

BREAKOUT CAPITAL
in strategic partnership with Rockefeller Capital Management

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EM Revival Quarterly *Q3 2026*

Review and Outlook

The defining story of the past few weeks across the world has been exceptionally narrow market breadth. As the AI trade continues to dominate global markets, breadth has collapsed. It's hard to overstate how narrow this global market has become, with most companies, industries and countries outside the AI stack struggling to generate any returns.

As we've pointed out before, three semiconductor stocks in two countries dominate the EM index, which lists 1100 stocks in 24 countries. The overall market-cap weighted EM index has risen more than 20% this year, but only 26% of the stocks and just 2 of the 11 sectors have outperformed the index. At the country level, Taiwan and South Korea have driven all the gains and more; the other 22 markets in the index are down 4% in total. The equal-weighted EM index has lagged the more widely followed market-cap weighted EM index by a massive 11 per cent per year since the AI trade got going in late 2022. Prior to that the equal-weighted index had beaten the market-cap weighted index since its inception in 1998. We construct the portfolio using an equal-weighted framework because we think it is the best way of generating higher absolute returns over time.

As the WSJ noted recently:

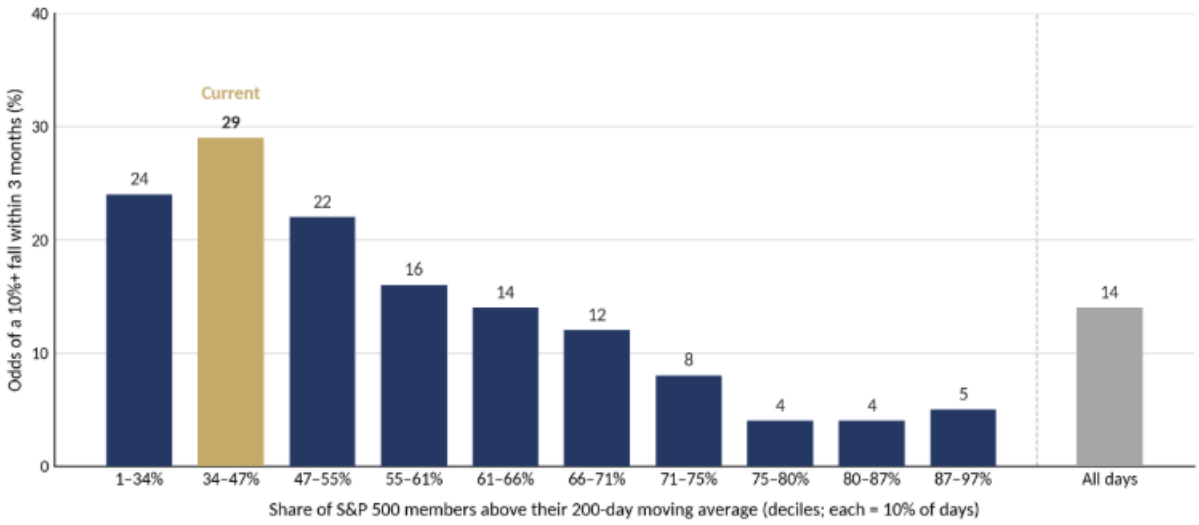
> *"The equal-weighted version of the S&P 500 has been trounced by the widely followed capitalization-weighted version for years now. That went into overdrive when ChatGPT was released in November 2022 and AI became the only game in town.*
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> *When one group of large companies opens up a big gap in just a handful of years, it precedes an even faster reckoning, and usually a bear market. Great technological advancements don't change that. The pattern held for radio, the Nifty Fifty and dot-coms, and this time probably isn't different.*
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> *Since ChatGPT's unveiling, the capitalization-weighted S&P 500 has earned nearly 50 percentage points more of total return than the equal-weighted one. To pick a historically similar moment to ChatGPT, the S&P 500 was beating its equal-weighted twin by an almost identical amount the same number of trading days after Yahoo's 1996 initial public offering.*

Maybe the equal-weighted index is just worse? Nope. It has beaten the S&P 500 since 1990. That's no accident because keeping an equal weighting forces an index to favor smaller, cheaper stocks—two factors known to boost long-run returns.

The more interesting point is when an equal-weight index wins. Like a rubber band stretched tight, it catches up a lot more quickly—and painfully—than it took to pull it into that shape."[1]

In the US, only one in three stocks and three of the 11 sectors outperformed the S&P 500 this year. The divergence has been especially pronounced over the past month, with the S&P 500's ex-AI cohort trailing the full index by 8 percentage points—the widest gap since the AI trade began nearly four years ago. When market breadth becomes this narrow, the historical likelihood of a reversal typically rises sharply [*see chart below*].

S&P 500 – Historical odds of a fall more than 10% within the next 3 months, by breadth



Source: Bloomberg, Breakout Capital Calculations, As of September 30, 2026.

Our research also shows that, over the last 300 years, all the major market bubbles have burst due to an increase in rates or some other tightening of financial conditions. And we believe this will be the case with the AI bubble as well. While the headline equity indices are still stable, pressures have already started to build in the weak segments of global markets, including very high yield parts of the US market and among the more heavily indebted nations of Europe. We believe higher rates – driven by persistently large debt and deficits in developed economies – will continue to percolate to other parts of the market and eventually disrupt the massive financing needed to keep the AI spending binge going.

[1] Jakab, Spencer, "Narrow Stock-Market Rallies Aren't Unusual. When to Start Worrying", *The Wall Street Journal*, October 12, 2026.

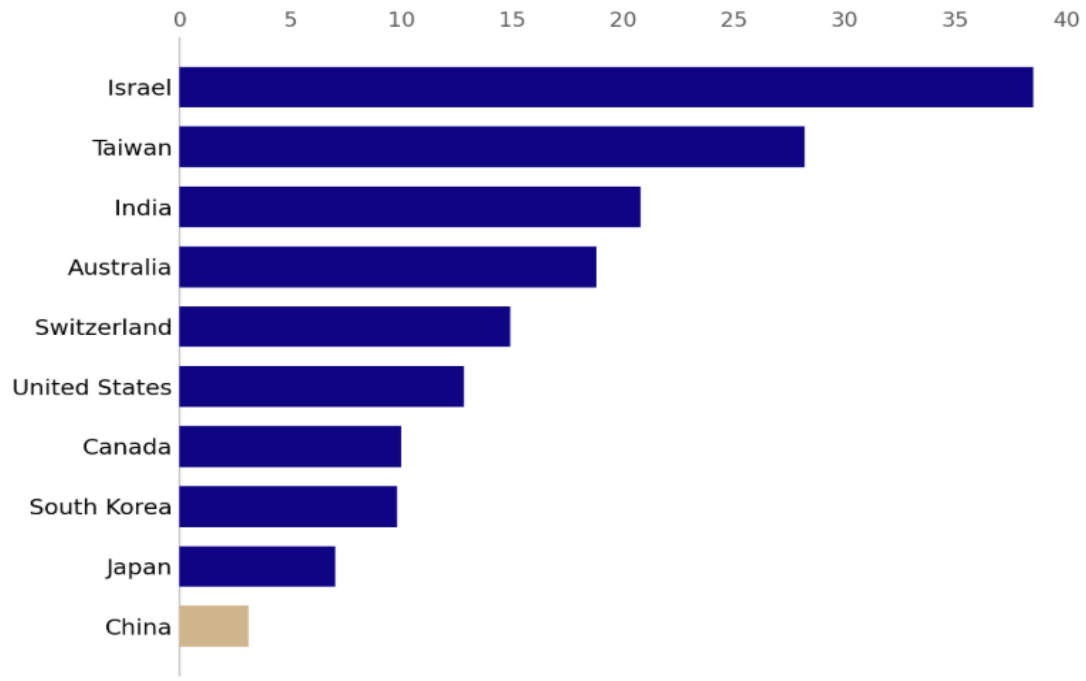
The Mystery of China

Our China allocation and stock selection continued to detract from returns in the third quarter of 2026. While we have long been bearish on China's economy, the fact is that the economy has grown but its shareholders have hardly benefitted. Since 1995 the economy has expanded more than 27-fold, from about $700 billion to $20 trillion, while the equity market is up just 4x. We think the reasons come down to three hurdles: extreme competitive intensity, excessive state intervention and heavy share issuance.

A 2025 study by HSBC[2] dramatized the problems created by heavy issuance. It was found that over the last decade, earnings grew 10 percent a year, but new issues diluted earnings per share just as fast, offsetting the gains. In all, this dilution left China's earnings per share growth behind South Africa's 4.5%, even though China's economy grew six times faster in dollar terms (10.8% a year against 1.8%). This also explains why, unlike in most EMs, in China long term EPS growth and stock market returns are not correlated with nominal GDP growth.

This is an especially problematic issue for us as we look for stocks that can compound steadily over time. China has more than 2200 companies worth over $1 billion, which exceeds even the 1800 listed in the US. Yet fewer of these large firms have seen their share price quintuple over the past decade in China than in any other major market [*see chart below*].

Proportion of Companies That Are Steady Compounders
(Percent)



Source: Bloomberg, Breakout Capital Calculations. As of September 30, 2026.

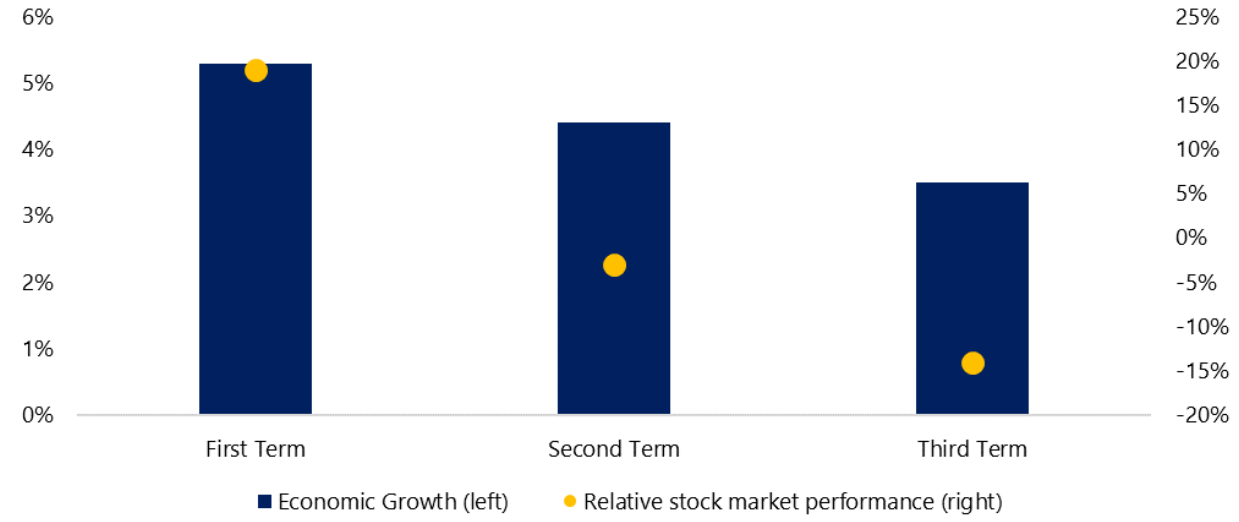
[2] *HSBC Global Research*, "GEMs Equity Quarterly: The EM bull case is holding together", July 11, 2025.

Since inception, 86% of the Chinese holdings in our flagship EM Revival Fund portfolio have seen earnings growth upgrades – highlighting our success in selecting high-quality businesses. However, more than 90% of our holdings have seen a sharp drop in their valuations. This reflects the minefield of investing in China, where even firms with strong earnings growth are de-rating. The poor returns of the overall Chinese market in recent years are particularly telling given all the hype around China as the only major competitor to the US in the AI race. We have been highly selective in our exposure to China and will be even more so given the persistently disappointing performance of this market.

Looking Beyond AI

On the other hand, we see idiosyncratic opportunities in countries outside the AI spotlight. For example, the recent first round election results in Brazil showed a strong tilt to challenger Flavio Bolsonaro – a more market friendly and orthodox leader than the current president. With the second round a few weeks off, the risk-reward seems favorable. Our research shows that the prospect of a new leader often triggers a market rally [*see chart below*], typically beginning almost 6 months before the actual election result.

Economic and Financial Market Impact by Leadership Term
(Percent)



Source: Haver, National Sources, Breakout Capital Calculations based on data across 30 major emerging markets, using elections held between 1980 and 2025.

Investors are betting that a new government with a working majority could finally take on the fiscal mess that has held Brazil back for a decade. A return to policy orthodoxy could lower inflation expectations, allow the central bank to start a cutting cycle in earnest, and lower the equity risk premium. This would complement Brazil's external strengths, namely rising oil production in a higher for longer oil price regime, making its stock market increasingly attractive. Brazilian equities are up 37% this year but remain relatively cheap.

Brazil thus ranks high on our country selection framework, which focuses on 10 fundamental drivers with a proven record of anticipating durable growth, from politics to debt and market sentiment. This careful, wide-angle approach may seem a bit stodgy when markets are obsessed by hype for one hot new thing, as they are now. But we believe it's well suited to picking countries likely to thrive when the mania of the moment passes, as it often has in the past.

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The MSCI Emerging Markets Index (the "MSCI EM Index") is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity market performance of large- and mid-capitalization companies across emerging market countries.

MSCI EM Semiconductor Index measures the performance of semiconductor companies in emerging markets, as defined by MSCI's index methodology; **MSCI EM Equal Weighted Index** tracks emerging-market equities with equal weights assigned to constituents rather than weights based on market capitalization; **Capitalization-weighted S&P 500 Index** weights constituents according to their market capitalization, giving larger companies greater influence on the index's performance; **S&P 500 tracks 500** is an index of leading U.S. companies and represents a broad cross-section of the U.S. large-cap equity market; **Equal-weighted S&P 500** gives each constituent approximately the same weight, reducing the influence of the largest companies relative to the standard capitalization-weighted index.

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For accredited investors only

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