

Q3 2026 Client Letter

Avalon portfolios were relatively flat in the third quarter, as gains in gold mining and natural resource holdings offset declines in bonds, real estate, and U.S. small-cap equities. The artificial intelligence (AI) buildout and conflict in the Middle East continued to drive markets during the quarter, though disruption in global bond markets took center stage. Within the U.S., the 10-year Treasury yield rose nearly 90 basis points to 5.3%, and long-dated Treasuries fell almost 9% in price. Long-dated yields are now at their highest levels since 2002. While the Federal Reserve raised short-term interest rates in September, new Fed Chair Warsh's strategy to limit communication created uncertainty over policy, fueling bond market volatility. Notably, long-term inflation forecasts have barely moved and remain near 2.4%, a sign that bond investors are pricing in higher economic growth and higher risk rather than higher inflation.

To put this quarter's interest rate movement in context, it helps to see where it fits within a much longer cycle. The last secular decline in rates ended in July 2020, when the 10-year yield touched 0.50%. That low marked the end of nearly forty years of disinflation (1981 to 2020). This quarter's move higher in yields provides further confirmation that we are in an era of reflation. For historical perspective, the previous secular uptrend drove yields from 1.25% in 1946 to 15% in 1981. As we have discussed for the past several years ([Q1 2021 Client Letter](#)), we continue to limit duration within our fixed income allocation in client portfolios.

Rising yields and a Fed rate hike did not stop precious metals from being the quarter's standout asset class. While rising rates are historically a headwind for non-yielding assets, gold rose more than 3% and gold mining shares surged over 16%. Persistent fiscal deficits, heavy Treasury issuance, and the weaponization of trade and supply chains are prompting central banks to diversify away from U.S. dollar reserves and into assets such as precious metals. While we have traded around the volatility in precious metals this year, Avalon portfolios continue to overweight this asset class.

Equity markets were mixed, absorbing higher interest rates and \$100 oil far less evenly than headline indices imply. While the market cap-weighted S&P 500 gained 2.4% for the quarter, the equal-weighted S&P 500 fell for seven consecutive weeks to close it. This is a historical anomaly previously seen only in the 2002 and 2022 bear markets. The same gap shows up in breadth: the S&P 500 is trading within 1% of its all-time high even though more index constituents are hitting 52-week lows than highs. That is the largest disconnect between the index and the average stock since 2000.

Market strength remains concentrated in mega-cap technology companies, where AI continues to drive robust earnings growth. In our prior commentary, we noted that hyperscalers would

need to demonstrate that AI capital expenditure is tied to revenue growth. Results reported during the quarter went a long way toward demonstrating that link: Google Cloud grew over 80% year-over-year with operating margins nearly doubling, Amazon Web Services posted its fastest growth in eighteen quarters while expanding margins, and Microsoft Azure grew more than 40%. These results reinforce the case for ongoing AI investment.

Looking ahead, the near-term setup seems noisier than the longer-term outlook. Midterm election years have historically shown weakness leading up to November as political uncertainty weighs on sentiment, though that uncertainty typically dissipates once results are finalized. We would note that the S&P 500 has posted positive 12-month returns following every midterm election since World War II. Beyond that, the hotly anticipated IPOs of Anthropic and OpenAI would bring two of the largest AI businesses into the public markets, which could draw further investor attention to the AI buildout.

Closer to home, we are now fully settled into our new offices at 525 Middlefield Road in Menlo Park. We have enjoyed hosting many of you already. If you have not yet visited, we welcome the opportunity to show you the new space.

Thank you for your continued trust and confidence in us.



Clara Basile



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