



2026 FALL INVESTMENT OUTLOOK

The economy and stock market continue to weather a litany of risks in 2026 from war, energy shocks, supply chain snarls, concerns about AI valuations, and rising interest rates. With just a few days remaining in September recent economic data have confirmed a sharp pick-up in growth as the quarter closes. High frequency data comprising the Dallas Fed Weekly Economic Index shows an acceleration in activity over the past two months while the latest so-called “flash” purchasing manager data from S&P Global giving an early read on September climbed to the highest levels since July 2021. The latest payroll data from the month of August was also sharply higher, rising to 162k additions compared to the prior three month average of just 38k. Business is clearly booming in both services and manufacturing as autumn commences, which has the Atlanta Fed’s GDPNow model currently projecting 5.1% annualized growth for the third quarter.

Perhaps such growth momentum was reason enough for the Federal Reserve to lift its fed funds policy rate for the first time in three years on September 16th, raising it by 25 basis points to a midpoint of 3.875%. The Treasury market had already been leading the central bank higher since mid-August. The two-year Treasury yield has risen 77 basis points since then to 4.91% (highest level since June 2024) and the benchmark 10-year Treasury crossed the 5% threshold for the first time since mid-2007, rising 128 basis points since late February to 5.21%. Inflation expectations remain well-anchored in the bond market (as measured by so-called breakeven rates) and the recent rise in headline nominal yields across the Treasury curve has been driven mostly by a rise in “real rates” (as measured by TIPS), perhaps indicating monetary policy at the moment is too loose for an economy running much hotter than its 2% growth potential.

The Federal Reserve’s hand was ultimately forced by the August CPI print on September 11th which showed an acceleration in both headline and core inflation from the prior month. The rise in commodity prices related to the war with Iran have made it especially difficult for prices to find a softer footing. Brent crude oil has risen 51% since early July to \$108 per bbl, leading to sharply higher diesel and gasoline prices, increasing the risk of the energy shock spreading into broader inflation. New chair Kevin Warsh had been adamant since his term began in May that the Fed’s 2% inflation target was a serious policy objective and sees commodity prices as a broader inflation signal more so than his predecessors. The latest data now has inflation running above that target for the 66th straight month. The central bank’s credibility was at stake headed into the September meeting both from a policy standpoint and politically (Warsh was being accused in the media and by some Democrats of being a Trump puppet). However, the Fed chairman achieved unanimous consensus with the FOMC’s latest decision and the committee hints at another rate hike before year-end.

The rally in stocks continued to broaden for most of the summer beyond the narrow AI cohort like semiconductors and mega cap technology shares, reflecting the acceleration in earnings growth that

has occurred this year. Third quarter earnings estimate revisions continued to modestly rise throughout the quarter ahead of the upcoming reporting season. Consensus estimates from FactSet currently project S&P 500 EPS growth of 29.1% in Q3, which would mark the third consecutive quarter above 25% if actual results concur. However, equities are likely to face tighter liquidity and financial conditions in the months ahead related to the recent rise in interest rates. Performance has narrowed in the stock market over the closing weeks of September since tighter conditions impact smaller capitalization, cyclical sectors, and the more interest-sensitive parts of the market to a greater degree than secular growers.

2026 YTD Total Returns

	<u>9/25/26</u>	<u>% Change</u>
Dow 30 Industrials	51,829	+9.1%
S&P 500	7,743	+14.1%
NASDAQ Composite	27,069	+17.0%
MSCI ACWI ex-USA	477	+15.8%

Outlook

Inflation will probably continue to accelerate into the fourth quarter, which could pull future rate hike expectations forward, before easing in early 2027 as base effects kick-in and year-over-year comparisons become easier. Fed fund futures are currently pricing two additional 25 basis point increases by January and a third by spring while the FOMC is telegraphing just one additional bump by year-end. Such incongruence will eventually need to be resolved.

Unfortunately, Federal Reserve policy is more like a blunt knife than a scalpel. Hiking rates won't do much to reduce the supply-driven inflation shock the economy is currently experiencing. Two of the world's critical shipping chokepoints for crude oil cannot be essentially closed without semi-permanently raising the commodity price. The U.S. strategic petroleum reserve is basically at its lowest level ever in the modern era, further pinching supply. Container traffic is also being re-routed and each Asia-to-Europe voyage around the Cape of Good Hope (instead of through the Suez Canal) is burning \$1 million in additional fuel, according to some sources. These inflation inputs cannot be fixed by a rate hike unless it cuts demand and slows the economy.

The resilience of the economy has given the central bank a pass for now but the Fed's past research finds that tighter policy produced relatively little additional disinflation around temporary supply shocks while putting more pressure on activity and employment. Housing will continue to be notably weaker, especially with the 10-year Treasury solidly above 5%. Although layoffs remain low, job postings have softened. The U.S. dollar has strengthened sharply the past three weeks, too, tightening global liquidity (by increasing the local burden of dollar-denominated debt). Credit is also tightening meaningfully by some measures in the high yield corporate bond market. Higher quality high yield securities like BB rated bonds have remained relatively resilient but CCC spreads have widened to more than 930 basis points above Treasuries compared to the February low of 563 basis points. The divergence between these two ratings is near a 30-year extreme and the higher borrowing costs for weaker credits should eventually pressure economic activity somewhere in the economy.

Investors would be wise not to extrapolate the strong third quarter growth for the ensuing periods. The sequencing of both growth and inflation is important and capital markets will need to digest the

impact of tighter financial conditions (i.e., higher interest rates, stronger dollar, higher commodity prices, and wider credit spreads) on both if sustained in the quarters that follow. U.S. net wealth rose by approximately \$9 trillion in the second quarter and that increase in wealth supported risk-taking and spending in the third quarter, but tighter conditions could now begin to work in the opposite direction. GDP growth will be roughly cut in half in Q4 and the growth comparisons early next year for both GDP and corporate earnings relative to 2026 become more difficult. While it may not be immediately apparent to markets there may be even more of an onus on AI in 2027 to sustain the solid growth the economy has recently realized.

The major sectors of the economy that have kept core inflation high have been healthcare, education, insurance, and rents. Inflation for these stickier categories, where price changes occur less frequently, is trending lower but just at a gradual pace. Most of these categories tend to be less interest-sensitive and the central bank can only impact such trends over the medium run. Historically, sharp drops here only occur around recessions. Nonetheless, progress is being made albeit slowly. Chair Warsh's preferred metric also suggests inflation breadth has narrowed as the share of inflation components rising more than 3% over a 12-month span continues to fall.

The sharp rise in Treasury yields over the past month is starting to magnify the competition for capital that is currently occurring in the bond market. There is little doubt that the surge in corporate bond sales financing AI is affecting yields. Estimates for full year AI-related debt issuance—including chip makers, utilities and others in the wider AI-adjacent theme—range from \$300 billion to \$570 billion. This issuance also tends to be longer maturity. Investors seem to be demanding a higher interest rate to absorb this AI-related debt alongside government debt, where the U.S. added more than \$1 trillion in the last three months alone.

These vast swaths of supply are one reason the 30-year Treasury has jumped to a yield of 5.51% (the highest level since 2004) and the 10-year Treasury to 5.21% (highest since 2007). Another reason may be the shift in mix of investors willing to buy and hold our Treasury debt. A recent Financial Times article indicates that price-insensitive investors like central banks held 76% of U.S. Treasuries 19 years ago but today they are diversifying into gold and other currencies and hold only 43%. The majority is now held by households and investment funds (i.e., price sensitive investors) who demand greater returns due to concerns around inflation, deficits, and debt. A somewhat vicious cycle could be commencing. Higher interest rates lead to higher debt-services costs, which further increases the federal deficit, leading to even more Treasury issuance that needs to be absorbed by such buyers.

The reckoning is likely to be deferred, however, until a time in the future when the AI investment boom slows enough to matter. In the meantime, leading data shows that not only does direct investment in chips and hardware continue at a torrid pace, but sectors adjacent to direct AI technology like construction, power, and industrials are also greatly benefitting as datacenter capacity expands. Core capital goods orders in the economy (which excludes defense and aircraft) are growing at a 15% annualized rate (and with the trend still accelerating), growth rates typically experienced during mid-cycle peaks historically. Thus, economic growth should continue at a solid pace in the fourth quarter as this capital is deployed in the economy. The four largest hyperscalers are committing \$800 billion in capex in 2026 alone (after spending \$448 billion last year and \$246 billion in 2024) and their off-balance-sheet commitments now exceed \$3 trillion.

Such spending is driving inordinate growth in corporate profits for the headline S&P 500 index. FactSet consensus estimates from Wall Street posit third quarter earnings growth of 29.1% and

fourth quarter growth of 26.8%, atypical for the sixth year of an economic expansion. Goldman Sachs analysts recently pointed out that there are three drivers behind the current unusually high earnings, which could ebb in 2027. AI capital expenditures are contributing nearly half of this year's EPS growth for the index. Semiconductor margin expansion is also at a multi-decade high as components such as memory are in severe shortages. Equity investment gains from mega-tech companies have also boosted book profits (a function of the circular investing that is occurring when AI vendors buy partial stakes in customer equity). All three factors could weaken next year and earnings growth could moderate to more normal levels of around 11%, according to the bank.

There are risks in the AI theme that are coming to the forefront as the third quarter closes, both for the investment case and in the technology sense as it rapidly advances. The \$3 trillion+ in AI infrastructure obligations will eventually need to satisfy investor return hurdles. OpenAI has annualized revenue of approximately \$40 billion and Anthropic \$65 billion, impressive run-rates in such a short period of time. However, this is a fraction of what has been committed on their behalf and those are revenues, not profits or free cash flow generation.

Furthermore, use of so-called "open-weight models" is proliferating as the performance gap relative to the proprietary frontier AI labs narrows. This expands the current safety slowdown narrative beyond just ethics as perhaps the tech leaders for the leading AI models are beginning to realize the business moats may not be as wide as expected and some of the technology could become commoditized. Nonetheless, some evidence has emerged that justifies a pacing of frontier AI development, such as the OpenAI-Hugging Face security containment failure this summer and rogue agents recently meddling with various government websites. Thus, use of an FDA-style regulatory model is quickly emerging in Washington, despite President Trump's pushback.

The midterm elections are just 36 days away. Democrats need a net gain of three seats to take back the House of Representatives. The current RealClearPolitics (RCP) polling average shows the party potentially gaining 8 seats. In the Senate the RCP average shows the generic ballot at essentially a dead heat but with seven of the nine seats currently held by Republicans as toss-ups. Regular gasoline prices of \$4.50 per gallon and 30-year fixed rate mortgages of more than 7.20% are huge political liabilities for Republicans. Unfortunately, the fringes of both political parties continue to dominate the media landscape and promote policies that are economically unrealistic. The country has very little fiscal space to maneuver in the next slowdown and the due bills are quickly approaching in the early 2030s as both the Medicare and Social Security trust funds deplete.

Investment Conclusion

We continue to remain selective in deploying client capital given the potential for tighter liquidity and financial conditions in the months ahead. Rising interest rates present opportunities to expand bond ladders in both Treasuries and corporates at yields not realized since 2007. The 5-year Treasury is yielding 5.05% as of this writing and a solid investment grade credit with stable cash flows can be purchased at a reasonably wider spread. Both are more attractive than current money market rates for those investors with little liquidity concerns. Rising interest rates could impact stock valuations, however, so we are keen on being deliberate with new purchases in select equities that offer a margin of safety and an attractive idiosyncratic theme.

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