Market Commentary

Value Equity Strategies

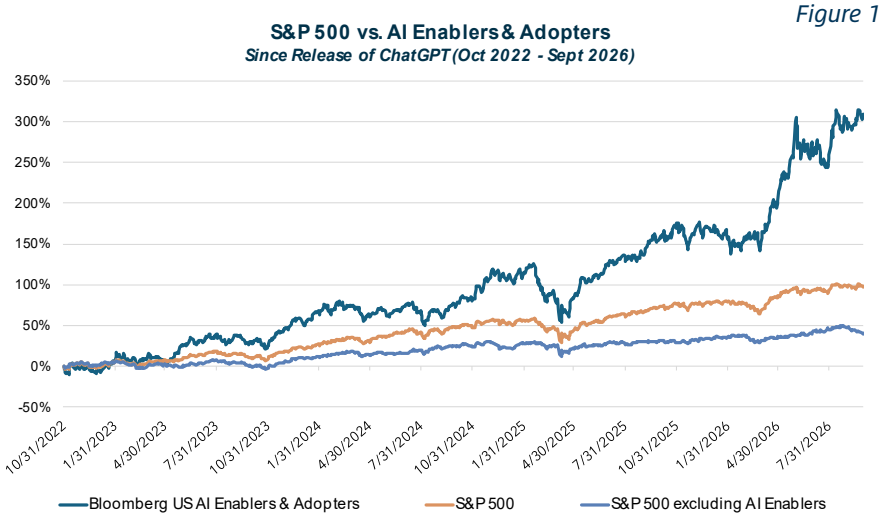
Confluence INVESTMENT MANAGEMENT

Third Quarter 2026

"Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one." – Charles Mackay, Extraordinary Popular Delusions and the Madness of Crowds (1841)

Investors remain captivated by the potential of artificial intelligence (AI), and this enthusiasm has carried the equity markets. The euphoria appears unbridled but narrow, with concentration continuing to build (see Figure 1). While equities managed to rally, the bond market sold off sharply: the 10-year Treasury yield surged 85 bps to 5.3%, its highest level since 2007. On the geopolitical front, the re-escalation in Iran and the breakdown of the US-Iran framework deal drove oil prices higher, with Brent crude up 42% and WTI up 30%. Inflationary pressures, aggravated by the energy spike, remain elevated and well above the Fed's 2.0% target. In September, this led to the first rate hike since 2023. Meanwhile, the economy and earnings remain exceptionally strong, supported primarily by spending on AI infrastructure and energy. For now, the equity markets are looking past the sharp rise in rates.

Figure 1



(Sources: Confluence, Bloomberg; as of 9/30/26)

Overall index returns were positive for the quarter, with the S&P 500 Index up 2.3%, but gains were driven by a small number of AI-focused names, as has been the case for much of the past few years. Year-to-date, the median stock is up only 2.6% compared with 12.7% for the overall S&P 500, and 45% of constituents posted negative returns. The top 10 names, all tech-related, contributed 67% of the index's year-to-date return.

More surprisingly, returns have skewed sharply in favor of value: the Russell 1000 Value Index is up a whopping 19.3% year-to-date versus only 6.3% for the Russell 1000 Growth Index. This seems counterintuitive amid the AI trade, given the Growth index's far larger Technology weighting (56% versus 21% for the Value index; see Figure 2). Technology and Energy led performance for both the quarter and the year, including double-digit YTD returns, while seven of the 11 sectors posted negative returns in the quarter.

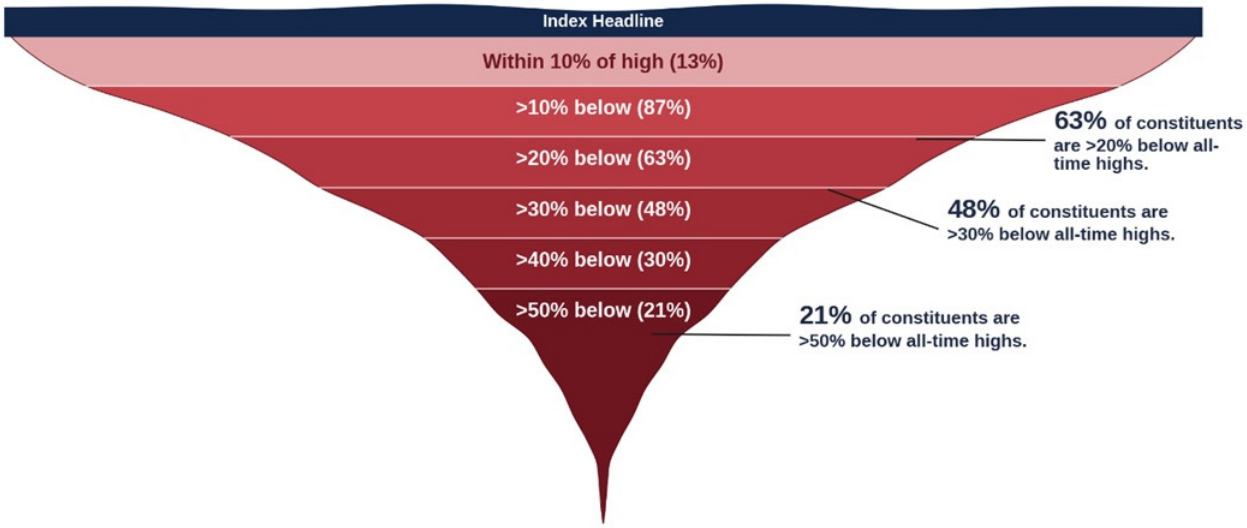
Figure 2 - **Returns by Sector**

	Energy	Materials	Financials	Industrials	Cons. Disc.	Tech.	Comm. Services	Real Estate	Health Care	Cons. Staples	Utilities	S&P 500
S&P 500 weight	3.4%	1.7%	11.4%	8.0%	8.6%	39.7%	9.9%	1.7%	9.3%	4.4%	1.9%	100.0%
Russell Growth weight	0.5%	0.2%	4.5%	7.4%	7.2%	56.4%	16.5%	0.4%	5.4%	1.2%	0.2%	100.0%
Russell Value weight	6.2%	3.6%	18.3%	10.5%	10.2%	20.6%	3.4%	3.4%	13.3%	7.2%	3.4%	100.0%
QTD	17.2	-2.8	-0.1	-9.7	-5.1	7.2	3.6	-5.6	6.5	-1.9	-12.4	2.3
YTD	40.3	8.8	-1.3	8.5	-5.8	28.4	4.5	5.3	10.2	6.0	-5.7	12.7

(Source: JP Morgan Asset Management; Guide to the Markets®, US 4Q 2026, as of September 30, 2026)

The market's lack of breadth reflects the small subset of stocks driving returns. A bear market is defined as a decline of 20% or more from peak, and despite the S&P 500 posting new highs, over 60% of its constituents are trading at least 20% below their all-time highs (see Figure 3, next page). For perspective, at the height of the dot-com bubble in March 2000, that figure reached 71%, a condition dubbed a "stealth bear market."

Figure 3 - **The majority of the S&P 500 is already in a structural bear market**



Context: By market value, 66% of IVV's weight sits within 20% of an all-time high, while 63% of its names are more than 20% below theirs. Median constituent: 27.5% below its high.

(Sources: Confluence, Bloomberg, FactSet, iShares Core S&P 500 ETF (IVV) holdings as of 9/30/26)

The Russell 1000 Value is experiencing similar narrowness. Year-to-date, its median return is only 2%, and close to half its constituents have negative total returns. Meanwhile, the top 20 names accounted for 75% of the index's year-to-date return.

This concentration is exposing a methodological flaw in "passive" style indexes: their risk profiles are fluid. We have written extensively about this phenomenon to help keep clients' investments aligned with their risk profiles, which are usually more constant (see related *Value Equity Insights* reports). The tables in Figure 4 show the dramatic changes in the Russell 1000 Value Index from May 2025 to late June 2026, following the index's annual style reconstitution. Over that span, the concentration of the top 10 names and the price-to-earnings ratio nearly doubled, while the dividend yield was cut in half.

Figure 4 - **Russell 1000 Value Risk Profile Changes in Just 13 Months**

Pre-June 2025 Reconstitution			
Name	Wgt (%)	PE	Yield
Berkshire Hathaway Inc. (Class B)	3.7%	25x	0.0%
JPMorgan Chase & Co.	3.0%	14x	2.0%
Exxon Mobil Corp.	1.8%	16x	3.6%
Walmart Inc.	1.7%	38x	0.8%
Johnson & Johnson	1.5%	15x	3.4%
The Procter & Gamble Co.	1.3%	25x	2.3%
Bank of America Corp.	1.2%	12x	2.3%
Philip Morris International Inc.	1.1%	24x	4.4%
UnitedHealth Group Inc.	1.0%	13x	1.6%
Cisco Systems Inc.	1.0%	17x	3.3%
Top 3	**8.5%**	**18x**	**1.9%**
Top 10	**17.3%**	**20x**	**2.4%**

Post-June 2026 Reconstitution			
Name	Wgt (%)	PE	Yield
Amazon.com, Inc.	5.9%	27x	0.0%
Apple Inc.	5.4%	33x	0.4%
Microsoft Corp.	3.9%	22x	1.0%
Berkshire Hathaway Inc. (Class B)	2.6%	24x	0.0%
JPMorgan Chase & Co.	2.5%	15x	1.8%
Intel Corp.	1.7%	130x	0.0%
Johnson & Johnson	1.7%	22x	2.5%
Exxon Mobil Corp.	1.6%	12x	3.3%
Cisco Systems, Inc.	1.3%	27x	2.4%
Walmart Inc.	1.3%	39x	0.8%
Top 3	**15.2%**	**27x**	**0.5%**
Top 10	**27.8%**	**35x**	**1.2%**

(Sources: FactSet, Bloomberg, iShares Russell 1000 Value ETF (IWD))

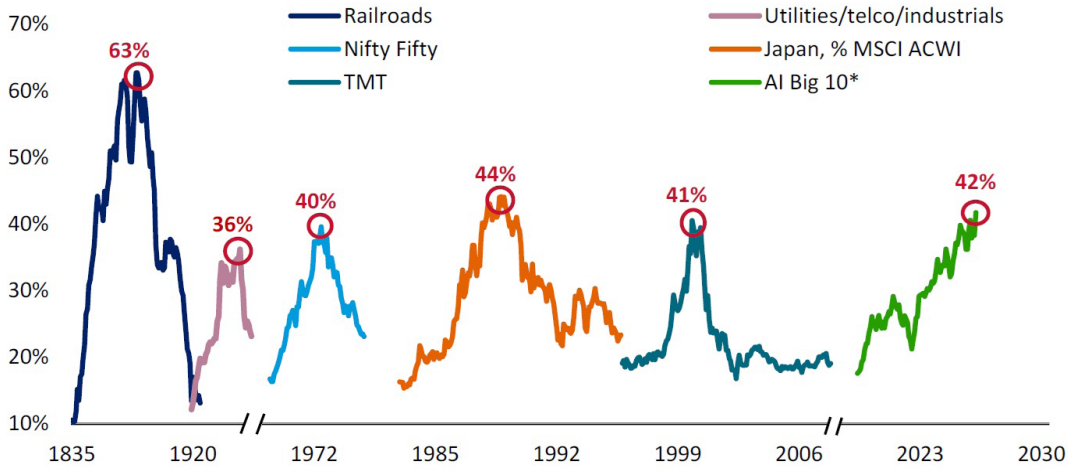
Of course, these extreme shifts have been driven by advances in AI and the arms race to build the data centers to support the technology. At the outset, the investment was funded primarily by the excess cash flow of mega-cap tech companies and venture capital. Today, however, spending has outstripped free cash flow, forcing companies to seek other sources of funding, such as stock issuance, bond issuance, circular vendor financing, and financial engineering (e.g., special purpose vehicles, asset-backed lending, sale-leasebacks, and third-party guarantees). The five largest hyperscalers alone went from $130 billion in combined capital investment in 2021 to an expected $800 billion in 2026, with $1.2 trillion projected for 2028. Accounting standards allow for much of the financial engineering to remain off the financial statements until the data centers come online over the ensuing years; these off-balance-sheet commitments are estimated to exceed $3 trillion. This capital spending also has the effect of driving revenue and earnings of the suppliers of the hardware (semis, memory, storage) as the buildout occurs, but it has yet to be depreciated/expensed or reflected on the financials of the data center builders. This elevates aggregate earnings in the interim and masks future obligations.

Perspective

No one knows how profoundly AI will transform the global economy – or whether it does indeed pose an existential threat to humanity – but the scale of investment and the financial engineering supporting it are elevating investor risk. Past waves of heavy investment in transformative technologies, from railroads and electricity to the internet, show that investors were often right about the opportunity but overly optimistic about price and timing (see Figure 5 for major historical bubbles). The recent sharp rise in interest rates has increased financing costs for the buildout and pressured valuations. If inflation remains elevated, rates may stay high or climb further. Geopolitical uncertainty in the Middle East and Ukraine is also roiling oil markets. That said, the economy remains on solid footing and employment is steady, supporting the outlook for earnings growth and broader market participation.

We remain steadfast in our process that focuses on protecting capital by emphasizing probabilities, as opposed to possibilities, and we do so by identifying competitively advantaged, conservatively financed businesses trading at attractive valuations.

Figure 5 - **Peak concentration levels of major historical bubbles >40%, except railroads >60%**



*(Source: BofA Global Investment Strategy, GFD Finaeon, Bloomberg) Note: all US sectors, as % of US market cap, except for Japan (which is as % of MSCI ACWI). *AI Big 10 = Magnificent 7 + Broadcom, AMD, and Micron.*

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Disclosures

Figure 1: Index data utilized: Bloomberg US AI Enablers and Adopters Price Return Index (BUSAIAE), Goldman Sachs US 500 Excluding Artificial Intelligence Enablers Price Return Index (SPXXAI), and S&P 500 Index (SPX). Returns through 9/30/2026.

Figure 3: Source: iShares Core S&P 500 ETF (IV)V holdings as of 9/30/2026; price data via Bloomberg/FactSet. All-time high = highest close from each stock's first trade through 9/30/2026. N = 514 constituents with data (5 excluded for no 9/30 price). Valley width at each depth = share of constituents at least that far below their all-time high.

Figure 4: Reflects constituents of the iShares Russell 1000 Value ETF (IWD). Pre-June 2025 Reconstitution as of 5/31/2025 and Post-June 2026 Reconstitution as of 6/30/2026.

Figure 5: Source: BofA Global Research. Reprinted by permission. Copyright © 2026 Bank of America Corporation ("BAC"). The use of the above in no way implies that BAC or any of its affiliates endorses the views or interpretation or the use of such information or acts as any endorsement of the use of such information. The information is provided "as is" and none of BAC or any of its affiliates warrants the accuracy or completeness of the information.

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