LPL Financial

Equity Strategy Insights

Assessing the Stock Market's Growing Wall of Worry

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Executive Summary

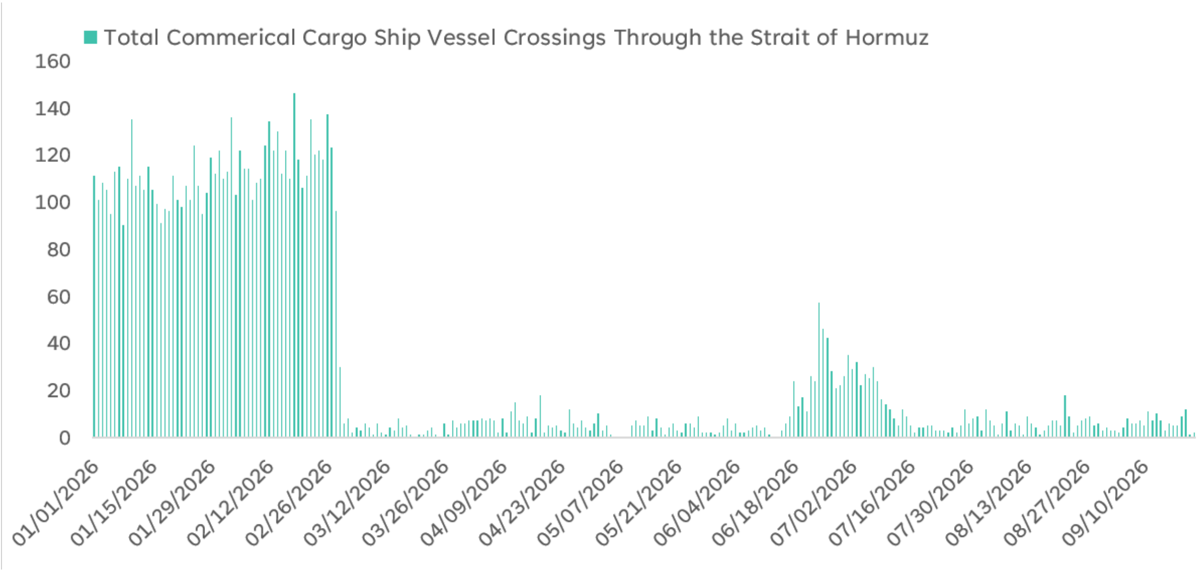
- Stocks continue to climb a wall of worry, a wall that has gotten a bit taller as fall begins.
- The conflict in the Middle East, higher interest rates, and questions surrounding the enormous artificial intelligence (AI) capital spending boom all present legitimate risks for investors.
- From a technical analysis perspective, deteriorating market breadth has raised questions about the durability of the stock market's latest move higher to near record highs.
- While each of these challenges could generate bouts of volatility, we believe the fundamental backdrop remains supportive enough for stocks to weather them.
- In this edition of *Equity Strategy Insights*, we assess the market's growing wall of worry, explain why these worries warrant attention, and justify our continued constructive intermediate-to-long-term stock market outlook.

Middle East Conflict and Surging Oil

The latest developments in the Iran conflict have shaken the fragile consensus view that the disruptions to the Strait of Hormuz and the Red Sea would soon be cleared. U.S. military bases and Naval escorts in the region have been fired upon. The critical East-West pipeline in Saudi Arabia that had been providing a bypass for the bottlenecked Strait of Hormuz is only partially operational after suffering attacks and may not be fully operational until late October. Energy stockpiles are dwindling in the U.S. and around the globe. WTI crude closed above $100 a barrel on September 10 for the first time since late May and remains elevated over $92 per barrel (as of 09/23/26).

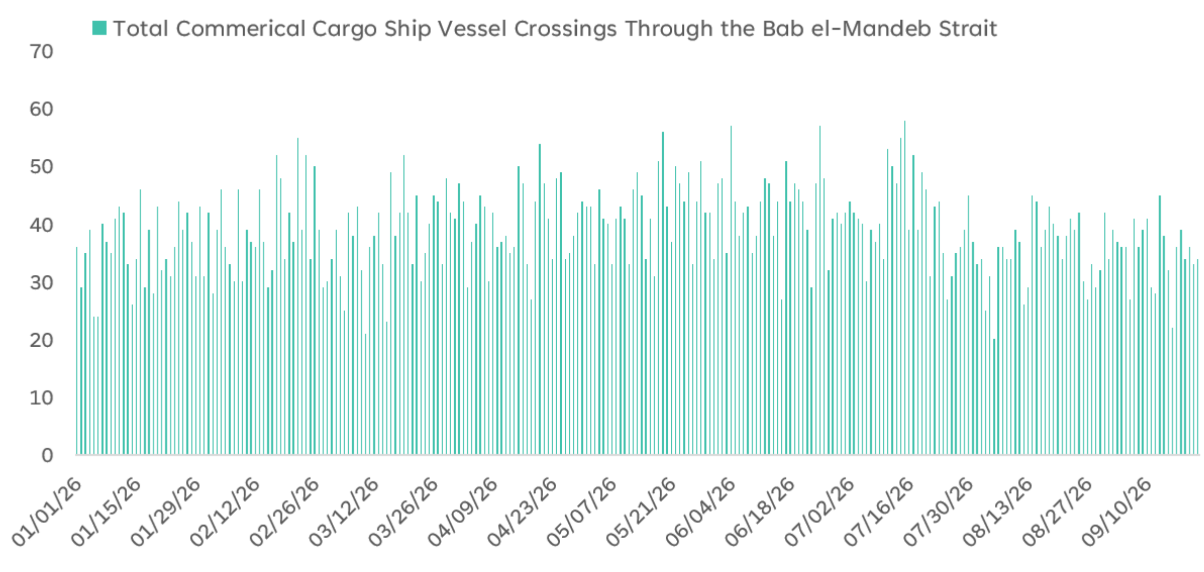
Predicting the path of this conflict is extremely difficult and perhaps unwise for asset allocators, so we prefer to maintain our energy sector overweight and positive view of the broader commodities complex for now while waiting for a lasting fix to restricted tanker traffic in the Strait of Hormuz and, to a lesser extent, the Bab el-Mandeb Strait. The recent headlines are hardly encouraging, but we are hopeful that pressure from China, including at this week's Trump-Xi Summit, and our Gulf allies, alongside sanctions and voter emphasis on affordability ahead of midterm elections, will bring the conflict to a resolution soon.

Tanker Traffic Through the Strait of Hormuz Remains Depressed



Source: LPL Research, Bloomberg, 09/22/26

Ship Traffic on Other Side of the Arabian Peninsula to Red Sea Has Been Surprisingly Steady



Source: LPL Research, Bloomberg, 09/22/26

Rising Interest Rates and Fed Rate Hikes

Rising interest rates present a near-term risk for stocks by increasing borrowing costs while presenting a headwind for stock market valuations. That risk becomes more pronounced when higher rates lead investors to anticipate a

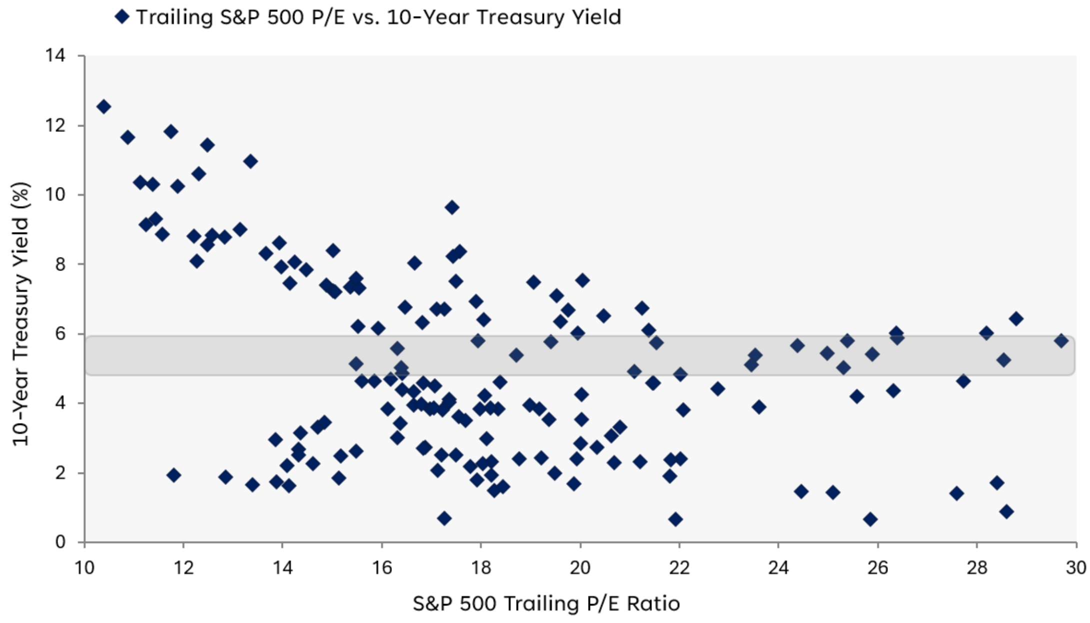
Federal Reserve (Fed) tightening cycle. History suggests this transition can create stock market volatility, but drawdowns have typically been short-lived. As we wrote in our September 9 market article, across the six Fed tightening cycles since 1994, the S&P 500 generally struggled during the first several months after the initial rate hike before subsequently regaining its footing and moving higher. Gains in the 12 months following the initial hike during the non-recessionary cycles (for this exercise we'll allow 2022 to count as recessionary even though it technically was not) averaged 14.3%, with a median of 7.2%. Past performance does not guarantee future results.

Our friends at Evercore ISI did an analysis dating back to the 1970s and reached a similar conclusion. In their study, the average S&P 500 performance three months after an initial Fed rate hike was a loss of 3%. After 12 months, even with recessionary periods and growth scares included, the average performance was a gain of 7%. So, while the prospect of tighter monetary policy is certainly a risk to markets, particularly with the S&P 500 near record highs, we expect the current economic backdrop – and related strength in earnings – to provide enough support for stocks to minimize the magnitude of near-term volatility.

A better way to think about interest rate risk is by looking at longer-term rates, because those are the rates that affect borrowing costs for consumers and businesses, as well as stock valuations. In terms of the effects on the economy, LPL's Chief Economist Dr. Jeffrey Roach explained in our September 14 Weekly Market Commentary why the U.S. economy today is more resilient to rising rates than in the past. Reasons include the powerful wealth effect from the bull market in stocks and the plethora of fixed rate mortgages at low interest rates.

Long-term interest rates also affect stock valuations, though not as much as you might think. As shown in the scatterplot chart "Stock Valuations Have Held Up at Yields Over 5% in Recent Decades," a 5% yield on the U.S. 10-year Treasury does not necessarily spell doom for this market. Although many of these observations came during the late 1990s dotcom boom, when the U.S. had a far more manageable debt load, it is noteworthy that the 10-year yield averaged 5.9% and the S&P 500 price-to-earnings ratio (P/E) averaged 23 during that period. Strong earnings and revolutionary technology development are a common theme then and today. Bottom line, rising interest rates may weigh on stocks. but if rates stay around recent highs or move lower, we would expect the headwinds to be manageable.

Stock Valuations Have Held Up Relatively Well Historically at 5-6% Yields



Source: LPL Research, Bloomberg 09/22/26 (Data 1980 to present, darker shaded area represents 10-year Treasury yields of 5-6%)
Disclosures: All indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

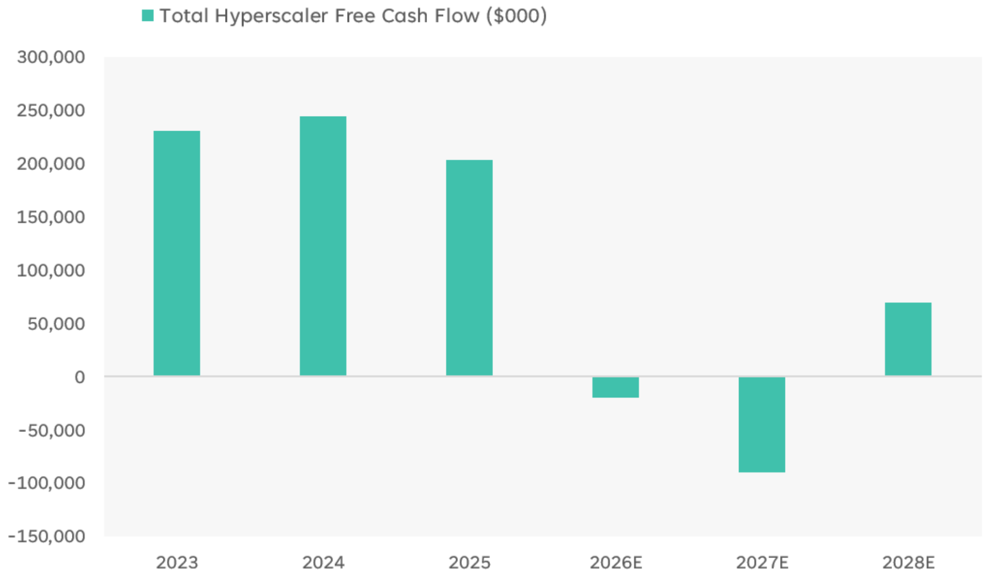
Artificial Intelligence Leads to a Rerun of the Bursting of the Dotcom Bubble Burst

As we wrote in our Midyear Outlook 2026: Policy, Buildouts, & Bottlenecks (available here), the Artificial Intelligence (AI) theme has entered a more advanced phase where the buildout winners may cede leadership to those that can monetize the technology. If the next leg of AI adoption delivers as expected the AI leaders in the U.S. and emerging Asia will be winners. If not, the hyperscalers making these massive investments may struggle as the investment cycle matures and comes under more scrutiny. Our expectation that scrutiny on AI investments would intensify in the second half of this year was a key reason why our year-end fair value estimate for the S&P 500, at a range of 7,650 to 7,750, is on the conservative side.

Given the theme of this commentary is worries, we'll start with the bad news. The nearly $1 trillion in hyperscaler capital investment this year, and anticipated spending over $1 trillion for at least the next two years, a healthy chunk of which will be debt financed, has likely wiped out 2027 free cash flow for this group of five U.S. technology leaders, illustrated in the "Hyperscaler Free Cash Flow May Have Been Erased Until 2028" chart. Current consensus estimates call for a return to positive free cash flow for this group in two years, but even in 2028 free cash flow is expected to be only about one-third of what it averaged during the past three years before the spending boom exploded higher.

Finally, as Tom Shipp and Tucker Beale pointed out in their August 31 Weekly Market Commentary, the depressed cash flow has reduced the S&P 500's free cash flow yield down to multi-decade lows at 1.6%. Earnings valuations look fine with the S&P 500's forward P/E at around 19. The earnings yield, or the inverse of the forward P/E, is quite reasonable at over 5%. But the earnings being realized by the so-called "picks and shovels" for the AI buildout, i.e., chips and memory makers, are being accompanied by slowly depreciating equipment being purchased by hyperscalers that will depress earnings years into the future. The risk that AI doesn't pay off and spending is cut is real and something to think about when considering the Magnificent Seven and the rest of the technology sector (accordingly, LPL Research maintains its neutral stance on the technology sector).

Hyperscaler Free Cash Flow May Have Been Erased Until 2028

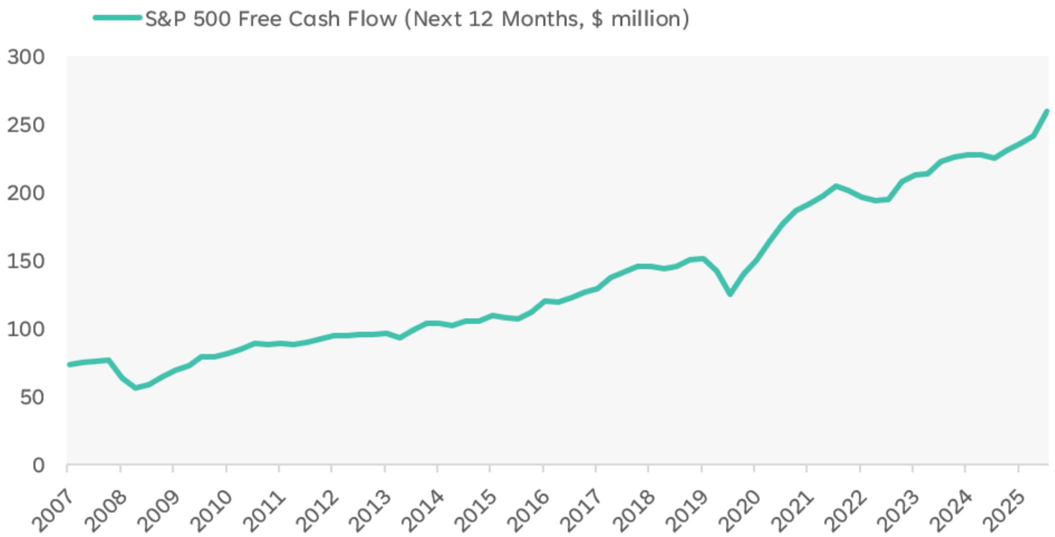


Source: LPL Research, Bloomberg 09/22/26
Disclosures: All indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.
Hyperscalers represented include Alphabet (GOOG/L), Amazon (AMZN), Microsoft (MSFT), Meta (META), and Oracle (ORCL).

But here's the good news. The capital expenditures for the hyperscalers are cash flows for the chipmakers, memory producers, and other AI infrastructure vendors. So, while free cash flows are depressed for one segment of the market, i.e., hyperscalers, it's getting a boost from another segment. Put those together and you get a solid outlook for free cash flows for the broad market. Keep in mind these are just estimates and corporate America could fall short of these numbers. But, as you can see in the "Broad Market Free Cash Flow Outlook is Solid" chart, enough offsets are expected to be in place to offset depressed free cash flows by the hyperscalers.

We freely admit there may be some overly optimistic assumptions about productivity gains, margin expansion, or even AI model pricing embedded in these forecasts. But, even if that is the case, it would take a lot of wasteful AI investment and probably a stalled economy (unlikely in our view) to prevent free cash flow at the broad market level from increasing over the next couple of years.

Broad Market Free Cash Flow Outlook is Solid



Source: LPL Research, Bloomberg, 09/22/26
Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results. Estimates may not materialize as predicted and are subject to change.

Bottom line, the uncertainty around payoffs from AI is a risk for markets, but we believe it's a manageable risk. Returns from AI need to justify the capital outlays — no small task — but the weight of the evidence tells us not to bet against the hyperscalers or equity markets broadly. Some spending will likely end up being ill-advised, but the companies doing the spending are in much better financial condition than those building out the internet nearly 30 years ago. This stock market may not have as much near-term upside as this AI debate continues during a seasonally challenging period leading up to the midterm elections. However, we expect stocks to continue to be well supported even in the face of ongoing disruptions to energy production and transportation in the Middle East and potential further increases in interest rates.

Participation and Price Diverge

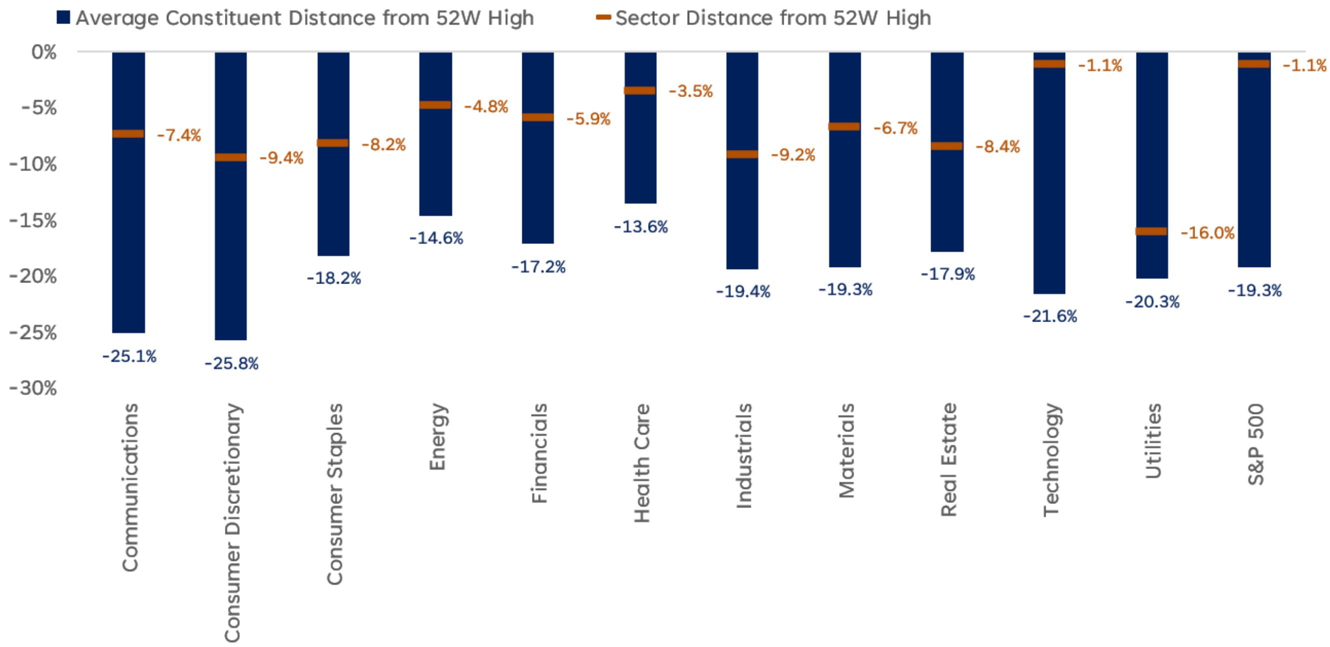
The S&P 500 has remained remarkably resilient in the face of mounting macro headwinds. Despite oil prices topping $100 per barrel, 10-year Treasury yields climbing to multi-year highs, and a renewed shift toward tighter monetary policy, the index continues to hover near record levels. Much of that resilience can be attributed to the resurgence of mega-cap stocks. After significant underperformance in the first quarter, the Magnificent Seven, comprised of Alphabet (GOOG/L), Amazon (AMZN), Apple (AAPL), Meta (META), Microsoft (MSFT), NVIDIA (NVDA), and Tesla (TSLA), have staged an impressive comeback, powering the index back to record-high territory and reclaiming leadership relative to the broader market.

Beneath the surface, however, the story looks far different. Since the July 28 low, the S&P 500 has gained more than 5% and reached fresh highs, yet market participation has deteriorated noticeably. The percentage of S&P 500 constituents trading above their 200-day moving average has fallen from 73% to 51% over the same period, suggesting the latest advance has become increasingly concentrated among a smaller group of stocks.

The lack of participation is also evident in new high data. While the S&P 500 sits just 1% below a record high, the average constituent remains more than 19% away from its own 52-week high. In other words, the typical stock has not kept pace with the index, underscoring the growing gap between headline performance and underlying market strength.

Deteriorating breadth is often viewed as a warning sign that an advance is losing structural support. Yet this cycle has repeatedly challenged traditional playbooks. Throughout the current bull market, breadth divergences have often emerged near important turning points, with mega-cap stocks leading the market off key lows and through major resistance levels before participation broadens to the rest of the index. Whether that pattern repeats will be an important test in the weeks ahead. If the major indexes break to new highs without an accompanying improvement in breadth, concerns about the durability of the rally are likely to grow. Conversely, a rebound in participation would help validate the breakout and reinforce the broader bull market trend.

A Tale of Two Trends: The S&P 500 Index and the Average Stock



Source: LPL Research, Bloomberg 09/23/26
Disclosures: All indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

Conclusion

Investors have plenty to worry about as fall begins. The conflict in the Middle East continues to disrupt critical energy infrastructure and transportation routes, keeping oil prices elevated and adding uncertainty around inflation. Meanwhile, rising interest rates and the prospect of additional rate hikes from the Fed could contribute to near-term market volatility. The enormous capital being committed to AI raises questions about future returns on that investment, particularly as hyperscalers drain their free cash flow. And deteriorating market breadth raises questions about the durability of the latest rally back near record highs.

All in all, we believe these risks are manageable. The economy has demonstrated resilience in the face of these headwinds. Corporate earnings remain very strong. The stock market's track record during non-recessionary Fed tightening cycles is excellent. Higher Treasury yields may constrain valuations, but strong earnings offer a powerful offset. While the AI investment boom inevitably will produce some winners and losers, spending is also creating substantial cash flows elsewhere in the technology ecosystem, supporting a solid cash flow outlook for the broad market. Finally, one of the strongest 12-month seasonal periods of the four-year presidential cycle for stocks is fast approaching with midterm elections less than six weeks away.

Bottom line, these crosscurrents may limit near-term upside and create periodic volatility, but they do not undermine our constructive intermediate-to-longer-term view of equities.

Important Disclosures

This material is for general information only and is not intended to provide specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors or will yield positive outcomes. Investing involves risks including possible loss of principal. Any economic forecasts set forth may not develop as predicted and are subject to change.

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Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet.

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