October 2026

# Quarterly Market Review

Third Quarter of 2026

## Growth Holds Its Ground; Inflation Calls the Fed Back In



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The third quarter delivered a familiar surprise: the economy refused to follow the slowdown script. Growth did not cool, it accelerated. Employers hired carefully and fired even more carefully. Consumers shook off July's lull and showed up for the back-to-school season. Then inflation spoiled the party. Pipeline price pressures built, energy and refining constraints resurfaced, and the Federal Reserve moved from talking about interest rate hikes to delivering one.

Markets told the same two-sided story. The S&P 500 gained 2.30% for the quarter, but the green headline hid a much choppier quarter underneath. Bonds offered little refuge: the Bloomberg U.S. Aggregate Bond Index fell 3.51%. Commodities, meanwhile, surged 16.19%. Staying invested mattered—but so did size, duration, and sensitivity to inflation.[1,2]

### Economic and Policy Backdrop

Q3 looks less like an economy bending and more like one finding another gear. Current Fed nowcasts average just over 3%, pointing to an acceleration from Q2's 2.2% pace[3]. The AI buildout is also moving from code to concrete, with spending on data centers, power capacity, and advanced equipment adding muscle to business investment. The fly in the AI ointment is politics: with electricity bills, grid strain, and water use moving onto midterm ballots, data centers have gone from ribbon-cutting trophies to political hot potatoes—raising the risk of permitting delays and higher costs, but not yet derailing the buildout. Manufacturing and services surveys remained in expansion territory during the summer.[4] Meanwhile, the pace of payroll growth has undoubtedly softened: the three-month hiring pace remained modest, job openings and quits were subdued, and layoffs stayed low. Yet the sharp drop in immigration has also reduced the pace of job creation needed to sustain low unemployment. This low-hire, low-fire labor market bears watching, but does not rise to a level of urgent concern at this point.

The consumer also refused to roll over. August retail sales jumped 1.2%, while the control group used in GDP calculations rose 1.4%, both comfortably ahead of expectations.[5] The strength was broad, suggesting that back-to-school spending and timing effects helped reverse July's air pocket. Housing was a different story. Weak starts, sales, pending activity, and mortgage applications all pointed to the same culprit: elevated financing costs are still biting.

Inflation, however, did not read the soft-landing script. Earlier improvement in consumer prices ran into renewed pressure from producer-price components, import prices, and elevated prices-paid indexes in manufacturing and services. Energy markets added another wrinkle as refining constraints and supply risks apply cost pressure. Diesel is doing the shouting; the national average stands at $6.38 a gallon, while California truckers face an eye-watering $8.18 per gallon—a cost shock that starts with transportation and travels through the entire supply chain.[6] These measures don't map perfectly into CPI or PCE, but together they send a clear message: cost pressure is still moving through the pipeline.

That left the Fed with less room to stay on the sidelines. On September 16, policymakers fired the opening shot in a renewed tightening cycle, raising the target range by 25 basis points to 3.75%–4.00%[7]. This marks a decisive change in posture as resilient employment and demand give policymakers room to focus on inflation. We expect two or three additional hikes by mid-2027—enough to keep the pressure on inflation, but nowhere near the 525-basis-point sledgehammer the Fed used from March 2022 through July 2023.

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## Equities

At first glance, equities had a decent quarter. Look one layer down and the picture was much less comfortable. The index was up; the average stock was not. The capitalization-weighted S&P 500 returned 2.30% for the quarter, but the equal-weighted index fell 1.87%. The S&P MidCap 400 lost 6.36%, the S&P SmallCap 600 dropped 7.93%, and the S&P 500 Dividend Aristocrats Index declined 3.16%. REITs fell 6.08% as higher long-term rates weighed on rate-sensitive assets. International equities were steadier, with the MSCI ACWI ex USA Index gaining 0.48%.[1]

That is a sharp reversal from Q2's broadening rally. Investors returned to a familiar habit: rewarding scale, earnings visibility, and balance-sheet strength. Fundamental strategies remained competitive over the longer horizon - the Russell RAFI U.S. Large Company Index gained 1.43% in Q3 and 17.61% year to date, versus 12.75% for the S&P 500 year to date[1]. Diversification will not win every quarterly race, but it remains the better way to avoid making an entire portfolio dependent on a handful of names.

## Fixed Income and Credit

Bonds had a rough quarter, and duration took the hardest hit. The Bloomberg U.S. Aggregate Bond Index fell 3.51%, Treasuries declined 3.04%, investment-grade corporates lost 3.94%, and the Bloomberg U.S. MBS Index fell 4.25%. The 10-year Treasury yield surged 81 basis points as the market confronted a wall of capital demand[2]. Heavy government borrowing collided with record-setting corporate issuance—fueled in part by the AI infrastructure buildout—forcing investors to demand more compensation for funding both Washington and corporate America[8]. The market was pricing more than another Fed hike; it was also charging governments for fiscal profligacy. The bond vigilantes are back, enforcing market discipline despite Treasury Secretary Scott Bessent's ill-advised attempt to hold down long-term yields through expanded bond buybacks.

Credit performance sent a less alarming message. High yield declined 1.82%—not pleasant, but noticeably better than longer-duration sectors—and remained slightly positive for the year at 0.10%. In other words, Q3 was primarily a rates story, not a credit event. Commodities were far less subtle: a 16.19% quarterly gain and a 32.87% year-to-date advance served as a flashing reminder that inflation risk has not disappeared. Credit fundamentals still look healthy, but tight spreads leave little cushion if growth or earnings disappoint.[2]

## Strategic Outlook

Our outlook remains constructive, but complacency has no place in it. Resilient consumer demand, low layoffs, and continued business activity should support earnings and credit quality. At the same time, slower hiring, weak housing, and narrower equity leadership show that higher rates are having an effect. The economy is still moving forward; it is simply carrying more weight.

The front end of the yield curve has already absorbed much of the damage. Even with additional Fed hikes likely, markets have repriced a meaningful portion of that risk in the short end of the curve. The long end is a different story. Heavy government borrowing, record-setting corporate issuance, and an elevated term premium leave longer-duration bonds exposed. Higher starting yields provide attractive income, but this is no time to make an oversized bet on falling rates.

The principal risks are that pipeline inflation keeps the Fed restrictive longer than markets or borrowers expect, and that continued fiscal profligacy pushes government risk premiums higher in the absence of a credible path toward restraint. Equities can continue to advance, although 2027 is unlikely to deliver another victory lap. Our base case is for positive but more modest—likely single-digit—returns as earnings growth does more of the work and elevated valuations leave less room for multiple expansion. That environment favors quality, durable cash flow, valuation discipline, and broader diversification across capitalization and investment styles.

*From the Desk of our Chief Investment Officer*

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The bottom line: Q3 was not a crisis; it was a warning label. Growth still has momentum, inflation still has a vote, and the Fed has shown it is willing to act. Markets can continue to advance, but the easy part may be behind us. Our job is not to predict every twist. It is to own durable cash flows, avoid paying any price for the most popular story, and keep enough flexibility to take advantage of the volatility that is likely to come with it.

## Disclosures

[1] Source: Standard & Poor's, MSCI and Research Affiliates index data; final returns through 9/30/2026.

[2] Source: Bloomberg index data; final returns through 9/30/2026.

[3] The New York Fed Staff Nowcast as of September 25, 2026.

[4] Bloomberg, ISM Manufacturing

[5] Bloomberg, U.S. Census Bureau

[6] Bloomberg, U.S. Energy Information Association (EIA)

[7] Bloomberg, Federal Reserve FOMC statement on September 16, 2026

[8] SIFMA, U.S. Corporate Bonds Statistics, September 14, 2026; Bloomberg News, various dates in September 2026.

Economic data sources include the U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, U.S. Census Bureau, Federal Reserve Board and Federal Reserve Banks, Institute for Supply Management, U.S. Energy Information Administration, National Association of Realtors, Mortgage Bankers Association and Bloomberg. Data reflects information available through 9/30/2026; individual observations carry their original release dates.

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