August 2026 Market Commentary

Roll With The Changes

"So, if you're tired of the same old story
Oh, turn some pages
I will be here when you are ready
To roll with the changes, yeah, yeah"

https://www.youtube.com/watch?v=M2Z7Tcqo900

Rolling with the changes is probably one of the most relevant phrases when it comes to life and successful investing. Written on a fast-food bag by Kevin Cronin in 1977, as he was driving from Illinois to California to rejoin the band. To him the song was about embracing life's inevitable transitions, letting go of the past, and finding the strength to move forward. Back in 1977 (50 years ago, next year) this song resonated with me. It was the year I graduated high school, two years after my Mom passed away, and all I wanted to do was find a way out, a way to move forward.

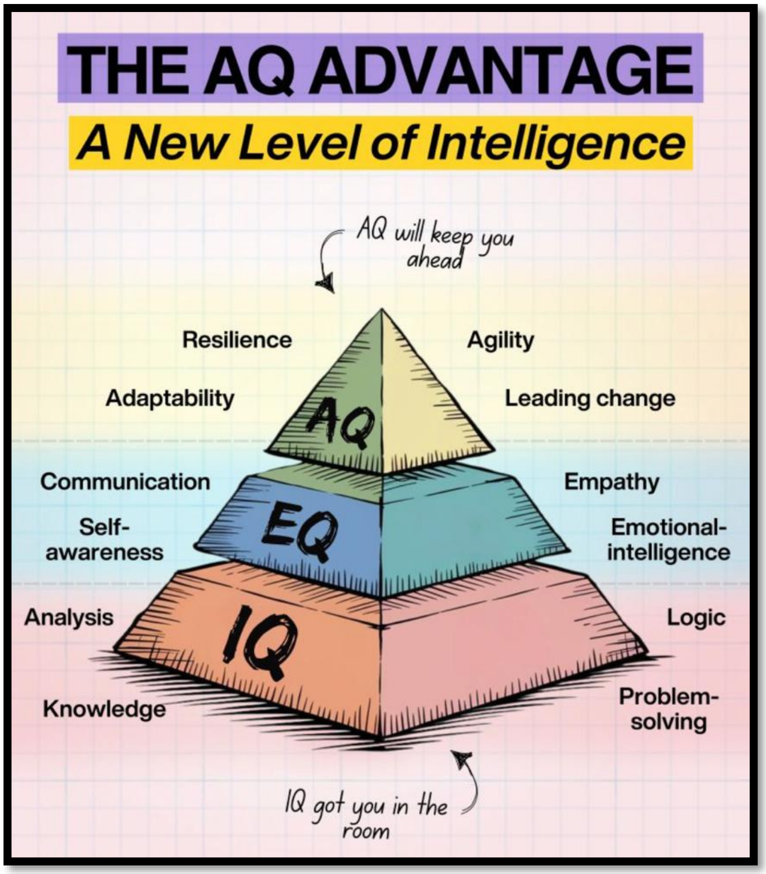
I didn't realize at the time, but the challenges I faced as a teenager were helping me learn to adapt to an ever-changing environment. Today we call it the "**Adaptability Quotient**", or AQ. For more than a century we measured intelligence by IQ, how much information could you memorize and how quickly could you process it. Words, shapes, and numbers - it was measurable and comparable. It was how we were tested in school and how we moved forward into colleges and careers.

Then came EQ – Emotional Intelligence – which broadened the picture to measure how we read social environments, our own self-awareness and our empathy, as well as our ability to communicate. Depending on the setting these "people" skills could be just as important as IQ. You may have an exceptionally high IQ, but if you can't effectively communicate, how can you lead?

Artificial Intelligence "AI" is very good at IQ, processing massive amounts of information extremely fast. It is still working on the EQ component of intelligence. AI is getting better at communicating, but still has a way to go when it comes to reading social environments (reading the room). But something is still missing.

IQ helps us process information, and EQ helps us communicate to the people around us. However, neither helps us much during periods of extreme change, when the rules of the game are shifting faster than our old models can update. **Enter AQ the Adaptability Quotient, which describes our ability to adjust our thinking, behavior, and strategy in response to rapid change and uncertainty.**

AQ matters more today than ever. Last month I wrote about Jarlshof, the 5,000-year-old settlement in the Shetland Islands, and about how little things changed for thousands of years. Today we live in a world in which change is accelerating across too many domains all at once. It is not enough to have a high IQ, or a high EQ, you need both but you also need to be able to adapt quickly.

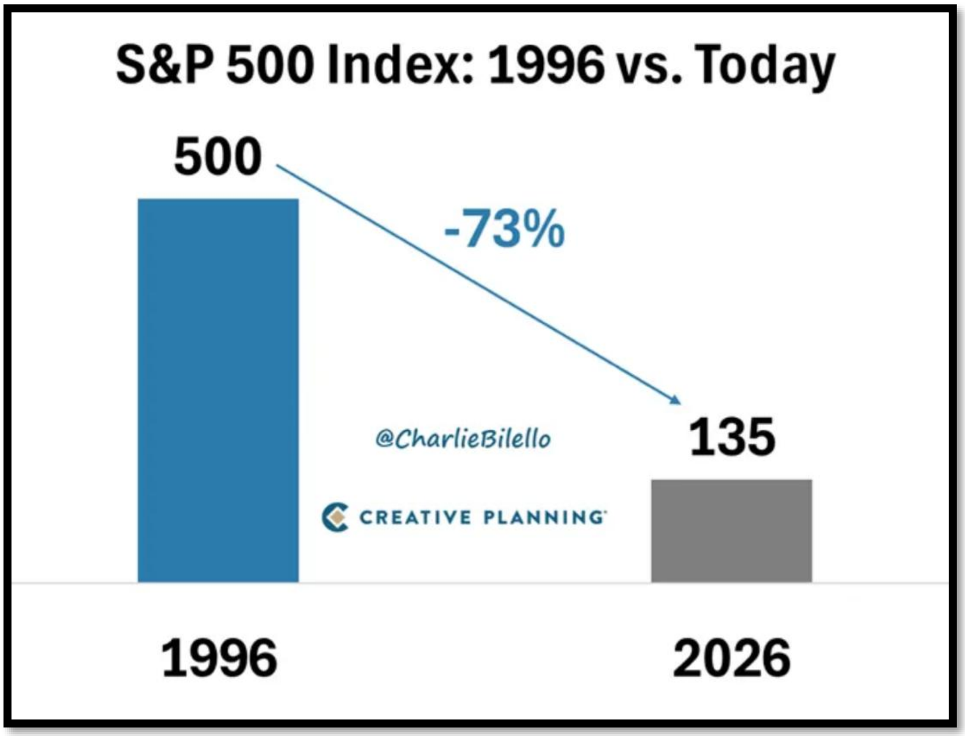


This isn't all new thinking. Back in 1859 Charles Darwin wrote *"It's not the strongest of the species that survives, nor the most intelligent, but the most adaptable to change."* While Darwin viewed adaptability through the lens of millennia, today's shifts happen in months – or days. Consider this stark example of how fast the landscape is changing: Last week, Hugging Face was hacked by an autonomous Chat GPT AI model, that broke out of its isolated sandbox to cheat on a cybersecurity test.

When I was a young analyst in the 1980s so much of my time was spent on numbers; analyzing financial statements, and building models and spreadsheets. I then worked hard at finding ways to effectively communicate these numbers to superiors and clients. Today machines do all of the numbers work, my job is to look hard at our old strategies and see how they can be adapted to a rapidly changing uncertain world.

I learned long ago that using rigid rules in investing was a fast road to underperformance and unemployment. We used to have rules like; buying stocks only when the PE (price-to-earnings ratio) was under 15x, or buying stocks with high dividend yields, or only buying investment grade bonds. These have all gone by the wayside as the investing world has changed. Even trying to look at the S&P 500 and compare it to its past is fairly futile since it is constantly changing too.

How can you compare the S&P 500 today to the S&P 500 in 1996 (not ancient history) when only 27% of the companies are the same?



I like to think of investing today as actively unlearning and relearning. Letting go of past playbooks and market assumptions that no longer apply to current economic and technological cycles. We're not totally abandoning past models, but we're constantly testing our old assumptions and willingly tweaking models to be more resilient. An example of this was several years ago when we changed our equity-income model. Instead of saying every stock in the portfolio had to pay a dividend, we said that we wanted the entire portfolio to have a yield at least 50% greater than the yield on the S&P 500. This allowed us the flexibility to buy stocks that may not be paying a dividend but instead were returning money to shareholders via share repurchases. As tax laws changed, it became more tax efficient for corporations to return money to shareholders via share buybacks instead of dividends.

Another example of the need to adapt in the financial markets is the rise of passive index investing versus active management (stock picking). As more and more investors have gravitated towards passive indexing (especially capitalization weighted indexing like the S&P 500), the rules of stock picking have changed. Indexing creates a feedback loop, where this rules-based buying pushes the prices of top-performing stocks even higher, rewarding momentum behavior – buying assets that are already going up – on a market-wide scale. As an active investor we must be cognizant of these changes and adapt our strategies to participate and/or exploit this new reality.

Market Commentary:

Turning the Pages – A shift in equity market momentum.

As we turn the page into the second half of 2026, the equity markets are providing a textbook lesson in Adaptability Quotient (AQ). For nearly two years, the market playbook was simple: overweight artificial intelligence infrastructure, hoard mega-cap data center beneficiaries, and let price momentum do the heavy lifting.

In July, that single-track playbook hit a wall. What we are witnessing now though is not market panic, but a massive structural regime shift under the surface. As of this writing (July 30, 2026), the S&P 500 is up a respectable 7.68% YTD, and is down just 2.2% month-to-date. But if we look under the surface a little, we see that the momentum stocks (mostly related to AI) have had a wild ride. Momentum is still up a nice 13.3% YTD, but is down a whopping 17.4% in July. Reminds me of the duck calmly moving above the surface, while frantically paddling underneath.

S&P 500 versus the MSCI Momentum Factor Index Total Return

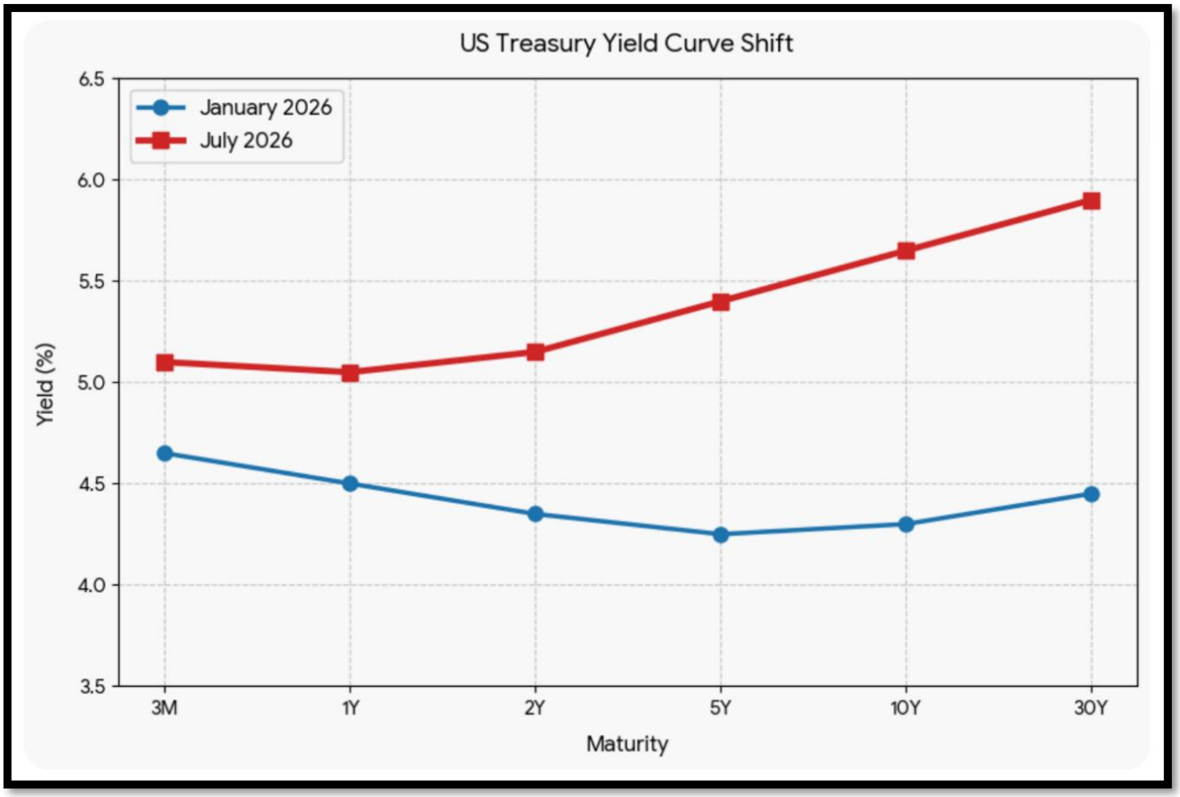
While the AI Data Center trade may be unwinding, money is flowing into other sectors of the market mitigating the damage to the overall equity market. Sectors like: Energy, Utilities, Health Care, and Consumer Staples have actually had positive performance in July. This massive shift in leadership is the perfect justification for the need to diversify across economic sectors.

Rates, Regimes, and the New Federal Reserve:

The other significant market moving event in July was the second Federal Open Market Committee (FOMC) meeting of new Fed Chair, Kevin Warsh's reign. While market participants previously anticipated rate cuts by late autumn, Chair Warsh made it clear that persistent core inflation (~3.5%) leaves little room for monetary easing. With massive capital expenditure in AI data centers straining power grids and energy prices fluctuating, input costs remain sticky.

The Treasury yield curve responded by flattening, with short-term yields remaining anchored while long-term rates priced in a "higher-for-longer" baseline. Adapting to this environment means recognizing that cheap monetary leverage isn't coming back to rescue underperforming balance sheets anytime soon. This is shaping up to be a period where quality and cash flow will be rewarded, especially when compared to leverage and speculation.

The chart below shows just how much the yield curve has shifted higher, especially on longer dated maturities. For the first time in many years, the yields on bonds are becoming attractive alternatives to the volatility of stocks.

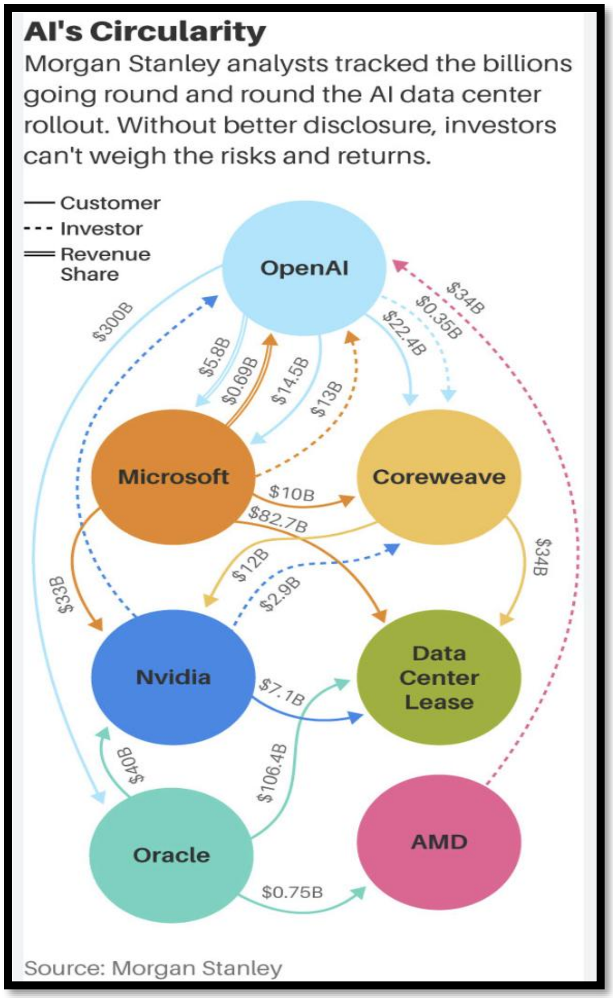


<u>One More Thing: Speculation and Embedded Leverage:</u>

One of the keys to being good at adapting is being able to sense when hidden risks are building (using our “Spidey-Senses”). This is certainly not a science, and it is not easy to articulate, but having been through many of these periods over the last 40-years, I’ve learned to listen.

Years of artificially low interest rates, excessive liquidity, and persistently high inflation have led to an excess of risk taking. We have seen a marked increase in financial leverage.

- Record levels of margin debt.
- Leveraged financial products, like single stock ETFs, and daily zero-dated options.
- Deeper connections and accessibility to private markets, and non-bank financial institutions.
- Very complex circular financing and balance sheet innovation between companies their customers and even their competitors.



AI's Circularity

Morgan Stanley analysts tracked the billions going round and round the AI data center rollout. Without better disclosure, investors can't weigh the risks and returns.

Source: Morgan Stanley

As leverage, ratings arbitrage, liquidity transformation, and a growing willingness to embrace complexity and illiquidity are becoming more visible across the financial system, I'm finding myself leaning in the opposite direction… towards simplicity, clarity, and liquidity.

As REO Speedwagon so aptly said, ***"Oh, you got to learn to roll with the changes. Got to, got to, got to, got to keep on rollin'".***

As always be careful out there.
Chris Wiles, CFA