



RICE HALL JAMES & ASSOCIATES, LLC

Market Review **Third Quarter 2026**

The third quarter of 2026 was somewhat unnerving and frantic as several long-simmering risks were pushed to the front.

During the period, the S&P 500 Index increased 2.30% while the Russell 2000 Index declined -7.23%. The Large Cap gain, however, was misleading in that Mega Cap Tech swooned in July before stabilizing the index in September. This was evident in the large discrepancy in performance between the S&P 500 (2.30%) and an equal-weighted portfolio of the same stocks, which fell -1.87% in the quarter and -4.81% in September. Market breadth worsened as the quarter progressed.

The first cause for caution was a sharp sell-off in artificial intelligence (AI) stocks. In July, China's Moonshot AI launched its Kimi K3 model, which rivaled the performance of the leading offerings from Anthropic and Open AI and revived concerns about corporate migration to cheaper, open-source models. The selling intensified when Situational Awareness, a prominent \$45 billion AI hedge fund, collapsed under the weight of heavily leveraged, concentrated positions, prompting fears of more forced selling ahead. More recently, the AI debate took a surreal turn, with several industry leaders warning that the technology could pose an existential threat to humanity.

The bigger driver of stocks and sentiment, however, was a sharp back-up in bond yields. The 2-Year U.S. Treasury Bond Yield rose 72 basis points, its largest quarterly increase since 2023. The 10-Year U.S. Treasury Bond Yield climbed 83 basis points to 5.27%, its highest level since 2007. At the short end, the catalyst was persistent inflation, which was exacerbated by higher energy prices due to renewed fighting in the Middle East. In response, the Federal Reserve increased interest rates for the first time since 2023. At the long-end, the prolonged conflict pushed the deteriorating U.S. fiscal position to the forefront, stoking latent anxieties about credit quality and heavy future issuance at a time when AI-related corporate borrowing is also surging.

At this point, the most important issues for investors are (i) the sustainability and duration of AI capital investment, and (ii) policymakers' ability to restore credibility on inflation and spend. The two are closely linked. In September, rising bond yields pushed investors out of cyclical stocks and back into the established AI leaders. The higher cost of capital, however, is likely to expose weaker projects, which will make future financing harder to obtain.

As we look ahead, the team remains optimistic about the prospects for Small Cap stocks, supported by continued AI-driven growth. Lost amid last quarter's wall of worry was the rapid adoption of Muse, Meta's new personal AI agent, which has outpaced ChatGPT's early growth. Its success is a good reminder that AI use cases and spending will continue to rapidly evolve. We also believe that the Federal Reserve's more hawkish stance is warranted and can help lessen inflation worries embedded in long-duration bond yields over time. Preserving growth while stabilizing prices, however, is a delicate balancing act.

In this environment, we continue to apply a thoughtful and balanced approach to our strategies that is consistent with our conservative growth process. Although we have fitting exposure to the most important growth themes in the market – including AI – we focus on profitable companies and avoid “story stocks”. At the same time, we are finding significant opportunity to invest in high-quality growth businesses, at reasonable valuations, in less well-trafficked parts of the market. As a result, we believe our portfolios are well-positioned to weather near-term uncertainty while capitalizing on long-term opportunity.



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Sources: FactSet, GICS Sector Classification, TeleCrunch

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The S&P 500 is widely regarded as the best single gauge of U.S. large cap equities. The index includes 500 leading companies spanning all sectors of the U.S. stock market. It covers approximately 80% of the U.S. equity market capitalization and over 50% of the global equity market.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index representing approximately 7% of the total market capitalization of that index, as of the most recent reconstitution. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small cap opportunity set.

The 2-Year Treasury Rate is the yield received for investing in a U.S. government issued treasury security that has a maturity of 2 years.

The 10-year Treasury yield is the yield that the government pays investors that purchase the specific security. Purchase of the 10-year note is essentially a loan made to the U.S. government.

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Index Definition Sources: Standard & Poor's, FTSE Russell, Investopedia