



AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

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In the classic 1939 film *The Wizard of Oz*, there's a scene where Dorothy, the Scarecrow, and Tin Man walk the Yellow Brick Road through a dark, unfamiliar forest on their way to the Emerald City. As they nervously envision what might be waiting for them around the next corner, their uneasiness builds and they begin repeating the dangers they fear are lurking ahead: "Lions and tigers and bears, oh my!"

The third quarter left investors with a similar uncertain tension. Instead of lions, tigers and bears, the potential dangers lurking today involve interest rates, inflation, and oil—oh my! While each is a complicated topic on its own, they have become increasingly intertwined and added to the near-term risks in global markets. Much like Dorothy's journey through the forest, an uncertain environment can often be better understood and managed over time—but it's never completely controlled.



Source: *The Wizard of Oz* (1939), MGM

While global equity markets had a relatively quiet third quarter¹, the impact of rising oil prices, persistent inflation, and a rate hike by the Federal Reserve (Fed) and its new Chairman have been much more noticeable in the bond market. Despite widespread expectations at the beginning of the year that interest rates would decline, longer-term bond yields climbed steadily throughout much of the quarter with the 10-year U.S. Treasury reaching 5.2% at the end of September. The move has implications beyond bonds, as Treasury yields influence borrowing costs for mortgages and other consumer and business loans. Rising yields have also created some challenges for fixed-income portfolios, with broad bond indexes sliding into negative return territory for the year². At this point, this is not a repeat of 2022, when the Fed aggressively raised short-term rates from near zero to over 4% to combat surging inflation, sending bond prices sharply lower. Today, the forces pushing bond yields higher are a bit more complex, extend beyond just the decisions made by the Fed, and have yet to make a meaningful impact on stocks or the broader economy.

¹ S&P 500 was up 2.3% during Q3 and up 12.7% YTD, ACWI ex USA was up 0.5% during Q3 and up 14.2% YTD

² The Bloomberg US Aggregate Bond Index returned -2.8% & Bloomberg Intermediate Govt/Credit Bond Index -1.6% through 9/30/2026

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Why are Bond Yields Rising?

With multiple factors at play, the simplest explanation might also be the best place to start—which is supply and demand. Both the government and corporations have a growing need for capital, resulting in more bonds being issued and more competition for investors' dollars. Several other factors are contributing to this imbalance as well, which include:

- **Someone Has to Buy All These Bonds.** The U.S. Treasury must finance large annual deficits while also refinancing maturing debt, creating an enormous supply of bonds for markets to absorb. At the same time, the AI buildout boom is creating another major source of demand for capital. Goldman Sachs estimates AI infrastructure—including computing equipment, data centers, and power—could require roughly \$7.6 trillion of investment between 2026 and 2031. Not all of that investment will be financed with debt, but its sheer size means companies such as Google and Amazon will increasingly compete with the federal government for the same pool of investor capital.

- **Growing Federal Deficits.** Large deficits during recessions are nothing new. What is more puzzling is running sizable deficits during periods of healthy economic growth and relatively low unemployment—a chronic problem that has persisted across multiple administrations.

More borrowing increases Treasury supply, while higher rates increase the government's interest expense. This creates a potentially negative and risky cycle in which rising interest costs contribute to larger deficits, requiring still more borrowing to cover the costs.

- **Economic Growth Has Remained Strong.**

Lower long-term rates would be easier to justify if economic activity and the labor market were weakening. Instead, both have remained surprisingly resilient despite higher interest rates and oil prices. Government spending and investment in AI, defense, and energy infrastructure have also supported activity. A stronger economy increases demand for capital and gives the Fed less reason to reverse course on interest rate hikes anytime soon.

- **Oil Has Complicated the Inflation Story.** Just as investors were growing a little more comfortable with the inflation outlook, higher energy prices introduced another wrinkle.

More importantly, diesel and other refined products have risen considerably faster than crude oil, producing unusually wide refining—or “crack”—spreads. Higher transportation and other input costs eventually make its way down to the consumer, increasing broader prices. If investors are less confident inflation will return toward 2%, they will demand more compensation for lending money, potentially keeping rates higher for longer.

Treasury Yields--2026

Treasury Maturity	January 1, 2026	September 30, 2026	Change (bps)
6-Month	3.6%	4.3%	+70
2-Year	3.5%	4.8%	+130
5-Year	3.7%	5.0%	+130
10-Year	4.2%	5.2%	+100

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Higher rates have clearly made matters more difficult for borrowers, particularly those refinancing debt issued at lower rates—yet today's lending environment is not overly restrictive and will likely do little to stem the AI buildout. Still, as economist John Kenneth Galbraith once cautioned, *“All crises have involved debt that, in one fashion or another, has become dangerously out of scale in relation to the underlying means of payment.”*³ Today's conditions don't imply that a crisis is just around the corner, but history provides a useful reminder that the amount of debt matters—and the cost of financing it matters too.

Staying in the Game

As we enter the final quarter of 2026, the investment backdrop remains constructive, but the margin for error has narrowed. Corporate earnings remain strong, and the enormous spending in AI continues to support economic growth and corporate profits. At the same time, much of that optimism is reflected in stock prices, reinforcing the importance of diversification, valuation discipline, and periodic portfolio rebalancing. While higher interest rates have created some challenges for bond prices and borrowers this year, they have also improved return prospects for fixed-income investors. With yields on high-quality bonds once again in the 5% range, bonds can provide both meaningful income and greater diversification from equity risk.

Despite the increasing risks, the AI narrative continues to support economic growth and the broader stock market. As we wrote in our second-quarter commentary, AI investment increasingly resembles a wedding cake, with spending flowing downstream from the large hyperscalers to semiconductors and data centers, and then into power generation, utilities, construction and other layers of the economy.

That relationship works in both directions. A meaningful slowdown in AI capital spending—whether caused by weaker returns on investment or more regulation—could ripple back through many of the same industries that have benefited from the buildout.

There are plenty of reasons to remain disciplined. For investors, that means participating in growth without feeling the need to swing for the fences. As the Major League Baseball postseason begins and teams compete for the World Series title, it's worth noting that championship teams understand the value of a good two-strike mentality. You don't always have to swing for a home run—sometimes protecting the plate, staying in the game, and making consistent contact are more important.

³A Short History of Financial Euphoria-1990

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