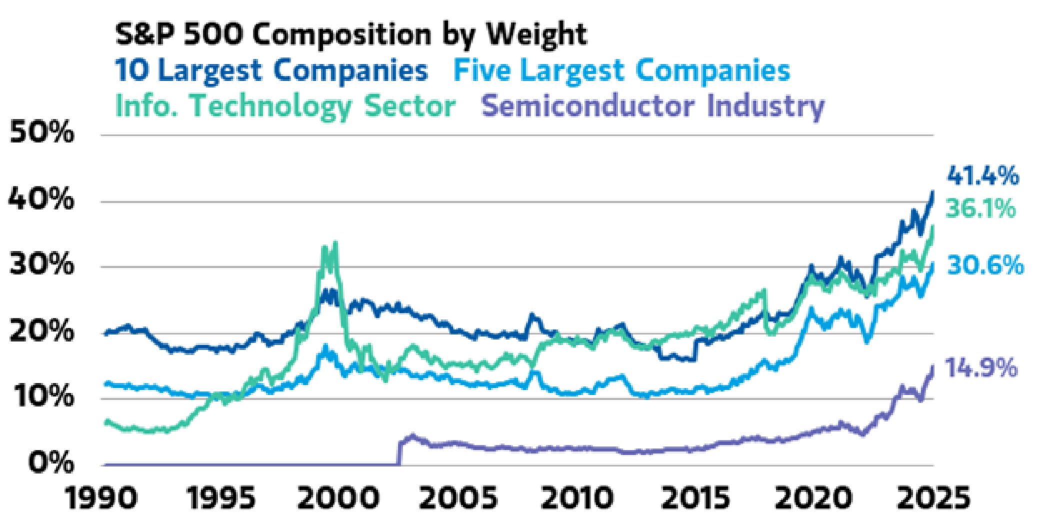
[Client Preferred Name]

October provided another month of positive performance. The S&P 500, Dow Jones Industrial, and NasDaq rose 2.3 percent, 2.6 percent, and 4.7 percent respectively. The Russell Midcap declined 0.8 percent and the Russell 2000 (small caps) rose 1.8 percent. Peaking under the hood a bit, though, half the S&P 500 sectors were negative: materials, real estate, financials, energy and consumer staples. International stocks rallied as well, despite a pause in dollar weakening, with the MSCI EAFE up 1.2 percent and the MSCI Emerging Markets up 4.2 percent. Bonds also closed up for the month with the Blomberg US Aggregate Bond index gaining 0.6 percent and the Bloomberg US Municipal index gaining 1.2 percent.

In our team's note to all our clients a month ago, we noted our current fear was not of imminent recession or inflation, but as Richard Bernstein put it, that the "Fed adds unnecessary liquidity to the financial markets and speculation runs rampant. This might be fun for some investors in the short-term, but it could create serious misallocations within the economy and add to significant future inflation." Conversely, our hope was that the economy "reaccelerates without much inflation. This would result in a broadening of the market in a very healthy way."

Unfortunately, nothing about the market movements in October dissuaded from fearing the former or encouraged us to lean into the latter more optimistic and preferred narrative. Why? Markets were incredibly narrow in October. The S&P 500 rose 2.27 percent for the month, but the equal-weight S&P 500 actually declined 0.5 percent. The majority of performance and gains came from only a handful of high-momentum, widely held securities. How does this occur? It's because the major indices with the exception of the Down Jones Industrial, are all market capitalization weighted. The largest firms now comprise over 41 percent of the S&P 500.



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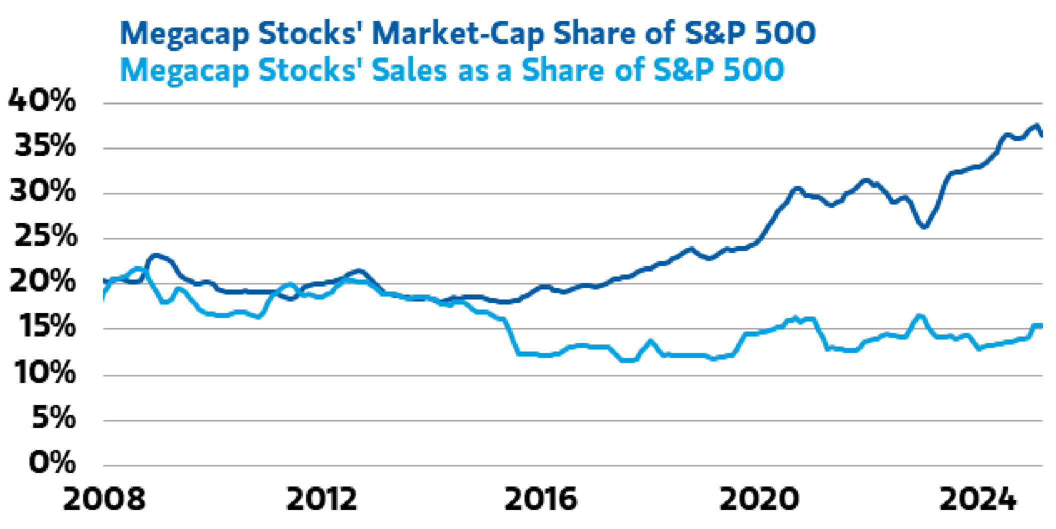
When market rallies are liquidity/momentum driven rather than fundamentally/earnings driven, we would expect to see such narrowness. Liquidity expansions often favor the most popular (and sometimes speculative) assets – but certainly the ones in the current investing zeitgeist. Presently, that likely translates to cryptocurrency and AI-related stocks. In defense of the AI stocks though, many have also demonstrated significant earnings growth this year. As fiduciaries, we would never be inclined to advise clients to place 30 percent of their portfolios in only five names or 36 percent in a single sector, but that is precisely what a purchase of an S&P 500 index fund entails today. There is great risk in being so concentrated especially because mega-caps as of yet do not have the revenue to justify their share of the market.



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Morgan Stanley frames it this way, "Overall, the Global Investment Committee sees an opportunity to reposition portfolios for solid but slowing US economic growth on the back of weaker labor markets in 2026. Recession odds, in our view, remain below 30%, and we acknowledge the likelihood of economic support in the first half of 2026 from a trifecta of stimulus: rate cuts, tax refunds and continued robust GenAI-linked capex. That said, we see the scope for upside economic surprises as narrow. This is especially true given consensus forecasts and expectations of 13%–14% profit growth for the S&P 500 next year.

Furthermore, in a valuation environment dominated by the need to drive productivity gains, and a policy environment driven by Washington access, we expect size, scale and pricing power to remain as important as ever. Specifically, we believe the "broadening economic success" thesis—as implied by market pricing and encompassing small, midsized and more credit-challenged firms—may disappoint, fostering a rotation back toward quality factors and strong fundamentals."

What does that mean for portfolios? It means we recommend shifting away from small and mid cap stocks, as well as more cyclical value stocks, as the likely winners in this liquidity-driven expansion will be the momentum trades such as the magnificent 7 stocks and other AI related names, as well as larger companies better able to withstand slowing economic growth in 2026 and benefit from AI adoption. We do fear that for the time being, bigger and more popular may outperform until the Fed has reason to change it policy guidance or due to some exogenous shock or a stall in the AI cap-ex build. As Lisa Shallett, our Chief Investment Officer, put it in her note from October 20th, "ultimately, the "broadening economic reacceleration" thesis—including small, midsized and more-credit-challenged companies—may disappoint, resulting in a rotation back toward quality factors and strong fundamentals, once again favoring big over small."

It also means we need to keep a watchful eye over inflation data. This year, inflation expectations have largely run far above actual inflation data (we forecast that would occur on our team, though we were contrarian in that view). Lower-than-expected inflation has in turn acted to buoy markets which are driven, in the near term, by differences in investor expectations and reality. As we often say, it's not the level of good or bad that matters – it's all about the difference in expectation and reality. Bad but better-than-expected data makes markets climb. Good but worse-than-expected data makes them fall. The political appropriation of the word inflation to describe any price increase whatsoever created investor expectations that tariffs (a tax increase) would produce 2022-style-inflation (it peaked around 9 percent that year). That scenario has remained perennially just around the corner according to the majority of pundits since April. We have consistently argued in these missives against the simple "tariffs are inflationary" logic. Inflation has run at a rate just shy of 3 percent the last 12 months and we expect reported October and November numbers to be in line with that rate. But as we get deeper into 2026 – and especially if too much capital is allocated to AI compute at the expense of other needs – inflation may become resurgent at the same time investors tire of the tariff-driven inflation narrative. Consider the simple case that we build too many AI data centers but not enough electricity generation to power them. The result would be increasing electricity prices. Such price pressures might produce a compound problem – a Fed suddenly interested in reducing liquidity while labor markets weaken, and aggregate spending slows as from a faltering AI related capex boom.

Were the Fed to become fearful that loose monetary policy is contributing to capital misallocation, their natural reflex will be to raise rates and restart quantitative tightening – always an auspicious sign for equity markets. Perhaps even more so now than normally, as Lisa Shallett detailed in her October 27th note, "with the US economy powered by data-center and related capex, as well as a resilient consumer, extreme dispersion is creating distortions in a "K-shaped" economy. Notably, the top 40% of households are driving 60% of spending, as equity-ownership wealth effects swamp labor-income growth's contribution to consumption." In other words, the market going up is a big part of what's buoying the whole economy as wealthy investors spend more freely when their stock portfolios rise. For now, our team remains cautiously optimistic that markets may move higher – albeit with heightened volatility -- and we concur with Morgan Stanley that October was a return to liquidity driven momentum rather than evidence of a rising tide lifting all boats.

We also think there's a good chance the Supreme Court curtails the Trump administration's tariff program -- the Trump administration has asked the Court to expedite the ruling -- and that the government reopens in November. The markets will likely treat the former like a tax cut and the latter like a government stimulus program as the flood of backpay for wages and some suspended contract payments floods forth from federal coffers. We will not be shocked to see the equity markets rally a bit if those events come to pass before year end.

As always, if you have any questions or concerns, please don't hesitate to let any member of the team know.

Hunter Stanco, CFA, MBA
Managing Director
Family Wealth Director
direct - 210-277-4439
hunter.stanco@morganstanley.com

Ian Davis
Senior Vice President
Alternative Investments Director
direct - 210-277-4422
ian.davis@morganstanley.com

Daniel Crites, CFP, MBA
Vice President
Financial Advisor
direct - 210-277-4443
daniel.crites@morganstanley.com

Jeff Wright, CFP, CIMA
Investment Consultant
direct 210-277-4448
jeff.wright@morganstanley.com

Adriana Sferle
Assistant Vice President
Wealth Management Associate
direct - 210-277-4469
adriana.sferle@morganstanley.com

Jeff Bowers
Senior Registered Associate
direct - 210-277-4419
jeff.bowers@morganstanley.com