CIBC PRIVATE WEALTH



JAMES DIXON, CIM®: MACRO THOUGHTS – OCT 28, 2026

HIGHER RATES: WHY EQUITIES CAN STILL OUTPERFORM

EXECUTIVE SUMMARY

The relationship between interest rates and equities has become one of the defining investment debates of 2026.

Conventional wisdom suggests that higher bond yields should pressure equity valuations, increase borrowing costs and ultimately constrain economic growth. Yet global equities have demonstrated remarkable resilience despite a substantial increase in government bond yields.

I believe the explanation lies in a fundamental distinction: higher interest rates driven by stronger economic growth are materially different from higher rates driven by deteriorating inflation expectations, weakening growth or financial instability.

My constructive outlook on equities remains intact, supported by four central observations:

- **Earnings growth is offsetting valuation pressure**. Corporate profitability has accelerated sufficiently to absorb higher discount rates, allowing equities to appreciate even as valuation multiples compress.
- **The economy remains in a mid-cycle expansion**. Fiscal spending, resilient corporate investment and the structural AI capital expenditure cycle continue to support economic activity.
- **Quality is becoming increasingly important.** Higher rates are exposing vulnerabilities among smaller, more leveraged businesses, while companies with strong balance sheets and durable free cash flow remain comparatively insulated.
- **Technology remains a compelling structural opportunity.** The extraordinary investment in artificial intelligence is beginning to translate into commercial adoption, with the potential for substantial earnings growth as capital expenditure converts into revenue.

My investment thesis therefore remains unchanged: remain constructive on equities, emphasize quality and maintain meaningful exposure to the beneficiaries of the AI investment cycle. However, as bond yields rise, earnings execution becomes increasingly important, and security selection should take precedence over indiscriminate market exposure.

1. RATES, EARNINGS AND THE GORDON GROWTH MODEL

Higher interest rates are generally considered a headwind for equities. As government bond yields rise, investors demand higher returns from risk assets, increasing the discount rate applied to future corporate earnings. All else equal, this reduces the present value of those earnings and places downward pressure on valuations.

However, the relationship is not one-dimensional.

The Gordon Growth Model provides a useful framework for understanding the interaction between interest rates and equity valuations:

$$P_0 = \frac{D_1}{r - g}$$

P= The present value of the equity.
D1 = The expected dividend in the next period.
r = The required rate of return.
g = The expected perpetual dividend growth rate.

The model illustrates two competing forces.

- Higher interest rates increase the required return, placing downward pressure on valuations.
- Stronger expected earnings and dividend growth can offset this pressure by supporting higher future distributions and, where sustainable, a higher long-term growth assumption.

This distinction is particularly relevant today!

The US 10-year Treasury yield increased circa 100bps through early October, while global equities continued to advance driven by resilient corporate profits (over the preceding year, S&P 500 corporate profits increased approximately 30%).

The result has been a market characterized by rising equity prices alongside declining price-to-earnings multiples. Investors are not necessarily paying more for future earnings. Rather, corporate profitability has increased sufficiently to support higher equity prices despite a less accommodating interest-rate environment.

While the Gordon Growth Model simplifies the valuation of businesses that reinvest rather than distribute earnings, its underlying principle remains instructive.

Higher yields are not inherently bearish for equities. What matters is whether the growth in corporate earnings and cash flows is sufficient to compensate investors for a higher required return. This is the case today.

This thesis is further supported by investment flows. For context, higher bond yields have not triggered a meaningful rotation out of equities. Instead, investor flows have remained positive across both asset classes which suggests that investors continue to recognize the distinct roles of fixed income and equities within diversified portfolios. It could similarly suggest, that investors are looking for protective equity allocations to offset portfolio fragility as opposed to using traditional 60/40 models to offset risk.

Key insight: For long-term investors, valuation remains important, but earnings growth ultimately determine whether companies can justify their valuations in a higher-rate environment. This again underscores the importance of quality holdings.

2. INFLATION AND MONETARY POLICY: A MORE NUANCED OUTLOOK

The latest US inflation report reinforces the complexity of the monetary policy outlook.

The September headline CPI increased 0.6% month-over-month and 3.7% year-over-year, while core inflation reached 2.6% annually. Higher energy prices contributed meaningfully to the headline increase,

although underlying price pressures remain sufficiently persistent to complicate the Fed's policy response.

The report challenges expectations for an imminent easing cycle (my base case at the beginning of the year) and raises the possibility that restrictive monetary conditions persist longer than previously anticipated. Nevertheless, my expectation for limited additional monetary tightening remains grounded in three considerations.

1. **Interest-sensitive sectors are already experiencing pressure.** Residential investment and other financing-dependent areas of the economy remain vulnerable to elevated borrowing costs. Monetary policy operates with a lag, and additional tightening risks exacerbating weakness in these sectors.
2. **The labor market appears softer beneath the headline economic data**. While AI-related capital expenditure has supported aggregate investment and corporate profitability, the corresponding increase in employment has been comparatively modest. This distinction is important: an economy can experience substantial productivity-enhancing investment without generating the wage pressures traditionally associated with an overheating expansion.
3. **Fiscal financing requirements complicate the policy outlook.** Substantial US Treasury issuance, particularly at the front end of the yield curve, increases the sensitivity of government financing costs to short-term interest rates. While this does not directly determine Fed policy, it represents an increasingly important consideration for financial conditions and fiscal sustainability.

Taken together, these factors support my expectation that the scope for additional tightening remains limited, although persistent inflation represents a meaningful risk to this outlook.

Key insight: Importantly, my constructive equity thesis does not depend on aggressive monetary easing. A period of relatively stable interest rates, accompanied by continued earnings growth, would provide a sufficiently supportive environment for quality equities.

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3. THE MID-CYCLE EXPANSION: QUALITY MATTERS

In my previous thesis (Aug 5 - POSITIONING FOR THE NEXT PHASE OF THE BULL MARKET) I argued that the economy was transitioning into a more mature phase of expansion rather than approaching the end of the cycle. Recent market behavior continues to support this interpretation.

Typically restrictive interest rates would be expected to constrain credit creation, weaken investment and eventually reduce corporate profitability. Yet the current cycle has distinguishing characteristics that turn this thesis on its head.

Large government deficits continue to provide fiscal support, while substantial investment in AI infrastructure is sustaining corporate capital expenditure. At the same time, much of this investment is being undertaken by exceptionally well-capitalized technology companies, making it less sensitive to borrowing costs than traditional economic activity.

The result is an economy that may tolerate higher interest rates than investors previously anticipated.

However, this resilience is not uniform. Morgan Stanley, in a recent thought piece highlights that more than half of the 3,000 largest U.S. stocks experienced drawdowns of at least 20% between June and early October. Meanwhile, spreads on lower-rated credit widened, and publicly traded business

development companies came under pressure. These developments reveal an important distinction between the resilience of market indices and the financial health of the broader corporate universe. Higher rates may not derail the overall expansion, but they are increasingly exposing weaker businesses within it.

This reinforces my preference for quality ie companies with strong balance sheets, durable competitive advantages, pricing power and consistent free cash flow. Businesses dependent on refinancing or external capital face growing pressure, while companies capable of financing growth internally retain considerable strategic flexibility.

Key Insight: I continue to favor quality businesses across technology, financial services, insurance, healthcare services and other industries capable of generating attractive returns on invested capital without excessive leverage.

As the expansion matures, I believe the dispersion between high-quality companies and financially weaker businesses will continue to widen.

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4. TECHNOLOGY AND AI: THE OPPORTUNITY

Technology remains a central component of my constructive equity outlook, notwithstanding concerns regarding market concentration, elevated capital expenditure and the sustainability of AI-related investment.

In my September thesis (Sep 30 - THE AI OPPORTUNITY IN THE EVOLVING CYCLE), I argued that artificial intelligence represents a structural investment cycle capable of generating substantial productivity improvements and long-term earnings growth. I continue to hold that view.

Goldman Sachs, in a though piece argued a similar narrative. They highlighting an important disconnect between the timing of AI investment and the realization of its financial benefits. They note, the largest technology platforms have undertaken extraordinary capital expenditure commitments to develop computing infrastructure, data centres and cloud capacity but the revenue associated with this investment may lag expenditure by three to six quarters.

This creates a period in which capital intensity increases before the full commercial benefits become visible in reported earnings. Importantly, investors should not confuse this timing mismatch with evidence that the investment cycle is economically unsustainable. 3 factors underpin this conviction.

1. **Commercial adoption is accelerating**. AI is transitioning from an experimental technology into practical applications across enterprise software, cloud computing, consumer platforms and business automation. As adoption broadens, the opportunity increasingly shifts from building infrastructure toward monetizing the capabilities that infrastructure enables.
2. **The largest technology platforms possess structural advantages.** Their distribution networks, existing customer relationships, proprietary data, computing capacity and substantial financial resources provide meaningful competitive advantages. These companies are also better positioned to absorb elevated capital expenditure without compromising financial stability.
3. **Returns on invested capital may improve as revenue catches up with investment**. If the substantial growth in cloud backlogs translates into recognized revenue, investors may begin to see stronger evidence of the economic returns generated by the AI build-out.

This thesis is particularly important in the context of higher interest rates. As illustrated by the Gordon Growth Model, higher discount rates place downward pressure on valuations. However, businesses capable of generating substantial incremental earnings growth can offset that pressure (paragraph 1).

I therefore continue to favor established U.S. mega-cap technology businesses with durable competitive positions, strong balance sheets and identifiable pathways to AI monetization ie quality! Not indiscriminate exposure to AI-related securities. Elevated infrastructure spending must ultimately generate returns above the cost of capital, and companies unable to demonstrate economic profitability remain vulnerable to valuation compression.

Key Insight: The next phase of the AI opportunity will increasingly be defined by monetization rather than capital expenditure announcements. As revenues begin to catch up with investment, the leading technology platforms may continue to deliver earnings growth capable of supporting valuations despite elevated bond yields.

5. PORTFOLIO POSITIONING & RISKS

My portfolio positioning continues to reflect the constructive outlook outlined in my previous investment pieces.

I favor maintaining meaningful equity exposure to quality (ie earnings durability and balance-sheet strength). I particularly favor those that stand to benefiting from structural growth opportunities on the back of artificial intelligence.

Three developments would cause me to reassess my outlook:

1. **Runaway inflation forcing additional monetary tightening.** A broadening of inflation beyond energy, accompanied by sustained increases in core inflation and inflation expectations, could force the Fed to tighten more aggressively than anticipated.
2. **Deteriorating corporate earnings**. Higher yields become materially more problematic when earnings growth slows. A combination of declining profitability and elevated discount rates would challenge my constructive equity thesis.
3. **Disappointing AI monetization.** If capital expenditure continues to accelerate without corresponding improvements in revenue, free cash flow and returns on invested capital, valuations across the technology sector would become increasingly vulnerable.

Key insight: For now, the balance of evidence continues to favor an ongoing economic expansion, albeit one characterized by greater differentiation between companies and increasing sensitivity to earnings.

CONCLUSION

The resilience of equity markets in the face of higher interest rates is not necessarily a contradiction. Rather, it reflects an environment in which corporate earnings growth, substantial fiscal spending and the structural AI investment cycle have been sufficiently powerful to offset pressure from rising discount rates.

The Gordon Growth Model provides a useful framework for understanding this relationship: while higher rates place downward pressure on valuations, stronger earnings growth can more than compensate for that effect.

The latest inflation data complicates the monetary policy outlook increasing the possibility that interest rates remain elevated for longer than previously anticipated. Nevertheless, I do not believe higher yields alone invalidate the constructive equity thesis developed throughout my recent work.

The central argument remains consistent:

- **Mid cycle.** The economy is experiencing a mid-cycle expansion,
- **Earnings**. Corporate profitability remains the principal driver of equity returns
- **Quality.** Quality businesses are best positioned to navigate a higher-rate environment.

Technology remains particularly compelling. The extraordinary investment in AI infrastructure is beginning to transition toward commercial adoption. The full earnings potential of that investment has yet to be realized.

Bottom line:. Higher rates do not necessarily end bull markets, but they expose weak business models, penalize excessive leverage and demand greater discipline in capital allocation.

I remain constructive on equities, with a preference for quality. In an environment where capital is no longer inexpensive, owning the right businesses matters more than simply owning the market.

CONTACT

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