A Market Caught Between Strong Earnings and Higher Rates

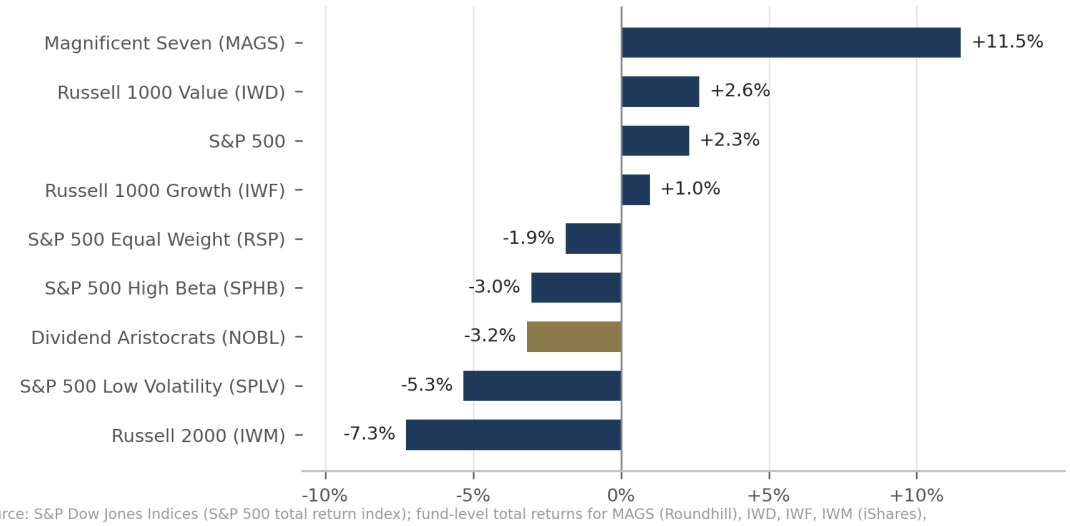
Three takeaways define the quarter. First, strong corporate earnings were offset by sharply higher Treasury yields, creating a more demanding valuation environment and favoring companies with durable cash flows, strong balance sheets, and the ability to grow earnings and dividends. Second, the energy shock strengthened the long-term case for North American production and LNG infrastructure, while weakness in defense shares appeared driven more by valuation and execution concerns than by deteriorating demand. Third, pressure on lower- and middle-income consumers reinforces the importance of selectivity, pricing power, and financial resilience. In this environment, we remain focused on businesses that can compound value across market cycles rather than positioning portfolios around short-term forecasts.

The third quarter of 2026 illustrated the tension now shaping markets: exceptionally strong corporate earnings were offset by the highest long-term interest rates in more than two decades. The 10-year Treasury yield climbed to its highest level since 2002, and the Federal Reserve raised interest rates for the first time since 2023. Higher risk-free rates reduce the value investors place on future earnings and weigh most heavily on companies that depend on borrowing or trade like bonds. Against that backdrop, the S&P 500 returned approximately 2.3% for the quarter and roughly 13% year to date, even as analysts expected a third consecutive quarter of earnings growth above 25%. The result was a market that appeared calm at the index level but was far more unsettled beneath the surface.

Dividend-focused strategies lagged once more, as they typically do when yields rise quickly: the ProShares S&P 500 Dividend Aristocrats ETF (NOBL), the proxy for the steady dividend-growers we favor, declined approximately 3.2% for the quarter. Leadership narrowed again. The Magnificent Seven, as measured by the Roundhill Magnificent Seven ETF, rose approximately 11.5%, while the equal-weighted S&P 500, a better guide to the average stock, lost roughly 2%.

A Narrow Market, Again

Third-quarter 2026 total return, June 30 to September 30, 2026



Source: S&P Dow Jones Indices (S&P 500 total return index); fund-level total returns for MAGS (Roundhill), IWD, IWF, IWM (iShares), RSP, SPHB, SPLV (Invesco) and NOBL (ProShares) from exchange closing prices and distributions; Brookmont calculations.

Sector returns reflected two dominant forces: an oil shock and rapidly rising interest rates. Energy returned approximately 16.5% as the Iran conflict reignited, while healthcare gained about 6.6% as investors favored earnings that are less dependent on the economic cycle. The weakest sectors were those most exposed to higher discount rates

and a stretched consumer: utilities fell roughly 12.4%, industrials declined 9.6% as aerospace and defense shares sold off despite record order books, and consumer discretionary fell 7.0% as mortgage rates reached 7% in September. Our energy holdings and most of our healthcare holdings advanced, while our defense, home-improvement, restaurant, and utility holdings declined. We view the weakness in defense and utilities primarily as a valuation response to higher rates rather than evidence of deteriorating demand. Our consumer holdings face a more immediate challenge from pressure on lower-income households and elevated mortgage rates, making company selection increasingly important.

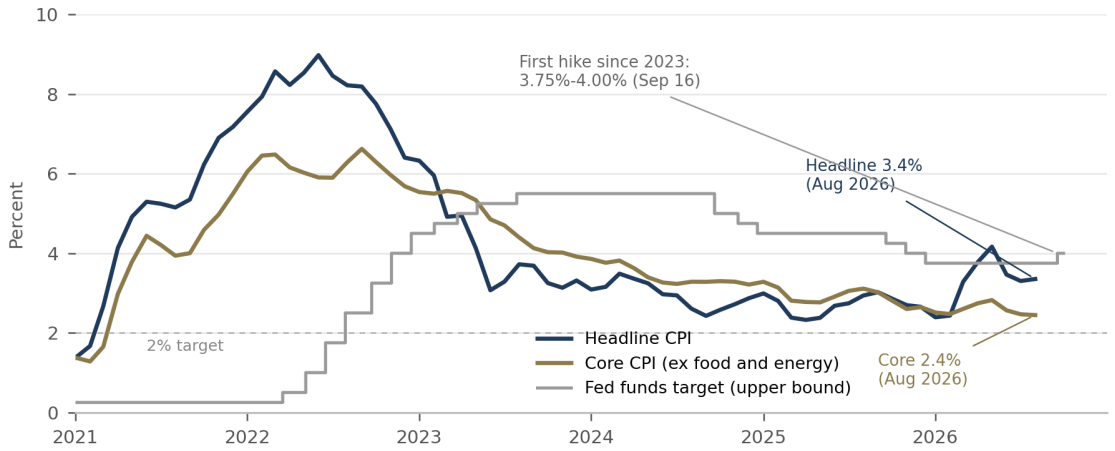
Earnings, by contrast, were extraordinary. Second-quarter results saw 86% of S&P 500 companies beat consensus EPS estimates, well above the five-year average of 78%. The market is not expensive against its own recent history; the difficulty is that bonds now offer a real alternative, which raises the bar for every holding and favors companies whose earnings and dividends can grow faster than the rate at which they are discounted.

The First Hike Since 2023

The Federal Reserve held rates steady on July 29 by a 9-3 vote, with three regional bank presidents dissenting in favor of an increase—the first votes for a hike in this cycle. At Jackson Hole on August 28, Chair Warsh said he "would be hard pressed to describe broad financial conditions as restrictive" and that he was "committed to a discipline, not to a decision." On September 16, the committee unanimously raised the target range by a quarter point to 3.75%-4.00%, its first increase since July 2023. The median participant now expects the federal funds rate to end 2026 at 4.1%, up from 3.8% in June and 3.4% in March. For investors, the important point is not simply that policy tightened, but that the expected path of rates shifted materially within a few months, increasing the discount rate applied to financial assets and raising the hurdle for equity valuations.

Hiking Into a Supply Shock

U.S. CPI inflation (year-over-year) and the fed funds target range upper bound, Jan 2021 to Sep 2026



Source: U.S. Bureau of Labor Statistics (CPI-U, seasonally adjusted, through August 2026; the October 2025 reading, never published because of the federal shutdown, is interpolated); Federal Reserve Board (target range upper limit, through September 30, 2026). Retrieved via FRED.

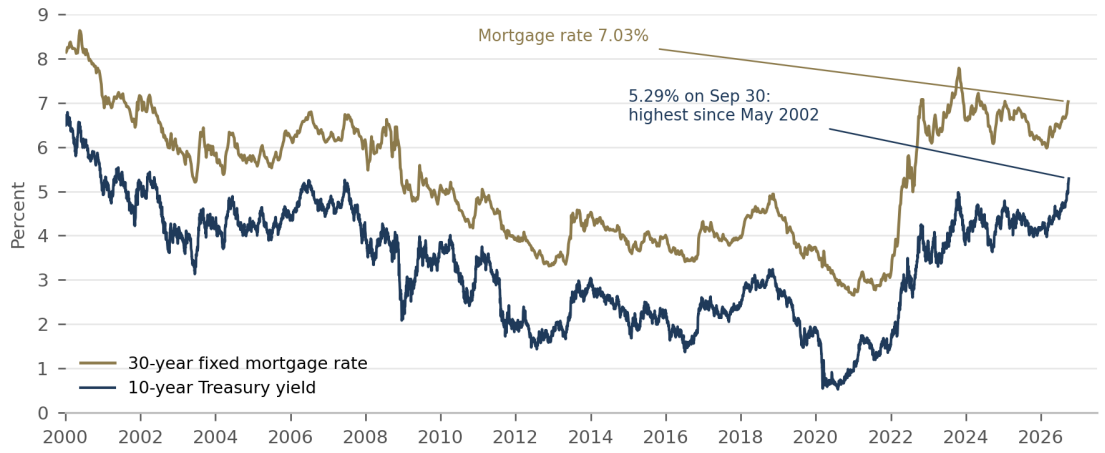
The inflation data explains the Fed's discomfort but also complicates it. Headline CPI has come down from its 4.2% peak in May to 3.4% in August, and the gap between headline and core inflation is almost entirely energy: energy prices were up 16% year over year in August and gasoline 27%. Core CPI, which excludes food and energy, slowed to 2.4%, its lowest reading since early 2021, and several participants at the Fed's July meeting judged that the pass-

through of past tariff increases “was now largely complete.” The Fed’s target measure, PCE inflation, was 3.4% in August (3.0% core), and Warsh has been explicit that “there is no soft inflation target.” Still, the committee is tightening into an energy supply shock while underlying inflation, at least as core CPI measures it, is close to where it was before the war began.

The larger move was at the long end of the curve, where the Fed has less control. The 10-year Treasury yield rose from 4.44% at the end of June to 5.29% on September 30, its highest since May 2002, and the 30-year reached 5.64%, its highest in more than two decades. Warsh offered three explanations at his September press conference: a stronger economy, geopolitics, and the AI buildout itself, in which “the so-called hyperscalers are out in the market raising funding” and “the competition for capital is real.” We would add a fourth. The federal deficit reached $2.0 trillion through the first eleven months of the fiscal year, and net interest cost passed $1 trillion, up 12% from a year earlier. A government borrowing at that pace competes for the same capital.

The Bond Market Sets the Terms

10-year U.S. Treasury yield (daily) and 30-year fixed mortgage rate (weekly), 2000 to September 2026



Source: U.S. Department of the Treasury (daily par yield curve, through September 30, 2026); Freddie Mac Primary Mortgage Market Survey (through September 24, 2026). Retrieved via FRED and treasury.gov.

The Iran Conflict, Round Two

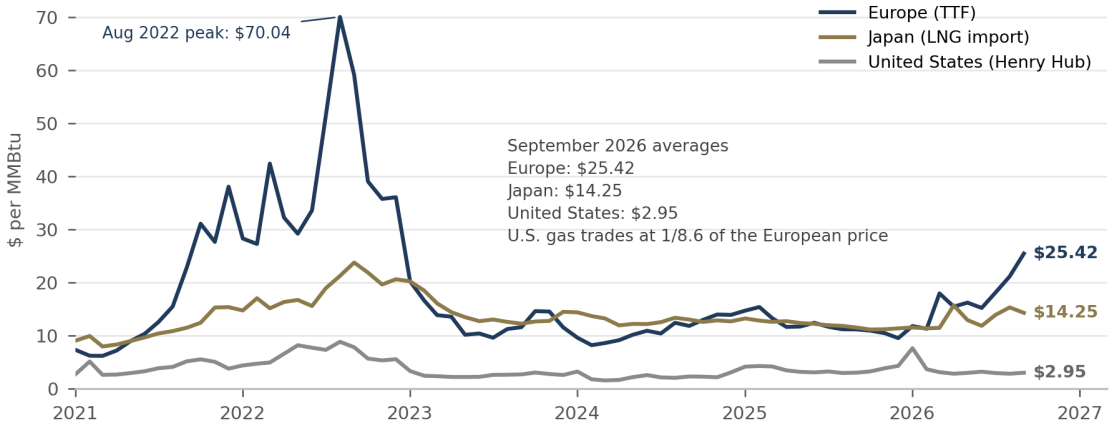
The 60-day negotiating window opened by the June 17 memorandum never reached its halfway point. After Iran attacked three merchant ships on July 7, U.S. forces struck roughly 170 targets over two days, the President declared the memorandum “over,” and the naval blockade of Iranian ports resumed on July 14. Iran declared the Strait of Hormuz closed on July 12, and the International Energy Agency estimates that more than 10 million barrels a day of Gulf production, roughly a tenth of global supply, remained shut in as of September, with Gulf exports at roughly half their pre-war level. On September 11, a drone attack shut Saudi Arabia’s East-West pipeline, the kingdom’s main bypass around the strait.

Brent crude, back at $70 a barrel on June 30, spiked to $130.80 on September 15, its highest since April, per the U.S. Energy Information Administration. U.S. gasoline rose from $3.83 a gallon at the end of June to $4.47 by the end of September, and diesel set a record of $6.53 on September 21, above its 2022 peak. On September 24, Iran offered to reopen the strait within seven days in exchange for lifting the blockade, waiving oil sanctions, and a ceasefire that

includes Lebanon. The President reportedly rejected the proposal, and indirect talks mediated by Qatar were underway in New York as the quarter closed. As we wrote in July, de-escalation is not resolution.

The U.S. Energy Advantage

Natural gas benchmark prices, U.S. dollars per million Btu, monthly averages, Jan 2021 to Sep 2026



Source: World Bank Commodity Price Data ("Pink Sheet"), updated October 2, 2026: Natural gas, U.S. (Henry Hub); Natural gas, Europe (TTF); Liquefied natural gas, Japan (import price). Brookmont calculations.

The natural gas market tells a different story, and it matters most for our positioning. QatarEnergy extended its force majeure on LNG cargoes through November, and in September European gas averaged approximately $25 per million Btu, 8.6 times the U.S. Henry Hub price of $2.95, according to World Bank data. U.S. LNG exports rose to approximately 10.9 million tonnes in September, with more than half of the cargoes going to Europe. This is why our ***Future of Energy*** theme is built around low-cost North American production and multi-year LNG offtake agreements rather than a bet on the spot price of crude. Our energy holdings rose more than 20% in the quarter, and the developments beneath the share prices were the more durable ones: Shell completed its acquisition of ARC Resources on September 2, adding roughly 370,000 barrels of oil equivalent a day of low-cost Canadian production alongside its LNG business, and Chevron, having lifted production 20% with the Hess acquisition, paid down a record $8.4 billion of debt in the second quarter and signed a 20-year agreement to supply 2.67 gigawatts of behind-the-meter power to a Microsoft data center in West Texas. That is also where our energy and artificial intelligence themes converge.

Defense: Record Backlogs, De-Rated Shares

The demand picture for our defense holdings has rarely been stronger, and their shares had a poor quarter. The administration's fiscal 2027 request totals $1.5 trillion, including more than $100 billion aimed at the defense industrial base, and the House passed its authorization bill on July 22. The pace of munitions use in the Gulf has made replenishment the priority, and the response has been multi-year contracts of unusual size: $22.9 billion for Tomahawk cruise missiles in August and up to $20.7 billion for AMRAAM air-to-air missiles on September 28. Second-quarter results reflected all of this: L3Harris reported a record $42 billion backlog and raised its full-year guidance, and RTX reported organic sales growth of 16%, a $289 billion backlog, and raised its earnings guidance for the second time this year.

Yet the iShares U.S. Aerospace & Defense ETF fell approximately 14% in the quarter, and most of our defense holdings declined with it. We believe three forces were at work. Valuations had risen substantially since 2023, leaving less room for disappointment; long-dated backlogs became less valuable on a present-value basis as the 10-year yield increased 85 basis points during the quarter; and several companies encountered execution issues, most visibly when Honeywell Aerospace lowered its 2026 organic growth outlook to 4%-5% from 7%-9% because of supply-chain constraints. These developments do not, in our view, alter the multi-year demand outlook. Domestic defense companies do not require direct U.S. involvement in a conflict to benefit from higher bookings, and the current environment includes depleted inventories, rising allied budgets, and an urgent need for replenishment. Our Geopolitical Volatility & Defense theme remains intact, but future returns will depend on companies converting record backlogs into revenue, margins, and free cash flow without further execution shortfalls.

The Consumer and the Midterms

The consumer is spending, but not comfortably. Retail sales rose 1.1% in August and 5.4% from a year earlier, though a meaningful share of that growth is gasoline, and the personal saving rate fell to 4.1% in August from 4.6% in July. Average hourly earnings grew 3.1% over the year to August, below the 3.4% inflation rate, so real wages are now falling for the average worker. Payrolls grew by 21,000 in July and 162,000 in August, but the preliminary annual benchmark revision pointed to 79,000 fewer jobs than currently reported, and the unemployment rate has held at 4.1% largely because the labor force is barely growing.

Sentiment has diverged sharply from spending. The Conference Board's consumer confidence index fell 6.7 points in September to 81.9, its expectations component declined for a third straight month, and consumers' one-year inflation expectations rose to 6.1%. The University of Michigan's sentiment index fell to 48.1, down 15% since January, on what the survey called "elevated fuel prices and re-escalating trade disputes." The strain is concentrated where we said it would be: 12.9% of credit card balances were 90 or more days delinquent in the second quarter per the New York Fed, student loan delinquencies rose to 10.6%, and the Fed's July minutes observed that "low- and moderate-income households were under increasing strains, with inflation eroding their real disposable income," even as higher-income households continued to spend on the strength of their portfolios. Company results told the same story: Costco's comparable sales rose 9.4%, while McDonald's U.S. comparable sales grew 0.8% on declining guest counts, and the home-improvement retailers reported flat to low-single-digit comparable sales as the housing market remains frozen.

Trade policy settled into a more durable, if not lower, shape: the tariffs the Supreme Court struck down in February have been replaced under other authorities, and the Congressional Budget Office puts the effective tariff rate at roughly 10%. President Xi's visit to Washington in late September extended the U.S.-China truce to January 2027, and Congress avoided a shutdown by funding the government through December 11.

That brings us to November 3. Polls and prediction markets point to a possible change of control in at least one chamber, and cost of living remains the issue voters cite most often. We would offer two observations. First, midterm elections have historically mattered less to long-term market outcomes than the surrounding headlines suggest. The S&P 500 has risen in the 12 months following each midterm election since 1946, with an average gain of 14%, and the fourth quarter of a midterm year has been positive 17 of 20 times. These observations describe history rather than predict the next outcome, but they suggest that the removal of uncertainty has often mattered more than which party prevailed. Second, the policies most relevant to our holdings are unlikely to change quickly regardless of the election result: tariffs now rest on executive authority, monetary policy rests with the Federal Reserve, and defense appropriations enjoy bipartisan support. A divided Congress would likely mean less legislation, not an immediate change in the economic backdrop. We do not position portfolios around election outcomes, and this year is no exception.

What a 5% Treasury Means for a Dividend Investor

With three-month Treasury bills yielding more than 4% and the 10-year note above 5%, investors may reasonably ask why they should own a stock with a 2% dividend yield. The answer begins with an important distinction: a bond offers a fixed coupon, while a well-supported dividend can grow over time. Periods of sharply rising yields nevertheless create a difficult near-term environment for dividend strategies. Since 2006, the 10-year yield has risen by at least three-quarters of a percentage point on 17 occasions, and the largest dividend-growth index fund trailed the S&P 500 in 14 of them. This quarter was no exception. The stocks that fell hardest were those that most resemble bonds, with utilities down 12.4% and real estate down 6.3%. In a 5% risk-free-rate environment, a high current yield without growth is not enough.

A Treasury coupon is fixed; the dividends and earnings of a high-quality business can grow. We select dividend-paying companies for the durability and growth of the cash flows supporting their payouts, not for yield alone. That is why the portfolios lean toward banks, energy producers, and healthcare companies whose dividends increased this year rather than toward bond-like sectors that were particularly vulnerable to rising rates. Every large bank we own raised its dividend by roughly 4% to 18% following the June stress test, and companies across the Dividend Growth Strategy increased their dividends by a weighted average of roughly 7% over the past year, excluding recent spin-offs. A 4.2% Treasury-bill yield applies to the next three months, not the next ten years. The 10-year Treasury, yielding 5.29%, and the inflation-protected note, offering a 2.9% real yield—the highest since 2008—are serious competitors for capital. Each equity holding must therefore justify its price through a combination of current income, dividend growth, earnings growth, and long-term appreciation potential. We believe most of our holdings meet that test, while recognizing that higher rates raise the standard for doing so.

Why Brookmont

The alternative to equities is more attractive than at any point in nearly two decades. A 10-year Treasury yield of approximately 5.3% is essentially equal to the S&P 500's forward earnings yield, and the Federal Reserve's staff observed in July that the equity risk premium had been lower in recent history only during the dot-com bubble. This does not eliminate the case for equities, but it changes the question investors must ask. Owning the market indiscriminately is less compelling when a risk-free asset offers a comparable current yield; equity exposure must instead be justified by durable earnings growth, rising dividends, financial strength, and the potential to compound value over time. That is the environment for which Brookmont's emphasis on quality and business-level research is designed.

We enter the fourth quarter facing a demanding but not necessarily bearish environment. The Federal Reserve is raising rates into an energy shock, long-term yields are at their highest levels in a generation, geopolitical developments remain unsettled, the AI investment cycle is becoming more capital intensive, and the election will soon remove one source of uncertainty. At the same time, corporate earnings remain strong, and our holdings have continued to raise their dividends. The key takeaway is that higher rates increase the cost of mistakes and reduce the margin for paying too much, even for good businesses. Our response is not to forecast the next move in rates, oil, or politics. It is to remain selective, require each holding to justify its place relative to an attractive risk-free alternative, and own companies with durable competitive advantages, strong balance sheets, disciplined capital allocation, and the ability to compound value through changing market conditions. That discipline—not any single macroeconomic prediction—remains the foundation of our approach.

Disclosures

This letter may contain "forward-looking statements" which are based on Brookmont's beliefs, as well as on a number of assumptions concerning future events, based on information currently available to Brookmont. Current and prospective clients are cautioned not to put undue reliance on such forward-looking statements, which are not a guarantee of future performance, and are subject to a number of uncertainties and other factors, many of which are outside Brookmont's control, and which could cause actual results to differ materially from such statements. All expressions of opinions are subject to change without notice.

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A complete description of Brookmont's performance calculation methodology, including a complete list of each security that contributed to the performance of this Brookmont portfolio is available upon request.

Certain economic and market information contained herein has been obtained from published sources prepared by other parties, which in certain cases has not been updated through the date of the distribution of this letter. While such sources are believed to be reliable for the purposes used herein, Brookmont does not assume any responsibility for the accuracy or completeness of such information.

These individual securities do not represent all of the securities purchased, sold, or recommended for this Brookmont portfolio and the reader should not assume that investments in the securities identified and discussed were or will be profitable.

The Brookmont Dividend Growth Strategy returns are based on an asset-weighted composite of discretionary accounts that include 100% of the recommended holdings. Individual accounts will have varying returns, including those invested in the Strategy. The reasons for this include 1) the period of time in which the accounts are active, 2) the timing of contributions and withdrawals, 3) the account size, and 4) holding other securities that are not included in the Strategy. Dividends and capital gains are not reinvested. The Strategy does not utilize leverage or derivatives. Returns are based on U.S. dollars. The inception of the Strategy is January 1, 2008.

The Brookmont Dividend Growth Strategy Composite contains fully discretionary accounts with similar value equity investment strategies and objectives. For comparison purposes, the Dividend Growth Strategy Composite is measured against a combination of two indices. The S&P Dividend Aristocrats Index was used prior to November 2013; ProShares S&P 500 Dividend Aristocrats ETF is used subsequently. The ProShares S&P 500 Dividend Aristocrats ETF is an exchange-traded fund designed to track the S&P 500 Dividend Aristocrats Index. The fund focuses on U.S. large-cap companies in the S&P 500 that have increased their dividends for at least 25 consecutive years, giving investors exposure to businesses with long records of dividend growth, financial durability, and shareholder returns.

NOBL is equal-weighted, which helps reduce reliance on a small number of very large companies and can provide broader exposure across dividend-growing stocks. It is typically considered by investors seeking a blend of income, quality, and lower-volatility equity exposure, though it may lag broader growth-oriented indexes when non-dividend-paying or faster-growing companies lead the market. There is no representation that this index is an appropriate benchmark for such a comparison. The volatility of this ETF may be materially different from the performance of the strategy.

The Brookmont Core Dividend Strategy returns are based on an asset-weighted composite of discretionary accounts that include 100% of the recommended holdings. Individual accounts will have varying returns, including those invested in the Strategy. The reasons for this include, 1) the period of time in which the accounts are active, 2) the timing of contributions and withdrawals, 3) the account size, and 4) holding other securities that are not included in the Strategy. Dividends and capital gains are not reinvested. The Strategy does not utilize leverage or derivatives. Returns are based in U.S. dollars. The inception of the Strategy is January 1, 2015.

The Brookmont Core Dividend Strategy Composite contains fully discretionary accounts with similar value equity investment strategies and objectives. For comparison purposes, the Core Dividend Strategy Composite is measured against the ProShares S&P 500 Dividend Aristocrats ETF. The ProShares S&P 500 Dividend Aristocrats ETF is an exchange-traded fund designed to track the S&P 500 Dividend Aristocrats Index. The fund focuses on U.S. large-cap companies in the S&P 500 that have increased their dividends for at least 25 consecutive years, giving investors exposure to businesses with long records of dividend growth, financial durability, and shareholder returns.

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The Brookmont Quality Growth Strategy returns are based on an asset-weighted composite of discretionary accounts that include 100% of the recommended holdings. Individual accounts will have varying returns, including those invested in the Strategy. The reasons for this include, 1) the period of time in which the accounts are active, 2) the timing of contributions and withdrawals, 3) the account size, and 4) holding other securities that are not included in the Strategy. Dividends and capital gains are not reinvested. The Strategy does not utilize leverage or derivatives. Returns are based in U.S. dollars. The inception of the Strategy is January 1, 2015.

The Brookmont Quality Growth Strategy Composite contains fully discretionary accounts with similar value equity investment strategies and objectives. For comparison purposes, the Quality Growth Strategy Composite is measured against the iShares Russell 1000 ETF. The iShares Russell 1000 ETF (ticker: IWB) is an exchange-traded fund designed to track the Russell 1000 Index, which represents large- and mid-capitalization U.S. companies. The fund provides broad exposure to the U.S. equity market and is commonly used as a core holding for investors seeking diversified access to established U.S. stocks. There is no representation that this index is an appropriate benchmark for such a comparison. The volatility of this ETF may be materially different from the performance of the strategy.

Brookmont's returns do include reinvestment of dividends and are shown gross-of-fees. All transaction costs are included. The iShares Russell 1000 ETF cumulative return includes reinvestment of dividends and capital gains. During a rising market, not reinvesting dividends could have a negative effect on cumulative returns.
Gross returns will be reduced by investment advisory fees and other expenses that may be incurred in the management of the account. Net-of-fees performance was calculated using actual management fees. Additional information regarding the policies for calculating and reporting returns is available upon request.

Your account returns might vary from the composites returns if you own securities that are not included in the Strategy or if your portfolio dollar-cost averaged into the Strategy during the reporting period.

The firm maintains a complete list and description of composites, which is available upon request. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. The composite policy requires the temporary removal of any portfolio incurring a client-initiated significant cash inflow or outflow of at least 15% of portfolio assets. The temporary removal of such an account occurs at the beginning of the month in which the significant cash flow occurs and the account re-enters the composite at the beginning of the month which follows the cash flow by at least 30 days. Additional information regarding the treatment of significant cash flows is available upon request.

Brookmont Capital Management claims compliance with the Global Investment Performance Standards (GIPS®). To receive a complete list and description of Brookmont's composites and a presentation that adheres to GIPS standards, please contact Suzie Begando at 214-953-0190 or write Brookmont Capital Management, 5950 Berkshire Lane, Suite 1420, Dallas, TX 75225.

The Brookmont Dividend Growth Strategy is available through several institutional platforms and registered investment advisors that are not affiliated with Brookmont Capital Management. The minimum investments and advisory fees required differ from one firm to another.

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Past performance is not indicative of future returns