



Heritage Financial Market Commentary

The Great Divergence: What the Surface of the Market is Hiding

Welcome to the fourth quarter of 2026. The S&P 500 continues to cling to near-record highs, painting a rosy picture of a pristine macroeconomic environment. But the index level is just the surface of the ocean, to understand the true currents, you must look deeper. Looking deeper, we are witnessing a profound misalignment between what the bond market and the stock market are telling us about the state of the world. These great divergences occur from time to time but rarely persist. So, let's look a little deeper, beneath the surface and into this great divergence.

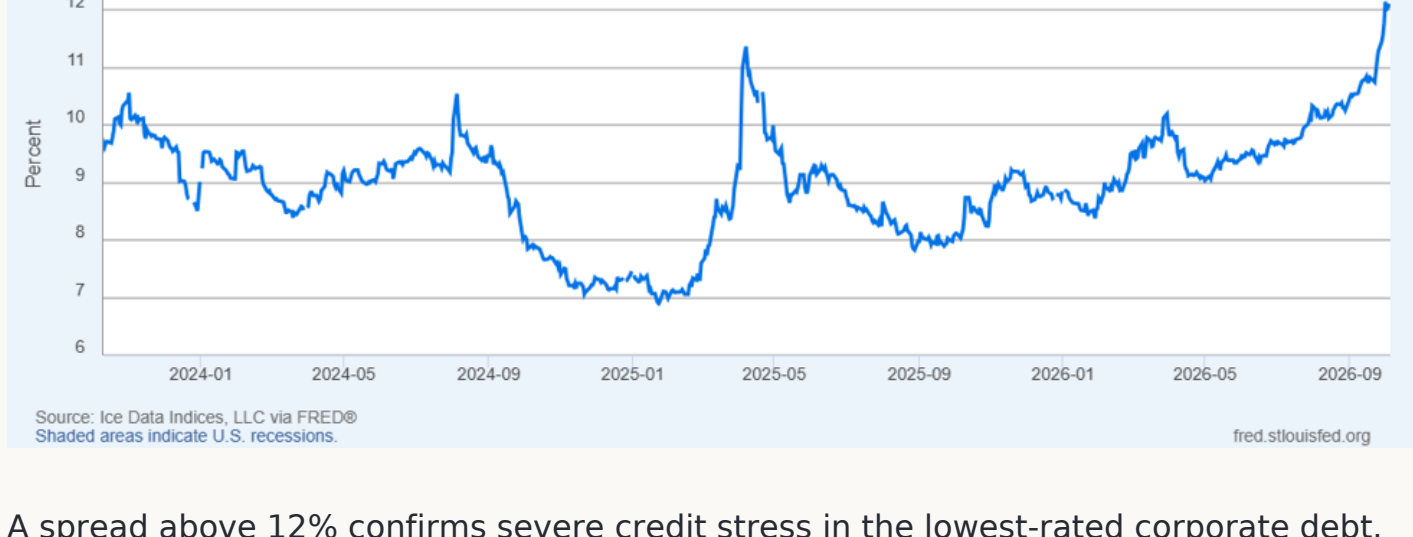
A Tale of Two Volatilities: MOVE vs. VIX

As Charles Dickens so eloquently put it: it was the best of times; it was the worst of times. And as of this moment, broad markets certainly feel that way. There is a huge divergence in the messages from equity and fixed-income markets. The VIX, commonly referred to as the stock market's "fear gauge", is sitting at the lower end of the historical spectrum, indicating that the equity options market is currently pricing in very little risk. Many equity investors seem to be hanging out in the best of times camp and with the S&P 500 near all-time highs, maybe this makes sense.

However, the bond market is telling a vastly different story. The MOVE Index, the fixed-income equivalent of the VIX, remains significantly elevated. The bond market is actively repricing risk, reacting to fiscal deterioration, heavy Treasury supply, and the realization that inflation may remain stickier than equity bulls want to admit. Bond investors are clearly seeing the world differently than stock investors. Higher interest rates can certainly explain some of this difference in perspective as they have disproportionately impacted fixed income prices.

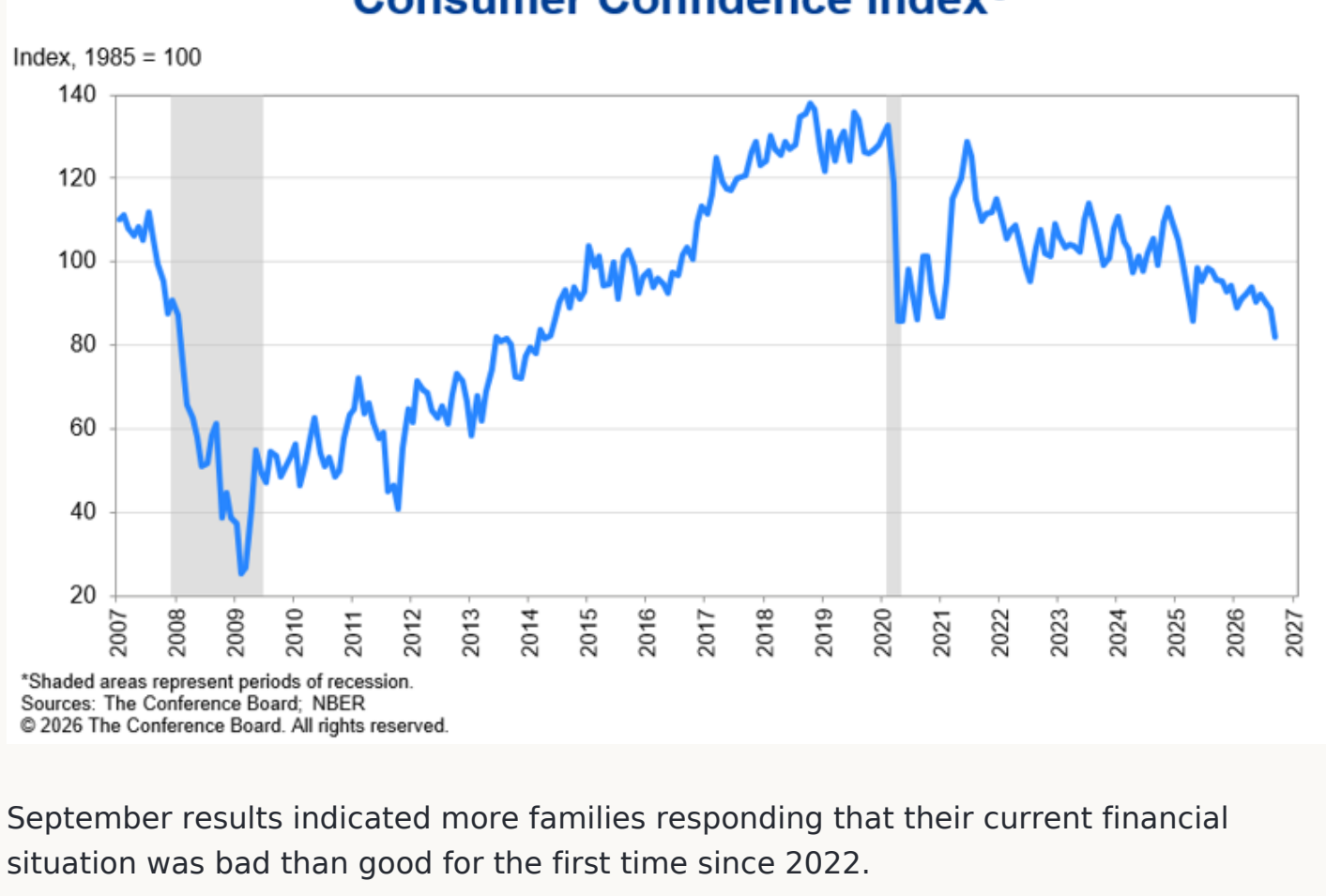
Cracks in the Credit and Consumer Confidence

We are beginning to see the impact of higher rates on lower quality companies. If we take a look the riskiest tranches of corporate credit, credit spreads have widened considerably. CCC and lower spreads have shot up to levels not seen since the 2022 market swoon. A credit spread is a measure of how much more these companies are paying to borrow money relative to Treasury securities.

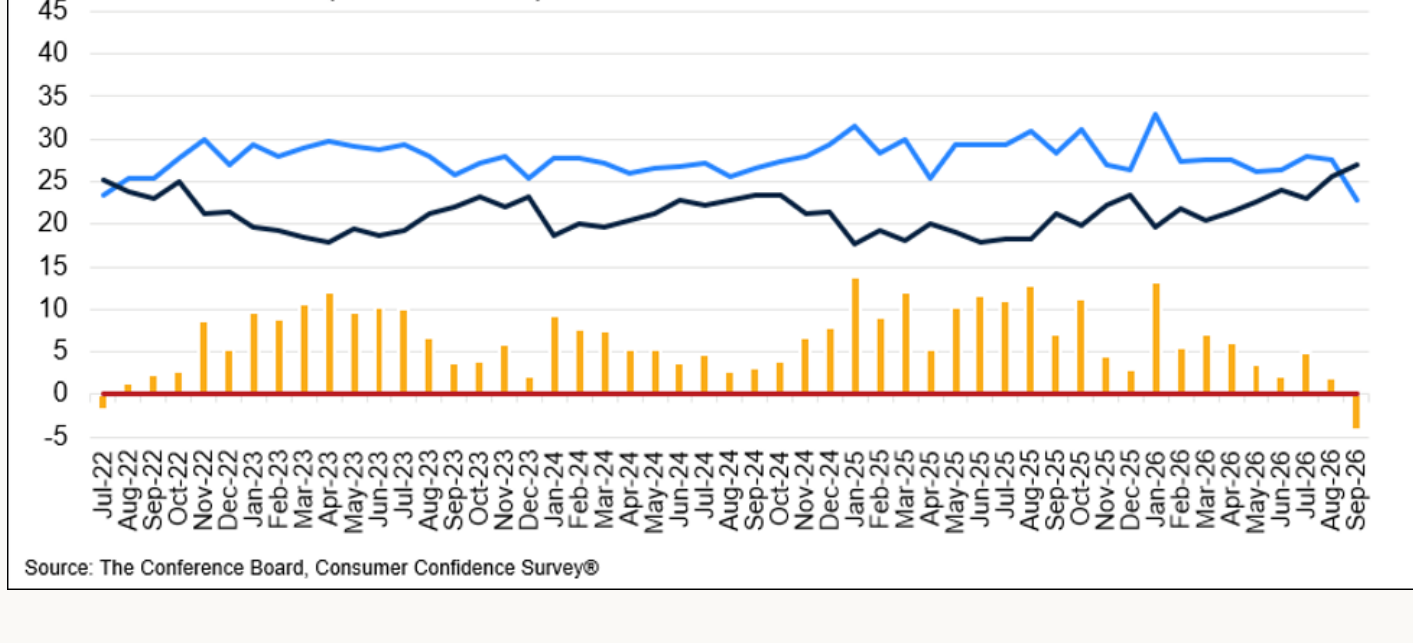


A spread above 12% confirms severe credit stress in the lowest-rated corporate debt. This generally indicates that market participants seem to be expecting higher future default rates in these companies. Higher credit spreads usually correlate with a weaker equity market.

Consumer confidence is showing cracks as well. The NBER consumer confidence level recently fell below 2020 Covid lows.



September results indicated more families responding that their current financial situation was bad than good for the first time since 2022.



The Illusion Provided by Narrow Market Breadth

If the consumer is struggling, why is the stock market so resilient? The answer lies in market breadth and the nature of a capitalization weighted index. The S&P 500 is capitalization weighted. This means a company's weighting in the index is determined by its market capitalization. The bigger the company, the more weight it has in the index. The magnificent 7 (Nvidia, Apple, Alphabet, Microsoft, Amazon, Meta and Tesla) currently make up more than a third of the S&P 500.

This means that those stocks and other mega cap names are disproportionately responsible for broad market returns, and the stock market can be up even when a majority of stocks are down.

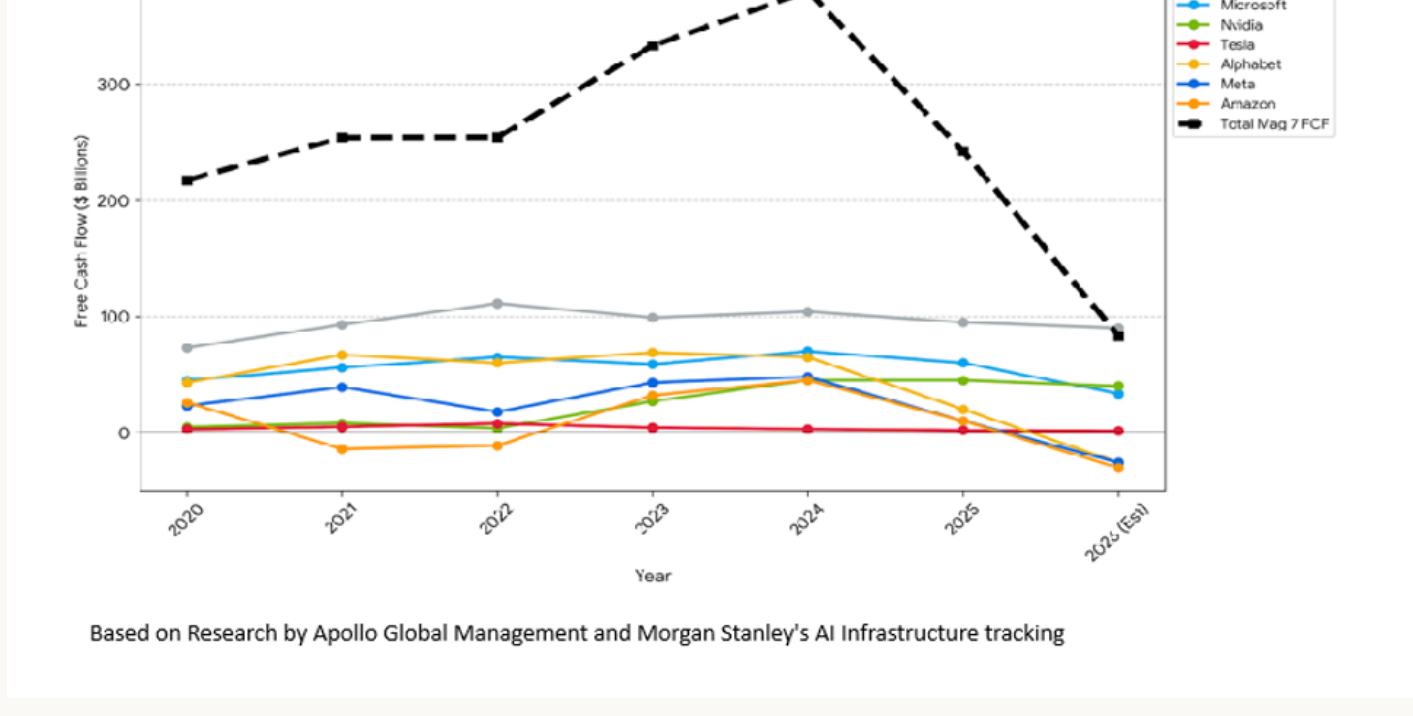
As of today, October 7th 2026, less than 30% of S&P 500 stocks are sitting above their 50-day moving averages. This means that most stocks are struggling. The market is relying almost entirely on a handful of mega-cap stocks to carry the index.



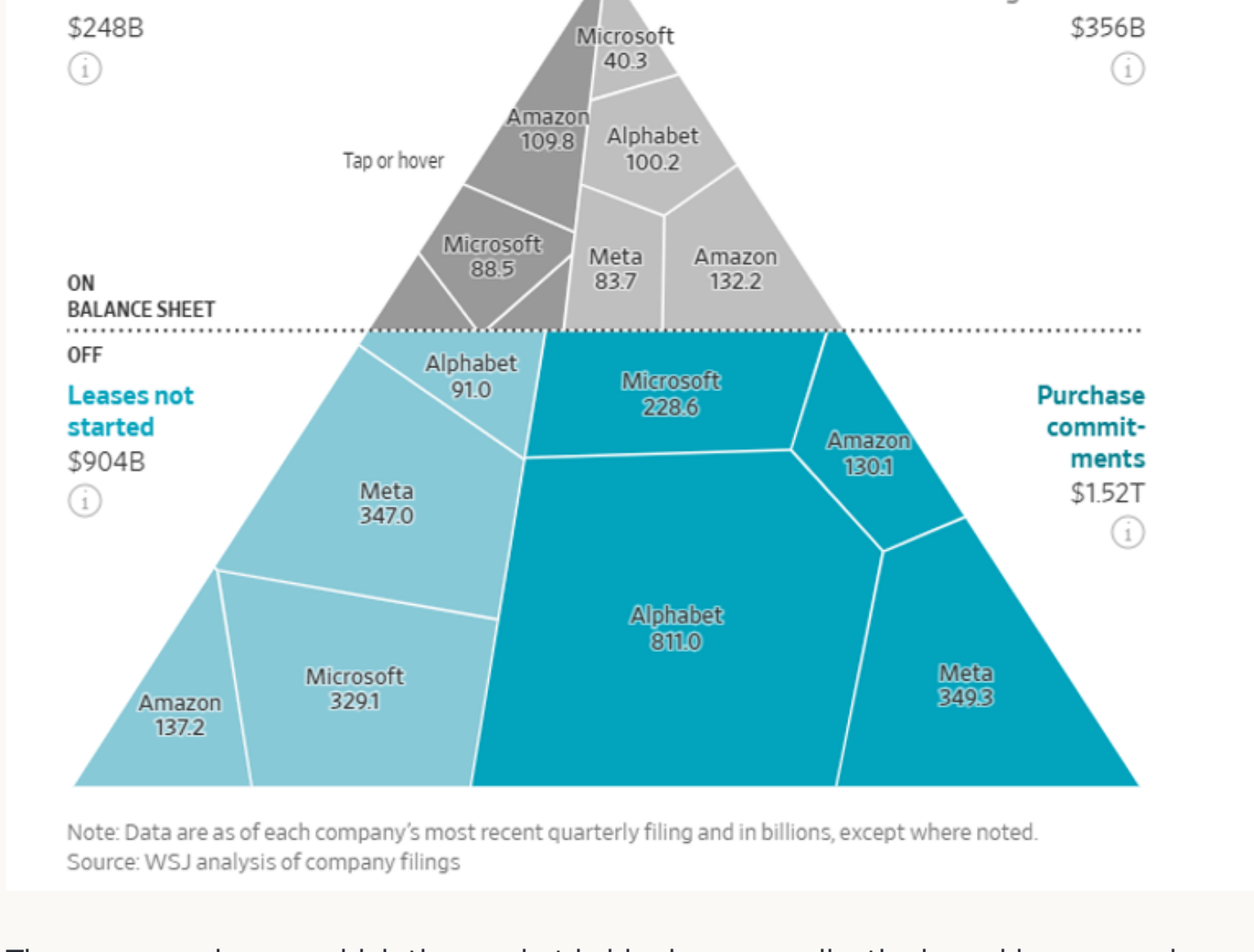
The Mega-Cap Mirage: Capex, Shadow Debt, and Negative Free Cash Flow

This brings us to a critical risk to the equity market today. The Magnificent 7 are beloved for their historic ability to generate massive free cash flows, which is precisely why investors have crowded into them as a perceived "safe haven." However, these current cash flows must be weighed against their staggering future projections and massive capital commitments.

In the global arms race for Artificial Intelligence dominance, these companies are undergoing a capex tsunami. This spending is so vast that the net free cash flow for these companies have dropped significantly and have turned negative in some instances.



Even more concerning are the massive off-balance sheet obligations these tech giants are quietly accumulating. Between long-term leases for data centers, aggressive power consumption agreements, and forward commitments for AI computing capacity, the hidden liabilities are eye-watering. Recent analysis from the Wall Street Journal [1] indicates that the off-balance sheet long-term commitments for six U.S. hyperscalers have surpassed \$1.3 trillion. When factoring in purchase commitments, lease commitments, and guarantees across hyperscalers and major chipmakers like Nvidia and AMD, that "shadow debt" figure balloons to \$3.1 trillion.



These companies, on which the market is hinging, are collectively making a massive bet on Artificial Intelligence. Whether we land in a best of times or worst of times scenario may depend on their ability to execute to perfection.

The ROI Dilemma: Who is Buying the AI and at What Price?

Equity markets are currently pricing these mega-caps for perfect execution, assuming the aggressive future revenue projections from AI will easily cover these historic capital expenditures. But here is the structural flaw in the bullish thesis: generating a sufficient return on trillions of dollars of infrastructure requires an end customer willing and able to pay for the resulting AI services. Yet, the AI customers they depend on are the very same mid-cap companies and everyday consumers who are currently suffering. We have an AI industry building a multi-trillion-dollar supply chain, banking on demand from an economy where the consumer is tapping out on credit cards, the lowest-rated corporations are seeing spreads gap out above 12%, and average corporate stocks can't hold their 50-day moving averages.

Aside, from dealing with a strained consumer and a heightened cost of capital, AI hyperscalers have to deal with increasing competition from cheaper Chinese models. Deepseek's latest model V4.1 show performance within 3% of top US AI models at a significantly lower price. This is a highly competitive space and pricing matters. Execution risk is high.

Conclusion

At Heritage Financial, our job is not to ride the momentum blindly, but to measure the risk against the reward and to ensure that your financial plan has you positioned to succeed in good times and in bad. We provide these insights not to serve as specific advice but merely to highlight the risks and opportunities in the market at present.

[1] Why Big Tech's AI Spending Is \$3 Trillion Higher Than It Seems - WSJ