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A Quarter of Digestion and Reflection

The third quarter was another reminder that markets do not always move together. After a strong stock rally in the second quarter with the S&P 500 climbing 15.2% the third quarter was more muted as markets digested various signals including strong earnings, geopolitical uncertainty, and higher interest rates.

The tech-heavy NASDAQ Index rose 2.61% and the S&P 500 gained 2.3% during the quarter. Smaller companies declined, with the Russell 2000 Index down 7.23% and the Russell MidCap Index lower 3%. International stocks were up a modest 0.48% for the quarter.

The bond market had a bumpy quarter as energy prices and hotter inflation data pushed the 10-year Treasury yield above 5.3% in September. This is around 0.85% higher than the previous quarter. The Federal Reserve raised interest rates 0.25% in September, and our economists currently forecast another rate hike in December.

Rising interest rates hurt bond prices in the near term, and we saw bond indices fall close to 3.5% in the quarter. The silver lining is that high-quality bonds look even more attractive for long term investors. In particular, municipal bond yields sport more attractive after-tax yields relative to their taxable peers following September, and we have seen solid gains in the first few weeks of the fourth quarter.

	3Q 2026 (%)	YTD 2026 (%)
Dow Jones Industrials	-2.70	5.92
Standard & Poor's 500	2.30	12.75
NASDAQ Composite	2.61	16.09
Russell 2000	-7.23	13.71
Russell MidCap	-3.00	11.84
Russell 1000 Growth	0.92	6.30
Russell 1000 Value	2.61	19.27
Barclays Capital Govt./Corp. Bond	-3.66	-3.19
Bloomberg 5 Year Municipal Bond	-3.55	-2.51
MSCI ACWI ex US Net	0.48	14.22

Source: Morningstar as of October 1, 2026

What's Driving Growth

On the stock side, earnings continue to do the heavy lifting. UBS US strategist, David Lefkowitz, expects third-quarter S&P 500 earnings growth of 28%. Artificial intelligence is a major part of that growth with AI-related capital spending expected to reach about $900 billion this year. David's team estimates that 60% of the earnings growth this quarter came from AI related spending. The outlook is that this growth will slow in 2027 but remain solid and supportive for stocks.

The question investors are increasingly focused on isn't whether AI is a huge growth driver. Investors are asking how much of today's enormous investment will translate into sustainable profits over time. That makes selectivity and diversification particularly important.

It is also worth remembering that there is more going on in the economy than AI. Manufacturing activity has shown growth activity for nine consecutive months, overall consumer spending remains strong, and earnings opportunities extend into areas like financials, industrials, health care, utilities, and consumer discretionary. Many clients' portfolios benefit from stocks in these other parts of the market where investment opportunities are more reasonably priced.

Election Takeaways

Yesterday's US midterm elections are obviously in the headlines. In a report issued by our CIO office earlier today (Blue Wave Ushers in Gridlock) the following key points were made:

--We expect sand in the legislative gears, not sharp policy changes.

--Democrats need to prove they can govern.

--Debt talks remain the clearest risk for bonds.

--AI volatility may pick up on politics, but underlying demand is still solid.

From an investment standpoint, "…the outcome could drive near-term volatility…however, we do not think the result changes the medium term fundamental outlook sufficiently to justify a…shift in portfolios."

The bottom line is that historically the markets like gridlock and divided government in Washington and today's rally is testament to that sentiment.

The Rest of the Year

As we head toward year-end, there are key factors for the market to digest including earnings, interest rates, energy prices, geopolitics, and the midterm elections. However, we encourage you to avoid letting any one of those issues, or near-term setbacks, drive investment decisions. Looking ahead we see a positive outlook for stocks given the strong underlying economy and earnings growth.

It is best to stay invested, remain diversified, and use periods of market strength or weakness to reposition based on the opportunities.

What matters most is having a portfolio that can participate when markets advance while remaining aligned with your longer-term financial plan.

We hope that you enjoy this festive time of the year and get to spend time with your loved ones.

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