That Bears Watching

Changing Seasons, Changing Outlooks

From the Desk of the Public Equities Team

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At a Glance:

- Artificial intelligence (AI) remains transformational, but the trade is changing. Political resistance and muted reactions to strong earnings suggest value may be shifting.
- Macro variables rhyme with the early innings of the late-cycle phase. Historically, this has meant positive but moderate equity returns over the medium term (12–18 months). [1]
- Elevated bearish sentiment argues against becoming outright defensive, even as tighter policy and stretched trailing returns support less risk concentration.
- Our portfolios remain invested with a cyclical tilt but are becoming more balanced. Namely, we have reduced exposure to selected AI capex beneficiaries, have started engaging again in the hyperscalers and have emphasized diversification in quality cash-flow compounders, albeit with a cyclical bias.

Seasons have changed, and so have the signals

Fall has always been your author's most colourful season: brisk temperatures, changing leaves and a return to activity, both in life and markets, after a long summer lull. All this comes with the nostalgia that the hottest days are behind us and the lurking reality that winter lies ahead. That feels like an apt characterization for markets.

Q2 2026 earnings were sizzling (~30% earnings growth), yet some of the fastest growers were met with indifference, which can't help but make us reflect that, similar to changing colours, so too are market leadership and the equity outlook. [1]

Take AI for example. It remains transformational. For example, one consumer AI app quickly became one of the most downloaded mobile applications [1]. Yet many of the stocks in the value chain of the AI data centre buildout remain below their highs, despite significant earnings growth and positive earnings revisions. [1]

Similarly, take notice of changes in market structure. Despite above-average Gross Domestic Product (GDP) growth, with the Atlanta Federal Reserve GDP forecasting model pencilling in Q3 2026 GDP growth somewhere in the 5% range, the best-performing sectors quarter-to-date are Energy, a consequence of geopolitical strife, and Healthcare, all while the 10-year U.S. Treasury flirts with levels last touched in May 2007.[1]

AI is still transformational, but the trade is changing

The prevailing view treats the AI value chain as one trade, and we think that is increasingly too simple. Recent political developments, ones that we think aren't being talked about enough, include bipartisan moves to slow data centre buildouts. What matters here is that major Republican and Democratic-led states, including Texas, Pennsylvania, Virginia and California, are moving in the same direction. [1]

To us, this suggests that (1) grid reliability, permitting and local capacity are adding political constraints and (2) we are no longer merely limited by supply constraints.

The investment implication is just that: supply. If political and permitting constraints slow construction while suppliers add capacity, the pricing power in memory, optical components, power equipment and related infrastructure that ushered in this AI beneficiary bull run is likely to erode.

In short, the long-term buildout should remain intact, but the near-term earnings revisions cycle becomes less exceptional. The market may already be hinting at that, with hyperscalers being rewarded by the market following July's sell-off. [1]

Extend this logic a step further. If political constraints slow the pace of new data centre construction, the hyperscalers could disproportionately benefit because they already have data centre builds in progress and there would be less near-term pressure on free cash flow. This slowdown also means that, when they do eventually get approvals, the cost to do so could be lower as supply bottlenecks ease.

Put differently, less infrastructure spending does not necessarily mean less AI value. It just changes where that value accrues.

Early late cycle is still late cycle

The second shift is broader than technology. Evidence increasingly points to the early stages of a late cycle. We are not trying to be colourful with nomenclature, just pointing out that in a late-stage cycle, while earnings growth remains positive, the rate of change is slower.

Said plainly, the expected return for taking incremental risk is lower than earlier in the cycle. Practically, if Q2 2026 earnings grew 51% year-over-year on an unadjusted basis (~30% on core), it is unlikely that they will accelerate from these levels. [1]

The Institute for Supply Management (ISM) Manufacturing Index helps frame where we are in the progression and what equity returns may look like. Historically, readings between 55 and 60 have been followed by mid-to-high-single-digit S&P 500 Index returns over the next 12 months. Above 60, subsequent returns have been below average. [1]

ISM Regime

	55–60	Above 60
Mean Return	7.2%	1.9%
Median Return	7.8%	2.6%
25th Percentile	-1.9%	-6.0%
75th Percentile	15.2%	10.8%
Min Return	-26.7%	-41.4%
Max Return	40.8%	32.5%
Standard Deviation	12.9%	13.7%
Observations	246	129

Source: Bloomberg Finance L.P. As of August 31, 2026. Past performance is not indicative of future returns. The S&P 500 Index is for information purposes only and is not necessarily correlated to any investment strategy.

August's ISM was 54.6, just below the 55 threshold and still short of the 60-level associated with the end of the cycle. For us, this isn't a crystal ball. Rather, it's our guidepost that expecting positive equity returns over the next 12 months remains reasonable, but that the amplitude is likely to be lower. Growth remains supportive, but the economy is moving closer to the range where we would become incrementally more cautious.

The direction of monetary policy also reinforces this signal. Market-implied central bank policy rates are rising across all large, developed economies for the first time in four years. The starting points differ, but the direction is unanimous: a global rate-hiking cycle has begun. [1]

Historically, tighter monetary conditions have presaged market volatility. Recall the axiom, "the Fed tightens till something breaks." We are at the beginning of this rate-hiking campaign, and it remains early against a backdrop of buoyant economic growth, outsized earnings and transformational AI technology. But the big picture is that the torque has turned to tightening.

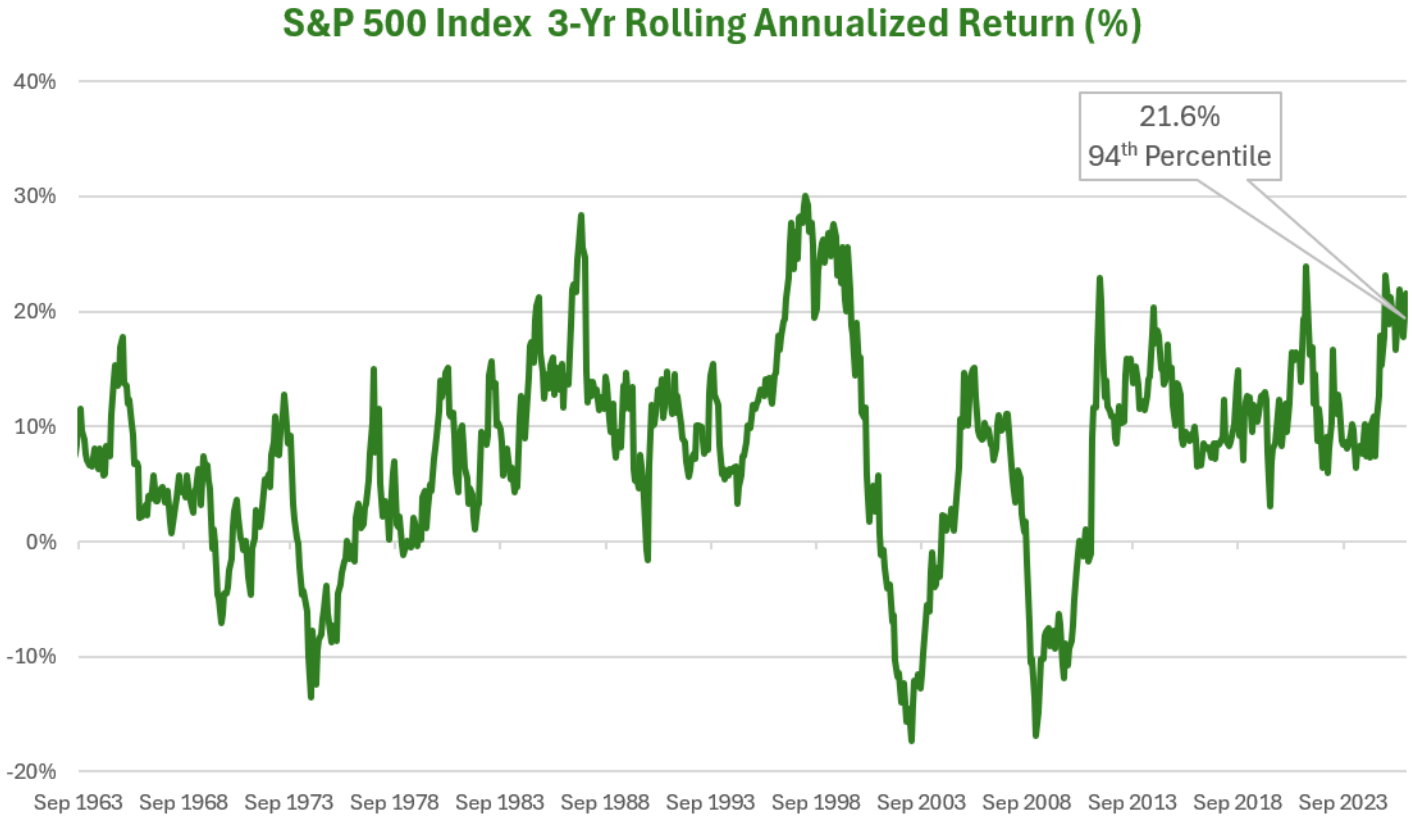
Market leadership also shares elements of late-cycle behaviour. Rising rates, stubborn inflation and a commodity bid are all corroborating cross-asset signals. Within equity markets, the leadership is Energy and Materials, deep cyclical sectors, along with defensive areas such as Healthcare, while software stocks are also finding a bid.

No single sector rotation proves a regime change, but the pattern is nevertheless consistent with a market becoming more discerning about where it pays to take risk. Historical returns provide broader context: the S&P 500 Index's three-year annualized return is now 21.6%, placing it in the 94th percentile of this data set, which goes back to the 1960s. [1]

Yes, returns can move higher from here, but you would need a combination of continued elevated earnings growth, falling inflation, easing geopolitical risks and a central bank that has moved back to a neutral posture. That constellation of good fortune can occur, but the onus falls on the bulls.

Again, to reiterate, **we aren't calling for a bear market**. We are just trying to be more realistic with our expectations going forward.

Three-Year Returns Are Historically Elevated



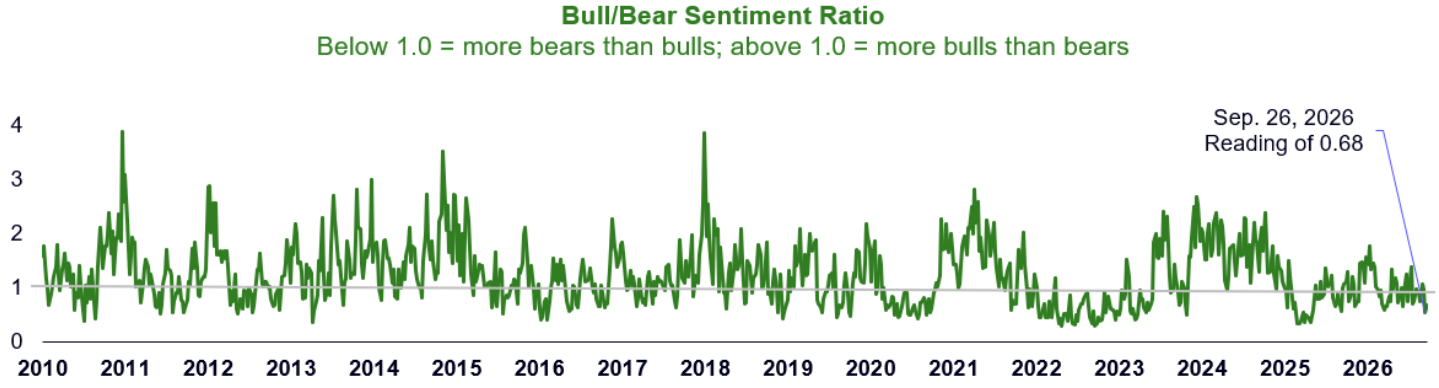
Source: Bloomberg Finance L.P. As of September 26, 2026. Past performance is not indicative of future returns. The S&P 500 Index is for information purposes only and is not necessarily correlated to any investment strategy.

Cautious investors can be a source of support

Late cycle does not mean last call. The chart below shows that bearish sentiment now exceeds bullish sentiment and sits at a 0.68 reading. What does this mean in reality? This can be interpreted as there being about 1.5 bears for every one bull, meaning elevated levels of caution are already embedded. [1]

Historically, such extremes have often created favourable near-term forward-return environments, which is why we are not positioned in the bunker with the hatches bolted shut. [1]

The Bears Outnumber the Bulls



Source: Bloomberg Finance L.P. As of September 26, 2026.

Where we stand

Our response is discipline and patience, not a full retreat. We have always communicated our process of investing in high-quality companies that display exploitable free-cash-flow growth.

We still think AI is transformational for business models and remain invested in some of the AI capital expenditure (capex) beneficiaries because of their strong free-cash-flow growth. However, it's no longer a one-way trade in which all AI capex beneficiaries win.

Research-driven differentiation on the sustainability of pricing power, competitive threats and total addressable market (TAM) growth remains paramount. At the margin, we have been reducing our weights in some of these names and/or redeploying to our lower-beta AI exposures.

Given the late-cycle dynamics we've discussed, we feel that we aren't being compensated for taking sizable risks, so for portfolios, that means we are not stepping out on any ledges. We have therefore moved to companies that have historically worked well during these periods, and the hyperscalers feature prominently.[1]

Ultimately, it's about making sure we have diversified the sources of portfolio cash-flow growth and reduced our reliance on any single theme. Our portfolios today include a mix of interest-rate-sensitive Financials, high-quality business models in software, a healthy but lower exposure to AI, an increasing tilt toward the hyperscalers and measured Energy exposure that provides optionality when uncertainty rises. We remain underweight defensive sectors such as Consumer Staples because economic growth has not degraded enough to justify a more defensive stance.

Importantly, we remain eagle-eyed for evidence that growth is rolling over. If it does, that would increase our conviction that the late cycle is progressing and warrant a more defensive mix, but we are not there yet.

Said plainly, positive returns are the base case, but expectations should be moderated from the high-double-digit experience of recent years. In that environment, diversified themes, appropriate position sizing and a focus on quality cash-flow compounders matter more than trying to force capital into an opportunity that is no longer mispriced.

What We're Watching

Data centre restrictions: Whether the policy move broadens and begins to alter orders, pricing and earnings revisions across the supply chain.

Market response: Whether strong results again produce positive price reactions in former leadership groups.

Monetary conditions: Whether expected rate increases translate into sustained tightening.

Economic momentum: Whether growth remains firm enough to support cyclicals or slows enough to justify a more defensive stance.

Markets rarely ring a bell when an opportunity moves from underappreciated to well understood. They simply stop paying investors as generously for the same risk. We still see reasons to remain invested, but fewer reasons to remain concentrated. The season has changed, and our portfolios should acknowledge that.

For further information, please contact your TDAM Representative.

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[1] Bloomberg Finance L.P. As of September 26, 2026.

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