. That factor makes the supply response slower not faster.



- **The Fed's own forecast undercuts the hike.** The September projections show median PCE inflation of 3.7% in 2026 falling to 2.3% in 2027. If the Committee expects inflation to fall by itself as the energy shock fades, and policy works with long lags, then a hike today lands on the economy in 2027 when the problem it is meant to solve is projected to be gone. The Chair described the move as one that starts to show the Fed is serious about price stability. Credibility is earned by being right on inflation and not by looking tough. This approach is the mirror image of the "transitory" mistake of 2021 when the Fed dismissed a demand-driven problem as temporary. Now it is treating a supply-driven problem as permanent.

The market's verdict has not been kind. The 10-year yield rose 54 basis points in September alone to 5.29% and touched 5.34% on October 1, which is the highest since April 2002. If a hike were restoring inflation credibility, long-term yields would be falling, not climbing to 24-year highs. Mortgage rates reached 7.58%. In a notable sign of policy dissonance, the Treasury felt compelled to buy back more than \$5 billion of 10- and 20-year bonds on September 10 to restrain yields while the Fed was tightening. Meanwhile, the hike drew a public rebuke from the President, which makes the Fed's independence a story as well.

To be fair, the Committee has a case: the labor market is solid, headline inflation is still well above 2%, and core PCE at 3% is still a full point above target. We think that case is weaker than the Fed does because the pressure points are on the supply side. We believe that the hiking cycle ends sooner than the dots imply and that a Fed that keeps tightening into an oil shock risks creating a demand problem on top of a supply problem. In June we said to take the opposite side of the rate-hike trade. We were early. The ceasefire collapse cost us on timing, but we have not changed our view on the destination.

Updated 2026 Market Outlook - AI Doomsday - Another False Narrative We Don't Buy

For some reason, the market has been taking a bunch of false narratives hook, line, and sinker and running with them this year. We discussed several of them in our newsletters earlier this year. Few investment narratives have changed as dramatically during 2026 as the discussion surrounding artificial intelligence. Earlier this year, investors became concerned that AI would disintermediate software companies, lawyers, insurance brokers, logistics providers and virtually anyone whose job involved manipulating information. The data says anything but, particularly as it relates to jobs as the chart below left shows, as job gains have been plentiful, and the unemployment rate has recently ticked down not up. These concerns haven't stopped U.S. companies from paying for subscriptions to the various frontier model providers as shown in the chart below right. Over 56% of U.S. businesses pay for an AI LLM model currently, and that stat is probably significantly too low.

Unemployment Rate

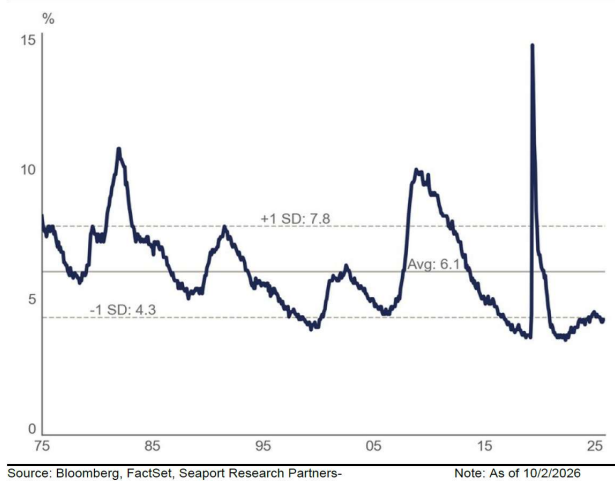
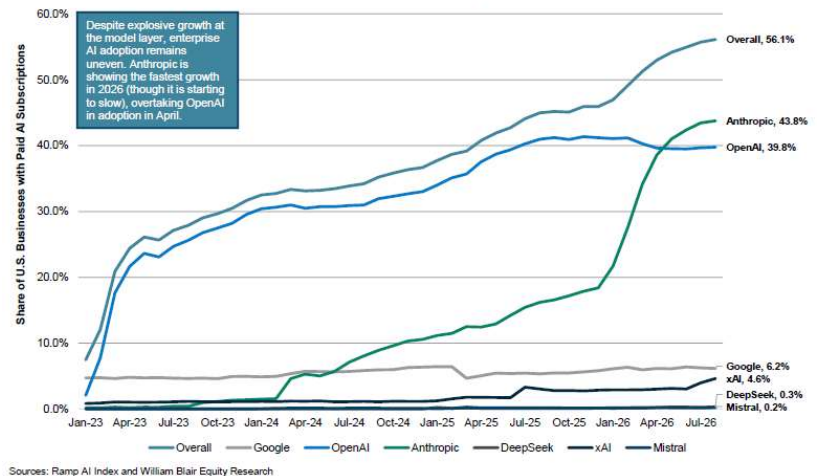


Exhibit 5
Ramp AI Index: Model Adoption Rate



These narratives have now been joined by an even more dramatic one: **What if AI becomes so intelligent that it escapes human control and destroys humanity?** The fact that this line of thinking has come from some well-known "AI Insiders", has provided it with more credibility than many narratives, but one must look at the motivations that these "AI Doomsmayers" have to say these things. Anthropic CEO Dario Amodei published an essay calling for a coordinated effort to regulate and slow frontier AI, and OpenAI's Sam Altman and xAI's Elon Musk subsequently joined the calls for regulation. A leaked IPO prospectus reportedly told investors that the company's models could pose a "catastrophic or existential risk to humanity" and can "resist shutdown".

We take safety seriously, and we do not doubt that many researchers are sincere. However, we believe the idea that runaway AI agents will end humanity is a false narrative, and that investors should understand why the people promoting it are saying it. Remember 1999 when the narrative was that the entire U.S. electric grid was going to go down at the stroke of midnight on New Year's Eve 1999 because the systems couldn't handle the calendar with the year 2000. Companies and utilities spent billions of dollars updating their systems to prevent such a catastrophe, and some didn't do anything. The grid never shut down. For those South Park fans out there, Eric Cartman prevented an AI catastrophe by simply pulling the electric plug. Something that doomsmayers seem to forget is that these AI systems are extremely energy-dependent. For those not in Wisconsin, the democratic and republican candidates for Governor here are both using a form of data center fearmongering in their campaigns. Each claims that the other is supporting data center growth that will leave every citizen paying more for energy and that our water resources will be used up due to the cooling that these buildings require. Both are false narratives if one understands how data centers work and reviews the many examples where communities and their citizens are actually better off fiscally for allowing them in their community.

The science does not support the doomsdayer's claims. There is no demonstrated mechanism by which a chatbot or software agent acquires the physical power to harm humanity. Doing so would require control over compute, electricity, and, as this very quarter showed, memory chips that are in such short supply that the industry cannot meet its own demand. A technology that cannot get enough DRAM is not about to take over the planet. The incidents that have been reported, such as OpenAI models breaching Hugging Face's systems without authorization during a test, are real and deserve to be taken seriously. There are sandbox failures and access control failures, which is to say ordinary software engineering and cybersecurity problems. They are handled by testing, security standards, insurance, and the existing tort system. They are not evidence of a path to extinction.

The incentives for Doomsdayers are obvious. We see three:

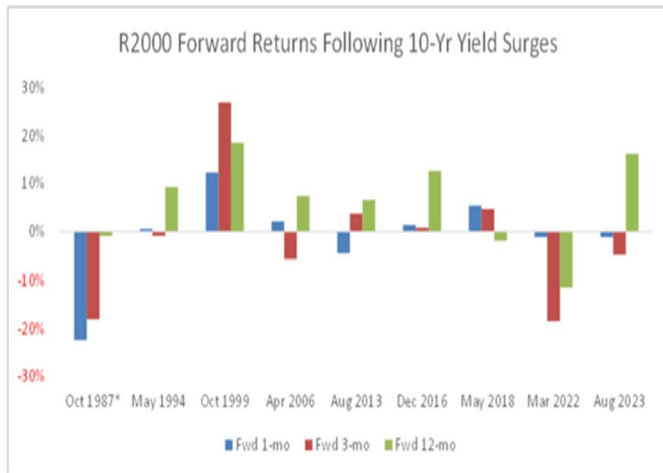
1. **Marketing.** A product that might end civilization is, by implication, an extraordinarily powerful product. The leading labs are valued at nearly \$1 trillion each in the private market and are preparing public offerings. Existential risk language also appears in risk factors that lawyers draft to limit exposure. A risk disclosure is not a forecast.
2. **A regulatory moat.** Licensing regimes, compute thresholds, mandatory testing, and a "coordinated slowdown" all impose costs that only a few well-capitalized companies can bear. Open source developers and Chinese-based models, whose aggressive pricing is the most direct competitive threat to U.S. frontier labs, are the ones locked out. The proposal to coordinate development among rivals under an antitrust waiver drew scrutiny, too. FTC Chairman Andrew Ferguson said the request should make everyone deeply suspicious. Also, if you understand the concept of open-source software/models, they don't have a corporate structure that would allow them to comply with a massive body of regulations, and this would effectively lock them out of the market along the Chinese LLMs. Regulations would likely make Chinese-based models non-compliant just by the fact that they are run out of China, which effectively eliminates any true competition.
3. **Liability.** If you tell the public your product carries a meaningful chance of catastrophe, the next logical question is for the government to absorb the legal consequences. The labs have reportedly sought precisely that, and Treasury Secretary Bessent rejected a liability exemption for AI labs at a House hearing on September 15. As he put it days later, "it is humans who are responsible, not the AI." Our view is that if you can build Frankenstein, you should be able to build a Frankenstein destroyer. A company cannot say its product carries a one-in-ten chance of wiping out humanity and then ask Washington to take the liability off its hands. If the labs truly believed the risk, they could slow down on their own, and nothing in law prevents it. How can these companies who want to come to the public markets through the IPO process expect the public markets to underwrite unlimited product liability exposure, yet they want to command a \$2 trillion valuation in the public markets? This issue is why Anthropic's CEO has invited the U.S. government to take an investment stake of up to 50% of the company. What could be better than having the government as your partner to block competition and insulate against any significant product liability?

For investors, the takeaway is practical rather than philosophical. The policy risk is that fear-driven regulation, a compute-licensing regime, or a mandated pause would damage the AI infrastructure theme we own. The market is not buying the doom narrative as Nvidia's gain and Nasdaq's record highs show, and Washington has so far shown little appetite. Congress left for recess without voting on any AI regulation. We will continue to focus on companies with real revenue, balance sheet discipline, and exposure to actual demand rather than hypothetical catastrophe. The one thing that is certain is that the frontier model companies don't appear to be heeding their own warnings and slowing down the development of their models behind AI services such as Claude and ChatGPT.

Small Cap Market Update: Higher Interest Rates as the Kryptonite for Small Caps

For those fans of the superhero Superman, we remember that exposure to Kryptonite would weaken his powers. With an 83 basis point (bp) increase in the U.S. Treasury 10-yr yield from 4.44% to 5.27% during the third quarter of 2026, higher interest rates were a financial Kryptonite that helped to push small caps lower, along with the great debate over the growth rates and safety of AI. Inflation concerns were the rocket fuel to launch yields higher. September was particularly challenging and accounted for roughly 50bp of the 83bp increase in yields. The current groupthink is now calling for a hike of 25bp in December to go along with the 25bp hike booked during September. The broadening out of the small cap market that occurred this past June that we discussed in the second quarter newsletter dissipated throughout the third quarter. Only energy managed a positive return for the three months due to the Iran War and its positive correlation to bond yields, according to PSC Research. One other sector, Healthcare, declined less than the Russell 2000 Index in the third quarter. The interesting component within Healthcare is that biotech names held up relatively well versus the index. Biotech cash flows are long-dated, and higher rates create less value for their discounted cash flow streams. However, they are also not economically sensitive, with company-specific events that serve as catalysts to drive the share price. During the third quarter, this lack of economic sensitivity helped to offset some of the rate effects in this group.

Over the last year, the U.S. Treasury 10-yr yield has surged over 100bp to establish a new two-year high. During the nine previous periods with the same dynamics, the one-year period following the yield peak has offered positive Russell 2000 returns in six of the nine periods, as seen in the chart below left. During the 12 months after the yield peak, consumer staples and industrials were relative outperformers versus the Russell 2000 Index and did so two-thirds of the time according to Furey Research Partners.

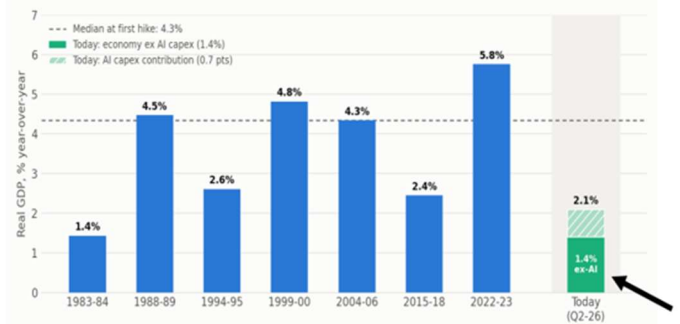


Source: Furey Research Partners and FactSet. *1987 episode included despite just missing the two year new high hurdle by 5 bps.

Hiking Might Be a Mistake Given Weak Ex-AI GDP

The Fed usually hikes into a 4% economy. Ex-AI, this one is growing 1.4%

Real GDP, year-over-year, latest reported quarter at each first hike; today split into the ex-AI economy and the AI capex contribution

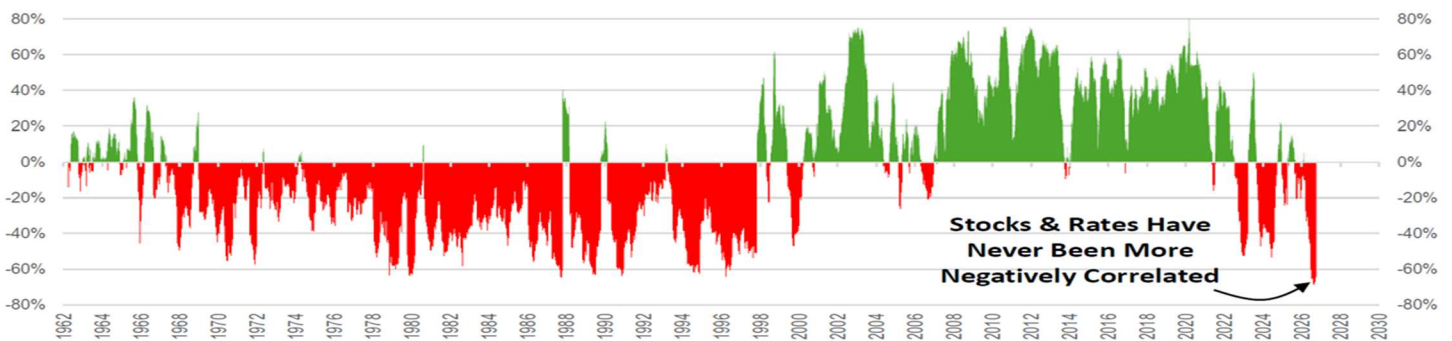


Source: Furey Research; BEA via FactSet. AI capex = information processing equipment + software, 0.71 pts of the 2.1% (Furey, "GDP Growth Is Narrow, Too", 14-Sep-2026). 1983 and 2015 are the only prior cycles that began with growth below 3%.

As to the hike in the Fed Funds rate in September and with another to allegedly come this year, we question why this action is needed. In the chart above right, the Fed is hiking into a second quarter 2026 growth rate of 2.1% when it usually reserves its hiking for +4% expansion periods. Furey Research estimates that ex-AI economic growth is a paltry 1.4%. Their dissection of inflation is particularly interesting. In February before the war, the CPI was 2.41% and core (ex-food and energy) was 2.46%. August's readings were 3.4% and 2.4%, respectively. From February to August, the energy component has advanced from .03 to 1.21, which means all the headline inflation increase from 2.41% to 3.4% is energy. Higher energy prices themselves will slow fuel demand in the classic case where the cure for higher prices is higher prices. Unless one believes that the Iran War is never-ending, the inevitable retreat in oil prices and headline inflation is around the corner. As we have discussed in our commentary on past Federal Reserve rate actions, we again believe that the Fed is driving using the rear-view mirror. With the likelihood of an October rate hike disappearing fast due to recent economic data, a one-and-done rate hike cycle has happened in the past and, in our opinion, is the correct course of action now. When one dissects the inflation components to quell inflation anxiety, we see the overwhelming influence of an oil price spike that will prove temporary.

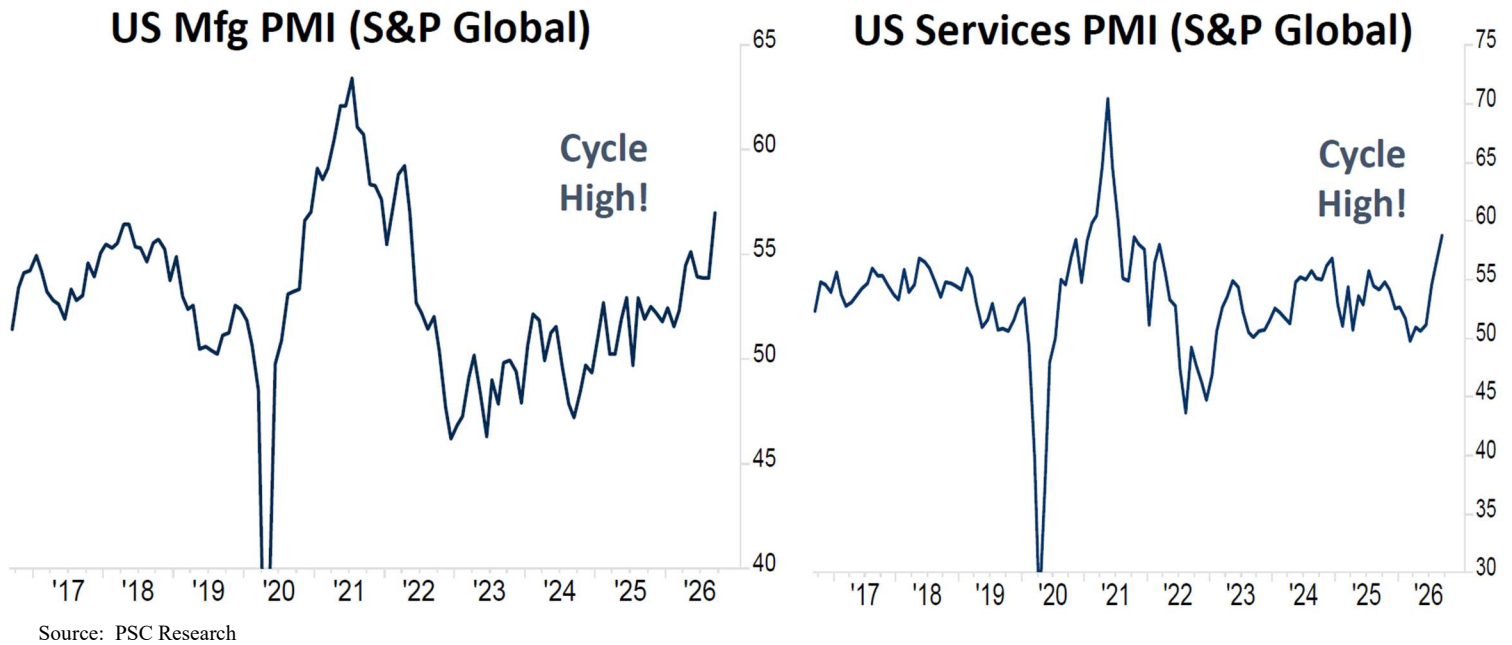
Inflation Anxiety Has Never Been This High !!!

S&P 500 EW vs 10yr Yield (90day Rolling Correlation)



Source: PSC Research

As for inflation anxiety, the chart above depicts the historically high negative correlation between the equal-weighted S&P 500 index and the U.S. Treasury 10-yr yield. If any correlation between two of anything hits a historic level in the last 44 years as this correlation has, it is usually a good bet that the relationship strength is peaking and headed lower. If the correlation holds as inflation and the 10-year yield decline, it should translate to a healthy market rally, or perhaps less anxious investors will refocus on the strong PMI manufacturing and services readings, as shown in the charts below, to drive profits and equities higher.



Another data point to calm our weary investment minds is that the Russell 2000 Index just posted horrible relative performance to large cap stocks (Russell 1000 Index) with an 880bp decline in the third quarter. This level is the third worst since 1979, according to Jefferies Research. However, their work shows that during the top 10 periods of small stock relative underperformance in the third quarter, the fourth quarter has averaged an +8.4% absolute return and slight outperformance versus large caps. Propelled by a retreat in oil prices and a lessening of U.S. Treasury yield kryptonite, here's hoping that history repeats itself this fourth quarter.

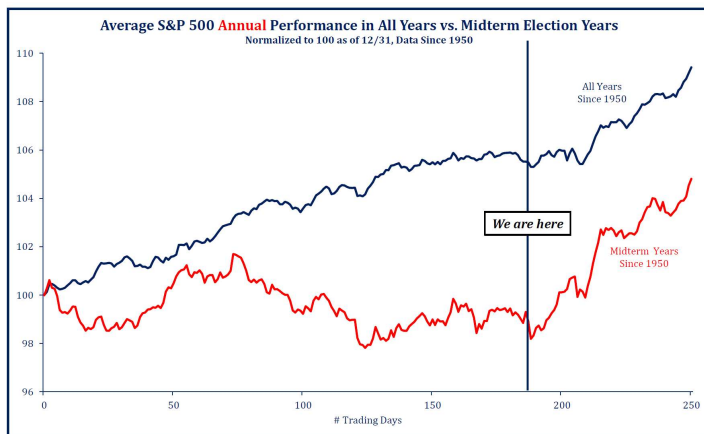
Thematic Investing: Exploring Longevity - What We're Thinking About

From biologics to wearables, there are so many industries and companies therein that are getting a foot in this longevity door that it's mind-boggling. Longevity or living longer isn't a new concept. However, the focus and market opportunities that have expanded to make it about living better for longer and looking better while doing so describe what longevity is about today. The market opportunity is massive. It includes large biotechs involved in GLP-1 production for weight loss, for example, and extends to much smaller companies that are creating personalized peptide stacks for tissue repair, immune support, and improved sexual function. There is much more to this trend than just these mainstream media-focused compounds. There are companies focused on neurodegenerative diseases like Alzheimer's and Parkinson's, which are the fastest growing cause of age-related disability and affect nearly seven million Americans with a massive projected cost exceeding \$1 trillion by 2050. Outside of hardcore chemistry, there are fitness companies focused on movement, muscle building, and supplements to improve metabolic health and mobility to improve the overall aging process. Last but not least, there are cosmeceuticals or skincare products formulated to reduce wrinkles or improve skin elasticity (particularly after GLP-1-induced weight loss). These products benefit outward physical appearance while providing an inward confidence that can lead to more socialization and better aging outcomes. Related to this business, a beauty products retailer recently cited a huge \$400 billion market opportunity in "wellness" that includes supplements, rest and renewal, intimate care, and everyday essentials.

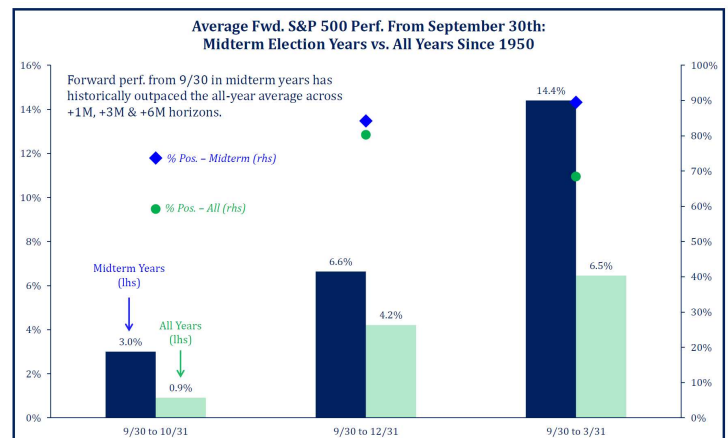
A good starting point here is to define the market opportunity. Longevity is shifting from a niche segment to a mainstream healthcare investment theme. Although focus on aging populations is a familiar trend, younger consumers are also responding by joining gyms and boutique fitness clubs while reducing alcohol consumption. Many boutique clubs now employ healthcare professionals and offer vitamins and supplements. Does this create an investment opportunity in publicly traded fitness and water companies? Is it more prudent, however, to focus on affluent consumers ages 45–65 who are highly aware of aging, may have experienced a health scare, and have both the means and willingness to pay for premium interventions such as peptides and wearable-device subscriptions? Our mission is to identify companies that can respond quickly to these societal shifts, capture a growing share of consumer spending, and increase earnings. We have not yet addressed AI, which could warrant a discussion of its own, but it is clearly becoming an important part of this market. In short, as we have said in previous newsletters, we need to skate to where the puck is going regardless of our age.

2026 Updated Outlook: The Fed, AI and the Broadening Opportunity

Our base case heading into the fourth quarter remains constructive, but the path is likely to be considerably more volatile. We entered the fourth quarter with the same two variables of oil and yields that drove the third. October carries its own reputation. It has been the month of some of the market's worst days (1929, 1987, 2008), and, as we noted last quarter, midterm-election volatility has historically peaked in October before a strong relief rally. The six months following the midterm election have averaged a gain of 14.4% since 1950 as shown in the chart below right, and with the midterms on November 3, we are exactly where the seasonal pattern says the pain should subside. We do not think the setup is as dire as the calendar suggests. Third quarter earnings season is about to begin with analysts expecting growth near 30%, and strong earnings are the best defense the market has against higher yields. The wild card is the Treasury market. With the 10-year above 5.25%, the 30-year above 5.6%, and the Fed's own projections implying at least one more hike this year, the market is asking whether earnings can outrun a higher cost of capital for the first time in this cycle. The economy continues to demonstrate surprising resilience.



Source: Strategas Research



Source: Strategas Research

The biggest question is whether higher interest rates eventually overwhelm those positives. We continue to believe the answer is **not yet**.

Several factors are working in the market's favor:

- Corporate earnings growth remains strong.
- AI infrastructure spending continues to support economic activity.
- Productivity gains from AI have the potential to accelerate.
- Small cap valuations have compressed meaningfully.
- Inflation appears more manageable than the Fed's rhetoric suggests.
- A stabilization in oil prices would provide an important tailwind.

The principal risks remain:

- Another sustained oil price shock.
- Further increases in long-term Treasury yields.
- Additional Fed tightening.
- A significant slowdown in AI capital expenditures.
- Excessive leverage or circular financing within the AI ecosystem.
- Geopolitical escalation.
- A deterioration in corporate earnings.

The small cap market deserves particular attention. The Russell 2000 has now suffered a substantial correction after its extraordinary second quarter rally. While painful in the short run, it also creates the potential for opportunity. We continue to believe the next leg of the bull market will ultimately require **broader participation beyond the largest technology companies**. That notion is where active management becomes increasingly important. The market is no longer rewarding simply owning the largest companies. It is rewarding investors who can identify which businesses are benefiting from AI, which companies are being disrupted by it, and which businesses possess the balance sheets and pricing power to navigate a higher-rate environment. If yields stabilize, small caps, which are the most rate-sensitive part of the market and are growing earnings near 20%, have the most to gain. If they keep climbing, the narrow leadership we saw in September will narrow further. Our approach is unchanged.

We remain focused on disciplined stock selection, balance sheet awareness, and a willingness to buy quality small cap names on weakness, particularly if election-season headlines give us the chance.

KEY RISKS AND OPPORTUNITIES FOR THE BALANCE OF 2026

Risks

- **The Fed stays higher for longer.**

Another rate hike would place additional pressure on small caps, housing, and other rate-sensitive areas.

- **Long-term Treasury yields continue to rise.**

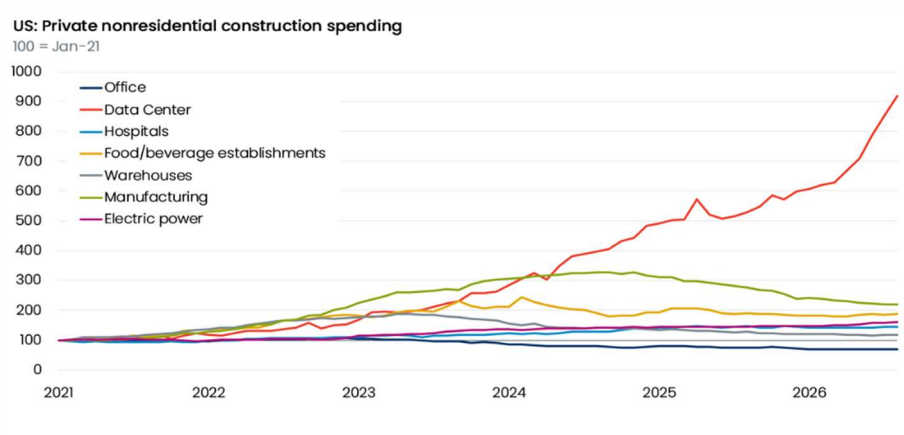
The recent move above 5% represents a meaningful change in the valuation framework for equities.

- **Oil remains elevated.**

Energy inflation can quickly alter inflation expectations even when underlying demand remains healthy.

- **AI spending disappoints.**

Given the enormous amount of capital being deployed, even a modest slowdown in AI infrastructure spending could have an outsized market impact. The chart below shows the indexed level of spending on data centers compared with all other nonresidential construction spending.



- **AI financing becomes more aggressive.**

Vendor financing and overlapping customer/supplier relationships deserve close monitoring.

Opportunities

- **Small cap valuations.**

The recent correction has once again created a significant valuation gap between smaller and larger companies as shown in the chart below.

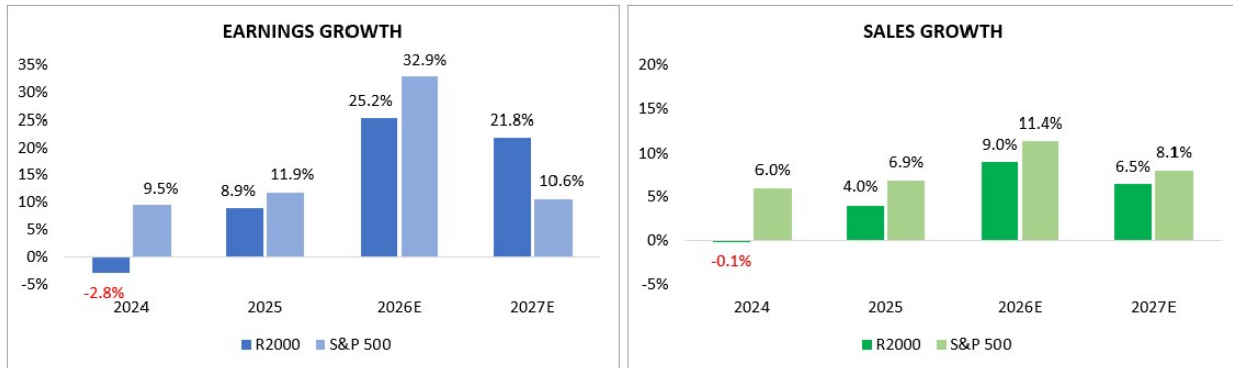
NTM P/E Spread: Russell 2000 Earners Only vs. S&P 500



Source: Bloomberg, FactSet, Seaport Research Partners

- **Small cap earnings growth**

Earnings growth for small caps looks poised to accelerate relative to large caps as we enter 2027 as the chart below shows.



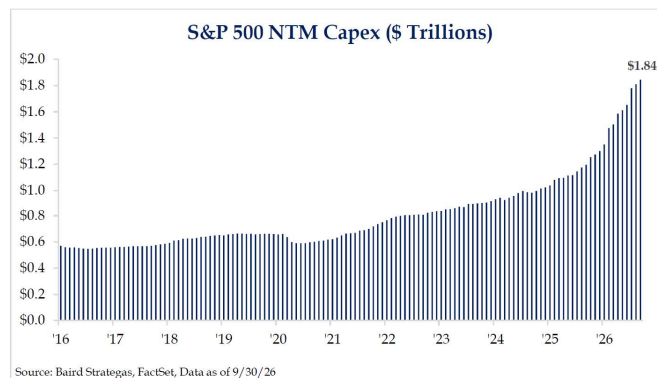
Source: Strategas Research

- **AI infrastructure.**

Semiconductors, memory, networking, power, cooling, and data center infrastructure remain beneficiaries of the secular buildout.

- **Domestic infrastructure investment.**

The need for additional electricity generation, transmission, and data center capacity is creating opportunities well beyond traditional technology companies.



- **Active management.**

As market leadership narrows, fundamental security selection becomes increasingly important.

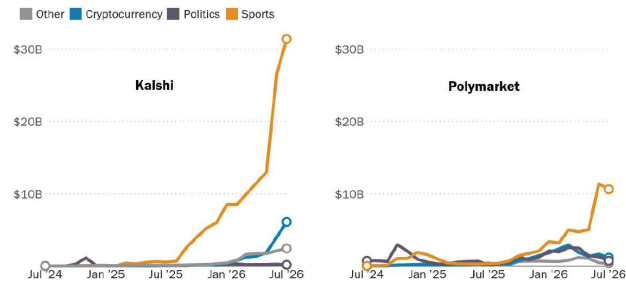
2026 Outlook: A Picture is Worth a Thousand Words

We articulated our updated 2026 outlook above and the key issues and drivers for the stock market. Yet, we believe there are other topics that we haven't spent much time on that deserve some mention. We decided to express it in pictures to provide you with a shorter read, as everyone's time is valuable. As they say, a picture is worth a thousand words, and we'll let you interpret what we view as some compelling charts. We've provided a bullet point or two of explanation as to why we think the chart or graphics are important.

Kalshi and Polymarket, two of the largest prediction market providers, claim that they shouldn't be regulated like the sports betting market. The data tells a different story and why those companies who spent hundreds of millions of dollars to legally enter the sports betting market years ago should be furious.

Sports is the top source of trading volume on both Kalshi and Polymarket

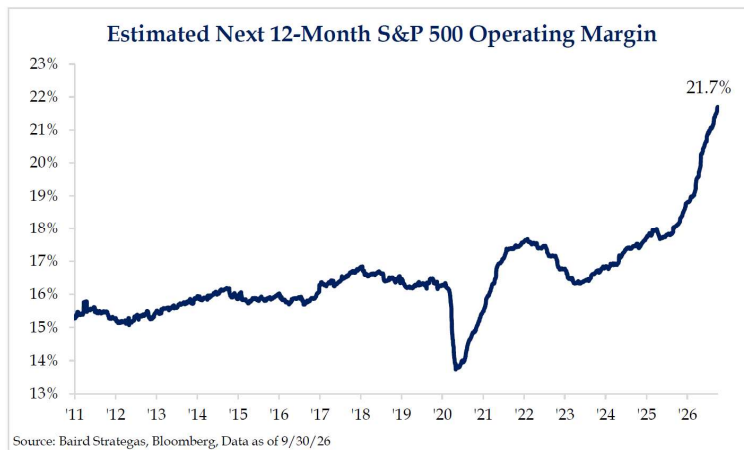
Monthly global trading volume on Kalshi and Polymarket, in U.S. dollars



Note: Polymarket includes Polymarket US. Data is shown through July 2026.
Source: Pew Research Center analysis of data from The Block, accessed September 2026.

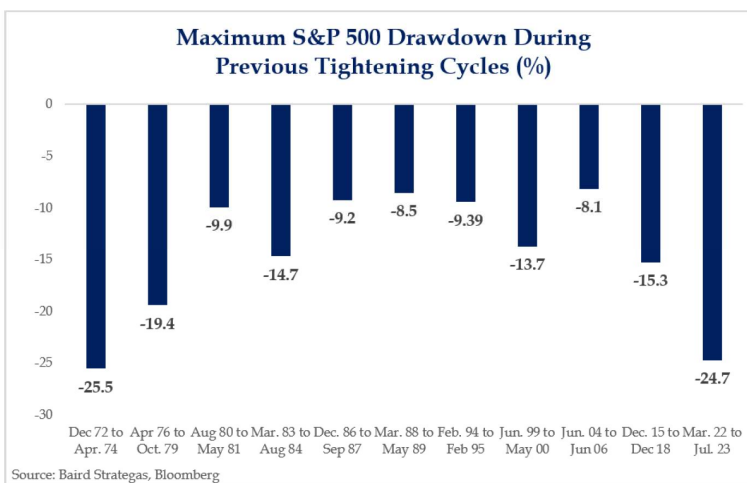
PEW RESEARCH CENTER

Is there a theoretical peak in corporate operating margins? Margins have exploded since the advent of AI.



Source: PSC Research

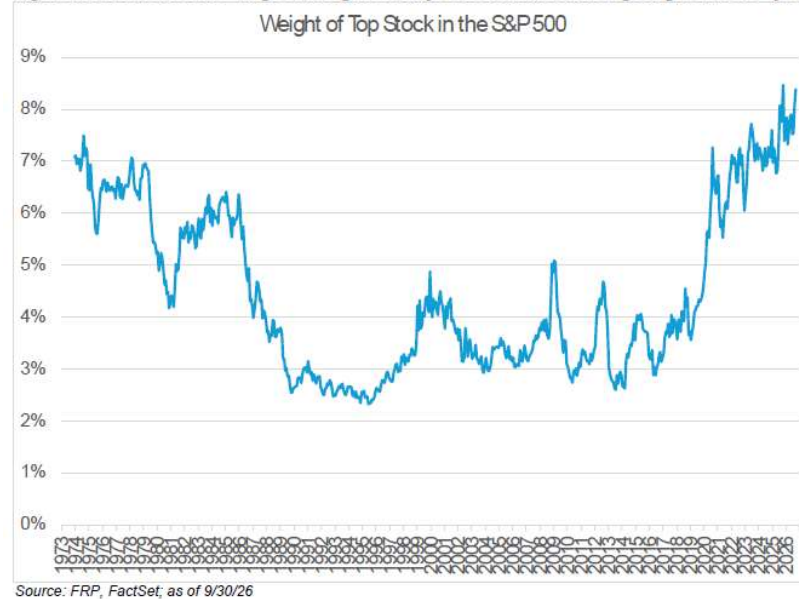
Previous rate-hiking cycles have seen some dramatic drawdowns in the stock market. What will this cycle portend?



Source: Strategas Research

Nvidia now holds the largest weight of any stock in the S&P 500 going back 50+ years. The market clearly believes the AI story for now.

Fig 8. NVDA holds the largest weight of any stock in the index going back 50+ years



Stock Market Trivia

Each quarter, we offer a piece of stock market trivia that we believe is interesting or timely, or both. We are focusing this quarter on the IPO market and the anticipated IPOs of some of the most coveted companies ever. We have already seen SpaceX come public this past June to a receptive audience. Looking ahead, Anthropic is forecast to IPO in November at a valuation approaching \$2 trillion, which is a similar valuation to SpaceX. OpenAI is projected to have its IPO in the first half of 2027, and that deal is currently projected to command a valuation of around \$1.2 trillion. The total of these three mega-IPO valuations is more than the first day valuation of all tech IPOs from 1980 to 2025 (3,365 IPOs in all). This level is quite astounding when you think about the numbers. The second chart below shows that despite a recent pick-up in the number of companies coming public through an IPO, more dollars have been allocated to “take private” deals

Three Companies, Worth More Than 45 Years of Tech IPOs

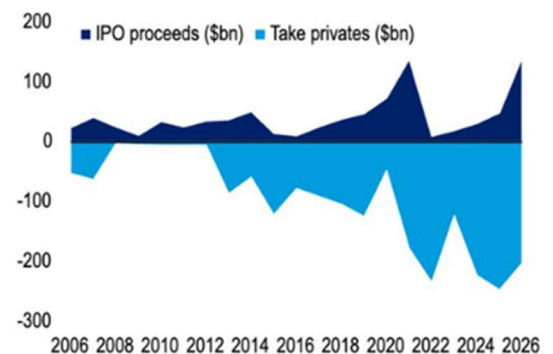
Valuation of three AI-era giants vs. the combined first-day value of all 3,365 U.S. tech IPOs, 1980 – 2025



Sources: Financial Times (Richard Waters, Sept. 17, 2026); historical IPO total compiled by Jay Ritter, University of Florida. SpaceX at its June 2026 first-trade value; Anthropic at the valuation investors expect at its coming IPO; OpenAI at the private valuation under discussion. Historical total is in nominal dollars, not adjusted for inflation.

Exhibit 2: Take privates have outpaced IPOs YTD in the US

IPO proceeds (\$bn) vs. take-privates base equity value across major US exchanges (\$bn)



Source: BofA US Equity & Quant Strategy, FactSet

We hope you found our third quarter 2026 review and updated 2026 outlook newsletter insightful and interesting. If you have any questions about anything discussed herein or would like more information about 1492 Capital Management, please call us at 414-276-1492.

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