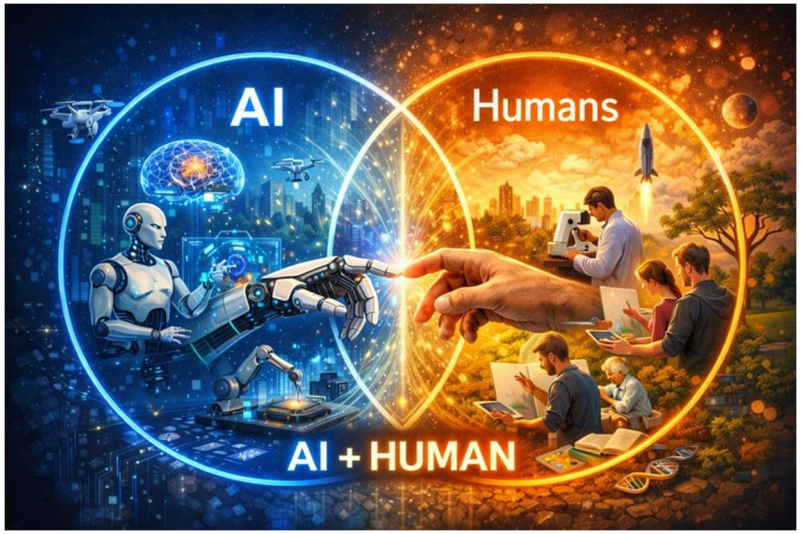
Re: Navigating an Era of Converging Risks

Warner & Your Team!



Investors face no shortage of concerns. Daily headlines point to rising federal debt and interest rates, weak consumer sentiment, geopolitical tensions, and rapid advances in artificial intelligence (AI) that could reshape the economy and, according to some experts, pose broader societal risks if not carefully managed. These issues warrant thoughtful consideration, but history shows that markets have repeatedly adapted to wars, recessions, technological revolutions, and political upheaval. In this quarterly letter, we will examine several of today's major concerns, their potential portfolio implications, and strategies for navigating uncertainty.

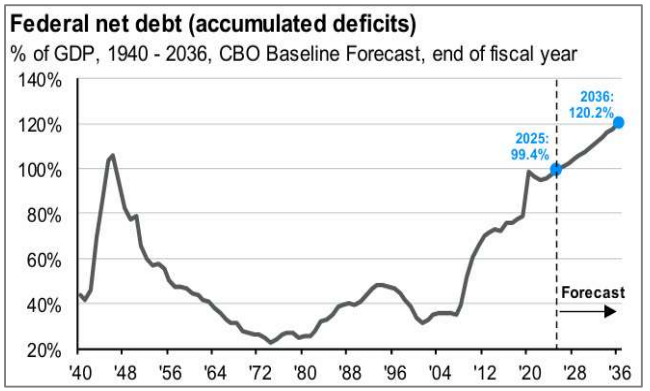
The Future of AI: Threat, Opportunity, or Both?

AI presents both risks and opportunities. Optimists foresee breakthroughs in medicine and science, greater productivity, and stronger economic growth. Pessimists warn of job displacement, social disruption, concentrated power, and unintended consequences. The outcome will likely include elements of both. For investors, the challenge is not to predict an extreme scenario, but to recognize that innovation has historically created winners and losers while advancing prosperity overall. Later in this letter, we will consider several possible AI scenarios.

What Is the Bond Market Telling Us?

Bond yields have risen in recent months as the economy has proved more resilient than expected, corporate borrowing to finance AI development has increased, and concerns about the nation's growing deficits have intensified. The graph to the right shows federal debt at close to 100% of GDP, its highest level since World War II. From the end of World War II through 1980, the government (under both Democratic and Republican control) maintained high marginal income tax rates of up to 70% for the highest income earners. Combined with strong economic growth, those policies coincided with a decline in federal debt from wartime levels to roughly 20% of GDP. In the intervening years, tax rates have been sharply cut while federal outlays have grown to a point where investors are increasingly concerned about the long-term sustainability of federal borrowing and deficits. (The latest report from the Treasury Department indicated a deficit of close to $2 trillion for the 2026 fiscal year, the largest outside the pandemic years. This pushes the national debt to $40.3 trillion and counting.)

Inflation expectations are also putting upward pressure on interest rates. Although inflation has declined significantly from its peak in June 2022, it remains above the Federal Reserve's 2% long-term target; the latest report showed consumer prices rising at an annualized rate of 3.7% through September, largely because of higher energy costs. Persistent inflation, strong consumer demand, a tight labor market, and substantial federal and corporate borrowing are keeping rates elevated. Bond investors are therefore demanding higher yields to compensate for inflation risk and absorb the growing supply of Treasury securities issued to finance the debt.

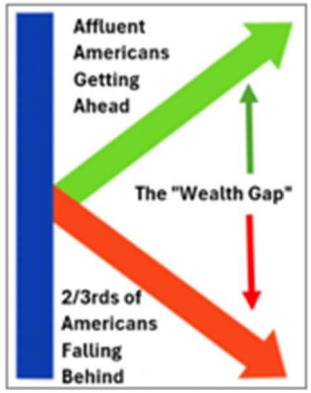


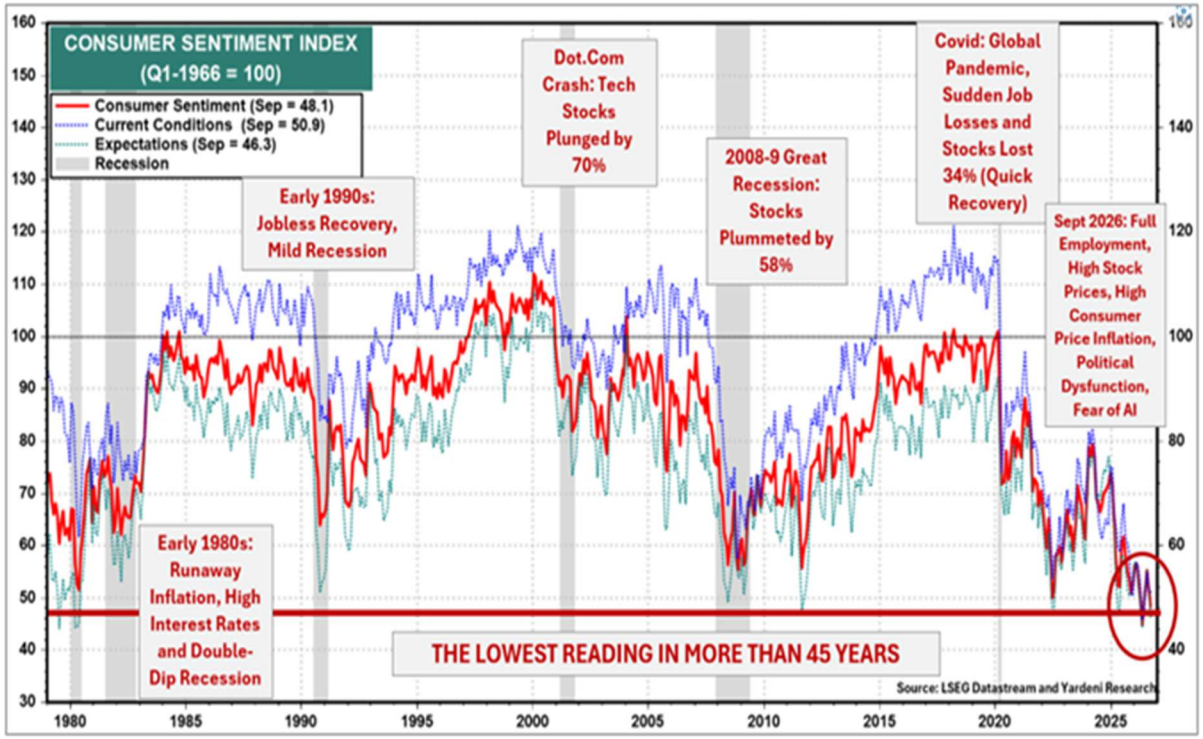
Solutions to the national debt crisis are well-defined but politically difficult to enact. According to the Congressional Budget Office (CBO), meaningful deficit reduction will require reforms to Medicare, Medicaid, and

Social Security, together with measures to increase federal revenue. In *Options for Reducing the Deficit: 2025 to 2034*, the CBO identified 76 policy options for reducing deficits over the coming decade. Smaller spending cuts may help, but the scale of projected deficits suggests that substantial changes to major entitlement programs and tax policy will be necessary.

A Resilient Economy, but Many Consumers Feel Left Behind

Consumer sentiment remains near a 45-year low even as the economy performs well by many measures. This disconnect reflects the gap between broad economic indicators and households' daily experience. According to the August 2026 PYMNTS Intelligence survey, roughly two-thirds of Americans depend on their next paycheck, and about one-quarter face significant financial stress. Meanwhile, the one-third who are not paycheck-dependent generate an estimated 65% to 75% of consumer spending. This imbalance helps explain the "K-shaped" economy: affluent households generally feel secure, while many others remain under pressure.





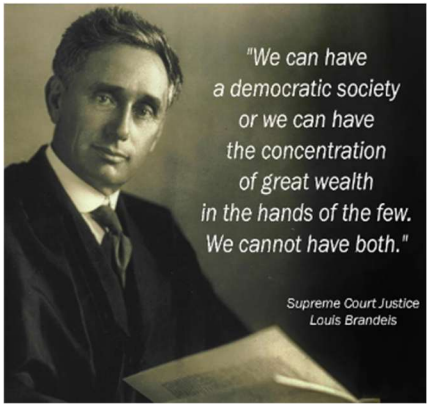
Broad economic indicators remain strong. Third-quarter GDP is expected to have grown at a 3.6% annualized rate, and the latest Purchasing Managers' Index shows accelerating services and manufacturing activity worldwide. Unemployment is 4.2%, below its 30-year average of 5.5%; consumer spending remains resilient, largely because of the top third of households; corporate profits are strong; and stocks are near record highs. Yet higher interest rates have raised borrowing costs for mortgages, auto loans, and credit cards, straining household budgets. Political polarization, rising federal debt, geopolitical tensions, and concern about rapid advances in AI have further deepened public unease.

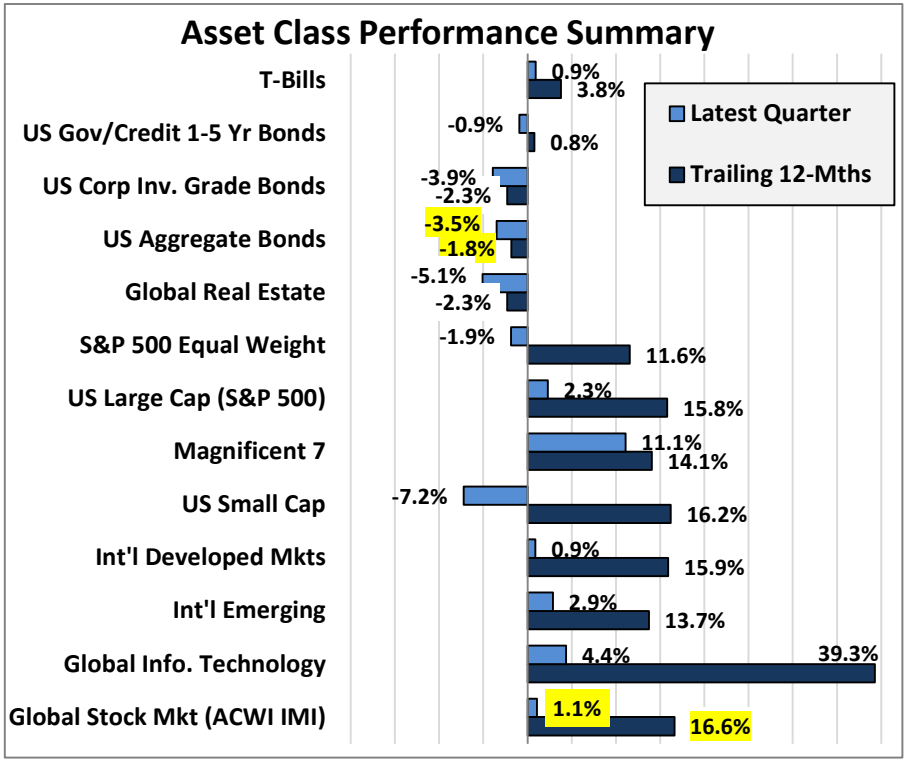
The graph on the upper right shows consumer sentiment at a 45-year low despite full employment and near-record stock prices. Historically, pessimism this pronounced has coincided with recessions and weak markets. Today, however, the K-shaped economy—characterized by high prices and stagnant inflation-adjusted wages for many households—is undermining consumer confidence.

What Might the Midterm Elections Mean for Investors?

A victory by the Democrats in one or both chambers of Congress would produce a divided government and a greater degree of legislative gridlock. While gridlock is often viewed negatively in political circles, financial markets have historically been more comfortable with divided government than many investors assume (the graph to the right indicates that the stock market has historically performed somewhat better during periods of divided government). The reason is straightforward: when neither party can easily enact major policy changes, businesses and investors operate in a more predictable environment. The downside, however, is that many of the nation's most significant long-term challenges, including entitlement reform and the growing debt burden, may remain unresolved. In that sense, gridlock may provide short-term stability while making long-term fiscal problems more difficult to address.

Another related political concern is the growing concentration of economic power among a relatively small group of ultra-wealthy individuals. As wealth has become increasingly concentrated over the past several decades, reaching levels not seen in generations, a small number of individuals have gained a greater ability to influence political priorities, policy debates, and government decision-making. While successful entrepreneurs and investors have long played an important role in economic progress, an excessive concentration of wealth and influence can strain perceptions of fairness, equal representation, and economic opportunity. Over the long run, this may contribute to greater social and political polarization, erode trust in institutions, and make it more difficult to build consensus around solutions to shared national challenges. (The quote to the left is often attributed to Supreme Court Justice Louis Brandeis during another period of highly concentrated wealth in the early twentieth century. By contrast, the period from the 1940s through the 1970s, often described as an era of broad-based prosperity and expanding middle-class wealth, saw a significant narrowing of the wealth gap.)





Asset Class Performance
(Some Weakness Beginning to Show)

The third quarter was a reminder that stock market leadership remained narrow, even as global equities continued to advance. The broad global stock market generated a gain of 1.1% for the quarter and a strong 16.6% return over the past twelve months. However, beneath those headline results, performance varied significantly across asset classes.

Large U.S. companies continued to lead the way, with the S&P 500 advancing 2.3% during the quarter and 15.8% over the trailing year. Technology-related companies remained particularly strong, as the Global Information Technology sector gained 4.4% for the quarter and an impressive 39.3% over the last twelve months. The "Magnificent 7" stocks also delivered another solid quarter, posting an 11.1% gain and a 14.1% one-year return.

While headline stock market returns remained positive, market breadth weakened. The equal-weighted S&P 500 declined 1.9% during the quarter, and U.S. small-cap stocks fell 7.2%, highlighting the gap between the largest market leaders and much of the broader market. International stocks produced mixed results, with developed markets gaining 0.9% and emerging markets rising 2.9% during the quarter.

The bond markets and real estate faced continued pressure from rising interest rates. Investment-grade bonds, aggregate bonds, and global real estate all posted negative quarterly returns, despite remaining positive or stabilizing over longer periods. Treasury bills remained one of the few bright spots within defensive assets, generating a 0.9% quarterly return and 3.8% over the past year.

Overall, the quarter illustrated a market environment characterized by resilient economic growth and continued investor enthusiasm for a relatively small group of large-cap growth and AI-related companies. While concentrated leadership can drive strong index-level returns for a time, history reminds us that market leadership eventually broadens and rotates. Maintaining a diversified portfolio remains important, particularly during periods when the performance gap between winners and laggards becomes unusually wide.

Returning to the Topic of AI and Portfolio Positioning

Many of the recent headlines have been stoking fears about the threat to society posed by AI, while the developers of AI are focused on its potential economic gains. For investors, we believe it is prudent to consider various potential scenarios for the future of AI, how portfolios might be affected, and what positioning might prove beneficial. Because these scenarios are not mutually exclusive and may overlap over time, we have incorporated strategies that also address the aforementioned risks of rising interest rates and higher than expected inflation.

Scenario 1: AI Renaissance (Best Case?)

In this scenario, AI drives a substantial increase in productivity, boosting corporate profits, accelerating economic growth, and improving living standards. A portfolio positioned to benefit from this environment would maintain an overweight allocation to equities, including innovation- and technology-oriented investments, while remaining globally diversified. The primary risk is becoming overly concentrated in perceived winners with unsustainably high valuations, creating conditions similar to the technology-driven market bubble of the late 1990s. (Note: Our model equity portfolio purposefully avoids such over-concentration given lessons learned from the past.)

Scenario 2: AI Transition (Base Case?)

In this scenario, AI creates meaningful economic benefits but also significant disruption, including job displacement, greater inequality, uneven growth, and periodic economic setbacks. A balanced portfolio emphasizing global diversification, adequate liquid reserves, high-quality US and global bonds, Treasury Inflation-Protected Securities (TIPS), and select infrastructure investments (e.g., electric transmission, power grid modernization, and utility infrastructure) may help navigate these uncertainties. The primary risk is that investors underestimate the length and complexity of the transition and make emotionally driven decisions during periods of heightened volatility. (Note: We recently incorporated TIPS into our model bond portfolio and will be exploring infrastructure opportunities where valuations and diversification characteristics are compelling.)

Scenario 3: AI Disorder (Worst Case?)

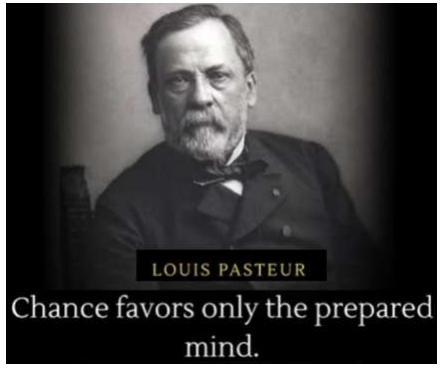
In this scenario, AI contributes to broad social, political, and economic instability, leading to policy uncertainty, persistent inflation, and slower long-term growth. An appropriate portfolio strategy would prioritize capital preservation by holding at least 8–10 years of anticipated spending needs in high-quality liquid assets, including adequate cash reserves, short- and intermediate-term government securities, and TIPS. After establishing this capital-preservation allocation, the remaining portfolio should be invested in diversified global equities and potentially other diversifiers, such as infrastructure and gold. The primary risk is becoming so focused on a worst-case outcome that investors unnecessarily sacrifice opportunities for long-term capital appreciation. (Note: During client financial-plan reviews, we are emphasizing stronger capital preservation allocations while maintaining appropriate exposure to attractively valued global equities with higher long-term expected returns.)

Common Thread Across All Scenarios

While these outcomes differ, each one points to the same fundamental investment principle: hold sufficient liquidity to meet short- and intermediate-term spending needs, maintain global diversification, and avoid making dramatic portfolio changes based on any single prediction about the future. The goal is not to predict the future with precision, but to build a portfolio resilient enough to succeed across a wide range of possible outcomes.

Closing Comment

While the challenges discussed in this quarterly letter are significant, it is worth remembering that every generation has faced its own version of uncertainty. Wars, economic crises, political upheaval, technological disruption, and social change have repeatedly tested societies and investors alike. Yet, over time, human ingenuity, scientific advancement, and our capacity to adapt have consistently driven progress. The future will undoubtedly bring disruptions and new challenges, but it will also bring solutions, opportunities, and innovations that are difficult to imagine today.



More than 170 years ago, the French chemist and microbiologist Louis Pasteur observed that "chance favors only the prepared mind." For investors, the lesson is clear: long-term success depends less on accurately predicting the future than on being prepared for a variety of outcomes. By focusing on what we can control and remaining committed to sound investment principles, we can navigate uncertainty with greater confidence.