The tension between several conflicting factors defined the third quarter in the capital markets, causing some unusual cross-currents. The U.S. Federal Reserve raised interest rates due to inflation concerns and the labor market is still weakening, yet economic growth remains resilient. Bond yields surged, but stocks ended the quarter mostly higher.

Economic Growth Continues...

despite turmoil in the bond market

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The 10-year yield experienced its fourth largest quarterly increase since 1994, closing the quarter at 5.29 percent, its highest monthly closing yield since 2000. Despite that, strong earnings allowed the Technology and Energy sectors to move higher, boosting large cap equity indices. Still, small-caps and the Dow Jones Industrial Average fell and emerging market stocks paused after a huge first half.

THE ECONOMY: A HAWKISH FED MEETS A COOLING LABOR MARKET

The FOMC voted to lift the target interest rate range 25 basis points to 3.75-4.00 percent, its first increase in more than three years. The dot plot showed 16 of 18 officials expecting at least one more hike by year-end, though New York Fed President Williams said on September 29 there was no need for urgency.

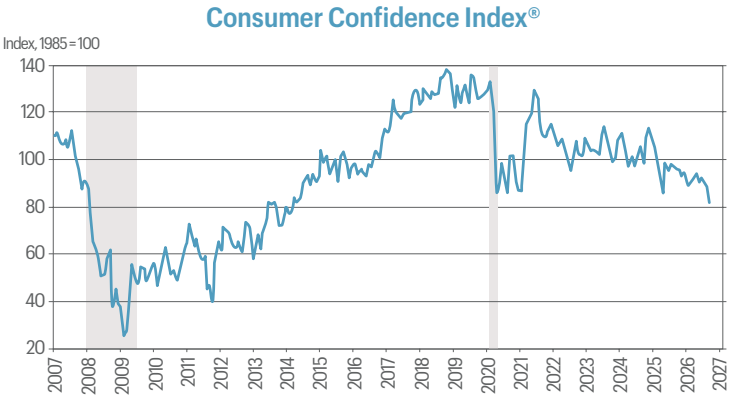
Inflation remains the Fed's central concern. The Consumer Price Index rose 3.7 percent year-over-year in September, up from 3.4 percent in August. The 12-month index for energy rose 20.4 percent and its subcomponent for gasoline rose 34.2 percent in September.

Economic growth has held up better than expected. Second-quarter GDP was revised up to 2.2 percent from 1.5 percent, with consumer spending growing at a strong 3.8 percent.

The Fed raised its 2026 growth projection to 2.3 percent, helped by AI-related capital spending.

S&P Global' s September flash PMI composite rose to 58.4 from 56, its highest since 2021, with both manufacturing and services expanding. Rising input prices and longer delivery times reinforced inflationary pressures.

The labor market is a weak spot. Employers added only 29,000 jobs in September versus roughly 90,000 expected, and unemployment rose to 4.2 percent from 4.1 percent. August and July payrolls were revised down, and the three-month average is about 51,000 jobs a month. Private payrolls rose while government payrolls fell. Wage growth cooled to 3.0 percent year-over-year, and consumer confidence fell to a 12-year low in September.



*Shaded areas represent periods of recession
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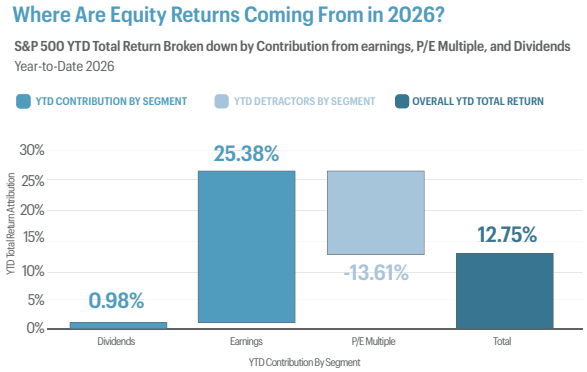
Energy and geopolitics keep the global backdrop difficult. WTI settled near $90.64 on September 30, and Brent traded around $108 before the Fed decision. European natural gas has nearly doubled since late June.

THE STOCK MARKET: EARNINGS ARE THE ENGINE POWERING STOCKS HIGHER

Stocks ended the third quarter higher, largely because corporate earnings outran the sell-off in government bonds. The S&P 500 Index gained 2.3 percent for the third quarter and is up 12.7 percent year-to-date on a total return basis. The NASDAQ Composite is up 15.6 percent this year, with gains concentrated in technology (+35.7 percent) and energy (+34.7 percent). Leadership is again narrowing as the NASDAQ Composite rose 2.5 percent in the third quarter while the Dow fell 2.7 percent.

Domestic small-cap stocks fell during the third quarter. The U.S. Federal Reserve raised rates with the target range increased 25 bps to 3.75-4.00 percent as inflation remains elevated. The Fed's rate hike hit smaller companies hard because many smaller companies carry more floating-rate debt than larger companies. As a result, the small-cap Russell 2000 Index fell 7.2 percent for the quarter but is still up 13.6 percent for the year.

Robust corporate profits kept stocks afloat. Analysts and corporate executives continue to be optimistic about corporate earnings growth for both the third quarter and going forward. While analyst estimates typically fall throughout a quarter, during the third quarter analysts were raising estimates. Also 62 percent of the companies that issued earnings guidance by the end of September were positive, versus a five-year average of 40 percent.



Source: Exhibit A, FactSet Research Systems Inc., Standard & Poor's (Latest: 9/30/2026)

The growth in corporate earnings is concentrated. The Energy sector is expected to post 114.0 percent earnings growth as oil rose 30 percent in the quarter to about $90. Technology is projected at 65.0 percent, led by semiconductors at 130 percent; excluding semis, it drops to 24.4 percent. Net profit margin is estimated at 15.0 percent, just behind the record 17.0 percent in the second quarter of this year.

The robust corporate earnings growth meant profits continued to rise faster than prices, so valuations compressed. The forward P/E ratio of the S&P 500 Index fell to 19.0 from 20.4 at the end of June, below both its five-year average of 19.8 and its 10-year average of 19.1, because forward earnings estimates rose 9.3 percent while the index rose 2.0 percent. The risk is that rising yields could lower what investors will pay for those earnings.

Foreign stocks were mixed during the third quarter. The MSCI EAFE Index of developed markets lost 0.1 percent trailing the S&P 500 Index, but is still up 9.9 percent year-to-date. The MSCI Emerging Market Index fell 2.4 percent

during the third quarter due to the July semiconductor sell-off, but still leads most equity groups at 22.8 percent year-to-date.

THE BOND MARKET: A CHALLENGING THIRD QUARTER, BUT YIELDS ARE NOW MORE ATTRACTIVE

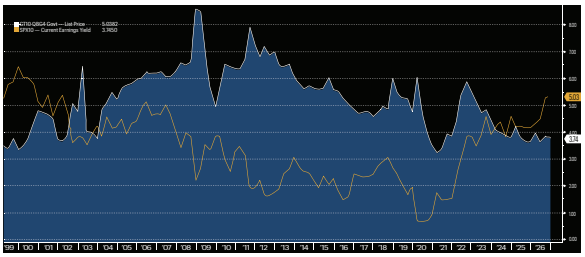
The third quarter of 2026 proved to be a challenging period for fixed income investors. The benchmark 10-year U.S. Treasury closed September at its highest month ending yield since November 2000 after experiencing its fourth largest quarterly increase since 1994. Rising interest rates pushed bond prices lower, producing negative total returns for most major core fixed income classes. The move in interest rates was due to significant re-pricing of inflation adjusted ("real") yields (Figure 1). Despite the material re-pricing within energy markets, investor expectations for longer-term inflation priced in the TIPS market has traded within a range of 2.2 to 2.5 percent (annualized rate) since the war in Iran began. Real yields typically increase when investors perceive stronger growth in the future, when the supply of government debt increases relative to demand, or when the Fed signals a sustained commitment to tighter policy. All three of these factors were present during the third quarter.

FIGURE 1:
10-Year U.S. Breakeven Inflation (yellow) vs. 10-Year U.S. Treasury Real Yield (white)

Source: Bloomberg LP, Federal Reserve Real Yield Index

Rising real yields make bonds more attractive on a fundamental basis as investors become more generously compensated for lending. The recent increase in rates has caused a notable increase in the relative attractiveness of fixed income, with many tenors of U.S. Treasury debt now trading at multi-decade highs. Attractiveness versus equities is frequently estimated via an equity risk premium metric, with a popular metric being the "Fed Model" of equity earnings yield minus the 10-Year Treasury yield. For most of the last 25 years the Fed Model Equity Risk Premium has been positive due to elevated equity earnings yields (as measured on the S&P 500 index by Bloomberg LP in Figure 2) as well as depressed Treasury yields. However, that relationship flipped in 2024 and has widened considerably during 2026.

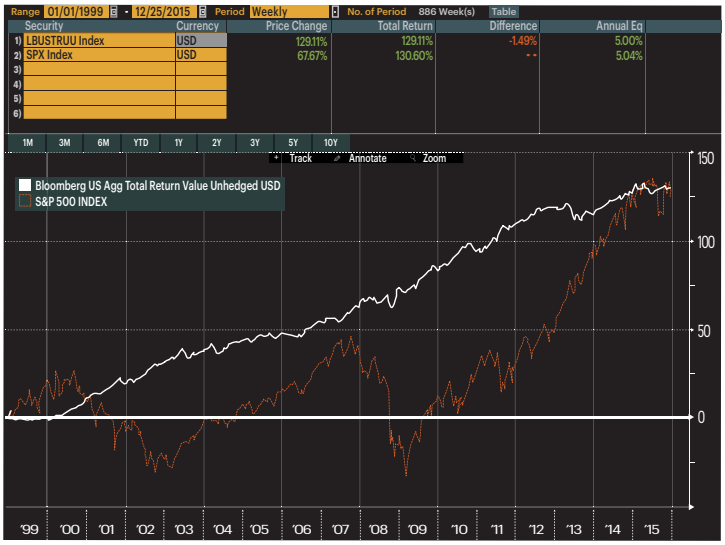
FIGURE 2:
S&P 500 Current Earnings Yield (white) vs. 10-Year U.S. Treasury Yield (yellow)



Source: Bloomberg LP

The last time bonds looked notably attractive using this relationship was 1999. Bonds outperformed stocks over the subsequent three-, five-, and ten-year periods due to major stock market corrections in 2000-02 and 2008-09. It took stocks over fifteen years to overtake bonds when measuring cumulative total returns using January 1999 as the starting point (Figure 3).

FIGURE 3:
Total Returns for Bloomberg US Aggregate Index vs. S&P 500 Index from 1999-2015



Source: Bloomberg LP

There was a major change in central bank policy during the third quarter as the Federal Reserve, ECB and Bank of Japan increased interest rates. The quarter began with the Federal Reserve in a holding pattern. At its July meeting, Federal Open Market Committee (FOMC) members voted 9-3 to maintain its benchmark policy rate within its existing target range of 3.50-3.75 percent. The three dissenting votes favored increasing rates, signaling that the FOMC was tilting in a hawkish direction. By September, economic and market data made the decision to hike clearer and the FOMC voted unanimously to increase its policy rate by 25 basis points, marking its first interest rate hike since July 2023. Despite his efforts to limit forward guidance, Fed Chair Warsh said during a speech in September that he would be "hard pressed to describe broad financial conditions as restrictive". Market participants responded by bidding yields higher. Current market pricing calls for the Fed to hike rates to near 4.70 percent by September 2027.

Corporate credit spreads (blue line in Figure 4) widened by six basis points while mortgage-backed securities (MBS) spreads (white line in Figure 4) widened more materially during the third quarter as interest rate volatility spiked. Companies issued nearly $200 billion of new debt in the investment grade market in September alone. This marked the second highest amount of September issuance, only surpassed in 2020. Year-to-date investment grade corporate issuance is running more than 20 percent higher than 2025's already elevated pace.

FIGURE 4:
Option Adjusted Spreads — Bloomberg US Corporate Index (lhs) & US MBS Fixed Rate Index (rhs)

Source: Bloomberg LP

MBS and corporate securities (both investment grade and high yield) experienced their worst quarter since 2022 due to the sharp uptick in interest rates. However, municipal bonds were the worst performing fixed income sector in the third quarter (Figure 5) and experienced their worst drawdown since 1981. Yields on highly rated municipal bonds now exceed the crucial 5 percent level across much of the curve. Nearly 75 percent of outstanding municipal bonds carry 5 percent coupons and rely on rates staying below this level for investors to enjoy full exemption from federal taxation. Now with large amounts of municipal bonds trading below par, investors seeking tax exemption risk incurring capital gains or even ordinary income taxes upon sale or maturity of newly acquired bonds. This dynamic creates opportunities for tax-sensitive but return-generating investors within the municipal space, particularly as new issuance accelerated to total over $200 billion in Q3.

WHAT TO WATCH NEXT

Third-quarter corporate earnings season could be a catalyst. Results and guidance will need to

deliver on the high expectations to defend current valuations. The central tension is simple. Earnings, margins and growth remain strong, but a 5 percent-plus 10-year yield raises the discount rate on future profits and borrowing costs for every company and household.

If the labor market keeps cooling and yields stay high, current equity valuations will be harder to sustain. If yields stabilize, the earnings strength looks set to carry the market.

In the bond market, we believe that interest rates are attractive at their current levels as nominal yields remain above future expected inflation rates. Fixed income securities offer compelling income return with further opportunity for price appreciation if inflation recedes and/or economic activity stalls.

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