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In Brief

U.S. equity markets were resilient in September despite increased volatility and sharply higher interest rates. The S&P-500 traded largely sideways (- 0.35), while the Nasdaq outperformed as Technology and AI-related companies continued to provide market leadership. Market breadth weakened, however, with Financials and Real Estate among the lagging sectors as higher borrowing costs weighed on rate-sensitive areas. Long-term Treasury yields rose substantially. The 10-year Treasury yield moved above 5.2%, reaching its highest level since 2007, while the 30-year exceeded 5.6%. Strong economic growth, elevated oil prices, persistent inflation and substantial government and private-sector financing requirements contributed to the increase. The 10-year yield rose approximately 80 basis points, i.e., 0.80%, during the third quarter, its largest quarterly increase since 2022. Despite this considerable tightening in financial conditions, equity markets have remained remarkably resilient, supported by strong corporate earnings and continued AI-related investment.

Economy

The U.S. economy entered the fourth quarter with considerable momentum. The Atlanta Fed's GDP Now model estimated third-quarter growth at approximately 5% in late September, supported by strong consumer spending and private investment. Business activity also accelerated, with the September Composite PMI reaching 58.4, its highest level in more than five years. AI, data centers, power infrastructure and related equipment spending continue to provide important sources of economic growth. The consumer remains resilient. Spending increased 0.9% in August and 0.6% after adjusting to inflation, although the savings rate declined to 4.1%. Inflation remained elevated, but showed some moderation, with core PCE rising 3.0% year-over-year. The economy, therefore, remains considerably stronger than expected earlier this year. The key question is increasingly whether strong productivity and investment growth can sustain this expansion without creating additional inflationary pressure and pushing long-term interest rates still higher.

Labor Market

The underlying trend in the labor market is weakening, although unemployment remains low at 4.1% and layoffs remain historically low. Job openings have declined and hiring remains subdued. Employers are becoming increasingly selective about adding workers. AI is contributing to weaker hiring, particularly in entry-level and routine white-collar positions, as companies can increasingly increase output without adding employees. Rather than causing widespread layoffs, AI is allowing companies to leave positions unfilled or hire fewer new employees. At the same time, wage pressures have begun to be firm. The Wage Growth Tracker rose to 4.1% year-over-year in August, the fastest pace since September 2025, while wage growth for job switchers accelerated to 5.0%, the strongest since June 2024. Labor supply is being constrained by tighter immigration policies and continued Baby Boomer retirements, which could put further upward pressure on wages even as hiring slows. For now, productivity provides an important offset: unit labor costs increased only 1.4% year-over-year in the second quarter. The labor market, therefore, presents an unusual combination of slower hiring, limited layoffs and renewed wage pressure.

Monetary Policy

The Federal Reserve raised the federal funds rate by 25 basis points in September to 3.75%–4.00%, its first increase after three rate cuts in 2025. Inflation remains above the Fed's 2% target, although the latest data were encouraging. The central bank's preferred measure of underlying inflation, core PCE, increased by a less-than-expected 0.2% in August, while the previous month was revised lower. Markets now assign less than a 40% probability to another rate increase in October. The Fed nevertheless faces a strong economy, supported by accelerating consumer spending and substantial capital investment. This allows monetary policy to remain focused

on inflation, but the softer inflation data reduces the immediate need for another increase. For financial markets, attention is, therefore, shifting increasingly toward long-term Treasury yields. Even if the Fed remains on hold in October, elevated long-term yields will continue to influence borrowing costs and equity valuations.

Corporate Earnings

Corporate earnings remain an important source of support for equity markets. Third-quarter S&P-500 earnings are expected to grow approximately 24% from a year ago, with revenues rising about 11%. Technology remains a major contributor, with earnings expected to rise roughly 42%, driven particularly by semiconductors and continued AI investment. Energy is also showing exceptionally strong earnings growth, helped by higher oil prices, while earnings momentum has improved in Industrials, Transportation, Financials and Utilities. Importantly, earnings strength is broadening beyond Technology. All 11 S&P-500 sectors are expected to deliver earnings growth for full-year 2026, while Financials are benefiting from a steeper yield curve and stronger capital-markets activity and Industrials from spending on AI infrastructure, power, defense and domestic manufacturing. Health Care fundamentals are also improving. Consumer-oriented sectors remain more mixed as higher interest rates and stretched household finances weigh on the outlook. The earnings outlook, therefore, remains strong but increasingly differentiated by sector. AI continues to lead profit growth, while the broadening of earnings into cyclical sectors provides an important additional source of support for the market.

Food for Thought

The sharp rise in long-term bond yields raises an important question: who is setting interest rates today? The Federal Reserve controls the overnight rate, but the 10- and 30-year Treasury yields are increasingly determined by global capital flows and the marginal investor. Hedge funds and other leveraged investors have become significant participants in the Treasury market, while foreign private investors, asset managers, pension funds and insurance companies continuously adjust their exposure according to relative yields, inflation expectations and currency-hedging costs. Federal Reserve research confirms that the Treasury investor base has shifted away from less price-sensitive foreign official buyers toward more price-sensitive hedge funds and private investors. Japan is an important part of this equation. Rising Japanese interest rates are changing the economics of the yen carry trade and making domestic bonds more attractive to Japanese investors. Japanese investors have already reduced some foreign bond holdings. A larger repatriation of capital could reduce an important source of demand for U.S. Treasuries and put additional upward pressure on yields. Oil is another important influence. Middle Eastern exports have been recovering, yet oil prices remain around \$100 as markets continue to price geopolitical and supply risks. Speculative and leveraged investors can amplify these movements, particularly when positioning becomes concentrated. Higher oil prices then feed directly into inflation expectations and bond yields. The result is a bond market influenced by far more than Federal Reserve policy. Treasury supply, hedge-fund positioning, Japanese capital flows, oil prices and inflation expectations can all move long-term yields independently of the Fed. Understanding who the marginal buyer or seller is may therefore be increasingly important in determining where long-term interest rates ultimately settle.

Market Outlook

We expect market volatility to remain elevated as the fourth quarter begins. The principal concern remains the rise in long-term interest rates. However, the absolute level of rates is less important for equities than the reason they are rising. Higher yields driven by stronger economic growth and demand for capital can coexist with rising stock prices, provided corporate earnings and productivity grow sufficiently to offset the higher cost of capital. The risk increases when yields rise because of persistent inflation or concerns about government financing, since higher rates then raise borrowing costs and reduce equity valuations without a corresponding improvement in economic growth. This distinction is particularly important today: the economy and corporate earnings remain strong, while

productivity growth is helping contain unit labor costs. In our fixed-income portfolios the average yields remain attractive enough to provide a meaningful cushion against further increases in interest rates. Nevertheless, we intend to reduce some intermediate-duration exposure and adopt more of a barbell approach, temporarily allocating proceeds to Treasury bills. This preserves attractive current income while reducing interest-rate sensitivity and provides liquidity to reinvest in longer maturities once we believe yields have reached a plateau. We, therefore, remain invested in equities while maintaining a disciplined approach, taking partial profits where valuations have become extended and selectively adding to positions when market weakness creates attractive opportunities.

Your Terra Nova Team