

Review & Outlook

THIRD QUARTER 2026



119 N. Commercial St., Ste. 191 • PO Box 1618 • Bellingham, WA 98227
P: 360.671.0148 • P: 800.292.8794 • F: 360.671.8936

Review and Outlook

The third quarter of 2026 saw mixed results. While the total return for the S&P 500 index was 2.52%, this number hides strong currents churning below the surface. For example, the Energy sector rose 17.2% and Technology rose 5.6%, but seven of the eleven sectors that make up the S&P 500 were negative, with Utilities being the worst performer at -11.2%. Somewhat surprisingly, the Financial sector, measured by the State Street Financial Select Sector SPDR ETF (Ticker XLF) was down 2.2%, something you would not expect in a strong economy.

In the bond market, the Bloomberg U.S. Aggregate Bond index was down 3.5%, reflecting the rise in short- and long-term interest rates. Small cap stocks, measured by the Russell 2000 index, were down 6.9% for the quarter, and returns for global developed (measured by the MSCI EAFE index) and global emerging markets (measured by the MSCI Emerging Markets index) were little changed, at 0.8% and -0.2%, respectively.

Within the S&P 500 index, extremely strong third quarter and year-over-year earnings growth was thanks to just a few sectors, with growth in the dominant Technology sector being concentrated to an even smaller handful of mega-cap companies. In particular, companies central to the current AI buildout (memory, CPU, and GPU), and energy companies that are benefitting from high prices for oil and refined products. Roughly half of the S&P 500's year-over-year earnings growth is from 20 companies, and 37% of its total earnings growth is from the top 10 companies. The top four companies (Micron, NVIDIA, Alphabet, and Microsoft) account for almost 25% of the S&P 500's total earnings growth over the past 12 months.

From a macroeconomic standpoint, the dominant story for the quarter has been steadily rising sovereign 10-year Treasury rates, in the U.S. and globally. A main driver for higher interest rates has been a historic, and increasing, demand for borrowed funds. Corporate borrowing is dominated by the relentless and massive investment in AI infrastructure. Governments around the globe, and in particular the U.S., continue to add to their massive debt loads. The simple supply and demand of debt markets is that if you increase demand substantially, lenders will want to be paid more, resulting in upward pressure on interest

rates. This demand for money, or borrowing, is measured in the trillions of dollars, and makes a significant downstream contribution to the year-over-year GDP growth that we observe in the U.S. economy.

U.S. 10-Year Treasuries started the quarter at about 4.5%, climbing to 5.29% by September 30th, its highest level since 2002. In Japan, which has the highest debt-to-GDP ratio among developed economies, the 10-year rate has moved to over 3%, which was last seen in the mid-1990s. From 2016 to 2021, Japan's 10-year rate hovered around 0%, at times actually being negative. Significantly, persistent inflation has led to an increase in the Fed rate, reversing a downward trend from September 2024 and December 2025. It is the first increase since July 2023, and the market views this as the first of a few rate hikes that will continue into 2027, then lowering again in 2028 and 2029.

For the time being, the AI boom seems mostly impervious to these higher interest rates. Despite the fact that AI companies are borrowing hundreds of billions of dollars to finance the infrastructure build-out and the development of

Index Performance Data
Total Return as of 9/30/2026

Indices ¹	Q3 2026	Trailing 12 Months
CRSP U.S. Total Market Index Total Return	1.41%	15.34%
iShares MSCI ACWI EX-US Total Return	-0.64%	16.32%
Bloomberg U.S. Aggregate Bond Index	-3.51%	-1.84%

the underlying large language models (LLMs) which power the platforms. Done without any clear evidence of long-term profitability for companies like OpenAI, Anthropic, or SpaceX

(which turns out to be mostly an AI company), and a hazy unease about financing that seems circular in nature, and leans heavily on the balance sheet of vendors.

There have been a few periods of significant market retracement in the AI trade, often associated with a rival model being released in China, however these moments have so far proven to be short lived.

Alongside the borrowing and spending of trillions on all things AI, high government deficits pump even more money into the economy. All of which also helps fuel inflation, an issue further exasperated by supply shocks in energy markets due to ongoing conflicts in the Middle East and Europe. In the mix is a stock market benefitting from all the spending (not to mention corporate tax cuts), creating wealth effects that lead to more spending.

At home, despite historically low consumer sentiment, American's total annual spending continues to grow thanks to the population's wealthiest deciles. Stress in consumer debt, like auto loans, credit card balances, and mortgages, has been increasing. Yet at the same time, luxury housing markets like Miami Beach have seen purchases of homes worth \$10 million or more increase 14% over 2025. The majority of these transactions happen in cash, outside of any kind of formal financing.^{2,3}

The result of all of this is an economy that seems a strange place of both pleasure and pain. A bifurcation that can be expressed in different ways, such as the "K" shaped

economy, where for some people things are getting better (the positive slope in the "K"), but for many other people things are getting worse (the negative slope in the "K").

Overall, we remain positive about the market in the short term, but are cautious as we look forward into 2027. In particular, we think

that AI spending and corporate earnings will continue to be strong through 2026. However, we remain vigilant, looking for meaningful cracks to emerge in the AI story, as a significant drop in AI investment could meaningfully affect economic growth and the stock market.

In Focus

Concerns about inflation and government borrowing have caused investors to avoid longer-dated bonds. We understand that view, but believe an entry point to extend duration is near. The traditional view is that as inflation slows, interest rates will also fall.

As such, it might make sense to think that as the war in Iran comes to close, oil prices will fall, which in turn will reduce inflation, causing interest rates to decline as well. And that is likely to happen, but with a few twists.

Oil is a globally priced commodity, moved around the world by pipelines and ships. For this reason, as we have seen in the Persian Gulf, a regional supply shock can become a global economic pain point. For the most-part, oil is refined to produce distillates (gasoline, jet-fuel, diesel, bunker oil) for transportation. In some parts of the U.S., like Maine, oil is also used for heating in the winter.

S&P 500 (Red) vs University of Michigan Consumer Sentiment Survey (Blue)⁸



The underlying stress leading to higher prices is not the actual supply of oil in the world; there was a surplus prior to February and the start of the war with Iran. Rather, the negative supply shock follows the physical destruction of refining infrastructure in the region that produced these distillates. Ships are moving through the Strait of Hormuz again, but the products people want aren't being produced in the same quantities as before the war. The problem isn't so much whether the Strait of Hormuz is open, but whether the products people want are available to move through the Strait at all.

Importantly, the war in Iran is the second major shock to global oil and distillate supply in the past several years. The first shock followed the Russian invasion of Ukraine, in combination with strong post-COVID demand. It will take time to rebuild refining capacity and make other adjustments. There is simply no way for product flows to return to normal in the very short run. In the long run, we will likely see real strategic investments.

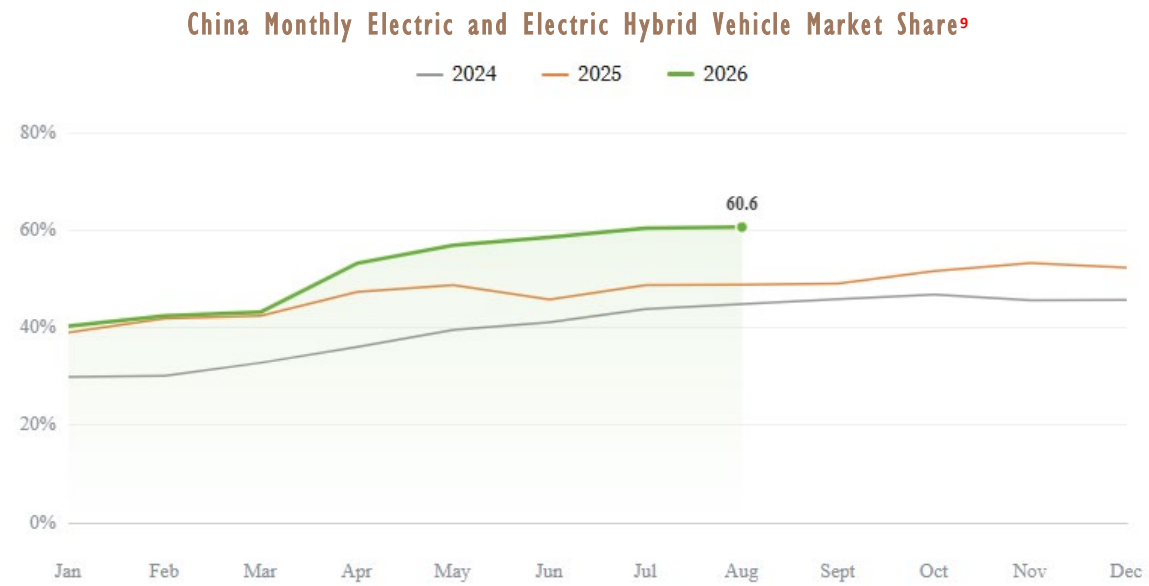
Of particular benefit would be anything that reduces the price of oil and distillates when supply is constrained in the future, for whatever reason. Both supply and demand could be targeted. On the supply side, two logical places to invest would be creating large reserves of excess supply, and building out oil reserves and infrastructure that avoid potential volatile choke points, like narrow straits in the Middle East and anything from Russia. On the demand side, there could be investments that slow the growth in or even reduce overall fossil fuel demand in the future.

One supply side strategy is simply to store massive amounts in strategic reserves. In 1975, the Ford

Administration created the Strategic Petroleum Reserve (SPR). It contains over 700 million barrels of crude when fully stocked, and held above 600 million barrels from 2003 to 2021. During the Biden Administration, stocks were drawn down to 351 million barrels due to supply shocks following the Russian invasion of Ukraine, ending at 395 million barrels at the beginning the second Trump Administration. At the beginning of the Iran war in February, the SPR held about 415 million barrels. After drawing on the SPR through the Iran war, it now holds about 280 million barrels, approaching its lowest level since 1982.⁴ Other countries around the world have similarly drawn down strategic reserves. Without this added supply, prices would undoubtedly be higher, but prices remain high nevertheless. It is also not clear how much more can be drawn from the reserves, since the quality degrades as you get to the bottom of the tank. In short, the strategic reserve solution has been helpful, but is far from a complete fix.

China continues to weather the current oil supply storm, thanks in part to their massive 1.6-billion-barrel strategic reserve, but also a combination of newer energy policies. While China still leans on coal-powered plants to produce electricity, it is a diminishing share of the total, now under 50%.⁵ For many years they have been developing more renewable energy than the rest of the world combined, and at least four times that of the U.S. They also let the real short-term increase in gasoline and diesel prices from the Iran war accelerate a shift to electric vehicles. It is reported that currently 65% of all new domestic vehicle sales are EV

and hybrids, and that EVs account for almost a third of all new heavy truck purchases. It is estimated that Chinese oil demand will drop by almost 9% in 2026, in large part from the



accelerated adaptation of EVs and hybrids.⁶ These investments that reduce the demand for oil will help China in the long run. We imagine other countries will make similar investments in the name of security or resilience. It is worth noting that the U.S. has backed away from investments in lower cost renewable energy.

We think those investments in EVs and hybrids, the slow 'return to normal' for oil supplies, and the enormous spending on AI that we discussed earlier, means inflation will be a challenge through 2027. As such, central banks will have to consider raising interest rates to address the challenge of stubborn inflation. The interesting twists come when inflation does begin to subside and central banks can start to reduce rates.

Part of the twist is that the adjustments central banks make to the rates they control (i.e., the overnight federal funds rate in the U.S.) don't seem to have the same effect on rates for longer-dated bonds, which are ultimately set by the market. Typically, when central banks adjust short-term rates, it influences the rates for all bonds. But lenders (investors) are starting to ask for higher returns when buying longer-dated bonds as worries about the sustainability of government borrowing continue to grow. In addition, the demand for longer-dated U.S. bonds is shifting as policy makers and central bankers around the world consider alternatives to U.S. Treasuries.

The takeaway is that whenever the Fed does lower interest rates, we may not see much change in longer-dated rates. That means we may be entering a period where the dynamics in the bond market (which affects the stock market) are quite different from what we've experienced in recent decades. Jamie Dimond, the president of JP Morgan, said recently he would not buy longer-dated bonds right now. He is worried that lingering inflation and other factors will put upward pressure on interest rates, making longer dated bonds less attractive.⁷ Indeed, one of the other factors to consider is what is happening with inflation and interest rates. When thinking about about a loss of confidence in the U.S. dollar or people in the rest of the world potentially looking to invest less in the U.S., we have to consider higher interest rates. And we are worried about those things.

But the yields on some longer-dated bonds are attractive, especially if you are concerned about a drop in AI spending and market correction. Thus, investment advisors need to be talking to their clients about strategies that include longer-dated bonds, being careful to discuss the risks. Understanding why interest rates are moving as they are now and what is likely to happen in the near future is crucial for good portfolio management. That fact seems to be especially relevant today. It isn't as simple as inflation and interest rates will fall when ships can move freely again through the Strait of Hormuz.

1. Index performance data provided by ICE Data Services, and calculated by Black Diamond, an SS&C Advent company.
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