COMMENTARY
2026 Q3

The third quarter looked steady on the surface, but it was more volatile underneath. The S&P 500 gained 2.3%, primarily driven by a rally in technology stocks, while bond yields rose. Energy prices, persistent inflation, and expectations for the Federal Reserve to raise its key policy interest rate were the main drivers. On September 16, the Fed raised the federal funds target range by 25 basis points to 3.75% to 4.00% which was the first increase since 2023. Resilient demand for goods and services resulted in core PCE inflation remaining above the Fed's 2%target for 66 consecutive months through August.

Treasury yields rose at every maturity. The 2-year yield rose 72 basis points over the quarter to 4.87%. The 10-year rose 83 basis points to 5.28%, and the 30-year rose 69 basis points to 5.62%. Both the 10-year and 30-year ended the quarter at their highest levels since 2002. High yield bonds returned -1.8% and investment grade bonds returned -3.7%. For the most part, rising rates rather than credit concerns caused losses, although spreads did widen near quarter-end. Large technology companies continue to finance AI spending in the bond market, which added to the upward pressure on rates.

Under the surface, stock market breadth was much narrower than the 2.3% return suggested. The Nasdaq rose 2.6%, but the Dow fell 2.3% and the S&P 600 small cap index fell 7.9%. The equal weight S&P 500 declined by 1.9%, and 83% of S&P 500 members ended the quarter more than 10% below their 52-week highs. International stocks were roughly flat, with developed markets up 0.8% and emerging market equities down 0.4%.

Corporate earnings were once again a bright spot. S&P 500 earnings for the second quarter grew nearly 53% year over year, and EPS growth exceeded 30% YoY, even after excluding accounting nuances. 86% of companies beat estimates, the highest share since the second quarter of 2021, and revenue grew nearly 16%. Expectations for third quarter earnings growth is over 29%, which would be a third straight quarter above 25%.

The economy held up well against this backdrop. GDP grew at a 2.2% annualized rate in the second quarter, down from 2.5% in the first. Payroll growth was positive, though the reports were volatile, and August came in well above expectations. The unemployment rate stayed low, and continuing jobless claims in September were near their lowest levels in more than three years. Consumer sentiment remains beaten down, but retail sales and corporate commentary suggest spending has been resilient. Diesel prices hit all-time highs, averaging about $6.53 a gallon in September before moderating at quarter-end. Signs of demand destruction, and less robust guidance during earnings season will be key indicators for risk assets in the fourth quarter.