Commentary

Quarterly Market Wrap | Q3 2026

The Cost of Capital Strikes Back



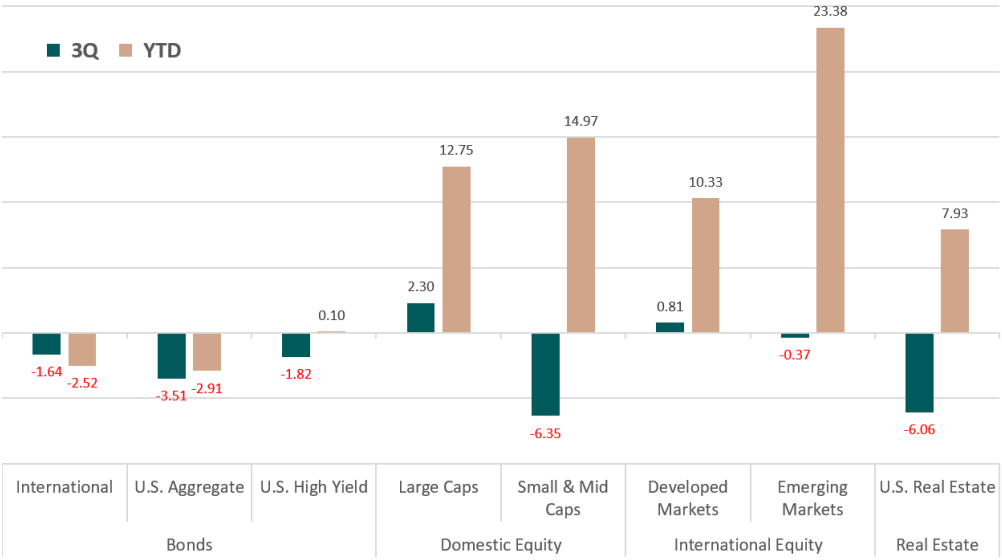
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The third quarter of 2026 was shaped by a renewed shift in monetary policy, rising energy prices and a sharp repricing across global bond markets. After cutting rates six times and by 175 basis points between September 2024 and December 2025, the Federal Reserve reversed course in September, raising rates for the first time in more than three years. At the same time, the ongoing U.S.-Iran conflict and disruptions in the Strait of Hormuz pushed oil prices higher and reinforced concerns that inflation could remain persistent.

The quarter ultimately became a contest between macroeconomic pressures and corporate fundamentals. Resilient growth, persistent inflation, tighter monetary policy, fiscal deficits and a global competition for capital pushed long-term yields higher, pressuring bonds and interest-rate-sensitive equities. Yet strong earnings growth, positive estimate revisions and elevated profit margins provided an important counterweight. Despite these supportive fundamentals, higher yields and renewed policy uncertainty contributed to a return of narrower market leadership during the quarter, reversing much of the broadening trend seen earlier in 2026. Within technology, leadership rotated sharply from capital-intensive, geopolitically exposed semiconductor companies toward recurring-revenue software-as-a-service businesses, with late-quarter concerns about agentic AI safety raising new questions about infrastructure demand and accelerating the shift. Together, these developments produced five defining themes for the quarter.

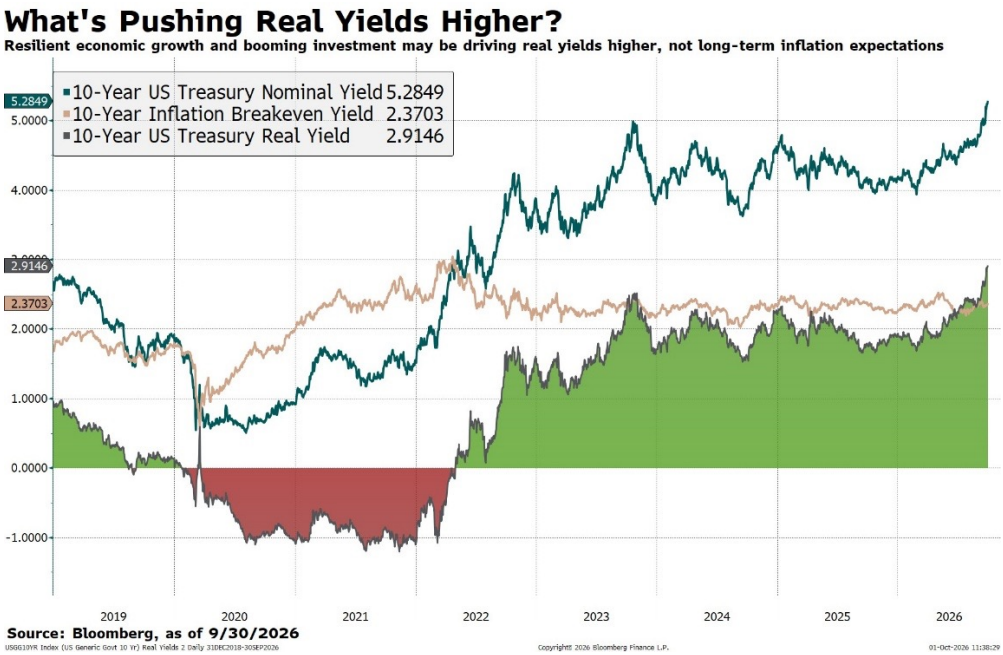
1. **The Fed raised rates, but the debate is far from settled:** September brought the first rate hike in more than three years after Fed Chair Kevin Warsh's hawkish August Jackson Hole message, persistent inflation and rising energy prices effectively narrowed the Fed's options. Raising rates helped preserve the Fed's inflation-fighting credibility and independence, even as investors continued to debate whether the economic backdrop justified tighter policy. Investors are now monitoring whether the increase is a minor recalibration or the beginning of a renewed tightening cycle.
2. **Oil flow links geopolitics and the markets:** The U.S.-Iran conflict and disruptions in the Strait of Hormuz sent oil prices higher, reinforcing inflation expectations and the prospect of tighter monetary policy. The result was simultaneous pressure on stocks and bonds.
3. **The bond market delivered a blunt message: The cost of capital is expensive:** Higher interest rates represented a significant market risk. While short-term rates remained anchored to Fed policy, longer-term yields reflected a broader mix of resilient growth, persistent inflation, fiscal deficits and elevated global rates.
   - **Competition for capital is back:** Government borrowing, AI-related infrastructure spending and increased corporate debt issuance all competed for investor dollars at a time when yields around the world became more attractive. Investors consequently demanded higher returns to commit capital, creating headwinds for long-duration bonds and interest rate-sensitive areas of the market.
4. **Earnings became an important equity market stabilizer:** Strong second-quarter earnings, resilient profit margins and continued upward revisions to 2026 and 2027 estimates helped offset higher yields and geopolitical uncertainty. With valuations already compressed, earnings growth increasingly carried the burden of supporting returns in the third quarter, with expectations improving beyond large-cap technology.
5. **Global alliances shifted as monetary and trade uncertainty spread:** An extension of the U.S.-China trade truce and renewed diplomatic discussions involving Iran and Russia created potential paths toward de-escalation, while new restrictions on Canadian imports underscored the fragility of established trade relationships. At the same time, rising sovereign yields across Europe and Japan showed that inflation, fiscal pressures and competition for global capital were influencing currencies, capital flows and U.S. asset valuations well beyond the Fed's reach.

Asset class performance – Q3 and YTD



Source: Bloomberg, as of Sept. 30, 2026. Asset class performance is presented by using total returns for an index proxy that best represents the respective broad asset class. U.S. Bonds (Bloomberg U.S. Aggregate Bond TR), U.S. High Yield (Bloomberg U.S. HY 2% Issuer-Capped TR), International Bonds (Bloomberg Global Aggregate ex USD TR), Large Caps (S&P 500 TR), Small & Mid-Caps (Russell 2500 TR), Developed Markets (MSCI EAFE NR USD), Emerging Markets (MSCI EM NR USD), Real Estate (FTSE NAREIT All Equity REITS TR). Indices are not available for direct investment. Investment in a security or strategy designed to replicate the performance of an index will incur expenses, such as management fees and transaction costs that will reduce returns.

Chart of the quarter: The real yield revolution



Much of the discussion around rising Treasury yields has focused on inflation. The chart suggests the story may be more complex. While long-term inflation expectations have remained relatively contained, real yields have surged to multiyear highs.

That distinction matters. If yields are rising because inflation is becoming unanchored, the implications for stocks, bonds and the economy are generally negative. However, if higher real yields reflect resilient growth, massive AI-driven capital investment and increased competition for global savings, the investment implications become far more nuanced.

The key question is no longer whether rates are rising, but why. If higher real yields ultimately reflect stronger productivity and higher future returns on capital, markets may be able to absorb a higher cost of capital. If not, elevated real yields could become a more persistent headwind for valuations and risk assets. The relationship between earnings growth and higher discount rates may ultimately prove to be one of the most important investment debates heading into 2027.

FTWA outlook & implications

The September rate increase changed our near-term policy baseline, but it did not resolve the forces shaping markets. Earnings growth, resilient profit margins and continued investment in AI and infrastructure remain important trends supporting the economy and equities. At the same time, persistent inflation, geopolitical risks and elevated global yields are likely to keep financial conditions restrictive and market leadership uneven.

FTWA remains cautiously constructive but selective. We believe the current environment favors quality, diversification and a focus on income and cash-flow durability rather than broad market beta or aggressive duration exposure. The opportunity set is improving, but the path forward is likely to remain volatile as investors balance solid fundamentals against a higher cost of capital.

Optimism:

1. **U.S. equities** remain supported by earnings growth, positive estimate revisions and elevated margins. Importantly, earnings growth has outpaced price appreciation, making large-cap valuations more attractive than they were earlier in the year. We continue to favor companies with durable earnings and strong balance sheets. Improving growth expectations and more attractive valuations are creating compelling opportunities among small- and mid-cap companies, particularly if long-term yields stabilize and monetary policy proves less restrictive than markets currently anticipate. Seasonality may provide an additional tailwind, as the fourth quarter has historically been the strongest period for S&P 500 returns since 2000, with midterm years often improving after early November elections reduce policy uncertainty. While these historical patterns are supportive, fundamentals and the path of yields remain the more important drivers.
2. **International equities** offer unique opportunities supported by attractive valuations, AI supply chains, defense spending and infrastructure investment. Europe continues to face a difficult mix of slowing growth, persistent inflation and rising sovereign yields, while Japan is navigating monetary policy normalization amid weakening economic momentum. Emerging markets have benefited from resilient global growth and stabilization efforts in China, although higher U.S. yields and dollar strength remain important headwinds. We favor a selective approach focused on regions and companies where earnings growth, valuation support and secular themes tied to AI infrastructure, industrial modernization and global commodity demand remain aligned.
3. **Fixed income** has entered a higher-income but more volatile regime. Starting yields have restored bonds' ability to generate meaningful income and provide portfolio balance, but the opportunity is not uniform. We favor high-quality domestic bonds, measured credit exposure and the belly of the curve (5-7 years), where investors can capture attractive carry without assuming the full policy sensitivity of the short end or the inflation, fiscal and supply risks affecting long-duration bonds. We complement those allocations with select nontraditional fixed-income strategies that can enhance carry and provide diversification benefits in a higher-rate environment.
4. **Alternatives** continue to offer opportunities driven by long-term themes including AI infrastructure, data centers, defense spending and industrial modernization. We favor infrastructure, mission-critical industrial net-lease real estate and other real assets with contracted or inflation-linked cash flows, alongside select direct lending, private credit and asset-backed lending strategies, where floating-rate structures and elevated base rates may support income generation and mitigate volatility. We complement these allocations with select diversifying strategies that may help mitigate volatility and provide differentiated sources of return. We remain selective, emphasizing quality manager selection, durable cash flows, strong collateral and disciplined underwriting, while recognizing that illiquidity, leverage and complexity should be accounted for at the individual client level.

Risks:

1. **Higher yields remain the primary market risk:** Long-term yields are increasingly being driven by factors beyond Fed policy, including persistent inflation, fiscal borrowing, global sovereign issuance, foreign reserve diversification and AI-related corporate financing. This combination has increased the term premium investors demand to hold U.S. duration and helps explain why long-term yields have remained elevated even as inflation data has improved. A further rise in real yields or the term premium could pressure long-duration bonds, equity valuations and interest rate-sensitive sectors.
2. **Inflation and monetary policy remain closely linked:** While inflation has moderated from its peak, producer prices continue to outpace consumer prices, suggesting margin pressures may persist as higher input costs work their way through the economy. Inflation is increasingly becoming a global story rather than solely a U.S. one, with renewed price pressures emerging across parts of Europe even as U.S. inflation trends improve. The longer the U.S.-Iran conflict persists, the greater the risk that higher energy costs work their way through the broader economy, slowing the path back toward central bank targets. In the absence of strong earnings growth, markets increasingly appear to be caught in an oil-

driven feedback loop, where higher energy prices pressure both stocks and bonds by reinforcing inflation concerns and the prospect of tighter monetary policy. As a result, inflation may prove more stubborn than expected, creating a more challenging backdrop for earnings growth and increasing the possibility of additional policy tightening. While we would not extrapolate September's rate hike into a prolonged tightening cycle, investors continue to assess how inflation, economic activity and Warsh's leadership may shape the path of monetary policy going forward.

3. **Credit and refinancing risks are becoming more important:** Attractive all-in yields do not necessarily imply attractive credit spreads. As low-coupon debt matures and refinancing activity accelerates, borrowers face a meaningfully higher cost of capital, making leverage, interest coverage, free cash flow and maturity schedules increasingly important. Floating-rate borrowers and portions of the private-credit market may experience these pressures first, while continued AI-related debt issuance could add further strain to credit markets over time. We continue to emphasize quality, liquidity, security selection and downside protection.
4. **Geopolitical risks remain elevated:** A prolonged path to a lasting resolution in the Middle East, or renewed escalation involving Iran and the Strait of Hormuz, remains a significant macroeconomic risk. Any disruption to energy production, shipping routes or global supply chains could place renewed upward pressure on inflation while weighing on consumer spending, business confidence and economic growth. Because energy remains closely tied to inflation expectations and monetary policy, geopolitical developments have the potential to influence markets well beyond the commodity complex.
5. **The durability of the AI buildout:** The AI investment cycle has become a major driver of economic growth, corporate earnings and capital spending, supported by record investment in data centers, semiconductors, power infrastructure and computing capacity. While demand remains robust, investors are increasingly focused on whether today's unprecedented spending ultimately translates into durable revenue growth, productivity gains and returns on invested capital sufficient to justify current valuations and funding levels. The long-term opportunity remains compelling, but monetization, efficiency gains, debt funding, capacity utilization and evolving AI safety concerns all warrant continued discipline.

While meaningful risks remain, we believe the longer-term outlook for the economy and markets remains cautiously constructive. Despite a challenging backdrop, consumers and corporate America have remained remarkably resilient, providing an important counterweight to many of the headwinds facing markets.

However, FTWA believes optimism should continue to be balanced with discipline. Investors are navigating a market increasingly influenced by the interaction between elevated bond yields, inflation, monetary policy, geopolitical developments and questions surrounding the sustainability of unprecedented AI-related capital spending. While these risks have distinct causes, they ultimately influence the same variables: the cost of capital, corporate profitability and investor risk appetite. In this environment, we believe diversification, quality and disciplined portfolio management remain critical, with an emphasis on durable earnings, cash-flow generation and thoughtful risk management rather than reacting to short-term headlines.

As always, our focus remains on helping clients pursue their long-term financial objectives through a disciplined investment process, thoughtful diversification and periodic portfolio rebalancing designed to align portfolios with evolving market conditions and individual goals.

DEFINITIONS:

Bloomberg U.S. Aggregate Bond TR: Measures the performance of the total U.S. investment-grade bond market, including U.S. Treasuries, agency debt, mortgage-backed securities, asset-backed securities, and corporate bonds.

Bloomberg U.S. HY 2% Issuer-Capped TR: Tracks the performance of fixed rate dollar denominated debt securities. The debt instruments are non-investment grade. There's a limit of 2% maximum exposure to any one issuer.

Bloomberg Global Aggregate ex USD Total Return: Tracks the performance of investment-grade, fixed-rate bonds issued in currencies other than the U.S. dollar, including treasury, government-related, corporate, and securitized bonds from both developed and emerging markets.

FTSE NAREIT All Equity REITS TR: Measures the performance of U.S. publicly traded equity REITs, including both price changes and dividend income.

MSCI EAFE NR USD: Captures large- and mid-cap representation across 21 developed markets countries around the world, excluding the U.S.

MSCI EM NR USD: Captures large- and mid-cap representation across 24 emerging markets countries.

Russell 2500 TR: Measures the performance of the smallest 2,500 companies in the Russell 3000 Index. This index is constructed to give a comprehensive and unbiased barometer for the small- and mid-cap segment of the U.S. equity universe.

S&P 500 Total Return: Includes a representative sample of 500 leading companies in leading industries of the U.S. economy, calculated on a total return basis.

RISK CONSIDERATIONS:

Investing involves risks and you may incur a profit or a loss. Past performance does not guarantee future results.

Different types of investments involve varying degrees of risk and there can be no assurance that the future performance of any specific investment vehicle, strategy or product referenced in the material will be profitable or suitable for your particular investment situation.

Equity securities are subject to frequent changes in valuation and are often more volatile than other asset classes. Equity valuation is subject in part to the associated fluctuations in the market confidence of its issuers.

Fixed income securities are subject to credit risk, liquidity risk, call risk and interest rate risk. As interest rates rise, bond prices generally fall.

International securities risks include fluctuations in the exchange rates of foreign currencies that may affect the U.S. dollar value of the investment, the possibility of substantial price volatility as a result of political and economic instability in the foreign country, less public information about issuers of securities, different securities regulation, different accounting, auditing and financial reporting standards and less liquidity than in the U.S. markets. Historically, these risks have tended to be more pronounced in emerging market countries than in more developed foreign countries.

Alts and non-traditional assets such as real estate, commodities, currencies and private companies, are subject to risks that are different from, and in some instances, greater than, other assets like stocks and bonds. Some non-traditional assets are less transparent and more sensitive to domestic and foreign political and economic conditions than more traditional investments. Non-traditional assets are also generally more difficult to value, and less liquid than traditional assets.

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