

Corporate Fundamentals 3Q26; Exceptionally Unique Forces Driving Fundamental Strength & Concern

Corporate Fundamentals Remain Resilient, but Key Risks Warrant Attention

Fundamentals resilient despite conflict

There were times in the past when corporate fundamentals would deteriorate in the face of an extended conflict in the Middle East that resulted in escalating gasoline prices, unhealthy inflation and interest rates climbing percentage points in a short amount of time. Provided that we are in the midst of an artificial intelligence revolution and that the domestic economy is less dependent on energy, domestic corporate fundamentals are holding up quite well despite these challenges.

Growth, margins, balance sheets solid

Based on consensus estimates revenue growth of about 8% is expected over the next twelve months for corporates. Despite higher energy and transportation costs, we expect operating margins to expand to nearly 21% in this same time frame. Even when excluding the largest companies (NVIDIA, Apple, Alphabet, Microsoft and Amazon), operating margins are expected to expand to nearly 18% by 2Q'27 from just over 16% in 2Q'26. Balance sheets are in good shape too - leverage is stable at 3.0x while free cash flow relative to debt remains near 15%. Using a number of different measures, we believe Corporates are in the middle-to-late stages of the credit cycle (Figure 1).

Figure 1

Observations of Factors in Current Credit Cycle				
	Early Cycle	Mid-Cycle	Late Cycle	Recession
Defaults	Plateauing	Trending lower	Bottoming	Rising
Profit Margins	Recovering	Expanding	Plateauing	Declining
Capex	Bottoming then rising	Stabilizing	Accelerating	Declining
Dividends	Payouts and Ratios Rising	Payouts rising and ratios stabilizing	Payouts rising, but ratios declining	Payouts declining; ratios rising
Buybacks	Reinstated	Rising but less than cash flow	Rising but exceeding cash flows	Declining or halted
M&A	Starting	Growing & major announcements	Peaks; Mega deals at high valuations	Cheap valuations
Cash Position	Build-up	Redeployment	Declining	Rebuilding

Indicates the characteristics we are observing currently

Source: AAM

Key watch items ahead

We believe there are several items that are critical to corporate fundamentals over the next several quarters including continued progress on the AI buildout, changes to refined product flows, and how healthy profit margins respond to the changing economic currents. We also will be scrutinizing how political changes in France and California may influence the cost of capital for issuers from those constituencies.

AI Trade: Can we avoid hiccups?

Near-term AI risks may be more concentrated in timing than demand

With adoption still growing, our current view is that demand for AI isn't the problem in a supply-constrained environment. Over the next three to four quarters, we think the risk is timing, as AI spending reshapes credit profiles and increases financial risk. S&P's base case has hyperscaler capital intensity peaking in 2027 and capex flattening from 2028,¹ so the question is whether funding, construction, and revenue stay in step through the peak. Moody's puts more weight on growth: its ratings give substantial credit for growth it expects to accelerate from an already large base, so a reset in those expectations would be the first source of ratings pressure.² Either way, a delay in bringing capacity online, or in turning it into revenue, could weigh on ratings for the hyperscalers and for AI-exposed issuers. We're watching three signals: how the OpenAI and Anthropic IPOs are received, whether data center construction stays on schedule, and whether hyperscalers' spending commitments turn into revenue.

Lab IPOs test counterparty risk

A public offering by a major frontier AI lab could provide investors with additional audited financial information about companies supporting a meaningful portion of the AI buildout. OpenAI and Anthropic account for an estimated 47% of booked hyperscaler backlog, yet neither publishes GAAP

financials, and both still depend on outside capital. Anthropic filed confidentially in June, and Bloomberg reports its roadshow could start in early November, a month or two later than planned. Sam Altman has ruled out a 2026 listing for OpenAI, which is raising privately to fund projected cash burn that more than doubles to \$57 billion in 2027. The contracts support the buildout, but the counterparties are hard to underwrite. In our view, a well-received IPO could narrow that gap; a weak one could make the labs' funding needs a question for hyperscaler credit.¹

Power and labor delay delivery

Power and labor constraints remain important factors affecting data center delivery timelines.³ Stifel's tracker shows a record 81.4 gigawatts (GW) under construction, but only 11.3 GW completed over the past year and a record 24.9 GW canceled.⁴ More than 100 local moratoria are in place, but most cover only new applications, shrinking the pipeline before money is committed. The bigger risk is a financed project that misses its power date. For experienced builders such as Google, Microsoft, Meta and Amazon, which buy equipment early and lock in contractors, a delay pushes revenue out. For the first-time owners behind much of the roughly \$50 billion in recent high-yield project bonds, it can trigger rent credits and tenant termination rights.³

Hyperscaler capex is the linchpin

In our view, the AI trade depends on the hyperscalers not blinking; their spending is the supply chain's revenue. S&P expects the six largest, including Oracle and SpaceX, to lift capex from about \$870 billion this year to more than \$1.3 trillion in 2027, peaking near 53% of revenue.¹ More than a third of this year's spending is debt-funded, and bond demand has cooled: orders covered hyperscaler deals nearly five times in February but less than twice in July, which most bank research teams attribute to heavy issuance rather than doubt about AI.^{5,6} Until revenue catches up, which the market expects in 2028, each earnings season tests the timing. Capex that holds or rises above prior guidance, with revenue growth accelerating as AI is monetized, would affirm the thesis and keep investment flowing. Late-October earnings bring the first 2027 guidance. A cut tied to construction timing is a delay we can look through; one tied to weaker returns or tighter budgets would signal a change in the AI narrative.

Elevated Energy Prices Remain a Headwind

Oil volatile but flows recovering

High energy prices continue to be a fly in the ointment of the economy and we suspect it will continue to be so over the next several quarters. Oil prices on the Nymex exchange have fluctuated in the past quarter (4 moves of +/- 10% in the past 90 days) as flows from the Middle East have climbed significantly despite fairly regular attacks on energy infrastructure by Iran and its proxies. Recent estimates suggest oil flowing out of the region are very near pre-conflict levels.

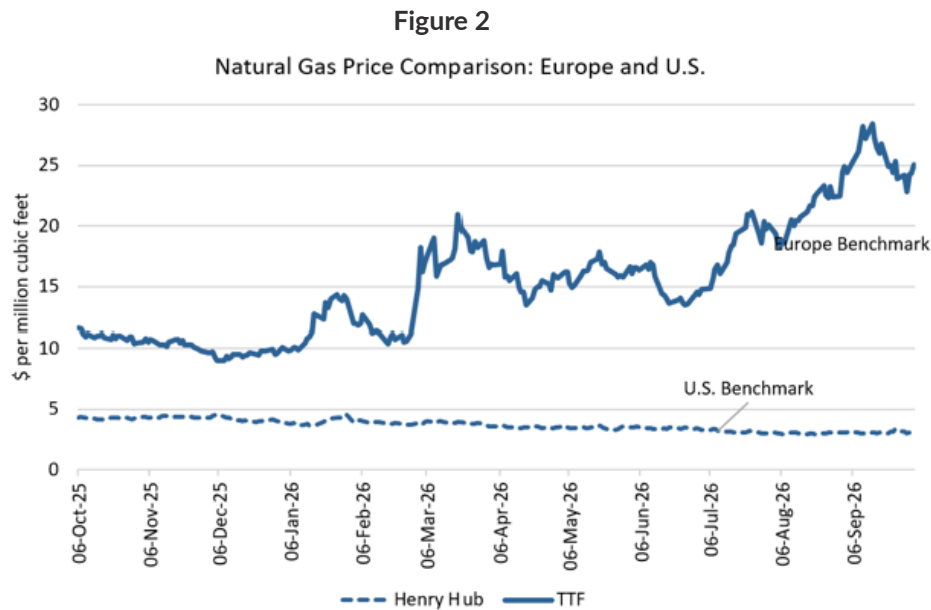
Diesel stays high on refinery outages

However, diesel prices on the Nymex exchange remain stubbornly high (up 116% YTD and 16% since our last corporate fundamental update July 15, 2026). Major diesel export regions like Russia and the Middle East have suffered from damaged refineries severely limiting the ability to convert crude oil into products like diesel, gasoline and jet fuel. We estimate that there are more than 8 million barrels per day of worldwide refining capacity offline (about 10% of capacity according to the International

Energy Agency) due to these issues. Moreover, China which has available refined export capacity, halted exports of refined oil products for October in order to boost domestic fuel supplies. While the G7 recently announced a coordinated release of 100 million barrels of crude/diesel over the next 4 months that should ease upward pricing pressure, we believe diesel prices are likely to remain historically high until there is clarity on the damaged refineries in the Middle East and Russia or China changes its export policy.

European gas squeeze persists

Natural gas prices are a key concern for the European economy too. According to Morgan Stanley, the conflict in the Middle East removed about 20% of worldwide liquefied natural gas export capabilities of which the EU relies. Recent reports suggest that exports out of the Middle East remain nearly 70% below pre-war levels. Based on reports from Qatar Energy, which is the largest LNG exporter in the world, we believe reduced natural gas exports out of the Middle East should be expected throughout 2027. This is problematic for Europe given inventories are about 74% of capacity relative to a 10-year average of 87% for this time of the year. This significant departure from norm is reflected in European natural gas prices that are 8x higher than in the U.S. and are up more than 160% year to date (Figure 2).



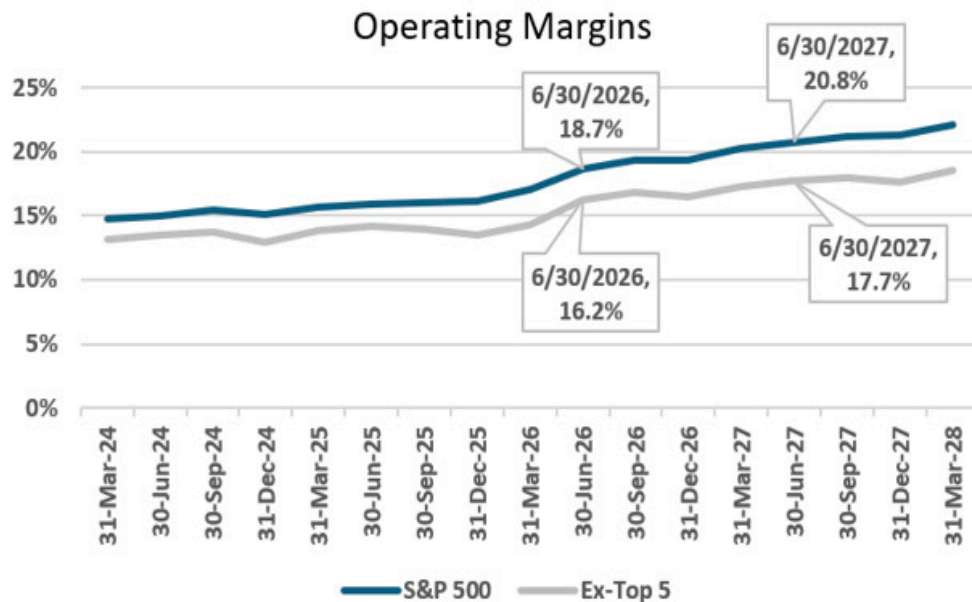
Source: AAM, Nymex, ICE and Bloomberg

Corporate margins remain resilient but cracks emerge

Margins expanding, but slowing

Over the last twelve months, operating margins of the S&P 500 have expanded by more than 250bps to nearly 19% (Figure 3). The expansion has been broad across nearly every sector, with Information Technology and Energy leading the way. Over the next twelve months, we continue to expect margin expansion, just not at the pace of the past year. Sectors that we expect to see margin weakness include Energy, Consumer Cyclicals, Consumer Non-Cyclical, and Financials.

Figure 3



Source: AAM, Bloomberg

Energy margins to contract; credit stable

Provided the backwardated nature of the crude and diesel futures curve, we expect margins in the energy sector to contract beginning in 2Q27. Despite this outlook for commodities, our internal view of fundamentals for the energy sector is stable based on the overall credit quality of the industry.

Retail bifurcated; 2027 earnings tough

Bifurcation is the story in Retail. The K-shaped consumer remains intact, with high-end and off-price retailers taking share while mass-market and department stores fight weaker traffic and smaller baskets. Shoppers are visiting more often but spending less per trip. Trade-down from middle- and upper-income households is a tailwind for discounters, but it comes at a cost: mix is shifting toward lower-margin consumables and private label, squeezing gross margins at mass merchants and dollar stores. We expect gross margin comps to ease in 2H26 and into 2027 as tariff periods are lapped, but wages, capex, inventory normalization, and restructuring costs make 2027 earnings growth a heavy lift, even as sales stabilize.

Food & Beverage: 2027 transition year

The margin squeeze hasn't gone away in the Food & Beverage sector, but it has rotated. The 2025 cocoa and coffee spikes (e.g., Hershey's operating margin fell from 25.9% to 12.3%) has given way to energy-linked inputs in 2026: oil, resins, and freight. Pricing power is largely tapped out after the 2022–2024 increases. According to Food Business News, pricing is back to 2–3% and volumes are expected down approximately 1–2%. Private-label goods are gaining, as the 27% price gap risks widening, forcing brands to spend on promotion, while GLP-1s and healthier eating add structural headwinds.

Bank earnings growth tempered

Meanwhile, Banks are competing for deposits and higher wholesale funding costs are limiting the benefit from higher asset yields, while commercial loan growth has slowed. Capital markets activity has also become less consistent after a strong start to 2026, reducing fee-revenue support and tempering overall earnings growth.

Politics Are Influencing Cost of Capital in France and California

French budget hard to deliver

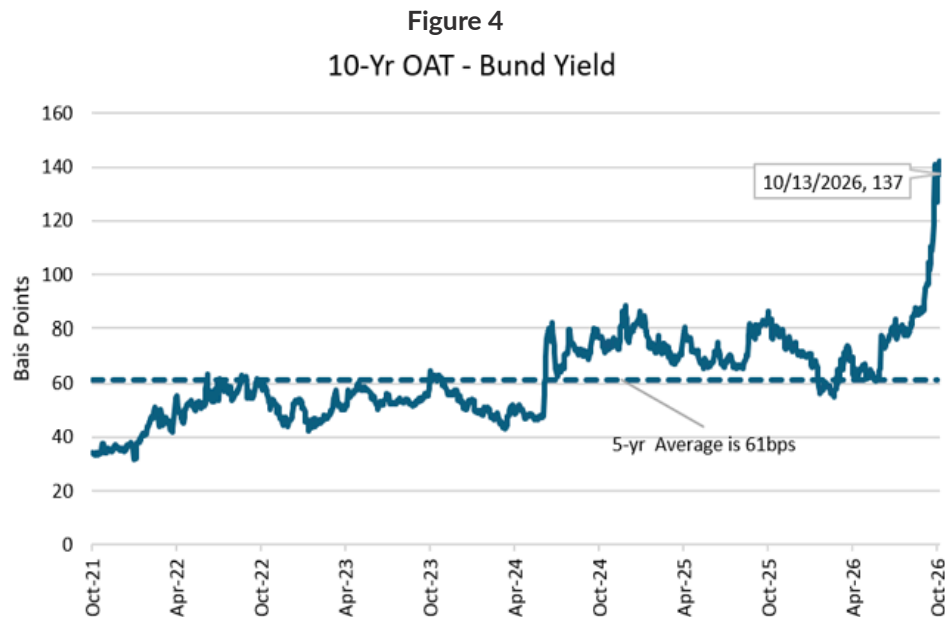
French fiscal and political risk intensified during the quarter as the government presented its 2027 budget and attention shifted toward next spring's presidential election. The budget includes €43 billion of measures to reduce the deficit from 5.4% of GDP in 2026 to 5.0% in 2027, but delivering that adjustment will be difficult without a parliamentary majority. Passage will likely require concessions to opposition parties and may require invoking Article 49.3. Barclays forecasts a 5.5% deficit and debt of roughly 121% of GDP in 2027, versus the government's 5.0% deficit target,⁷ reflecting a more conservative growth outlook, higher borrowing costs and the likelihood that political concessions dilute the planned fiscal adjustment.

Election adds fiscal uncertainty

The approaching presidential election further complicates the path to fiscal consolidation. In an October 12 Toluna-Harris Interactive poll, Marine Le Pen received 35% of first-round voting intentions, compared with 18% for Jean-Luc Mélenchon⁸. Le Pen has sought to strengthen National Rally's fiscal credentials with a multi-year consolidation plan and a proposed constitutional "golden rule" aimed at putting debt/GDP on a declining path. While that shift has eased some concerns about an RN government, questions remain about the feasibility of the proposed savings. Mélenchon's support also highlights the possibility of a more expansionary fiscal policy outcome. Uncertainty may extend beyond the presidential vote: subsequent parliamentary elections could determine how much of any fiscal program can actually be implemented.

Higher OAT yields strain budget

The rise in French borrowing costs is now adding to that challenge. The 10-year OAT-Bund spread (Figure 4) widened from roughly 85bps to above 150bps at its widest, while the 10-year OAT yield approached 5%. Higher global rates, crowded positioning and poor liquidity amplified the selloff, and OATs have since retraced part of the widening. However, borrowing costs remain well above the assumptions underlying the government's budget. If sustained, higher rates will increase interest expense, making the fiscal targets harder to achieve and reinforcing the pressure that drove the repricing in the first place.



Source: AAM & Bloomberg; the spread represents the French 10Y OAT yield minus the German 10Y Bund yield.

California Utilities Wildfire Liabilities Remain Uncertain

Wildfire reform bill failed

Late in the third quarter, California Governor Newsom's proposal to provide legislative support to California utilities in the face of mounting wildfire risk failed to make it to the floor for a vote. The watered-down bill left out Newsom's proposal to shift wildfire liability costs away from utilities, including moving more of the cost of utility-sparked fires onto property insurers. It also left out a shield against insurer subrogation lawsuits. Additionally, the bill failed to attract support from consumer advocates as it shifted costs onto insurers and victims.

Utility tail risk unresolved

For bondholders, the main issue is that the underlying problem is unresolved. Lawmakers neither decoupled utility liability from the wildfire fund's solvency nor added a replenishment mechanism. The roughly \$21 billion California Wildfire Fund has no permanent way to refill and claims from the January 2025 Eaton Fire could deplete it faster. In our view, California utilities therefore still carry open-ended tail risk if a large fire exhausts the fund. Therefore, California utility debt will likely carry wider spreads and potential ratings pressure. The risk is a prolonged period of credit uncertainty until a durable fix passes with the earliest reform likely to take place during the legislative session in 2027.

Sources:

¹ S&P Global Ratings, "S&P Global Ratings' View on Artificial Intelligence and Hyperscalers," Aug. [day], 2026;

² Moody's Ratings, "Rising Tech Debt More Risk or Reward? A Moody's perspective," Bloomberg Intelligence webinar, Sept. 29, 2026.;

³ BofA Global Research, "AI Data Center Construction 101 – Ask the Expert," Aug. 17, 2026;

⁴ Stifel, "Data Center Project Tracker: Data Center Project Tracker: Trends in Texas & Ohio Remain Robust," Oct. 1st, 2026 (Aterio data);

⁵ Wells Fargo, "Hyperscaler spreads: Priced as one trade, not seven credits," data as of Aug. 18, 2026;

⁶ Barclays, "AI Infrastructure Financing: Tracking Issuance Across Asset Classes," Aug. 20, 2026.

⁷ Barclays Research, Euro Themes: French Politics and Fiscal Policy – A Budget of Transition, October 2, 2026.

⁸ Toluna–Harris Interactive, Baromètre de l'élection présidentielle 2027, Wave 7, commissioned by RTL and M6, fieldwork October 5–8, 2026; published October 12, 2026. First-round voting intentions: Marine Le Pen 35%; Jean-Luc Mélenchon 18%. RTL coverage

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