

Quarterly Newsletter



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Market Overview

U.S. equity markets presented a sharply divergent picture in the third quarter of 2026. The S&P 500 grinded higher, adding 2.30% for the quarter to bring its year-to-date return to 12.75%. The tech-heavy Nasdaq Composite led again, posting a 2.61% Q3 gain and extending its year-to-date leadership to 16.09%. However, the broader market struggled. The Dow Jones pulled back 2.34% in Q3, while small-cap equities bore the brunt of the volatility, with the Russell 2000 suffering a steep 7.23% decline, though it holds a 13.71% year-to-date gain.

This stark divergence reflects a market increasingly divided by interest rate realities. Large-cap technology companies, insulated by strong balance sheets and AI-related capital expenditures, continued to drive the major indices. Conversely, the Russell 2000's sharp reversal highlighted the intense pressure that persistently high borrowing costs exert on smaller, rate-sensitive businesses. This "higher for longer" environment has created exceptionally narrow market leadership.

Inflation and rate expectations continued to dictate fixed-income performance. With yields climbing across the curve—the 10-year Treasury pushed to 5.29% and the 30-year reached 5.64% by quarter-end—bond markets faced persistent headwinds. The Bloomberg US Aggregate index remained down 2.91% year-to-date as prices adjusted to the Federal Reserve's hawkish stance. This unwavering commitment to price stability has kept the U.S. Dollar well-supported, gaining another 1.27% in Q3.

Global equities navigated this challenging environment with mixed results. The MSCI World Index posted a modest 1.88% Q3 gain, lifting its year-to-date return to 11.75%. Emerging markets cooled with a 2.37% Q3 decline but maintained significant outperformance with a 22.08% year-to-date return, while developed international markets (EAFE) finished flat (+0.01%). In commodities, Brent crude surged 47.68% for the quarter, pushing its year-to-date gain to an incredible 112.18% and contributing to the sticky inflation data keeping investors on alert heading into year-end.

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U.S. Equity Returns Table Source: Tamarac			U.S. Treasury Yield Table Source: Treasury				Other Indices Table Source: Morningstar		
Index	Q3 2026 Returns	2026 Returns		09/2026	09/2025	09/2024		Q3 2026 Returns	2026 Returns
Dow Jones	-2.34%	7.19%	3 month	4.20%	4.02%	4.73%	Gold (GLD)	3.38%	-4.06%
S&P 500	2.30%	12.75%	2 year	4.88%	3.60%	3.66%	Brent Oil (BNO)	47.68%	112.18%
NASDAQ	2.61%	16.09%	5 year	5.09%	3.74%	3.58%	U.S. Dollar Index (UUP)	1.27%	6.44%
Russell 2000	-7.23%	13.71%	10 year	5.29%	4.16%	3.81%	Int'l Equity Markets (EFA)	0.01%	8.17%
MSCI World	1.88%	11.75%	30 year	5.64%	4.73%	4.14%	Emerging Equity Markets (EEM)	-2.37%	22.08%

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The Shock Returns and the Fed Hikes—Now the Bond Market Sets the Terms

When we last wrote in early July, we identified inflation as the dominant risk to economic expansion and a renewed energy spike as the tail risk we were most focused on hedging. The third quarter delivered a version of both. The U.S.–Iran truce broke down on July 8, the U.S. naval blockade of Iran was reimposed, and Brent crude climbed back above \$100 per barrel, settling at \$103.53 on September 30th. The Federal Reserve delivered its first rate hike since 2023, and the 10-year Treasury yield posted its largest quarterly increase in over 30 years. Yet the S&P 500 gained 2.3% for the quarter, closing at 7,651.54, up 12.7% year to date. **The inflation persistence we warned about has migrated from the gas pump to the bond market, and the central question for the final quarter is whether rising borrowing costs slow an economy that is still expanding at a solid pace.**

The economy remains stronger than expected. Real GDP grew at a 2.2% annualized rate in the second quarter—revised up from 1.5%—and first-quarter growth was revised up to 2.5%.¹ The American consumer remains remarkably resilient with real consumer spending jumped 0.6% in August and is up 2.6% from a year ago.² Monthly payroll gains have been erratic all year, and September's soft report—a gain of just 29,000 against expectations near 84,000, with unemployment edging up to 4.2%—does not yet establish a trend: the rise in unemployment largely reflected people re-entering the workforce, and the broader U-6 underemployment rate fell to its lowest level since January 2025.³ With real disposable income flat in August and the saving rate down to 4.1%, households are sustaining spending partly by saving less of current income.⁴ **Growth remained resilient through the energy shock, but the consumer's cushion is thinning just as energy and borrowing costs rise together.**

Inflation improved more on paper than in substance. Headline PCE was 3.4% year over year in August and core⁵ was 3.0%, so our call last quarter for headline inflation near 4% was right on direction but too high on level. Core is cooling, with its three-month annualized pace near 2%, but headline has yet to reflect September's 14%+ surge in Brent. The physical oil market remains tight: the U.S. Energy Information Administration (EIA) estimates global inventories fell by 3.9 million barrels per day and does not expect Gulf production to regain pre-conflict levels until the second quarter of 2027,⁶ while Qatar-mediated peace talks remain stalled. **We expect headline PCE to reaccelerate into the 3.5%–3.8% range over the next two reports, even as core likely continues to cool.**

On September 16th, the Federal Open Market Committee (FOMC) voted unanimously to raise the federal funds rate a quarter point to 3.75%–4.00%, with Chair Warsh saying he would be “hard pressed” to describe financial conditions as restrictive. The median projection implies one more hike this year, with PCE inflation of 3.7% in 2026.⁷ With headline inflation likely to reaccelerate and growth running well above trend, we expect the Fed to deliver that hike in December. Where we differ from the market is on what follows. Core inflation is already cooling, long-term yields are doing much of the tightening, and the energy shock should fade as a source of headline inflation by next spring: oil prices first spiked in March 2026, so year-over-year comparisons turn favorable beginning in March 2027, and the EIA expects Gulf production to return to pre-conflict levels by the second quarter of 2027—a timeline a durable settlement would only accelerate. As a result, **we believe there is a heightened probability of December marking the end of this cycle at 4.00%–4.25%, followed by an extended hold, with no easing before mid-2027 at the earliest.**

The bond selloff has become the defining story of the year. The 10-year Treasury yield touched 5.34% on October 1, its highest level since 2002, and the 30-year yield reached 5.69%.⁸ Chair Warsh attributed the rise to economic strength, hyperscaler borrowing to fund the AI buildout, and geopolitics; concern over fiscal deficits is adding a rising term premium. **Yields above 5% offer the most compelling nominal income available in nearly a quarter century, and we believe it may be prudent to begin extending duration in high-quality bonds—gradually and concentrated in intermediate maturities, since the pressures behind higher yields, particularly at the long end, have not abated.**

Equities held up well but narrowly: technology was the only S&P 500 sector to gain in September, while nearly four-fifths of index constituents declined. Fundamentals remain formidable—analysts expect earnings growth of 29.1% for the third quarter and 32.0% for 2026, slowing to 15.4% in 2027—and because earnings have outpaced prices, the forward P/E ratio has compressed to 19.2 from 20.4 at the end of June.⁹ **Even so, the S&P 500's forward earnings yield of roughly 5.2% now sits near the 10-year Treasury yield, compressing the simple earnings-yield spread to roughly zero. That leaves considerably less valuation support for equities and makes further gains increasingly dependent on earnings delivery rather than multiple expansion.**

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Our scenario framework for the final quarter centers on energy prices, long-term rates, and the consumer:

1. **Higher for Longer, Growth Holds (Base Case):**

- **Scenario:** Brent holds at \$85–\$105, core PCE stays near 3%, the Fed hikes once more in December, then pauses, and the 10-year yield trades between 4.9% and 5.5% as economic growth settles near 2.0% to 2.5%.
- **Market Impact:** The S&P 500 ends the year at 7,300–7,900, with elevated volatility around the November 3 midterms and leadership concentrated in technology and energy.
- **Likelihood:** Moderate—this is our base case.
- **Implications:** Favor pricing power, energy, and self-funding quality growth; extend duration in stages into intermediate maturities while maintaining a short-term Treasury anchor.

2. **Diplomatic Breakthrough and Bond Relief (Bull Case):**

- **Scenario:** A durable ceasefire reopens the Strait of Hormuz, Brent retreats to \$75–\$85, the Fed skips the December hike, and the 10-year yield falls toward 4.50%–4.75%.
- **Market Impact:** The S&P 500 advances to 7,900–8,300 as leadership broadens to financials, real estate, industrials, and small caps.
- **Likelihood:** Lower to moderate, given repeated diplomatic false starts this year.
- **Implications:** Constructive for lagging cyclical; duration extended today would add price gains to elevated income.

3. **Energy Shock Meets Rate Shock (Bear Case):**

- **Scenario:** Brent holds above \$110, the 10-year yield breaks through 5.5%, headline PCE nears 4%, and the Fed keeps hiking into 2027 as the economy slows, pushing the consumer to retrench.
- **Market Impact:** The S&P 500 corrects 10%–20% as multiples compress toward the mid-teens; energy, defensives, and short-term Treasuries outperform.
- **Likelihood:** Lower, but rising—this is the combination we are monitoring most closely.
- **Implications:** Emphasize balance-sheet strength, essential services, energy, and cash equivalents yielding near 4%; treat 10-year yields above 5.5% as an opportunity to add intermediate duration; avoid leverage and speculative growth

The third quarter confirmed the economy's resilience, but the cost of that resilience is now being priced in the bond market. We believe our growth at a reasonable price ("GARP") strategy is well suited to this environment, emphasizing pricing power, robust balance sheets, and secular tailwinds in domestic energy infrastructure, AI and data center buildout, defense and aerospace, and essential services. We are maintaining the energy exposure added earlier this year, which has provided an effective hedge as energy became the best-performing sector since June 30th, and higher yields reinforce our discipline of paying only reasonable multiples for growth. In fixed income, we are maintaining a barbell structure—short-term Treasuries and bond ETFs for liquidity and flexibility paired with a staged extension into intermediate maturities—to capture the highest yields in more than two decades without overcommitting to the long end of the curve. **In our view, this balanced approach positions portfolios well for a fourth quarter in which interest rates, not oil, are likely to set the market's direction.**

Brent J. Miller, CFA® – Senior Portfolio Manager

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¹<https://www.bea.gov/news/2026/gdp-second-estimate-4th-quarter-and-year-2025>

²<https://www.bls.gov/news.release/pdf/empst.pdf>

³<https://www.bea.gov/news/2026/personal-income-and-outlays-may-2026>

⁴<https://www.federalreserve.gov/newsevents/pressreleases/monetary20260617a.htm>

⁵Core PCE measures the average change in prices for consumer goods and services while excluding volatile food and energy components.

⁶<https://www.factset.com/earningsinsight>

⁷<https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20260916.pdf>

⁸<https://www.cnn.com/2026/10/01/business/bond-market-treasury-yields>

⁹<https://www.factset.com/earningsinsight>

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