

Q3 2026 Market Review & Outlook

October 8, 2026

The US equity market, as measured by the S&P 500, rose again in the third quarter, with a total return of about 2.3%, bringing the year-to-date gain to 12.7%. Investors continue to shrug off negative headlines, focusing instead on ongoing massive AI spending by corporations, and the related turbocharged corporate earnings, lower stock market valuations and continued US economic growth.

From our perspective, this makes sense. AI is transformative. Actual and expected earnings growth that continue to outstrip market gains mean lower price-to-earnings (P/E) ratios. The S&P 500 P/E has declined by around 15% year-to-date, to ~19x from ~22x. And low unemployment, strong consumer spending, and new highs in total US household wealth all bode well.

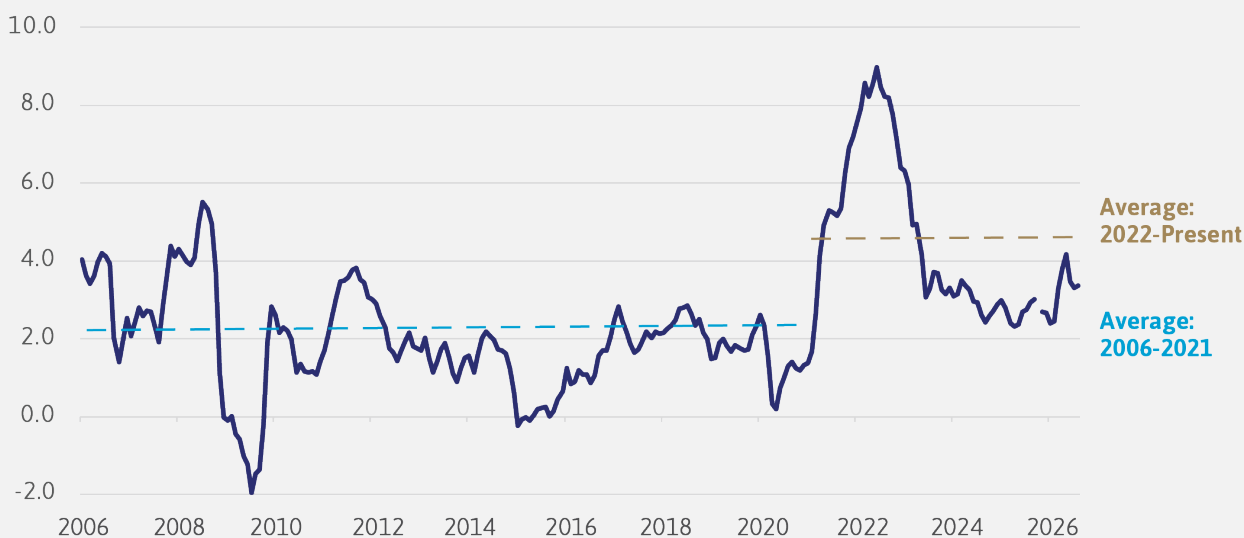
But those headlines, Fed hikes, and rising long-term interest rates bear watching too, so here are some brief thoughts on the main ones.

GEOPOLITICS AND DOMESTIC POLITICS

If the wars in Ukraine and the Middle East continue or, worse, escalate, energy prices are likely to rise, putting continued upward pressure on inflation, which is already above the Federal Reserve's long-term goal of 2%.

Inflation Remains High

Headline CPI has remained above trend over the last 5-years.



Source: Bureau of Labor Statistics.

Any escalation that disrupts broader supply chains could push global economic growth lower.

In the United States, midterm elections appear likely to result in shared control in the legislative branch, which historically has led to solid market returns, but the growing support in both parties for populist tax and regulatory policies, which have historically weighed on economic growth, muddies the outlook.

INFLATION, THE FED, AND THE DEBT

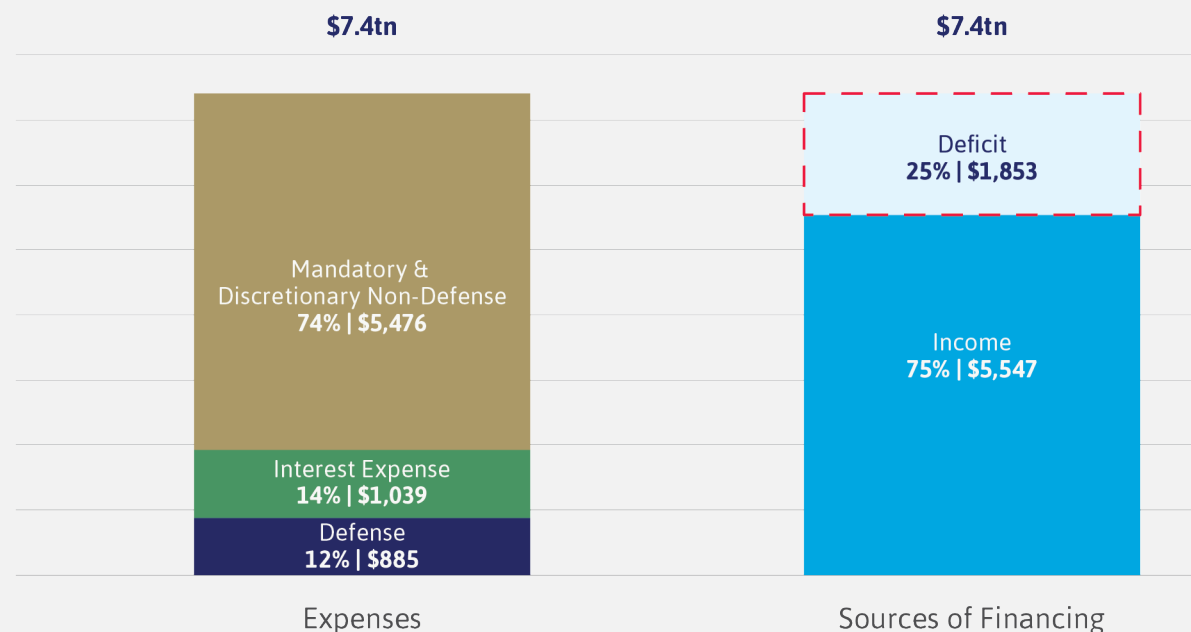
With tariff policy and increasing energy and AI-related technology prices all pushing inflation higher, the Fed raised rates in September for the first time since 2023. Three or four more hikes are expected through 2027, according to current market projections.¹

Investors are so far taking this in stride. While yields on Treasuries are rising, they are still below nominal (including inflation) GDP growth in the United States, reflecting continued market expectations of higher economic growth.

A prolonged hiking cycle, well beyond what is currently expected, could push longer-term interest rates still higher, leading to increased borrowing costs. Higher mortgage and other consumer credit costs and rising corporate and government borrowing rates could risk a slowdown, or even a recession. At over \$1 trillion annually (more than the total annual defense spending), interest costs already account for more than half the annual federal deficit. This will only get worse as the deficit and interest costs rise, another long-term risk.

The Government Deficit

Remains massive with interest expense a rising component of spending.



Source: BEA, CBO, Treasury Department, J.P. Morgan Guide to the Markets. Data as of September 30, 2026.

¹ Bloomberg World Interest Rate Probabilities, as of 9/30/2026.

MARKET CONCENTRATION & AI CAPITAL SPENDING

Stocks that have significant exposure to the AI infrastructure buildout (hyperscalers, semiconductors, other hardware providers, and software, power, and mining companies) now represent nearly 60% of the S&P 500's market capitalization. Spending on the buildout is accelerating and financing is broadening from hyperscaler operating cash flow to a mix of bonds, convertibles, leases, private credit, equity raises, and vendor-backed financing.

When will all this spending result in attractive returns on capital? That's the \$5.1 trillion and rising question.² At present, signs are positive, with corporate and consumer usage continuing to surge, and revenues starting to grow and profits starting to come in. As discussed in our recent edition of *Independent Thinking*, there are some constraints on AI growth, notably around generating enough energy to meet demand. But these may also serve as a restraint on irrational spending. In any case, it seems likely that aggregate corporate productivity will increase as companies and individuals exploit AI tools.

Here is our outlook for each of our asset classes:

CASH AND DEFENSIVE ASSETS

Cash yields should rise as the Fed continues hiking its target rate, making cash and short-term bonds a useful investment with a positive real return. Investor expectations of inflation; high government debt and deficits; and higher expected long-term real GDP growth have combined to boost fixed income yields.

The rise in yields resulted in negative total returns for the intermediate-term, tax-exempt fixed income indices, both for the quarter and the year-to-date periods (-4.6% and -3.8%, respectively). Ten-year Treasuries yielded ~5.3% at the end of the quarter, the highest since before the Great Financial Crisis. The municipal bond index yielded ~4.0% and the Bloomberg US Aggregate Bond Index yielded ~5.5% for the same period. Present yields, to our mind, adequately compensate investors for the inherent risks.

CREDIT STRATEGIES

Credit-sensitive fixed income also experienced higher interest rates and declining prices for the quarter, as credit spreads (the difference between risk-free Treasury yields and the yields of riskier bonds) increased modestly while the underlying base yields of Treasuries also increased. The combination pushed the yield on the Bloomberg Corporate High Yield Index above 8%, an increase of more than one percentage point, resulting in a loss of 1.8%.

Business Development Companies, or BDCs, (publicly traded vehicles that own a portfolio of middle market, floating rate corporate loans) fared better for the quarter, with higher coupons and continued low default rates.

As an asset class, we believe that credit offers an attractive risk-adjusted return potential at current yield levels.

DIVERSIFIED MARKET STRATEGIES

We continue to believe that a modest gold allocation has a role in balanced portfolios. As global debt increases, central banks should continue to increase their allocation to gold within their reserve holdings. Large institutions and individual investors could follow, as investors seek a store of value, which could provide potential tailwinds to gold prices. Bitcoin may also appeal to investors as a scarce, non-sovereign asset, albeit

² Cumulative capex spending 2025-2029 – Source: FactSet.

more volatile and asymmetric than gold. Both can be attractive, when scaled appropriately, for clients with appropriate risk tolerances.

GROWTH ASSETS

Identifying sectors, regions and individual companies that have exposure to AI at reasonable growth-adjusted valuations, combined with appropriate portfolio-level diversification, both within and beyond AI exposure, remains our goal. While AI is a massive single theme, exposure can be gained in various ways across various types of companies, including hyperscalers, semiconductors and hardware manufacturers, power generation and infrastructure, and the AI productivity beneficiaries. Cash-generative companies exposed to AI but with diverse and resilient business models are still our preference.

Internationally, earnings have also been robust, keeping pace with those in the United States, largely led by their own AI champions (concentrated in South Korea, Taiwan, China and Japan) and leading to robust returns so far this year for broader international stocks and emerging markets, up 14.7% and 23.5% respectively. Here too, P/E ratios have fallen, albeit more modestly, as earnings growth outstripped market returns. International markets remain in our opinion relatively attractive on a valuation basis, but with their own large exposures to large AI companies, correlation to US stocks has increased. Investors must now seek diversification elsewhere, away from AI.

PRIVATE MARKETS

Annual private market fundraising by private equity, venture capital, real estate, real assets and credit continues to decline, with 2026 set to be the lowest fundraising year in over a decade.³ Dry powder, or the amount of capital committed to private funds but not yet deployed, is also in decline as private investors deploy more capital in aggregate than they raise. For current vintage private investors, this environment is potentially very attractive. Reduced capital can improve underwriting discipline and create a better environment for managers with capital, sourcing advantages, and demonstrated underwriting skill.

Currently, we see opportunity in early-stage venture capital, especially when accessed through fund managers with a demonstrated ability to identify the next generation of entrepreneurs. We also see opportunity in private credit, where recent volatility has increased yields and the fundamentals of the underlying lenders remain solid.

CONCLUSION

We believe AI will continue to have a positive net impact on real economic growth and drive earnings growth, but risks are present that demand investment discipline.

We are focused on maintaining a healthy exposure to AI while remaining sensitive to valuations and risk. By maintaining our allocations to the equity market and by taking advantage of the higher yields available in fixed income, opportunities in the credit and private markets and, as appropriate, diversified market strategies, we are confident that we are managing diversified portfolios designed to be resilient for our clients.

³ PitchBook Q2 2026 Global Private Market Fundraising Report.

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