

Market recap

Third quarter 2026

Asset class returns

	Q3 2026	YTD
Commodities S&P GSCI	+25.1%	+55.2%
U.S. equity S&P 500	+2.3%	+12.7%
Foreign developed equity MSCI EAFE	+0.9%	+10.8%
Emerging market equity MSCI EM	-0.2%	+23.7%
Fixed income Bloomberg U.S. Aggregate	-3.5%	-2.9%

S&P 500 sector returns

	Q3 2026	YTD
Energy	+17.2%	+40.3%
Information Technology	+7.2%	+28.4%
Health Care	+6.5%	+10.2%
Communication Services	+3.6%	+4.5%
Financials	-0.1%	-1.3%
Consumer Staples	-1.9%	+6.0%
Materials	-2.8%	+8.8%
Consumer Discretionary	-5.1%	-5.8%
Real Estate	-5.6%	+5.3%
Industrials	-9.7%	+8.5%
Utilities	-12.4%	-5.7%

Total returns through 9/30/2026. Sectors are S&P 500 sector indexes, ranked by quarterly return. Sources: FactSet, Macrobond, Morningstar Direct.

If the second quarter was a story of recovery, the third was a reminder of how much of that recovery still hinges on a single variable: energy. Brent crude, which had fallen into the low \$70s after June's deal, worked its way back above \$100. Against that backdrop, equities spent the quarter consolidating the large gains of the spring amid ongoing conflict, higher oil prices, and higher inflation. The forward P/E multiple on the S&P 500 was 22.0x at the start of the year and has since contracted to 19.0x despite the double-digit price increase. The reason for the multiple contraction has been surging earnings per share. Another big headline in Q3 was the Federal Reserve delivering its first rate hike in more than three years in September with a more hawkish outlook than markets had expected. 1-2 additional hikes are forecasted for the remainder of 2026 as the committee has made it clear that they want to bring inflation down sooner rather than later. Broader, non-core inflation measures are likely to remain elevated thanks to their inclusion of energy prices. Headline CPI ran at 3.3% and 3.4% year-over-year in July and August, and the culprit is gasoline, accounting for roughly a third of the increase. Strip out food and energy, though, and the picture is far more comfortable. Core CPI eased to 2.4%, its lowest reading since early 2021.

That brings us to the quarter's main event: the rate hike. After holding rates through the first half of the year – with three members dissenting in favor of a hike in July, and Chair Warsh striking a notably hawkish tone at Jackson Hole in late August – the FOMC raised the funds rate by a quarter point on September 16, to a target range of 3.75%–4.00%. It was the first hike since 2023, and it reversed one of the three cuts that closed out last year. The key difference between 2026 and 2022 is that the hikes this year started from a range of 3.50%–3.75%, unlike 2022 when we were coming off a base of 0%. Remember, we came into this year with markets forecasting 1-2 cuts! The September vote was unanimous, and the statement was clear: inflation remains elevated, and the committee “will deliver price stability.” The updated dot plot showed that the committee (based on the median dot) expects one more hike before year-end, with several looking for two. Longer rates had already been moving in anticipation – the 10-year U.S. Treasury yield broke above 5.00% in late September and closed the quarter at

5.29%, its highest close since 2002! The 2-year Treasury yield ended the quarter at 4.88%, a full point above the funds rate, which implies roughly four more hikes over the next year or two. The good news is that the hike was accompanied by positive revisions to the FOMC's GDP and employment forecasts, but inflation was also revised higher.

While the economy appears to be humming along, even with elevated inflation, consumer sentiment is nowhere near as rosy. This dour view reflects gasoline hitting a record high for this late in the year and diesel prices being at their highest levels ever! Real wages are stagnant, which is a concern as well. The good news is that this has not affected consumer spending in any meaningful way yet. The \$90 trillion in wealth that baby boomers have amassed is a big tailwind for continued spending, evidenced by August retail sales which were robust basically across the board. Food and energy together are only about 11% of consumer spending today, versus more than a quarter in the 1970s, and the U.S. is now the world's largest oil producer, which mutes the pass-through from an oil shock to the domestic economy. We remain concerned about higher oil prices feeding into inflation, into rates, and eventually into demand but we are not there yet.

Markets, for their part, largely digested the flow of events rather than advancing. After the April-May rally that carried the S&P 500 to record highs and a nine-week winning streak, the index spent the third quarter consolidating. Technology, which had driven the spring surge, stalled over the summer as investors questioned valuations, then rallied in September to finish the quarter second only to Energy. The broader market did not keep up: the equal-weighted S&P 500 fell -1.9% in Q3 while the cap-weighted index gained +2.3%. Rising bond yields and a climbing oil price were the obvious headwinds. Artificial Intelligence also remains a large consideration as investors are trying to figure out what sectors will benefit and which will be hurt. If you remember, software had a reckoning earlier in the spring as markets decided AI was going to eat its lunch. That proved to be relatively short lived, however, as prices got cheap enough to buy and the industry has basically recovered its losses. For the time being, it appears as though markets are trying to balance the pros of AI productivity gains with an unclear off-ramp for the Iran conflict.

Still, markets have held up remarkably well, climbing the "Wall of Worry" time and time again, aided by the fundamental fact that earnings remain exceptionally strong. Second-quarter results beat consensus by roughly 7%, the strongest beat in five years, and forward earnings estimates have continued to climb, with full-year 2026 S&P 500 growth now tracking around 32%. As mentioned above, the index's forward multiple sits around 19.0x, still below where it began the year, driven by rising forward earnings estimates. 4 years into the bull market that began in October 2022, this is the setup you want to see.

Nonetheless, it is important to remember that the market continues to work through a regime change. Gone is the zero-rate, hyper-globalized era that rewarded asset-light businesses. Now we are in an environment of higher rates and inflation, reshoring, and an AI build-out that is fundamentally physical. That build-out runs through chips, data centers, the power grid, and the raw materials that feed all three. Commercial real estate financing is now occurring at much higher rates than it has been in the last 1-2 decades, but we'd like to remind you that the current absolute levels of rates are normal relative to all of history. The dispersion between the winners and losers is wide enough to reward active selection. It informs the overweights in our Sector Rotation strategy (ETF: SECT) toward materials, industrials, and utilities, as well as the regional tilt in our International strategy (ETF: INTL) toward Asia. Our Thematic strategy (ETF: TMAT) continues to try to identify underpriced areas with large total addressable markets and the potential for exponential growth while our BuyWrite strategy (ETF: BUYW) sits on the other end of the spectrum as an income-oriented, defensive complement to equity beta – a role that earns its keep in a quarter defined by rising rates and range-bound prices.

As we head into the final quarter of 2026, the risks remain easy to name: the Strait of Hormuz remains contested, headline inflation is moving in the wrong direction, and the Fed has told us plainly that its next move is almost certainly another hike or two. Add in the pre-midterm seasonal weakness and the continued dispersion of the AI trade and you've got a murky outlook from the top. But from the bottom, the earnings backdrop is sound, the multiple is reasonable, and the consumer is still spending. As always, we would remind investors that time in the market is what matters most, not timing it. We hope you and your loved ones are healthy and safe, and please let us know if we can answer any questions.

Valuation metrics per FactSet Data.

Important disclosures

All metrics from Morningstar Direct, Macrobond, and FactSet Financial Data and Analytics.

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