

7/6/2026

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Investment Insights

I hope everyone had a great Fourth of July. It's my favorite holiday, and I enjoyed spending the weekend with friends and family. The holiday also comes just past the halfway point of the year, making it a good time to assess the markets. This letter may be a bit more technical than usual because the ongoing AI buildout continues to drive market performance, and it is difficult to discuss developments without getting into some detail.

Big Companies Are Spending Massively

The AI infrastructure buildout remains unprecedented. Hyperscalers such as Amazon, Microsoft, Alphabet, Meta, and Oracle are expected to invest more than \$700 billion in 2026 and over \$1 trillion in 2027. OpenAI, Anthropic, and SpaceX could add another \$150 billion in 2026 and \$190 billion in 2027. Initially funded by cash flows from their core businesses, these investments are increasingly being financed through debt and equity markets. As capital needs have grown, investor enthusiasm has cooled. Over the past three months, these companies have experienced drawdowns, and over the last month many have lagged the S&P 500 and global equity markets.

Other Sectors are Sluggish

Additionally, large sectors like consumer staples, communications, and financials are flat or negative on the year.

What Does This Mean Going Forward?

The divergence between winners and losers is both notable and important. Hardware producers have historically been cyclical businesses, while sectors such as consumer staples, communications, financials, and software have generally delivered more consistent growth.

In February, I wrote that hardware providers would likely become less important over time as computing power became cheaper and more widely available. That is exactly what we are seeing. The cost per token (roughly equivalent to a word generated by an AI model) has fallen sharply. Lower costs should drive broader AI adoption and increase demand for inference computing. So far, that demand has

fueled strong growth in DRAM (short term compute memory), flash memory (hard drive), and CPU compute, markets that have historically been cyclical and are likely to remain so.

Competition is also intensifying. Amazon's Trainium, Google's TPU, Nvidia's and AMD's next-generation systems are all designed to lower the cost of computing and improve performance.

As computing costs decline and AI becomes more accessible, hyperscalers will have more opportunities to monetize their platforms. Today, much of their revenue comes from renting compute capacity, similar to how a REIT rents real estate. Over time, higher-margin businesses such as AI agents, advertising, automation, and software applications should become increasingly important as the cost of their primary input, compute, continues to fall. Investors remain somewhat skeptical because commercial demand is still developing and the required upfront investment has been enormous.

Lower token costs ultimately expand the market for AI. However, if computing becomes abundant and inexpensive enough, semiconductor economics could become more commodity-like, leading to lower margins and a return to more cyclical industry dynamics. This is a risk we continue to monitor closely.

How We've Allocated in This Environment

Our goal has been to participate in the areas the market is rewarding today while maintaining exposure to the long-term beneficiaries of lower computing costs. To that end, we have maintained an allocation to the semiconductor industry through SOXX since the second quarter of 2025, which has performed exceptionally well. The position appreciated enough during the second quarter that we rebalanced it in several of our more conservative strategies prior to Micron's earnings release. We also took advantage of the software selloff earlier this year, increasing exposure to companies that stand to benefit from broader AI adoption, including hyperscalers such as Microsoft. In addition, positions such as the Nasdaq 100 and Vanguard Mega Cap Growth ETF provide exposure to both semiconductor producers and the companies most likely to benefit as computing costs continue to decline. These themes have been meaningful contributors to client portfolio returns.

Within alternatives, our allocations to gold and an options strategy designed to participate in equity upside while limiting downside risk both performed well. We

have since exited our gold position, a decision that has proven beneficial during the second quarter.

Our alternatives exposure has been particularly important given our conservative positioning within fixed income. We have maintained that stance for two reasons. First, inflation has remained difficult to forecast amid tariffs and geopolitical tensions. As a result, our short-term Treasury Inflation-Protected Securities (STIP) position has been one of our strongest performers this year. Second, credit spreads remain tight despite signs of growing risk in certain areas of the market, particularly private credit, where we currently have no allocation.

Inflation remains one of the more challenging aspects of the current outlook. While there have been some encouraging developments, the picture remains mixed: the ceasefire has proven unreliable, tariff-related effects should gradually roll out of year-over-year comparisons, and wage growth remains contained. We will be closely monitoring inflation data throughout the summer, particularly in housing, healthcare, and financial services, which continue to be key drivers of price pressures. Although goods inflation should moderate as tariff impacts fade, recent data suggest that the path back to the Federal Reserve's target may be slower and more uneven than expected, increasing the likelihood that the Fed maintains a restrictive stance for longer than markets anticipated following Kevin Warsh's nomination as the next Fed Chair.

Other Concerns

I have other concerns that I will put here briefly. Notably, I am concerned with the increasing gambling economy which I wrote about in detail and that can be found on our Team's website. I also think the Strait of Taiwan is more economically sensitive than the Strait of Hormuz which is also worth being interested in. I continue to be concerned about private markets.

Expected Changes

We do not anticipate significant allocation changes this quarter. We expect to gradually trim some semiconductor-specific exposure and decrease allocations to companies that are going to the capital markets for AI spend. We will modestly increase the allocation to the options strategy, funded from core fixed income



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holdings, as we believe it offers attractive risk-adjusted return potential across a range of market environments. As always, thank you for your continued trust and confidence in our team.

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