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MARKET MUSINGS

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CAN THE ECONOMY OUTRUN THE FED?

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SUMMARY

- The Fed is expected to raise rates this week, but a repeat of 2022's hiking cycle is not our base case. In five of the past six hiking cycles, stocks were positive over the following year, underscoring that economic conditions and inflation trends matter more than the direction of rates alone.
- The economy continues to expand, and earnings growth has helped bring stock valuations back to their 10-year average. Investors are paying more reasonable prices for growing profits, which helps reduce some risk as the market digests the uncertainty around AI spending and rising oil prices.
- Historical market patterns favor additional gains through year-end. Similar first-half recoveries as well as double-digit market gains through August have typically preceded positive finishes, suggesting any near-term weakness would remain consistent with a broader advance.
- Our **microcast**[™] signal remains at a neutral allocation. Taken together, our tactical risk models continue to indicate a constructive backdrop for equities.

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See content within for additional information on the summary items discussed above

THE FED IS EXPECTED TO RAISE RATES AS INFLATION REMAINS ELEVATED

The Fed is expected to raise interest rates by 0.25% this week. Inflation remains a concern, but the economy is strong enough to give policymakers room to act. This would be the first increase to the federal funds rate since July 2023.

The start of a Fed hiking cycle is not, by itself, a reason to turn bearish on stocks. Over the past 30 years, stocks were higher one year after the first rate hike in five of the six previous Fed hiking cycles. Market performance was often weak in the first one to three months, but 2022 was the only cycle in which the market finished lower a year later (data from LPL):

S&P 500 After Initial Rate Hikes

Cumulative price performance from the first hike in each cycle (%)

Six rate-hiking cycles since 1994 | Returns shown 1–12 months after the initial hike

■ POSITIVE RETURN ■ NEGATIVE RETURN

Initial Hike	1 Mo.	2 Mo.	3 Mo.	4 Mo.	5 Mo.	6 Mo.	12 Mo.
Feb. 1994	-0.8%	-6.1%	-3.2%	-1.1%	-3.9%	-1.0%	+4.8%
Mar. 1997	-2.9%	+7.7%	+13.2%	+19.6%	+17.5%	+20.0%	+41.8%
Jun. 1999	-3.1%	-3.4%	-6.3%	-0.3%	+1.7%	+7.6%	+7.4%
Jun. 2004	-3.4%	-3.5%	-2.0%	-0.5%	+3.7%	+7.5%	+6.6%
Dec. 2015	-9.2%	-8.2%	-1.8%	+1.1%	+0.6%	+1.4%	+11.3%
Mar. 2022	+0.8%	-7.8%	-15.6%	-11.0%	-0.5%	-10.6%	-7.6%
Median	-3.0%	-4.8%	-2.6%	-0.4%	+1.1%	+4.5%	+7.0%

Source: Supplied reference exhibit. Values are visually reconstructed and may differ slightly from the underlying source data.

Disclosure: Past performance is not indicative of future results. Indexes are unmanaged and cannot be invested in directly.



The 2022 hiking cycle reflected an unusual set of circumstances. Pandemic-driven supply disruptions collided with strong consumer demand, fueled by three major fiscal stimulus packages and the reopening of the global economy, which drove inflation to its highest level in four decades. The Fed was slow to respond and ultimately had to tighten aggressively to catch up.

We think today's backdrop is fundamentally different. While the recent uptick in inflation is a legitimate concern, it remains well below the levels reached before the Fed began hiking rates in March 2022. Policymakers today aren't confronting the same combination of supply shocks, extraordinary fiscal stimulus, and delayed policy response that defined 2021-2022.

Ultimately, what matters for the market is how tighter policy affects economic growth, corporate earnings, and liquidity. As the historical record above shows, a rate hike is not inherently negative. The key question is whether tighter financial conditions materially weaken the economic and earnings outlook. For now, that backdrop remains strong.

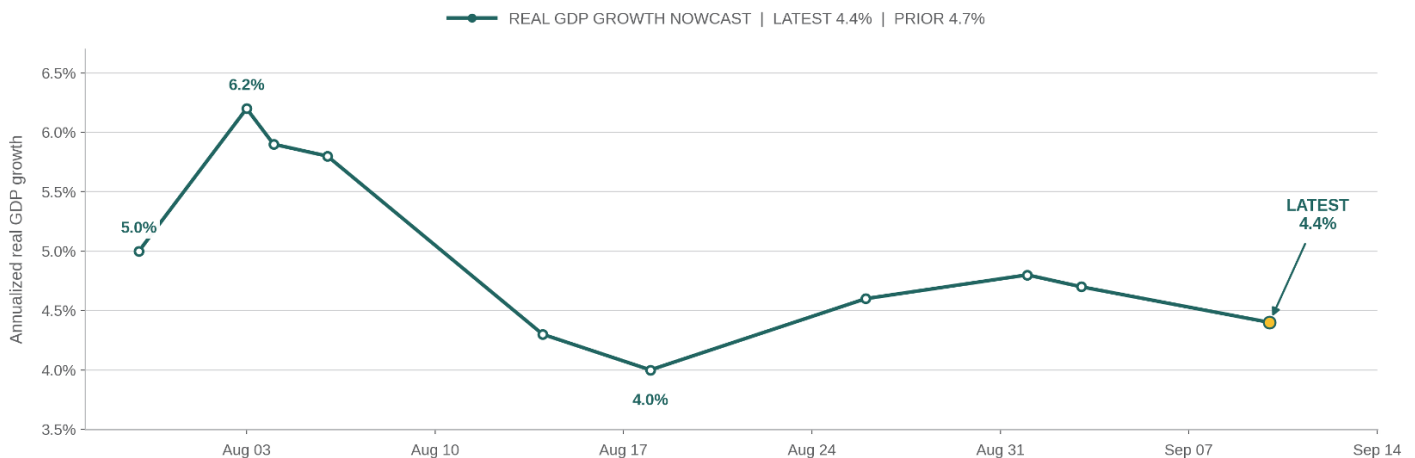
THE ECONOMY REMAINS RESILIENT, AND CORPORATE EARNINGS ARE STRONG

The US economy remains stronger than the prevailing narrative suggests. Unemployment is still low, while current estimates point to roughly 4.4% annualized GDP growth in the third quarter. That underlying strength gives the Fed more room to raise rates without immediately threatening the economic expansion (data from the Atlanta Fed):

GDPNow Estimate: 2026 Third Quarter

Annualized real GDP growth estimate as incoming data are incorporated

Initial estimate July 30 | Latest update September 10, 2026



Source: Official GDPNow update commentaries. Figures are annualized estimates of real GDP growth.

Disclosure: GDPNow is a model-based nowcast, not an official forecast. Estimates may change materially as new economic data arrive.



As we've discussed in previous issues of Market Musings, investment in artificial intelligence has become an important contributor to economic growth. That makes last week's warnings from leaders at Anthropic, OpenAI, and Google, as well as Elon Musk, to pause or slow the development of frontier models economically relevant, not just technologically significant.

The key question is whether those warnings lead to a meaningful slowdown in AI-related capital spending. If they do, one of the economy's strongest sources of incremental investment could weaken. For now, however, the effect on growth and corporate earnings is still too uncertain to quantify.

Please see important disclosures at the end of this article

The good news is that strong earnings growth has made valuations more reasonable. The S&P 500 now trades at 19.1 times forward earnings, roughly in line with its 10-year average and below its five-year average of 19.9 times (chart from DataTrek):

S&P 500 Forward P/E: Ten Years

Forward 12-month earnings multiple with trailing valuation averages

Daily observations | Through September 11, 2026



Source: Actual daily index prices and forward earnings estimates from our data system. Event labels are based on public announcements and reports.
Disclosure: Past performance is not indicative of future results. Indexes are unmanaged and cannot be invested in directly.



That matters because investors are paying less for each dollar of expected earnings than they were through much of 2024 and 2025, even as both the economy and earnings outlook remains constructive. The market is not “cheap,” but valuations are no longer as demanding. That gives the market more room to absorb higher rates, uncertainty around AI investment, and volatility in oil prices without requiring a meaningful reset in prices.

MARKET HISTORY SUPPORTS A STRONG FINISH TO THE YEAR

History also supports a constructive outlook for the remainder of the year. Since 1950, there have been six prior instances when the S&P 500 followed a negative first quarter with a second-quarter gain of more than 10%, as it did this year. In every case, stocks went on to post gains in both the third and fourth quarters, with an average second-half return of 15%. With two weeks remaining in the third quarter, the S&P 500 is up 2.3% through September 11, 2026 (table from Stock Trader’s Almanac):

S&P 500 After Weak Q1, Strong Q2

Historical performance after a negative first quarter and a second-quarter gain above 10%

Occurrences since 1950 | Quarterly and calendar-year price returns

Year	Q1	Q2	Q3	Q4	2nd Half	Full Year
1968	-6.5%	10.4%	3.1%	1.2%	4.3%	7.7%
1980	-5.4%	11.9%	9.8%	8.2%	18.8%	25.8%
2003	-3.5%	14.8%	2.2%	11.6%	14.1%	26.4%
2009	-11.7%	15.2%	15.0%	5.5%	21.3%	23.5%
2020	-20.0%	20.0%	8.5%	11.7%	21.2%	16.3%
2025	-4.6%	10.6%	7.8%	2.3%	10.3%	16.4%
2026	-4.6%	14.9%	—	—	—	—
Average			7.7%	6.8%	15.0%	19.3%
Median			8.1%	6.8%	16.5%	19.9%
Higher			100.0%	100.0%	100.0%	100.0%

Weakest historical second half: 1968 (+4.3%)

Source: Supplied reference exhibit. Values are visually reconstructed; published summary statistics may reflect unrounded underlying returns.

Disclosure: Past performance is not indicative of future results. Indexes are unmanaged and cannot be invested in directly.



In addition, when the S&P 500 gained between 10% and 20% through August, stocks finished higher in the final four months in 18 of 20 cases, with an average gain of 6%. Performance in September and October was mostly a coin flip, with much of the strength arriving in November and December (table from 3Fourteen):

S&P 500 Fall Returns After 10%–20% Starts

September–December performance when the index gained between 10% and 20% through August

1950–2025 | 20 completed cases | 2026 through August 28: 12.7%

● POSITIVE ● NEGATIVE

YEAR	JAN-AUG	SEP	OCT	NOV	DEC	SEP-DEC
1951	14.0%	-0.1%	-1.4%	-0.3%	3.9%	2.1%
1958	19.4%	4.8%	2.5%	2.2%	5.2%	15.6%
1961	17.1%	-2.0%	2.8%	3.9%	0.3%	5.1%
1963	14.9%	-1.1%	3.2%	-1.1%	2.4%	3.5%
1967	16.6%	3.3%	-3.5%	0.8%	2.6%	3.0%
1976	14.1%	2.3%	-2.2%	-0.8%	5.2%	4.4%
1979	13.7%	0.0%	-6.9%	4.3%	1.7%	-1.3%
1980	13.4%	2.5%	1.6%	10.2%	-3.4%	10.9%
1983	16.9%	1.0%	-1.5%	1.7%	-0.9%	0.3%
1985	12.8%	-3.5%	4.3%	6.5%	4.5%	12.0%
1986	19.7%	-8.5%	5.5%	2.1%	-2.8%	-4.3%
1991	19.7%	-1.9%	1.2%	-4.4%	11.2%	5.5%
2003	14.6%	-1.2%	5.5%	0.7%	5.1%	10.3%
2009	13.0%	3.6%	-2.0%	5.7%	1.8%	9.3%
2012	11.8%	2.4%	-2.0%	0.3%	0.7%	1.4%
2013	14.5%	3.0%	4.5%	2.8%	2.4%	13.2%
2017	10.4%	1.9%	2.2%	2.8%	1.0%	8.2%
2019	16.7%	1.7%	2.0%	3.4%	2.9%	10.4%
2023	17.4%	-4.9%	-2.2%	8.9%	4.4%	5.8%
2024	18.4%	2.0%	-1.0%	5.7%	-2.5%	4.1%
2026*	12.7%	—	—	—	—	—
AVERAGE	15.5%	0.3%	0.6%	2.8%	2.3%	6.0%
MEDIAN	14.7%	1.4%	1.4%	2.5%	2.4%	5.3%
% POSITIVE	100.0%	55.0%	55.0%	80.0%	80.0%	90.0%

Disclosure: Completed cases gained more than 10% but less than 20% from the prior year-end through August month-end. 2026 is through August 28 and is excluded from the summary. Monthly and September–December figures are price returns. Past performance is not indicative of future results. Source: Actual daily S&P 500 price-index data in our system.



These historical patterns do not determine how the year will finish, but they reinforce a constructive outlook. Near-term volatility would be entirely consistent with prior cycles and, on its own, would not change the broader investment case.

In summary, an expected Fed rate hike this week may evoke memories of 2022, but today's backdrop is fundamentally different. Economic growth remains healthy, inflation is rising at a much slower pace, corporate profits continue to grow, and valuations are less demanding than they were at the start of the year. History also suggests that the market can continue to advance through a tightening cycle, even if the path over the next several weeks is uneven.

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