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2026 3rd Quarter Review

ECONOMIC COMMENTARY

Geopolitics created headwinds for both stocks and bonds in the third quarter. The June memorandum of understanding between the United States and Iran, which had raised hopes for a durable end to the conflict, unraveled within weeks as the two nations exchanged hostilities. The 60-day negotiating window established in June expired on August 17th without a settlement, and diplomacy remained stalled into quarter-end. In the final week of September, President Trump rebuffed an Iranian peace proposal, three more vessels were struck in the strait, and the two sides were trading proposals over a possible seven-day ceasefire as the quarter closed.

While markets have seemingly adjusted to what was supposed to be a "four- to six-week" operation in Iran now looking more like a prolonged stalemate, the impact on energy costs has been difficult to ignore. Brent crude, which had retreated toward $78 per barrel in mid-June on hopes of peace, round-tripped to roughly $84 by late July and then climbed steadily once the negotiating window lapsed, breaking above $100 on September 9th.

The elevated cost of energy eventually forced the Fed's hand. After holding the federal funds target range at 3.50%-3.75% in July, Chairman Kevin Warsh used his August Jackson Hole address to signal a lower tolerance for upside inflation surprises, and at the September meeting the Federal Open Market Committee (FOMC) voted unanimously, 12-0, to raise the target range by a quarter point to 3.75%-4.00%. The Fed's updated "dot plot" lifted the median year-end funds rate projection to 4.1%, implying one additional quarter-point hike in 2026 and no change in 2027. The Fed was not alone in tightening, as the European Central Bank and Bank of Japan also raised rates in September, underscoring that the energy shock has become a global inflation problem.

Were it not for the Iran war and the associated spike in energy prices, the Fed would likely have viewed the quarter's inflation data favorably. Headline CPI rose 3.4% year-over-year in both July and August, down from the 4.2% pace reported for May, while core CPI, which excludes food and energy, eased to 2.4% in August. Energy remains the driving inflationary force, as the CPI energy index was up more than 16% over the past year and gasoline alone accounted for over a third of August's monthly increase. The Fed's preferred gauge, the personal consumption expenditure (PCE) price index, rose 3.4% year-over-year in August on a headline basis and 3.0% excluding food and energy, both below expectations.



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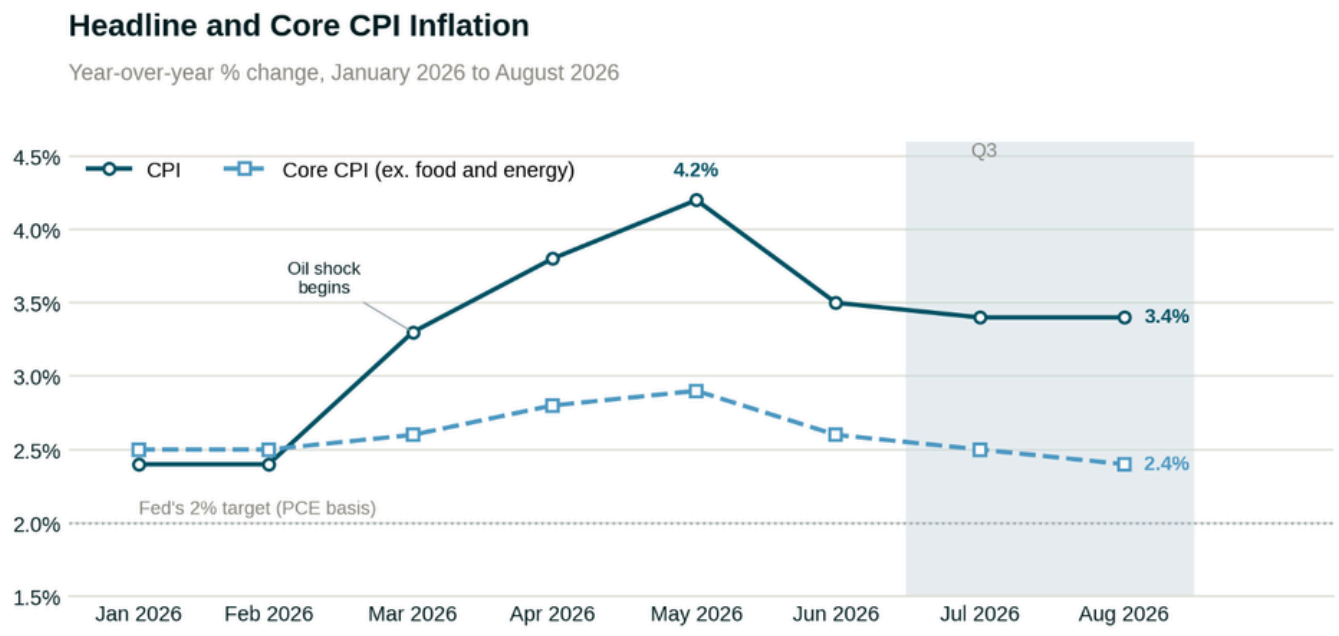
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Energy costs are beginning to impact prices in the core data, however. The trickle-down impact of higher fuel costs was most visible in the transportation category as airline fares rose 2.7% in August and are up 23.4% compared with a year ago amid higher jet fuel costs. Pipeline pressures are also building at the wholesale level, where processed goods prices increased 1.8% in August. That suggests higher fuel, freight, and petrochemical input costs may reach consumer goods prices in the coming months. The Fed recognizes this and the hawkish shift in interest rate policy reflects an attempt at preventing a temporary energy shock from becoming embedded in broader prices.

Prices rising faster than paychecks are taking a toll on households. Real average hourly earnings were down 0.3% year-over-year in August, the personal saving rate remains near its lowest level since late 2022, consumer confidence fell to a 12-year low in September, and one-year-ahead inflation expectations in the University of Michigan survey jumped to 4.6%.

Despite the strain on consumers, the broader economy has proven resilient and robust. Second-quarter GDP was revised up sharply to a 2.2% annualized rate from 1.5% previously, and first-quarter growth was revised up to 2.5%. The labor market, however, ended the quarter on a softer note. After a strong August, nonfarm payrolls rose by just 29,000 in September, well below the roughly 84,000 consensus estimate, and revisions to prior months subtracted 60,000 jobs, including a downward revision of August's gain to 133,000 from 162,000. The unemployment rate edged up to 4.2% from 4.1%, although the increase largely reflected more people entering the labor force rather than a wave of layoffs, with the participation rate rising to 61.8%. The report reinforced the "low-hire, low-fire" pattern that has persisted all year and shifted expectations for monetary policy, with markets now pricing a high probability that the Fed holds rates steady at its late-October meeting rather than hiking again.

Exhibit 1. Headline and Core Inflation: CPI



Data Source: Bureau of Labor Statistics. Chart by VestGen.

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MARKET COMMENTARY

Equity market performance was resilient amidst the geopolitical turmoil, oil above $100, and the first Fed rate hike in three years. The S&P 500 gained 2.0% for the quarter to close at 7,652 after setting a record close of 7,799 on August 13th, its 27th all-time high of the year. The Nasdaq Composite gained 2.5% and reached its own record close on September 22nd, while the Dow Jones Industrial Average fell 2.7% for the quarter, including a 4.3% decline in September, after closing above 54,000 for the first time in early August. The headline index performance masks a sharp shift beneath the surface, however. The broadening of market leadership from Q2 largely stalled, and by September the market was once again being carried by a narrow group of technology and semiconductor names.

Market breadth deteriorated significantly in September. Of the eleven S&P 500 sector funds, only Technology finished the month higher, gaining roughly 5%, while semiconductor stocks rose more than 11%. The other ten sector funds declined, led by Materials, Real Estate, Consumer Discretionary, and Utilities, each down roughly 6-7%. Rate-sensitive and income-oriented sectors bore the brunt of rising Treasury yields, since bonds now offer competitive income without equity risk, while high fuel costs weighed on consumer-facing companies. Even Energy fell in September despite higher crude prices, although it remained the top-performing sector year-to-date, while Consumer Discretionary is the weakest. At quarter-end, only 21% of S&P 500 stocks were above their 50-day moving average and just 40% were above their 200-day, both signs of declining stock market momentum.

Earnings results provided fundamental support for higher equity valuations. Second quarter S&P 500 earnings grew roughly 50% year-over-year, although that figure was inflated by large mark-to-market gains on equity investments at Alphabet and Amazon. Excluding those two companies, earnings still grew a very strong 32%, on revenue growth of 15%, the fastest since 2021. Expectations for the third quarter rose as the quarter progressed, with analysts now projecting earnings growth of approximately 29% and revenue growth of approximately 12%, which would mark a third consecutive quarter of earnings growth above 25%.

Semiconductors are driving most of the growth, with chipmakers and equipment suppliers projected to grow third-quarter earnings by roughly 126%, and AI spending commitments continue to build. Because earnings have grown faster than prices, the market's forward valuation has compressed this year. The concentration of that growth, however, leaves the market more exposed to any slowdown in data center spending. While the hyperscalers have shown no interest in slowing down, public sentiment may lead to a tougher regulatory environment. An August survey from the University of Pennsylvania's Annenberg Public Policy Center found that 61% of U.S. adults oppose data center construction in their area, a 12% increase over four months, with opposition crossing party lines. As a result, data centers have become a campaign issue in the November midterms. While a national ban is unlikely, it is possible that elections lead to a slower permitting environment as state and local governments tighten rules on the construction of new data centers and regulate the resource use of those already in operation.

Small-cap stocks gave back some of their second-quarter leadership as rising rates weighed on smaller companies, which tend to rely more heavily on floating-rate and short-term financing, leaving the Russell 2000 index down 7.2% for the quarter but still up 14.1% year-to-date. Valuations for small and mid-sized companies remain attractive relative to large caps, and we continue to believe that broader adoption of AI should support productivity gains for companies of all sizes, but the near-term path for the asset class is closely tied to the direction of interest rates.

International markets faced a tougher backdrop in the third quarter following their strong first half. Developed-market equities, measured by the MSCI EAFE Index, were flat during the quarter, while emerging-market equities declined 2.4%, as measured by the MSCI Emerging Markets Index. A firmer U.S. dollar late in the quarter, higher energy costs for import-dependent economies in Europe and Asia, and the European Central Bank's September rate hike all served as headwinds. Japanese equities mirrored the narrowing leadership seen in the US. The Nikkei 225, which is heavily weighted toward semiconductor names, climbed back above 66,000 on AI-led buying, while the broader TOPIX lagged and rate-sensitive shares came under pressure.



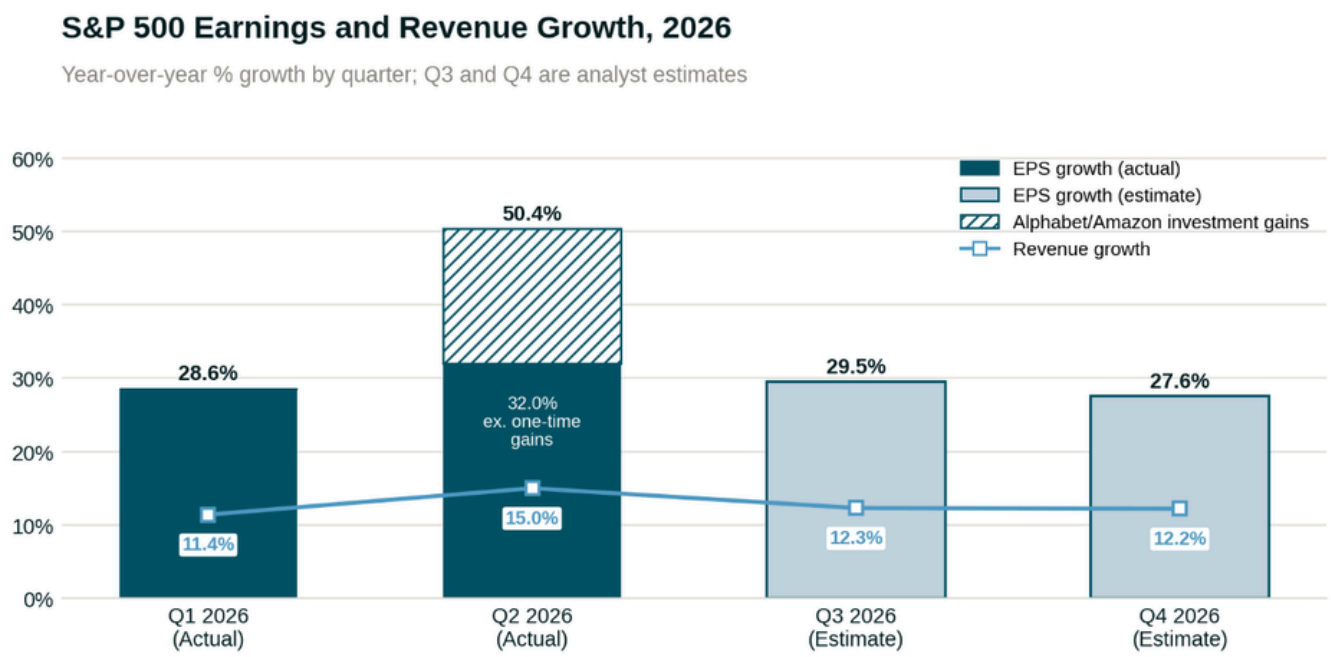
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Rising yields in Japan matter well beyond its borders. Japan could see more of its domestic capital stay home as local bond yields become more competitive, removing a long-standing source of demand for US Treasuries and other foreign bonds at a time when global borrowing costs are already climbing. The Yen carry trade, in which traders borrow Yen at a low rate and purchase assets in a country with higher yields, looks relatively less attractive in this environment and the higher volatility in currencies makes it more difficult for investors to hedge against exchange rate risk.

Bonds markets rarely dominate the headlines, but the sharp move higher in long-term rates was arguably the biggest development during the quarter. The 10-year Treasury yield rose from roughly 4.4% at the start of the quarter to 5.29% on September 30th, crossing 5% in mid-September for the first time since 2007 and reaching its highest level since 2002 by quarter-end. The 30-year yield climbed above 5.6%, also its highest since 2002. The rate increase has been global, with government borrowing costs in Britain, France, and Japan also reaching multi-decade highs. The rate move was driven by energy-driven inflation, central bank policy, strong economic data, concerns over US federal debt exceeding $40 trillion, and competition from heavy corporate bond issuance as the hyperscalers finance their AI buildout. Higher yields are filtering into the real economy, as the average 30-year mortgage rate climbed to 7.30%, its highest level since November 2023.

Credit markets have begun to show modest stress, but perceived recession risk remains low which has kept spreads and defaults within historical norms. High yield bond spreads widened to roughly 300 basis points in late September from about 280 basis points at midyear, with the widening concentrated in the lowest-rated CCC segment. The trailing twelve-month high yield default rate of 2.8% is roughly in line with the long-term historical average.

Exhibit 2. S&P 500 Quarterly Earnings and Revenue Growth, 2026

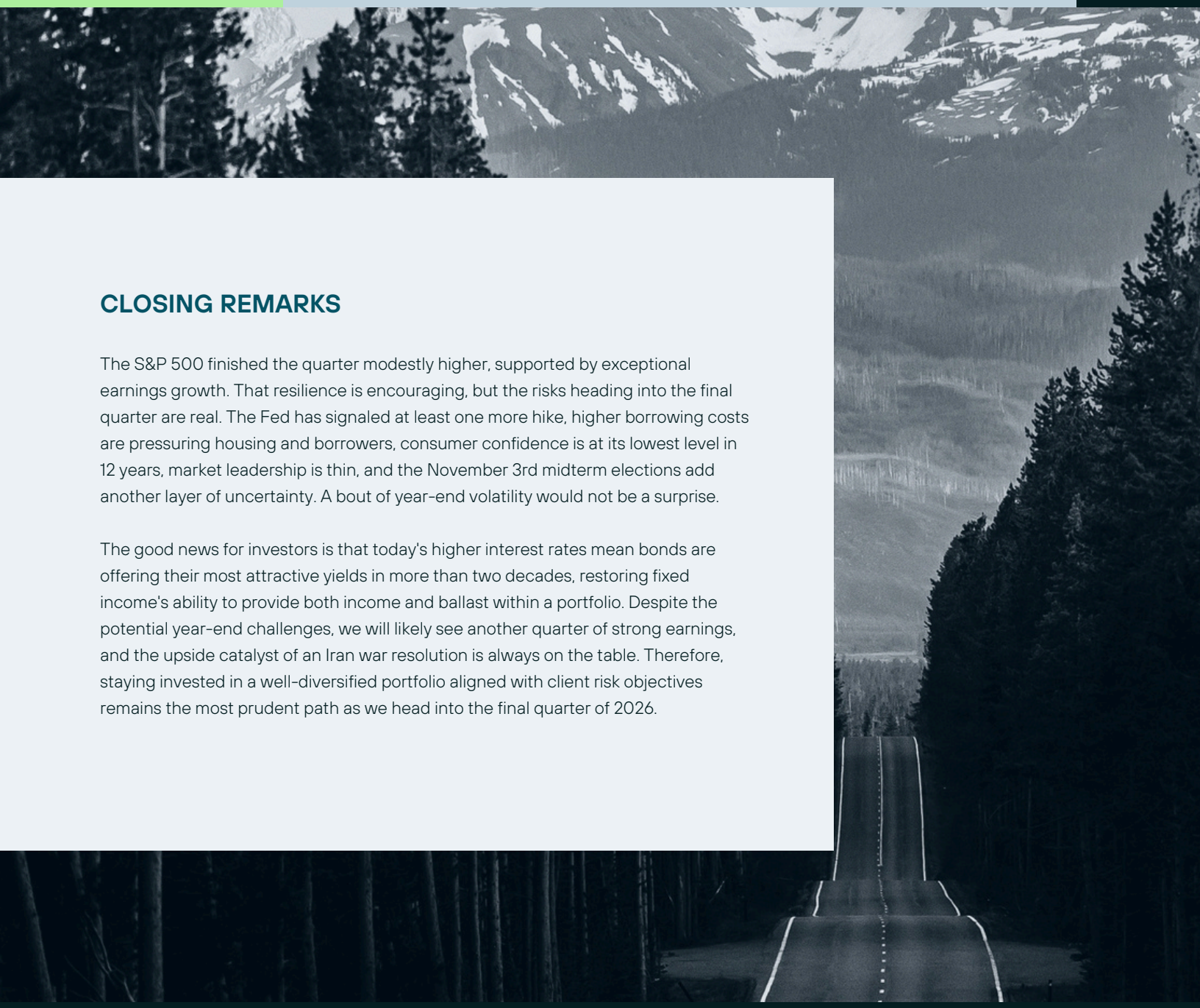


Data Source: FactSet. Chart by VestGen.

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CLOSING REMARKS

The S&P 500 finished the quarter modestly higher, supported by exceptional earnings growth. That resilience is encouraging, but the risks heading into the final quarter are real. The Fed has signaled at least one more hike, higher borrowing costs are pressuring housing and borrowers, consumer confidence is at its lowest level in 12 years, market leadership is thin, and the November 3rd midterm elections add another layer of uncertainty. A bout of year-end volatility would not be a surprise.

The good news for investors is that today's higher interest rates mean bonds are offering their most attractive yields in more than two decades, restoring fixed income's ability to provide both income and ballast within a portfolio. Despite the potential year-end challenges, we will likely see another quarter of strong earnings, and the upside catalyst of an Iran war resolution is always on the table. Therefore, staying invested in a well-diversified portfolio aligned with client risk objectives remains the most prudent path as we head into the final quarter of 2026.

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