Monthly Market Commentary

October 7, 2026

New Highs for Stocks and Rates – A Mixed Bag for Policymakers and Investors

Executive Summary

The third quarter delivered new highs in both stock prices and interest rates, reflecting an economy that remains resilient but increasingly difficult for policymakers and investors to navigate.

Policy - The war in Iran, tariffs, persistent inflation, and record federal debt have raised borrowing costs and uncertainty. Meanwhile, the approaching midterms are sharpening voter attention on affordability and increasing the political consequences of the Federal Reserve's effort to restrain prices without undermining employment.

Economy - Economic data remain mixed but generally constructive. Second-quarter GDP was revised to 2.2%, supported by consumer spending and AI-related investment. PCE inflation, however, remains elevated at 3.4%, while September payroll growth slowed to 29,000. Low unemployment and limited layoffs suggest a "low-hire, low-fire" environment rather than a broad contraction, providing continued support for consumption and corporate profits.

Fixed Income - For bond investors, strong demand, heavy government borrowing, and monetary-policy uncertainty pushed the 10-year Treasury yield to roughly 5.25%. Higher rates are pressuring housing, commercial real estate, and leveraged sectors, yet economic momentum has prevented a meaningful rally in longer-duration bonds. Income opportunities have improved, but patience and selectivity remain essential.

Equities – Stocks continue to advance, led by a narrow group of technology and AI-related companies. Strong projected earnings support the outlook, but elevated rates, rich valuations, and weak participation outside the largest stocks leave markets vulnerable to disappointment. We remain constructive on equities, though the path will likely be narrower and more volatile, with the S&P 500 fairly valued near 8,000 by year-end.

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Policy

The war in Iran, tariffs, and the record $40 trillion in Federal debt grabbed headlines and investor attention during the third quarter.

While Washington wants lower **borrowing costs** it continues to pursue policies that keep inflation, deficits, and uncertainty elevated. As a result, the bond market has priced-in further pressures on prices, federal borrowing, and to some extent, institutional credibility.

Higher market interest rates serve to raise household and business financing costs and widen federal deficits through greater debt service costs. AI-related investment supports growth but also increases demand for energy, equipment, labor, and capital.

The US economy therefore remains resilient while inflation persists, raising the stakes for the midterms.

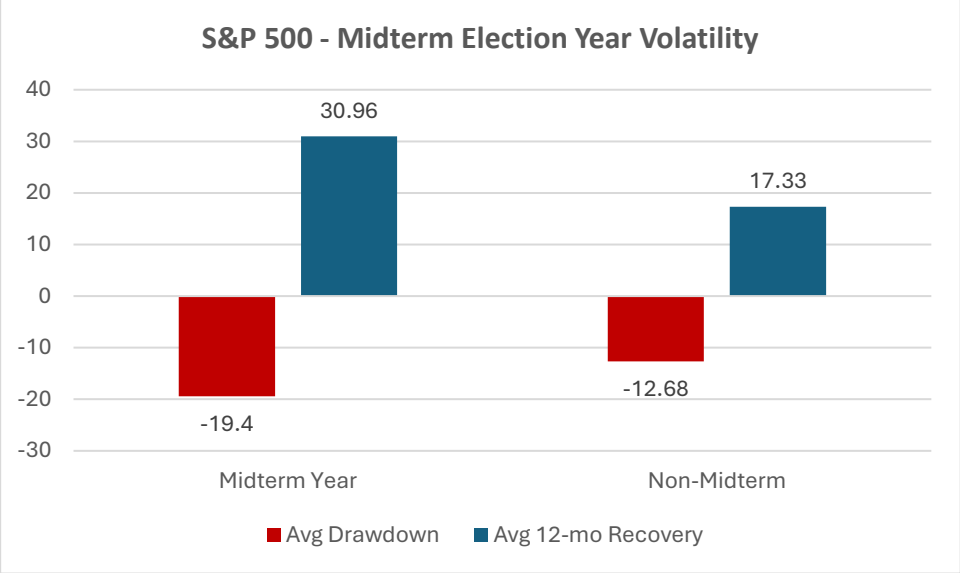
The upcoming **midterm elections** will test whether Republicans can withstand geopolitical strain and rising prices amid otherwise healthy growth. Democrats have the clearer House path, aided by the usual drag on the president's party and a generic-ballot advantage, though new district lines may limit gains.

The Senate is less predictable: Democrats need four seats, must capitalize in Maine and North Carolina, and defend New Hampshire, Michigan, and Georgia. President Trump's approval remains the key variable and is already prompting some Republicans to distance themselves on exposed issues.

Of course, election uncertainty can lead to market volatility. History shows that midterm election years tend to be the most volatile of the four-year presidential cycle as the equity market typically endures a pullback of ~-20.0% during mid-term election years.

Yet it is important to note that 12 months following the S&P 500's low point in mid-term years, the Index has rebounded by an average of >+30.0%, emphasizing the importance of adhering to one's long-term allocations during periods of market distress.

Chart – Midterm Volatility



Higher market volatility and rising market interest rates can also feed into the Democrats' message on affordability, as the **Federal Reserve** tightens policy to bring down prices.

Indeed, the Fed raised rates at its last meeting and signaled that tightening may not be finished.

The expected quarter-point increase brought the range to 3.75%–4.00%, but the larger message was that policy may remain "insufficiently restrictive." Fed Chair Kevin Warsh is avoiding a preset path, preserving flexibility while weaning markets from more than two decades of forward guidance.

Therefore, the Fed must balance overtightening, which could weaken employment, against pausing too soon and reigniting inflation. Either error could damage credibility and force a harsher response later.

Economy

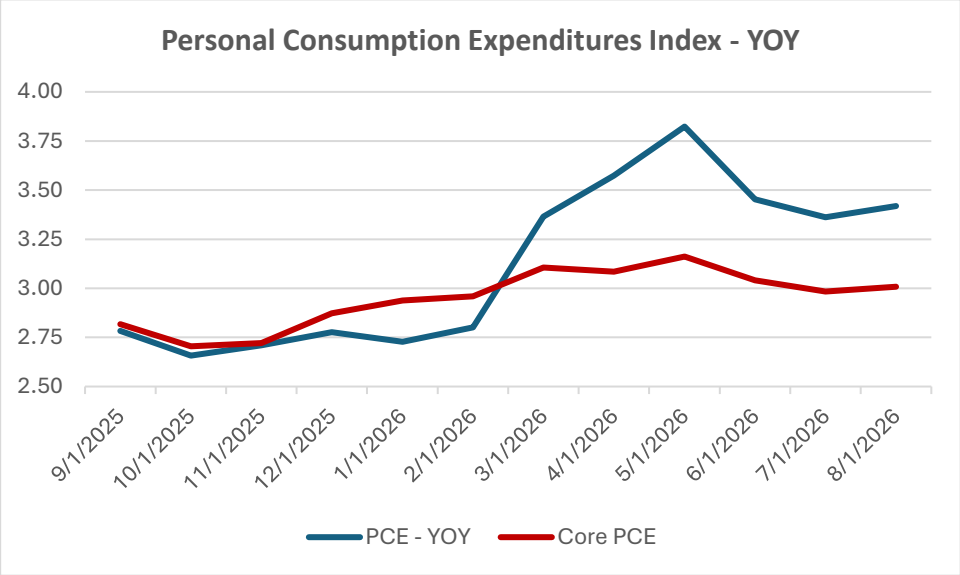
The US economy has stronger underlying momentum than previously estimated.

Second-quarter **GDP** was revised up to +2.2%, as consumer spending and AI-related business investment continue to support demand growth, while also offsetting risks from trade, immigration, and energy costs.

This economic resilience, however, still confronts persistent price pressures.

The Fed's favorite **inflation** indicator, the Personal Consumption Expenditures Index (PCE) remains at 3.4% year over year, and well above the preferred 2.0% inflation target. Strong household demand, AI-related business investment, and high energy costs suggest continued price pressures.

Chart – PCE Inflation



Fortunately, the labor market provides a counterweight to the growth story.

While the September **Employment** Report showed payrolls increased by only 29,000, prior months were revised lower, the jobless rate remains low at 4.2% as participation improved.

We view the "low-hire, low-fire" pattern as signaling reduced opportunity rather than a broad contraction, with hiring concentrated in healthcare, construction, and areas supported by data-center and AI investment. Employment remains solid, providing a backstop for consumption and corporate profits.

Fixed Income

The economy is running hot and therefore a challenge for the bond market.

Market interest rates surged in the third quarter as the war in Iran, $40 trillion in federal debt, persistent inflation, solid demand growth, and monetary-policy uncertainty combined to push the 10-year Treasury yield to roughly 5.25%, its highest quarter-end level in more than 20 years.

For investors, the usual link between tighter policy and slower growth is not working as expected.

Higher rates are hurting housing, commercial real estate, and leveraged sectors, yet the broader economy continues to absorb the pressure. AI capital spending, firm labor demand, and income from

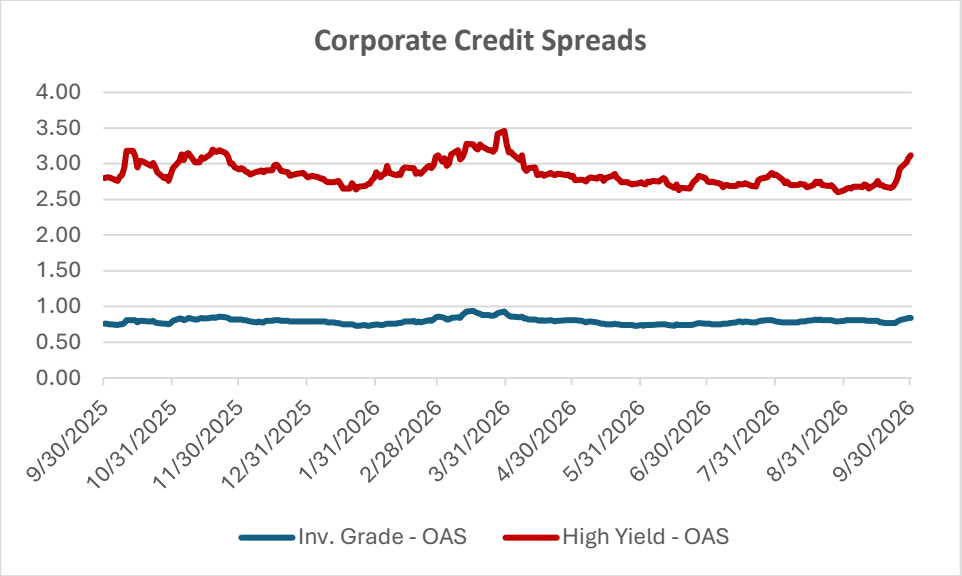
higher-yielding savings are sustaining activity. Stronger data therefore reinforce higher-for-longer rates and pressure long-duration bonds.

This creates a difficult setup for the Fed.

Policymakers must determine whether the expansion reflects a temporary investment surge or durable demand that will keep inflation above target. If the AI build-out continues, modest rate increases may not slow the sectors driving growth, leaving the rest of the economy—where financing is already restrictive—to bear more of the adjustment.

We suspect the near-term risk is less an immediate recession than a prolonged repricing of capital.

Chart – Corporate Credit Spreads



To be sure, while corporate credit yields have climbed, their spreads relative to Treasuries remain relatively tight when compared to historical widths, suggesting the potential for lower default risk.

Treasury yields may remain elevated even with anchored inflation expectations because real growth, heavy government borrowing, and corporate issuance compete for capital. Until hiring, investment, or consumer spending slows convincingly, investors may continue demanding greater compensation for duration risk.

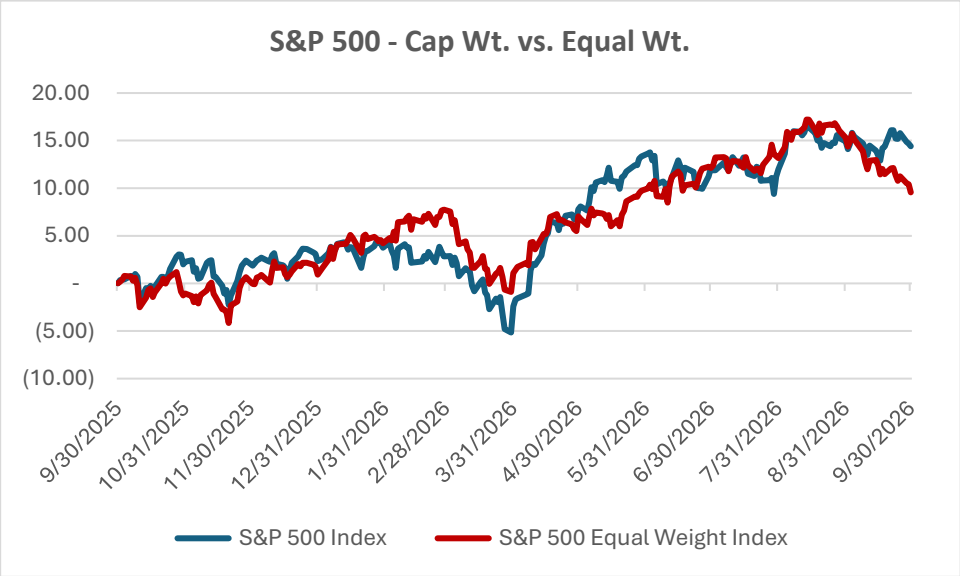
Patience and selectivity remain essential: income opportunities have improved, but lower yields will likely require clear evidence that economic momentum is cooling.

Equities

While performance for the major equity indexes still suggests resilience, the underlying picture is much less comfortable.

Market leadership remains concentrated in a small group of technology and AI-linked companies, driving the Nasdaq Composite and the cap-weighted S&P 500 Index higher. Yet given the rise in market interest rates, small caps and the more cyclically based Dow Jones Industrials have struggled to keep up, while the equally-weighted S&P 500 under-performed the cap-weighted index by approximately 500 basis points over the past several weeks.

Chart – S&P 500 Equal Weighted Index vs. S&P 500 Cap Weighted Index



This divergence may persist as corporate profits, capital spending, and investor enthusiasm continue to support the AI narrative. Yet it also leaves the broader market increasingly exposed to disappointment from a relatively narrow group of names, particularly as valuations come into question with discount rates climbing.

Fortunately, third quarter earnings for the S&P 500 Index are projected to rise by approximately 30% on a year-over-year (YOY) basis, providing some lift to investor sentiment as volatile headlines accompany the upcoming midterm elections.

In the months ahead, the central tension will likely remain between the strength of corporate profits and the degree to which rising market interest rates threaten valuations.

A softer inflation trend or a gradual cooling in the labor market could give the Fed room to slow the pace of tightening and allow participation in the rally to broaden. A renewed inflation surprise, however, would likely reinforce the pressure already visible in bonds, small caps, and consumer-facing sectors.

For now, we believe the equity market can continue moving higher, but the path looks narrower, more volatile, and increasingly dependent on AI investment delivering the earnings growth investors have already priced in. We continue to believe the S&P 500 Index will be fairly valued in the 8,000 range by year end.

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