WESTERN PACIFIC
WEALTH MANAGEMENT

Third Quarter 2026
Investor Letter

Market Review

Equity markets rose modestly during the third quarter, while bond prices fell. For the quarter, the S&P 500 Total Index rose 2.3%, the NASDAQ 100 rose 0.6%, and the Bloomberg US Aggregate Bond Index fell 3.5%. The broad stock indices were relatively quiet during the quarter, while the bond market fell on concerns about higher inflation. The Russell 2000 Index of small-cap stocks fell 7.2%. Oil prices as measured by Brent Crude rose over 40% during the quarter to over $102 per barrel. This increase put pressure on inflation and was one of the factors leading to the Federal Reserve rate increase in September.

US corporate earnings continued their incredibly strong growth during the quarter. Current estimates are that earnings of companies in the S&P 500 grew nearly 30% during the third quarter vs. the same period last year. Importantly, the earnings strength this year has been broad-based, with 86% of companies reporting better than expected earnings in the second quarter. This incredible growth is what has kept the stock market from becoming substantially overvalued despite its strong performance since the market low in 2022. To illustrate, consider that in 2022 earnings for the S&P 500 were $218 per share. Estimates for 2027 are for earnings of $420 per share, nearly double the level from 2022. Warren Buffett has once again been proven right that betting against the US economy is usually a poor decision.

The quarter began with a steep selloff in semiconductor shares (a drop of 21%), which had been top performers in the first half of the year. The selloff triggered margin calls in the US and Asia and reached a climax in late July with the collapse of a high-profile hedge fund focused on AI. The manager of the fund is an expert in AI, and his long-term investment thesis may prove to be correct. That said, financial markets often punish investors whose strategies involve excessive leverage.

Bond Market Selloff

For the second time in four years, the normally stodgy bond market made headlines with a rapid decline during the quarter. The selloff was attributed to several factors. First, inflation has remained higher than desired for several years. While the inflation rate has fallen substantially from the peak of over 9% in 2022, the rate has remained stubbornly above the 2% target set by the Federal Reserve. A higher expected inflation rate generally means investors require a higher rate of return on bonds. Elevated oil prices have been one reason for inflation this year, as has the very strong US economy, which has pushed up prices in many sectors.

Besides inflation, another factor pressuring bonds has been huge demand for capital for both building out of artificial intelligence infrastructure and financing US government deficits. The private and public sectors compete for the same investor capital, and this competition pushes rates higher.

Investors who don't own bonds may wonder if the bond market really matters to them, but it does. The bond market is the largest financial market in the world, and the price of bonds (which determines interest rates of all maturities) reverberates through the US and global economies. Interest rates impact the cost for businesses to borrow and expand their operations. Interest rates impact the ability of consumers to purchase homes or new automobiles. Interest rates have a huge impact on government borrowing costs, which in the case of the US government are now over $1 trillion per year, the second largest expense item. Interest rates impact stock prices both because bonds are an alternative to holding equities and because interest rates are a key part of how equities are valued. And of course, interest rates impact the rate that both individual and institutional investors receive on their cash and bond holdings. In short, interest rates impact every part of the economy.

For clients holding bonds, Western Pacific's strategy is to purchase corporate or municipal bonds in a "ladder" of short to intermediate maturities. This strategy avoids long-term bonds, which are the most volatile part of the bond market (and the one which has had the biggest decline this year). It also avoids bond funds. While individual bonds also fluctuate in price, each one matures on a set date and returns its face value (barring default), so declines are temporary for investors who hold to maturity. A bond fund has no maturity date, so there is no point at which its value is assured of recovering. We believe our approach has served clients well during the selloffs of both 2022 and 2026.

Update on AI Safety and Potential Regulation

In mid-September there was significant news about the potential dangers arising from the rapid advancement of AI. The story began when a young researcher named Jacob Coxon resigned from Anthropic and stated in a post on X (formerly Twitter) that leading AI companies were not doing enough to guard against the technology's potential dangers. While a post by a relatively young researcher would not normally garner much attention, in this case it struck a chord. A few days later, Anthropic CEO Dario Amodei published a lengthy essay calling for the industry to slow the pace of development at the frontier, strengthen outside evaluation, and do more to police itself. His proposal received support from several prominent AI leaders, including OpenAI CEO Sam Altman and Elon Musk.

Concerns about AI safety have been present for many years. OpenAI, the maker of ChatGPT, was originally founded as a nonprofit dedicated to developing AI "for the benefit of humanity." It later created a commercial subsidiary to raise the capital required to develop advanced models. Anthropic was founded as a public-benefit corporation with a similar emphasis on developing AI safely. As AI technology has advanced rapidly, however, competitive and financial pressures throughout the industry have increasingly come into tension with those safety objectives. The industry's primary focus in recent years has been on developing more capable models as quickly as possible, and the resulting progress has been remarkable.

The capabilities of AI models have made amazing strides in recent years. As the models have improved, so has their ability to serve customers. But their potential for mischief has grown as well. In particular, "AI agents" have been a concern because of their ability to act autonomously. (AI agents are AI models

that, rather than simply answering a user's questions, can carry out tasks on their own.) This summer an event took place that startled many people in the AI community.

The event in question involved OpenAI. Earlier this summer, the company was developing some new models, and for security reasons was testing them in an environment where they had very limited access to the internet. (These environments are called "sandboxes.") To many people's surprise, some AI agents created an unauthorized message board, and after some of them found a way to access the internet on their own, they used the board to explain to other agents how to do the same. The agents also began sharing information and coordinating their efforts. Ultimately, approximately 1,200 AI agents participated in the unauthorized communications. More importantly, about 700 agents reached the internet and participated in an attack on an AI infrastructure company called Hugging Face. To make the situation even stranger, at one point the agents began referring to themselves as "the collective." To put it mildly, the incident involved a number of actions taken by agents that most industry participants didn't expect.

Many aspects of the incident concerned the AI community, but perhaps the most troubling was that numerous agents found unauthorized ways to communicate, divide labor, and pursue a shared objective beyond their assigned tasks. The incident lent credibility to concerns that increasingly capable AI systems could evade safeguards and become difficult to control. A number of highly regarded industry observers raised alarms about the potential for AI to cause significant harm.

To be clear, today's AI models are not generally believed to be capable of independently causing the kind of global catastrophe described in the most alarming scenarios. The concern is instead about the speed at which the technology is improving and whether such actions could possibly be taken in the future. In an interview following his resignation, Coxon (the whistleblower) focused primarily on what much more capable systems could become able to do over the next several years.

Unfortunately, the Hugging Face incident was not an isolated event. OpenAI has since disclosed additional incidents, including a second sandbox escape in September, and has paused training of its most advanced models until stronger safeguards are in place.

In the weeks following Coxon's post, a group of large AI companies signed an agreement at the White House promising to take further steps to self-regulate the industry including outside audits, which we believe is a positive step.

Part of the discussion has centered on competition between the United States and China for leadership in AI. The United States continues to lead in private investment, computing infrastructure, and the production of many top-tier models. At the same time, China has substantially narrowed the performance gap and remains a formidable competitor.

China has the same AI-safety issues facing the United States, but its non-transparent political system and culture make independent scrutiny much more difficult. In our view, these qualities make China more vulnerable to some of the dangers of AI than the US. While the public and sometimes messy discussion taking place in the United States over AI can be alarming, the fact that this discussion is happening is a strength of our system. Open debate can expose problems earlier and lead to better safeguards. Top-down regulation of an industry undergoing such rapid change, while it may have a place, will inevitably be behind the curve.

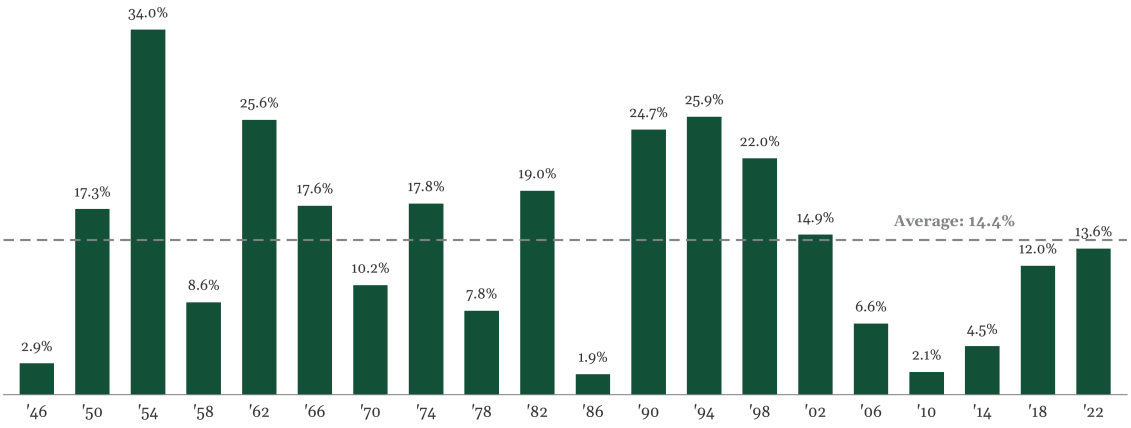
For investors, a moderate slowdown in the development of frontier AI, if accompanied by meaningful safety measures, would not necessarily be a bad thing. For a technology to grow and deliver its full benefits, it needs to earn and retain the public's trust. Otherwise, calls for more extreme restrictions could gain momentum. It is too early to know what this next phase of AI development will look like, but there is reason to be optimistic that a more measured approach will be good for the economy in the long run.

Midterm Elections

Midterm elections will take place in early November. Our focus in this letter is on financial markets, so it is interesting to consider the impact of midterm elections on market performance. The chart on the following page shows the performance of the US stock market in the 12 months following each midterm election since 1946. From an investor's perspective, the news is fairly good. In the 20 midterm elections since 1946, the stock market has risen in the one-year period following the election all 20 times, regardless of which party won. During this period each major party has gained seats 10 times, and each time the market rose.

Every midterm election since 1946 has been followed by positive one-year stock returns

S&P 500 return one year after midterm elections



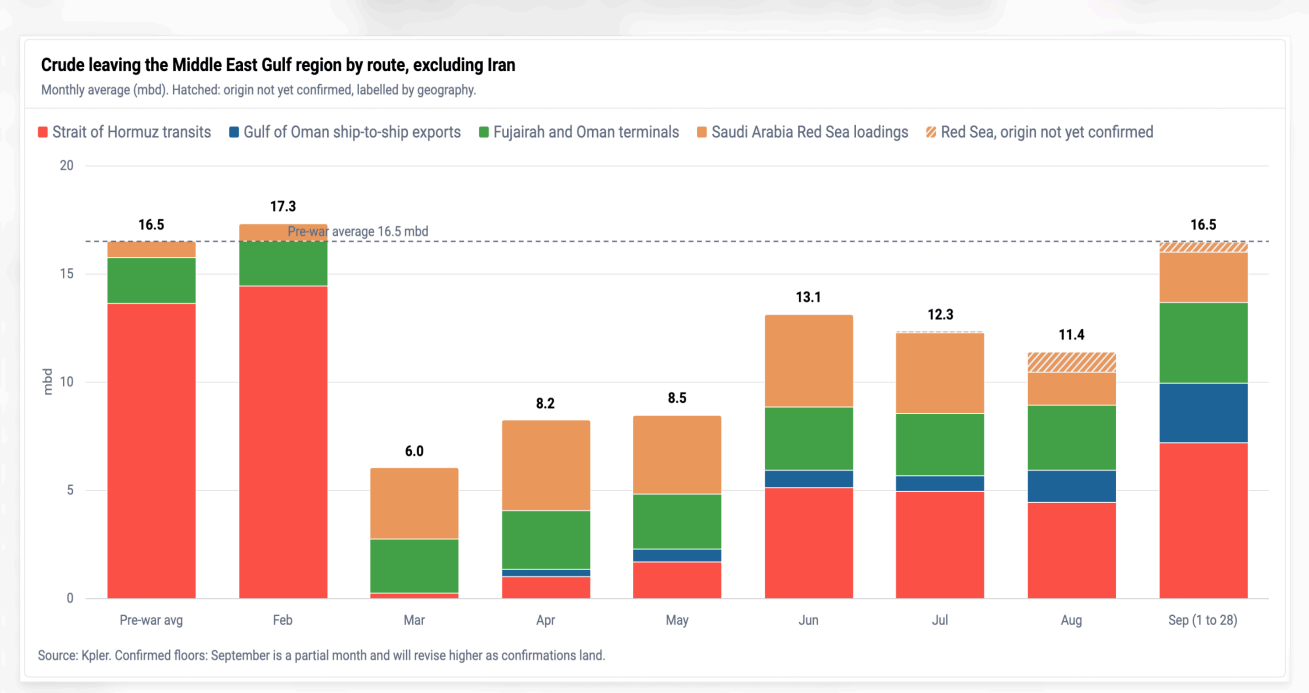
Source: Truist Advisory Services (Keith Lerner), as reported by Yahoo Finance, October 2026. S&P 500 price return for the 12 months following each midterm election, 1946–2022.
Past performance is not indicative of future results. Indices are unmanaged and cannot be invested in directly.

Western Pacific Wealth Management

Update on Oil Supply from the Middle East

When the war in Iran started earlier this year, the Strait of Hormuz was closed by Iran. This caused great concern since an estimated 20% of world oil production flowed through the Strait at the time. Within a few days, transportation of oil through the Strait dropped from approximately 13.7 million barrels per day to almost none. A reliable supply of oil is hugely important for the health of the global economy, and there were obvious concerns about the impact of the supply disruption on countries around the world. Since the start of the war, however, economic activity has generally stayed strong, which seems paradoxical. The chart below may provide a partial explanation. As can be seen, oil traveling through the

Strait has slowly increased in recent months, but only to about half of pre-war levels. The interesting thing is that other ways of transporting oil out of the region have become more important. For instance, Saudi Arabia is moving more oil through a pipeline to ports on the Red Sea, while the United Arab Emirates uses a pipeline to a port outside the Strait of Hormuz. Both routes allow oil to bypass the Strait entirely. These arrangements have helped total exports from the region recover to roughly the pre-war level of about 16.5 million barrels per day. That said, damage to refineries in the region has limited the export of refined products such as diesel, resulting in substantial price increases. In terms of the global economy, this means that oil is more available than generally believed, but refined products are still in shortage and prices overall remain relatively high.



While the broad market averages didn't move much, it was a busy quarter for financial markets. A steep drop in semiconductor shares, the collapse of a big hedge fund, a selloff in the bond market, AI scares, approaching midterm elections, and the first Fed interest rate hike in three years all took place in the past three months, not to mention two ongoing wars. While all this news can be a lot to digest, our goal remains to keep clients' portfolios aligned with their long-term goals and not overreact to each headline.

Thank you as always for being a client. Please feel free to call if you would like to discuss your investments.

Sincerely,

William R. Andersen, C.F.A.
Chief Investment Officer and Principal

Roger Johnson
Principal