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Quarterly Investment Commentary



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3Q26 Review

After a strong 2Q26, stocks turned in a mixed 3Q. The S&P 500 (+2.03%) and NASDAQ (+2.47%) advanced, but the Dow (-2.70%) and Russell 2000 (-7.52%) fell. The equal weight S&P fell 2.23%, lagging the cap-weighted index by 426 basis points (bps), implying breadth was weak. Treasuries were weak (the 10-year yield rose from 4.38% at 6/30/26 to 5.26% at 9/30/26, reaching the highest level since 2002.) WTI crude advanced 30% as U.S.-Iran peace hopes dwindled. Precious metals were up modestly. Corporate earnings growth for 2Q was up more than 50%, and above 30% excluding some large one-time gains.

The AI complex witnessed noticeable volatility with the SOX falling 11.4%. Software continued to rebound. MSFT (+37.5%) and META (+28.7%) were the Mag 7 standouts. Capex trends, demand for computer capacity as well as data centers made headlines. Security concerns around AI in general were featured in many conversations.

The Fed hiked rates in September by 25 bps, the first increase since July 2023, and emphasized the 2% inflation target repeatedly. By quarter-end, Fed funds futures signaled an unlikely increase in October, but another hike in December.

Best-performing sectors were energy (+16.48%), technology (+7.06%), and health care (+6.03%); worst performers were utilities (-13.03%) and industrials (-9.91%).

Introduction

The economy has been surprisingly resilient so far this year. There were dips earlier this year, when the Middle East war was in full swing; but in recent months, global industrial production and exports have rebounded to their record highs from before the war.

Over the past year, market expectations have pivoted from rate cuts to hikes, resulting in higher borrowing costs. In the process, long-dated Treasuries are down 10% and the forward P/E has compressed by ~3x. However, equities are still up 12% on much stronger than expected earnings growth. The U.S. 30-year bond yield has risen to more than 5½%, the highest in ~20 years. A confluence of factors has caused the back end of the yield curve to sell off, including repricing of central bank policy, sticky inflation (ongoing oil and trade shocks), rising fiscal deficits globally, and possible crowding-out effects.

Basic Fundamentals

Positive

1. Stable labor market
2. Booming technology investments
3. Strong earnings growth

Negative

1. Rise in price of oil
2. Rise in the cost of money
3. Fade in fiscal stimulus

The amazing story of 2026 can be summed up by the following:

Oil Prices ↑ + Fed hike + AI threat to humanity = stocks flattish. WOW!

The Economy

Recent economic strength reflects the solid foundation under the global economic expansion that existed entering 2026. Growth has broadened and persistently surprised bond investors and central banks, as we have argued would be the case. Prior significant policy stimulus, both monetary and fiscal, and stellar corporate profitability, had primed the global economy for stronger growth. Higher bond yields represent a risk, but for now, we judge the increase in yields to be largely reflective of better growth, and not yet restrictive.

The ongoing strength in employment conditions confirms that the various headwinds buffeting the global economy have not been sufficient to undermine the expansion (nor business confidence about hiring). The driving forces behind the solid demand for labor are that corporate profits and margins have boomed around the world this decade and are at elevated levels. For as long as companies still see better profits ahead, they will continue to expand.

Comments on the Bond Market Riot (published Sept. 28, 2026)

1. Yields across the Treasury curve have moved irregularly higher since COVID in 2020. The pace of upward action has accelerated in the last month.
2. Economic statistics have accelerated somewhat recently (e.g., PMIs surging last week.)
3. Fed funds are still below nominal growth, which implies interest rates are still stimulative, and certainly not restrictive.
4. The Fed has more (maybe a lot more) work to do to get the inflation rate down toward 2%. The two-year yield is significantly higher than the current Fed funds rate – that alone suggests more Fed work is needed.
5. It is likely that bond yields will have to go higher to arrest the pace of economic growth and the rate of inflation.
6. The level of bond yields is less important than the pace of change (which has accelerated in the last month). (The level will become more important once the 10-year yield is higher than nominal GDP.)
7. The 10-year Treasury total return is now negative over the last 10 years.
8. We are starting to see some widening in credit spreads in low quality (e.g., CCC) paper, but most investment-grade spreads remain fairly tight. (Watch this space carefully.)
9. Bonds (e.g., a 10-year Treasury) are a lot more interesting than they were six months ago (5.26% vs. 4.20%).
10. The bond yield increase has impacted stocks as the P/E ratio on the S&P 500 has moved down from 22x to 19x forward earnings (in other words, stocks are up, but much less than earnings).
11. While the S&P 500 is still ≈6% above its 200-day moving average, more than half the stocks have fallen below their 200 DMA.
12. We would be a bit more cautious in equities (a little cash is okay) and in balanced accounts, a few more bonds probably make sense.

The Fed, Interest Rates, and Bonds

The strength in global economic activity, persistent and mildly intensifying inflationary trends, the ongoing deterioration in government finances, and more recently, a revival in corporate borrowing, are combining to push up bond yields. This is likely to continue if central banks don't try to catch up. Credit markets around the globe need to be watched carefully and generally remain relatively well bid, with spreads holding at low levels (excluding the lowest rung of U.S. corporate debt, CCC-rated paper). The total return on 10-year government bonds is now negative this decade, and especially poor when measured in real terms. Today's much higher bond yields than earlier this decade will eventually be supportive of total returns going forward, but the catalyst for a sustained period of capital gains is still not evident.

The significant increase in oil prices so far this year hasn't knocked the wind out of the economy's sails. The question is whether rapidly rising interest rates will do so. The rapid rise in two-year government note yields worldwide signals that major central banks need to raise their policy rates further in response to the inflationary impact of higher-for-longer oil prices resulting from the recent re-escalation of the Middle East war. Unfortunately, these higher rates also exacerbate the outlook for large government deficits worldwide.

With no end to the Iran conflict in sight, the developed world's major central banks are either hiking rates or poised to begin doing so.

Fed members signaled that the current tightening cycle will be mild, contingent on an optimistic inflation forecast. The FOMC began a tightening campaign, but not one of the market participants who submitted forecasts expects the Fed funds rate will be more than 50 bps higher at the end of 2026 and 2027 than it is now.

Bond yields may need to rise to the point where they undermine corporate profitability and employment demand. While there is undoubtedly a level that would crunch profits and economic growth, the speed of the rise in yields can also play a role in slowing or expediting the cycle.

Decisive breakouts in the U.S. 10-year Treasury yield have been the catalyst for equity setbacks this decade. Yields are currently in the process of breaking out, thus our bias would be to de-risk if yields do not soon pause. One of the most long-term bond-bearish developments this decade has been the massive increase in government budget deficits (and debt levels). This development is notable because it has continued during a prolonged, above-potential economic expansion. Significant fiscal stimulus has boosted economic activity and added to inflationary pressures.

Earnings

To sufficiently tackle inflation, global equities will continue to be supported by rising earnings amidst an ongoing global economic expansion. That said, significant optimism is already priced into stocks. The ongoing global economic expansion will support equity markets, but earnings growth is poised to slow next year from an extremely high level. Rising bond yields and uncertainty about the evolution of AI make stocks increasingly vulnerable to a correction.

The recent breakout in bond yields is threatening to trigger another bout of risk-off. A spike in higher yields from current levels could trigger an equity decline, especially if perceived to be open-ended and driven by higher inflation expectations and/or a belief that central banks will need to become restrictive, rather than by improving growth expectations. Thus, until the bond market calms, it will not be easy to make a directional bet on equities.

The durability of earnings growth will remain the focal point for equity investors. First-order effects from higher rates on fundamentals (i.e., interest expense) are expected to be gradual due to predominantly fixed and long-dated debt issued by corporates. In the short term, this is more than offset by rising profitability for financials and a higher return on cash balances. While there could be a negative second order effect on the AI capex cycle and the consumer, the sensitivity should be low, given corporates are starting from very healthy balance sheets and sit on much higher margins than historically, while households (excluding low end) continue to sit on ample liquidity and record wealth.

AI

The AI boom continues to grow and is now among the largest of the tech-related booms over the past two centuries. Most other examples ended abruptly, often painfully, even where the technology delivered strong economic benefits. AI-related capex accounted for an estimated 27% of U.S. fixed investment in 2Q26 and cumulative investment in the sector has topped 2% of U.S. GDP in the past three years. Only the UK railway mania of the 1840s showed a larger surge in investment.

Stocks

If the 10-year has risen nearly 70 bps in just a few months, why don't stocks seem to care? Our work suggests that more than half of the increase has been driven by geopolitical rather than fundamental factors. That leaves room for the 10-year to retrace into the 4.80% if geopolitical risk fades.

A shallow hiking cycle should be manageable for equities. If inflation reaccelerates and the forward curve starts to price in a broader hiking cycle (i.e., four to five hikes), equities will likely face more significant downside, although this is not our base case.

Miscellaneous

The Trump-Xi summit did not create concrete benefits to U.S.-China trade. Strategic tensions persist.

2026 Election Odds (our guess)

	Republican	Democrat
House	10%	90%
Senate	50%	50%

A diplomatic settlement of the war would certainly help to bring down oil prices and interest rates. However, President Trump has reportedly rejected an offer by Iran to reopen the Strait of Hormuz and end the conflict. It appears as if he intends to resume bombing Iran after the midterm elections if Iran doesn't agree to dismantle its nuclear program. That would mean higher-for-longer oil prices, sticky inflation, and more central bank tightening.

Technicals

Recently, the S&P 500 advanced more than 1% to within 1% of a new 52-week high while new lows outnumbered new highs. The last time that happened was Dec. 21, 1999, a few months before the dotcom bubble top. Prior to that, the only time in history this dynamic happened was July 23, 1929. We recently witnessed more 52-week lows than highs for 10 straight days – both with the index near record highs. Credit markets show increasing signs of stress; CCC spreads have widened recently and are approaching 2022 levels.

Conclusions

1. Numerous U.S. economic variables are growing quickly right now, e.g., U.S. real GDP tracking 5% q/q A.R. in 3Q, nominal GDP running roughly 8%, NIPA corporate profits up 23% y/y in 2Q26, and data center construction up 57% y/y in July.
2. From these aggressive (peak?) growth rates, a slowdown is likely, given persistently higher oil prices, central bank tightening, higher long-term rates, and the U.S. fiscal impulse turning negative. These are meaningful headwinds, based on history.
3. But this slowdown is likely not a recession because 1) credit conditions look relatively benign; 2) consumer net worth is rising; 3) firing remains restrained; 4) gig work is still available; 5) new business formation is up; and 6) trend productivity growth is accelerating. Bottom line: Headwinds are intensifying, but we continue to believe that the U.S. is headed for a mid-cycle slowdown, not something worse.
4. Despite various economic headwinds, further gains in U.S. and euro area PMI surveys confirm that the foundations under the global economic expansion are still solid. A rate hike or two will not dent economic activity. If bond yields do not soon calm, we expect to de-risk and reduce equity holdings.
5. It is becoming increasingly apparent to us that markets are entering into a new regime, as the combination of Fed rate hikes and elevated oil prices push yields across the curve to levels not seen in 15-20 years. The low-interest-rate environment of the 2010s is gone, and with this new era comes an injection of bond volatility. We see elevated oil prices as a key swing factor for keeping rates high as inflation continues to pass through into the economy.

Q4 Assumptions

1. Fed will raise rates again.
2. Inflation will remain sticky.
3. After a strong 3Q26 GDP, 4Q will slow somewhat.
4. Labor market to remain stable.
5. Earnings will remain strong, but visibility on a 1H27 slowdown will surface.
6. The bond market will be volatile, with rates somewhat higher.
7. Stocks will struggle and make little forward progress.
8. Technology/AI investment will remain top of mind.
9. Oil prices will remain stubbornly high.
10. Mid-term elections will favor the Democrats.

10 Predictions for 2026: Review and update (4Q26)

Introduction (written December 2025)

The U.S. is set to remain the world's growth engine, driven by a resilient economy and an AI-driven super cycle that is fueling record capex, rapid earnings expansion, and unprecedented market concentration. The growth outlook is good, which bodes well for corporate profits and should be supportive of risk asset markets. The recently passed U.S. tax bill (One Big Beautiful Bill – OBBB) should provide a boost especially to capex. Deregulation should also support activity. A combination of the OBBB's impact on both consumer and capital spending, America's hosting the World Cup, and the country's 250th anniversary will all create a tailwind for 2026 economic growth and earnings. Add to that a Fed that seems almost certain to focus more on the full employment part of its mandate rather than inflation and it is difficult to get bearish. However, the downside of good growth may be upward pressure on inflation.

Key:



Heading in the right direction



Heading in the wrong direction



Too soon or too close to call

1 	Economic growth in the U.S. improves from approximately 2.0% to approximately 2.5% real GDP. Despite oil reaching \$100 per barrel (which one might think could bring any economy to its knees), economic growth in the U.S. remains relatively robust on the back of a resilient consumer and significant capital expenditures. The lagged impact of last year's Fed interest-rate cuts and the One Big Beautiful Bill, while diminishing, are still positive. Wealth effect benefits and reasonable productivity growth give further support to this prediction.
2 	Inflation remains sticky, fails to reach the Fed's 2% target, and fails to make much if any progress toward the Fed's 2% target. Sadly, this one is nearly certain. Most year-over-year and year-to-date inflation measures have a 3-handle, with some over 4%. Oil has certainly been a culprit and will cause inflation to fade somewhat, at least at the headline level. But many non-oil inputs to the inflation rate have risen, too. Recently installed Fed Chair Warsh has made it clear that the Fed has missed the inflation target of 2% five years in a row. Even if inflation calms, the "affordability" issue will play a role in the upcoming election.
3 	The 10-year Treasury yield trades primarily between high 3% and mid 4% as credit spreads widen (i.e., a "coupon-ish" year). Treasury rates have improved topside in accelerating fashion toward the end of Q3. Some credit spreads (especially low quality) have begun to widen. Suspect this prediction will be half correct.
4 	Earnings growth falls short of consensus +14% and P/Es decline modestly, making it a tougher year to make money. Earnings growth has been extraordinary, both in absolute terms and relative to expectations. Earnings growth has exceeded expectations by nearly 15%, stocks are up roughly 10%, and therefore the P/E of the market has fallen by about 15% (or three P/E turns) since the start of the year. The rise in the price of oil raised energy estimates and did surprisingly little damage to the rest of the market. Technology earnings continue to soar higher.
5 	Stocks fail to advance by a double-digit percentage for only the third time in 10 years. The U.S. stock market has advanced by a double-digit percentage for three years in a row. A fourth year of double-digit earnings growth has happened only once in the last 100 years. (Actually, five years – 1995-1999.) The S&P 500 has advanced a bit over 10% so far this year. If the market keeps "walking the tightrope" of good employment and economic growth sufficient to produce double-digit earnings growth but not so strong as to stoke inflation further, another double-digit stock market return is possible. No matter the outcome, high valuation levels demand a strong fundamental/earnings backdrop for another significant advance in equity averages.

6 	Technology, communication services, and financials outperform materials, utilities, and consumer discretionary. This prediction looked hopeless on March 31. But, as of Sept. 30, our projected outperformers are leading our projected underperformers by approximately 1000 bps, thanks to strong performance from technology and a much-improved financial sector, as well as relative weakness in utilities and consumer discretionary. The strong performance of growth versus value since the March 30 low has also put us in the winning column.
7 	International stocks outperform the U.S. for the second year in a row (first time in 20 years). International stocks are ahead of U.S. stocks by about 150 bps, but the lead has changed several times. Certainly, EM stocks have helped the international averages. Oil price increases are more damaging to international than the U.S. This one could be a photo finish.
8 	AI continues to be volatile/erratic, creating another year of elevated volatility. “AI” has become a buzzword all across society. Virtually all agree that AI is a transformative technology. The controversy is over magnitude, timeframe, and winners/losers. The “circular financing” dilemma remains a point of controversy and consternation. Software companies have been at the brunt of that discussion. Our expectation remains that AI will be controversial, create confusion and volatility, and result in some amazing positive stories and some noticeable losses.
9 	Faith-based share of industry AUM increases for the tenth year in a row. The faith-based share of money management industry AUM has increased nine years in a row, granted from a very small base. We expect this to be the tenth year in a row making it a decade of more than doubling market share. Why? More and more individuals, financial advisors, and institutions are desiring to align their portfolios with their values. Investors are both excluding companies that maim, kill or addict people as well as favoring companies that “do good.” With ample evidence pointing to these investors not having to surrender any investment performance, this area continues to be one of increasing interest.
10 	Republicans retain control of the Senate but surrender the House, losing at least 20-25 seats. On average, over the decades, the best economic growth in the four-year presidential cycle has occurred in the second year (this year). But it historically (and by a wide margin) has been the worst-performing stock market year. Mid-term elections are rarely good for the party in control. Polls have not only suggested the Republicans lose the House (perhaps losing 25-35 seats), but that the Senate is now reachable for the Democrats. An end to the war will likely moderate the projected Republican losses, but the increase in inflation (and the focus on “affordability”) will not help. If this prediction is accurate, it will render President Trump largely a lame duck, making the One Big Beautiful Bill his most significant second term achievement.

Final Tally:

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In summary (written December 2025)

Equity valuations and widespread investor complacency make the risk-reward trade-off less favorable than the positive top-down view implies. A shift to a defensive position is likely to occur at some point, although the timing is uncertain. Be quick to cut beta exposure if these tail risks surface. These include a spike in bond yields, a renewed intensity of the trade war, and/or if the AI euphoria fades.

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