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MARKET MUSINGS

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Q3 2026 MARKET REVIEW: YIELDS RISING

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SUMMARY

- The surge in Treasury yields reflects a stronger economy and higher borrowing demands rather than a significant increase in long-term inflation expectations. While rising rates have weighed on bonds and interest-rate-sensitive sectors, corporate earnings remain strong, credit markets show little evidence of widespread stress, and today's yields are not historically unusual.
- Market leadership narrowed considerably during the third quarter. Large-cap stocks outperformed while small caps, the average S&P 500 stock, and emerging markets struggled. Rising Treasury yields pressured bonds, while oil rebounded sharply and gold posted only modest gains.
- Stocks have generated positive long-term returns under virtually every combination of presidential and congressional control. While some political arrangements have coincided with weaker returns, those differences often reflect broader economic conditions rather than the party in power. Economic growth, corporate earnings, and monetary policy remain far more important drivers of market performance.
- Our **micro**cast™ 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

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WHAT'S BEHIND THE LATEST SURGE **IN BOND YIELDS?**

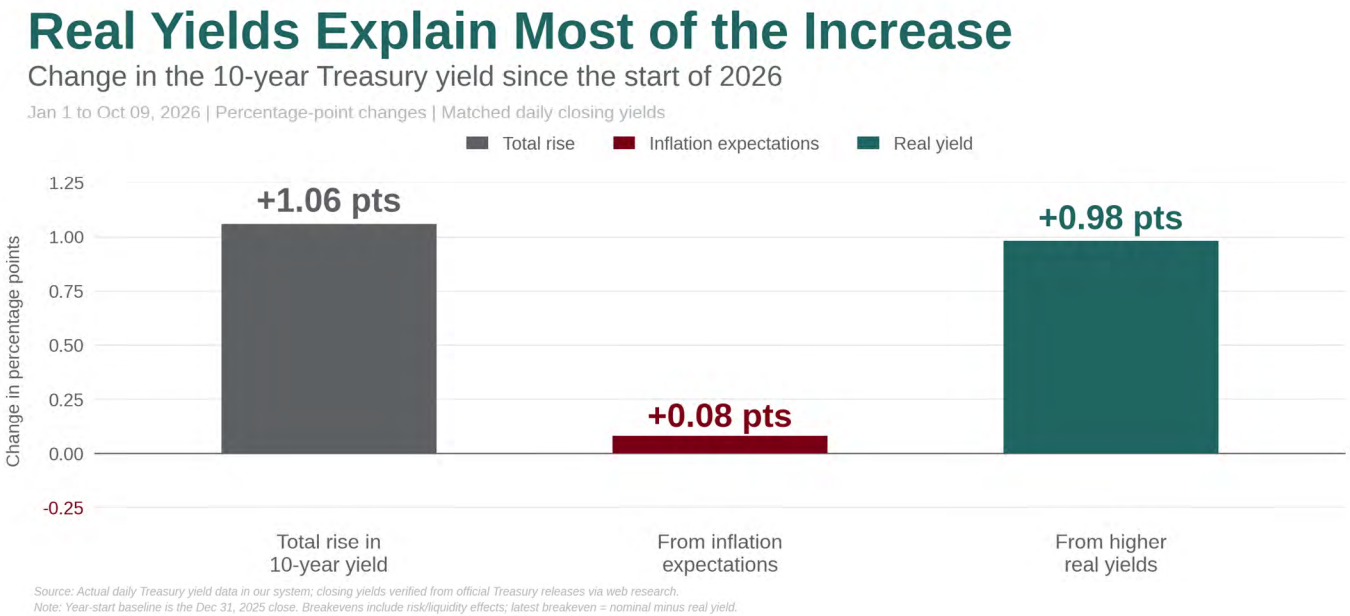
Treasury yields have surged to their highest levels in more than 20 years, raising concerns about inflation and the outlook for the economy. But the reasons behind the increase tell a more nuanced story. In our view, **rising yields largely reflect a resilient economy, strong demand for capital, and a Federal Reserve that has little reason to lower interest rates while growth remains strong and inflation stays above its target.**

The 10-year Treasury yield climbed from roughly 4% in February to more than 5.3% in early October, its highest level since 2002. In the third quarter alone, it rose 0.82 percentage points, the largest quarterly jump since 1994. Because bond prices fall when yields rise, the move has been painful for bond investors, although nowhere near as damaging as the rise in yields back in 2022.

With oil above $100 per barrel, gasoline prices at multiyear highs, and tariffs affecting the cost of imported goods, it would be natural to assume that rising inflation is driving Treasury yields higher. But the data tells a different story.

Looking at the entire year, the 10-year Treasury yield has risen more than one percentage point, while market expectations for inflation over the next decade have barely changed. In fact, of the 1.06 percentage-point increase in Treasury yields, **just 0.08 percentage points can be attributed to higher inflation expectations.** Nearly all the increase has instead come from higher inflation-adjusted interest rates, commonly referred to as real yields.

This is an important distinction. While investors recognize the near-term pressure from higher energy prices and tariffs, they are not anticipating a significant acceleration in inflation over the longer term (data from FRED):

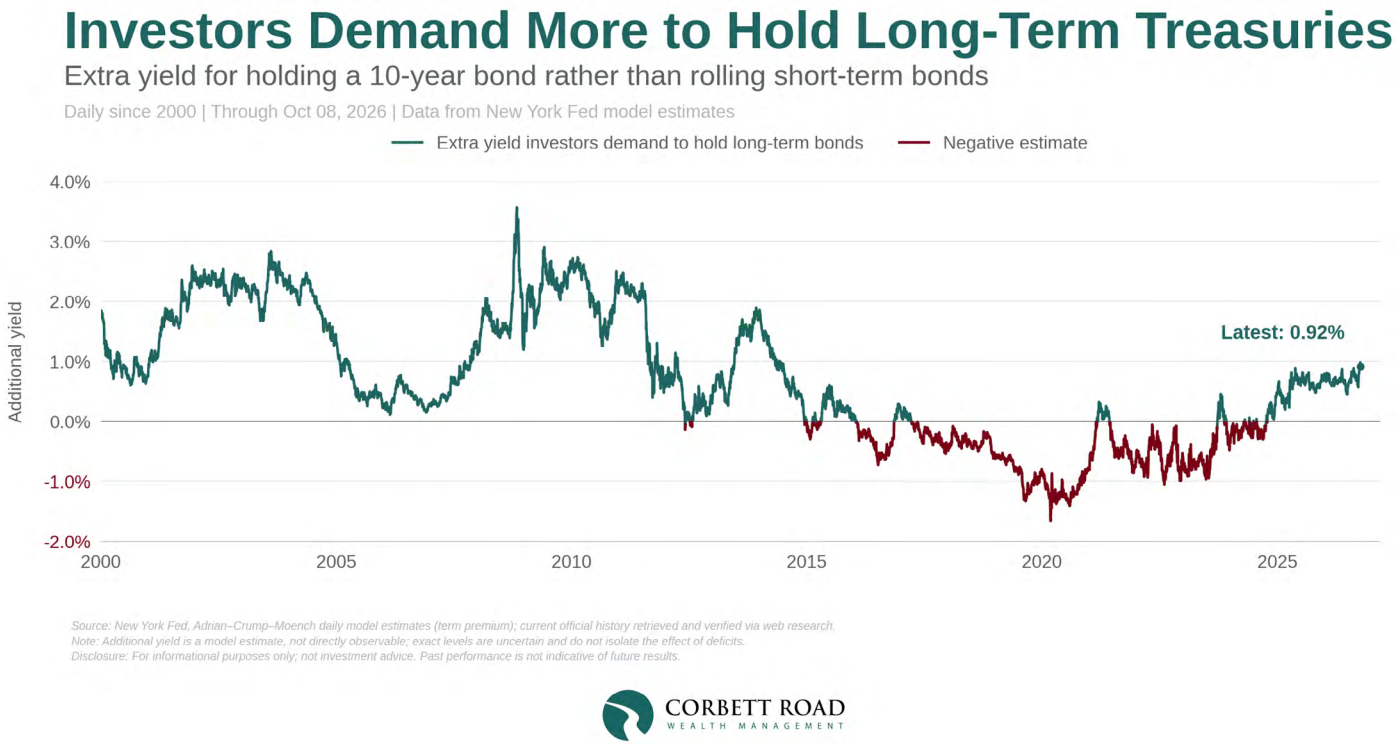


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Two forces are behind this. **The first is a resilient economy.** As we discussed last month, growth remains solid, earnings continue to expand, and businesses are investing heavily, particularly in AI. A strong economy increases demand for borrowing, which pushes market rates higher. It also gives the Fed little reason to cut while inflation sits above its 2% target.

The second factor is government borrowing. Large federal deficits require the Treasury to issue substantial amounts of debt, increasing the supply of government bonds. As more bonds become available, investors may demand higher yields to absorb that additional supply, particularly when lending money for longer periods.

One measure of this additional compensation is the term premium, which reflects the extra return investors require for the uncertainty of holding longer-term bonds rather than repeatedly investing in shorter-term securities. After remaining near zero or negative for much of the past decade, this measure has climbed to its highest level in more than ten years (data from the Federal Reserve Bank of New York):



Higher borrowing costs have already weighed on the housing market and will eventually put pressure on other rate-sensitive areas of the economy, such as commercial real estate and smaller businesses. However, there is little evidence that higher rates are creating widespread financial stress. Corporate earnings remain strong, default rates have not risen meaningfully, and credit spreads—the additional yield investors demand to lend to riskier companies—remain relatively tight.

Higher interest rates also have a silver lining. Savers are earning attractive returns on cash for the first time in years, while bond investors have an opportunity to lock in yields

that were largely unavailable over the past two decades.

Lastly, some historical perspective is useful. Before the Global Financial Crisis, 10-year Treasury yields of 4–5% were hardly unusual. **It was the prolonged period of exceptionally low interest rates that followed, driven by aggressive monetary stimulus and persistently low inflation, that represented the anomaly.** After more than a decade of near-zero policy rates and historically low bond yields, today's interest rate environment may feel unusually restrictive. But it may simply reflect a return to more historically normal conditions.

THIRD QUARTER 2026 **ASSET CLASS REVIEW**

The following table highlights major asset-class returns during the third quarter and year to date:

Asset-Class Performance

Third-quarter and year-to-date 2026 returns

Performance through September 30, 2026

ASSET CLASS	BENCHMARK	Q3 2026	YTD 2026
U.S. Large-Cap Stocks	S&P 500 Total Return Index	2.3%	12.7%
U.S. Small-Cap Stocks	Russell 2000 Total Return Index	-7.2%	13.7%
International Developed Stocks	MSCI EAFE Net Total Return Index	0.8%	10.3%
Emerging Market Stocks	MSCI Emerging Markets Net Total Return Index	-0.4%	23.4%
U.S. Bonds	U.S. Aggregate Bond Total Return Index	-3.5%	-2.9%
Treasury Inflation-Protected Securities	U.S. Treasury Inflation Notes Total Return Index	-3.2%	-2.1%
High Yield Bonds	U.S. Corporate High Yield Total Return Index	-1.8%	0.1%
International Developed Bonds	International Treasury Bond ETF (price-return proxy)	-3.1%	-4.5%
Commodities	S&P GSCI Total Return Index	25.1%	55.2%
REITs	Dow Jones U.S. Select REIT Total Return Index	-5.7%	10.9%
Gold	Gold Spot Price (USD per ounce)	3.7%	-3.7%
Oil	West Texas Intermediate Crude Oil Spot (USD per barrel)	37.7%	69.7%

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Some additional insights from the above table:

1. **The broadening of market leadership we highlighted in July reversed during the third quarter.** During the first half of the year, gains extended beyond the largest technology companies, with small caps and the average S&P 500 stock outperforming. That changed in the third quarter. While the S&P 500 gained 2.3%, small caps declined 7.2%, and the equal-weight S&P 500 also fell. In other words, the index's modest gain masked a much more difficult environment for the average stock.

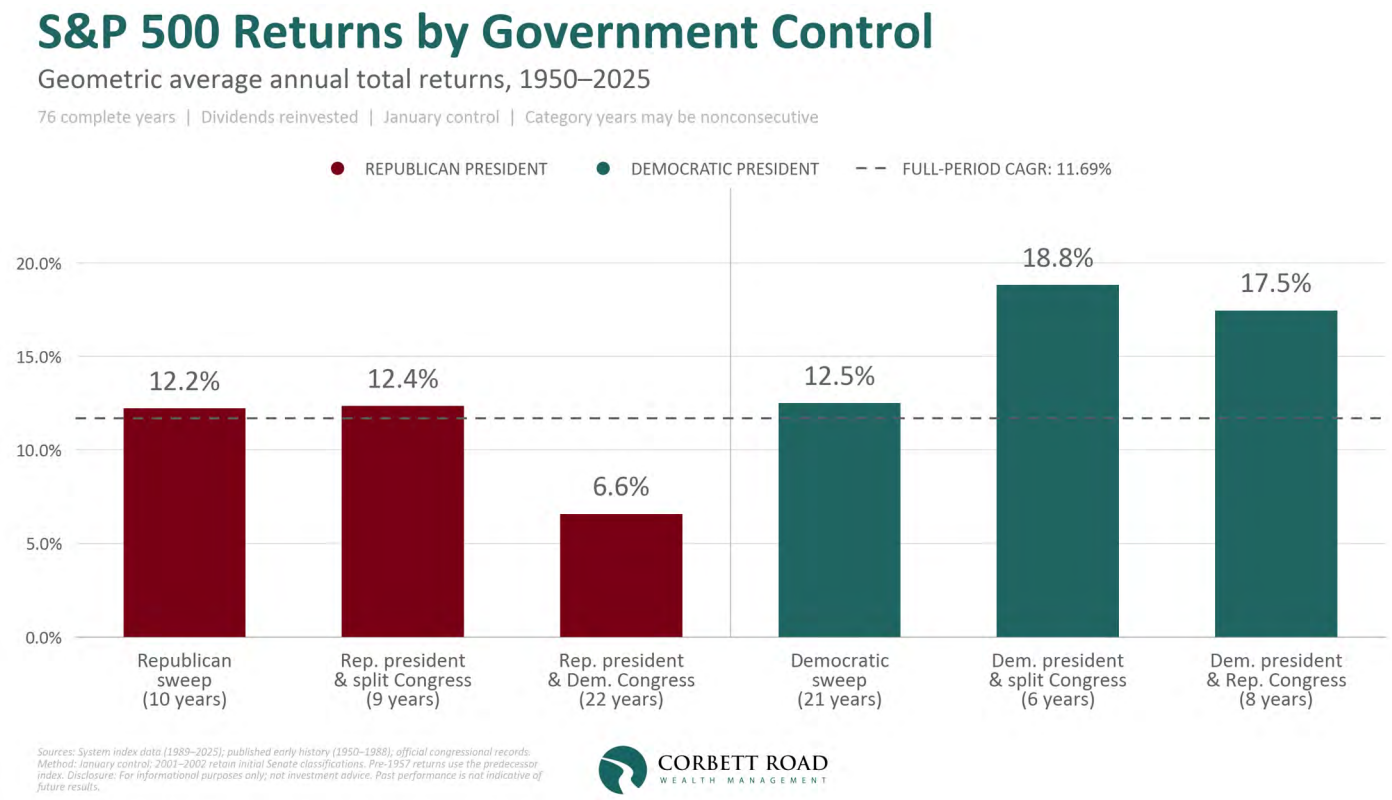
2. **International markets were mixed.** Developed international stocks saw slight gains, while emerging markets gave back some of their substantial first-half gains as semiconductor and memory stocks pulled back. Despite the weaker quarter, emerging markets remained well ahead of U.S. large caps for the year.
3. **Bonds came under renewed pressure from rising yields.** Longer-maturity government bonds were hit harder than shorter-term debt. But high-yield bonds held up better, helped by higher income, shorter maturities, and solid corporate fundamentals. This is a useful reminder that greater credit risk does not necessarily mean greater sensitivity to rising interest rates.
4. **Oil reversed course, again.** After its sharp second-quarter decline, oil rebounded as hopes for an agreement with Iran faded and concerns about Middle Eastern supply disruptions resurfaced. Energy stocks benefited, leading U.S. sectors for the quarter. For the broader economy, however, higher fuel costs added to inflation concerns and complicated the outlook for future monetary policy.
5. **Gold's recovery was muted.** Gold gained 3.7% during the quarter but remained down for the year. One factor weighing on prices has been the rise in real interest rates. Unlike bonds or cash, gold pays no interest, making it less attractive when investors can earn higher returns from income-producing investments. Even renewed geopolitical uncertainty was not enough to sustain a stronger rally.

DOES WHO CONTROLS THE GOVERNMENT **ACTUALLY MATTER FOR MARKETS?**

With the midterm elections less than a month away, investors are naturally wondering what the potential shift in political control could mean for the stock market. Current polling and prediction markets suggest Democrats are favored to regain control of the House of Representatives, with the Senate also potentially within reach.

Before examining the historical data, **the most important takeaway is that stocks have performed well under virtually every combination of political control.** That does not mean election outcomes are irrelevant, but economic growth, corporate earnings, and monetary policy have generally been far more important drivers of long-term market returns.

The following chart shows the S&P 500's historical performance under different combinations of presidential and congressional control (data from 3Fourteen Research):



One notable exception is the relatively modest 6.6% annualized return under Republican presidents and Democratic-controlled Congresses. However, **that figure is heavily influenced by the Global Financial Crisis**, which occurred during George W. Bush's presidency while Democrats controlled both chambers of Congress. The resulting market decline reflected a severe financial and economic collapse, not the political composition of Washington.

This illustrates an important limitation of historical election analysis: stock market returns have varied under different combinations of political control, but that does not mean those differences were caused by which party controlled Washington. As we've emphasized many times, **investors should be cautious about making portfolio decisions based on election results. Over time, economic fundamentals have played a far more important role in determining stock market performance.**

In summary, the sharp rise in Treasury yields has created challenges for bond investors and interest-rate-sensitive areas of the economy, but the underlying drivers are not necessarily a cause for alarm. Inflation expectations remain relatively stable, economic growth is resilient, and corporate earnings continue to expand. While the third quarter saw market leadership narrow and several asset classes struggle, the broader economic backdrop remains constructive. Looking ahead, the midterm elections may create uncertainty, but history shows that neither political party consistently delivers better market returns. Ultimately, economic fundamentals matter much more than the political makeup of Washington, and those fundamentals continue to support a positive long-term outlook for investors.

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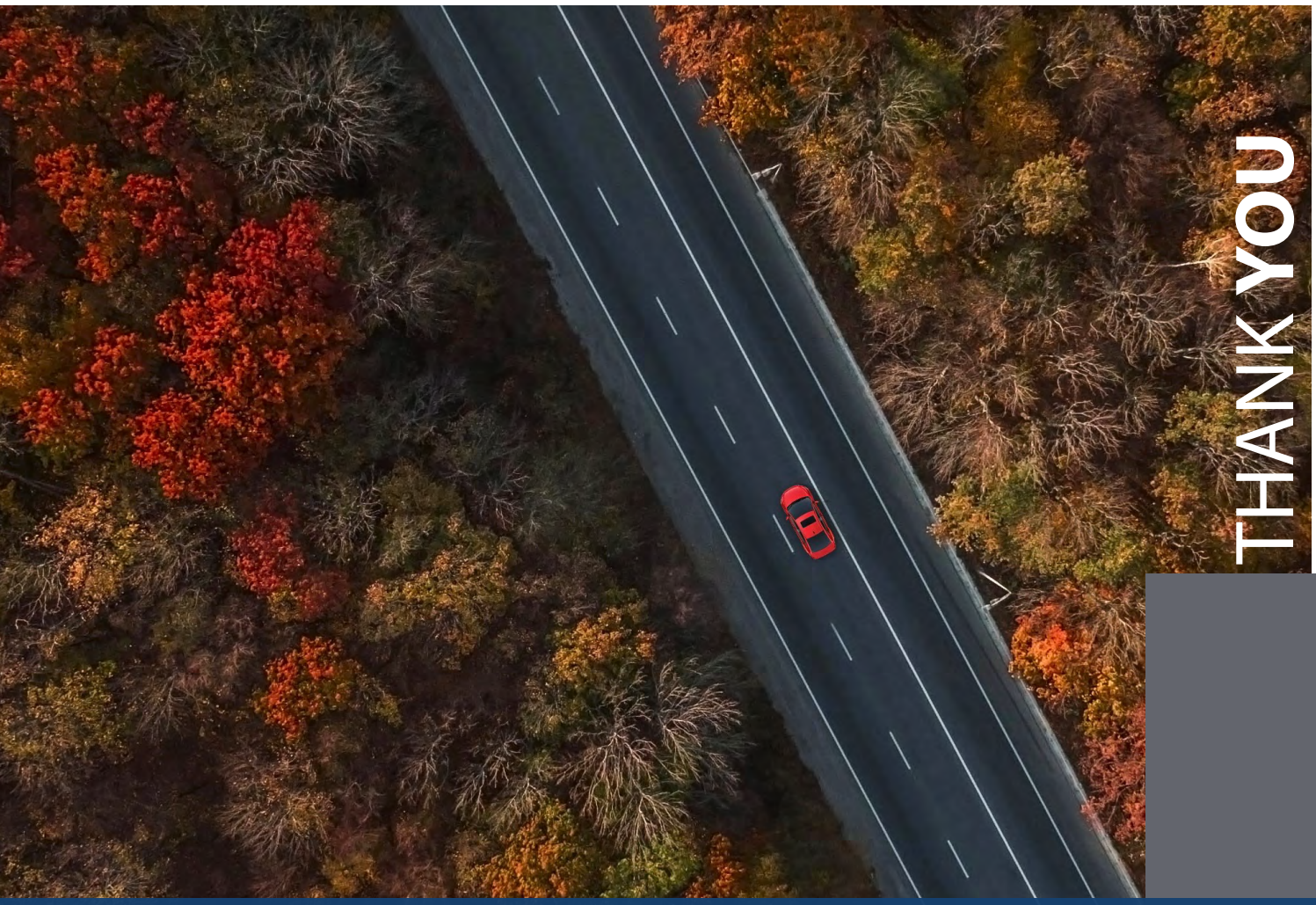
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