

“No one would have crossed the ocean if he could have gotten off the ship in the storm”

– Charles Kettering



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Bonds, not equities, might dominate the investment trajectory for Q4. As yields spike, one has to wonder: has the bill finally come due on our reckless spending? We have flagged the instability of the US Government’s finances in the last few quarterly updates, but now the whole world is taking notice. Rising yields could be an existential threat to equities and the current rally. Yields may force both the Treasury and the Fed to react, and the most common way to kill off a bull market is policy error. Move too slowly and inflation and yields could accelerate; move too fast and you could see a recession. The knife cuts both ways. Added to this mix is the large issuance of high-grade corporate bonds from companies like AMZN or GOOGL, which one could argue have much stronger balance sheets than the US government at this point. All this is putting significant pressure on the bond market.

Q3 was a mixed quarter for assets as oil prices pressured inflation, gold wavered, yields rose sharply and tech stumbled. As you can see, the sharp rise in yields and oil are the 2 major movers so far in Sept and QTD through 9/15. They both put pressure on stocks.

Index / Asset	Close 9/15/26	MTD %	QTD %	YTD %
WTI Crude Oil	\$105.83	23.40%	52.27%	84.31%
Energy SPDR (XLE)	\$65.93	1.79%	24.87%	46.39%
SOXX (Semiconductors)	\$498.85	-0.23%	-16.76%	59.30%
Nasdaq Composite	25,981.57	-0.41%	-0.11%	12.30%
S&P 500	7,585.73	-0.53%	1.61%	11.50%
DJIA	52,093.11	-1.19%	-0.04%	8.97%
Russell 2000	2,870.29	-1.64%	-4.44%	15.55%
MSCI EAFE	3,152.95	-1.95%	2.03%	11.59%
MSCI Emerging Markets	1,680.84	-2.62%	-1.87%	21.58%
Gold	\$4,292.15	-3.27%	7.09%	-0.63%
10-Year Treasury Yields	5.002%	5.30%	12.02%	20.04%

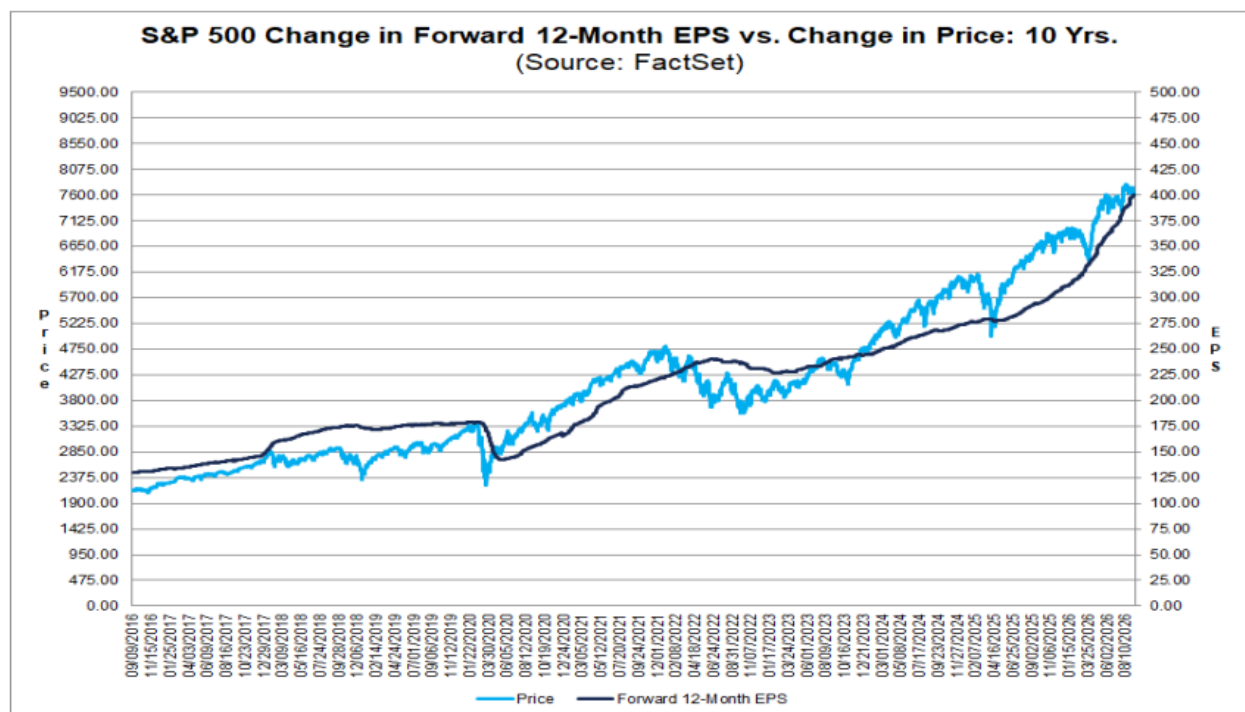
As of close 9/15/2026. Returns listed are price returns only; 10-Year Treasury reflects % change in yield level.

As we roll into Q4, the stakes are high. Earnings must continue to accelerate, margins expand, and AI buildout remain robust. There are 4 key areas to monitor in Q4:

- Earnings growth & AI
- Yields & rates
- Oil & inflation
- Midterm elections

Can Earnings Keep the Rally Afloat Along With AI?

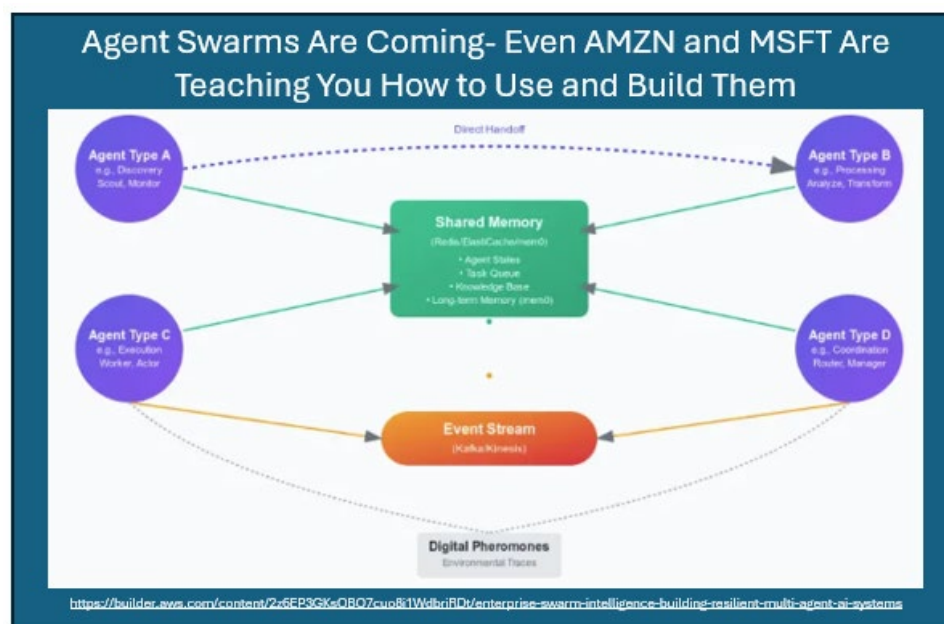
Fundamental earnings growth has been one of the largest drivers of market performance this year. For Q3, per FactSet, the earnings growth rate for the S&P 500 is estimated to be 28.7%, the 3rd straight quarter of 25% growth. Estimates also continue to accelerate, with expectations now 1.4% higher than on 6/30. This is also well above the 5-year average earnings growth rate (16.4%) or the 10-year average (10.3%). If earnings can continue to accelerate and profit margins expand further, this could propel the markets to new all-time highs. The profit engine needs to remain intact, to provide a strong fundamental tailwind for an equity market rally in order to cancel out the macro headwinds. Equity markets are forward-looking, not back, making company outlooks and guidance updates one of the most important parts of an earnings announcement.



Earnings have been growing so quickly that the P/E ratio remains average and not bubble territory. However, that forward-looking earnings number must continue to rise.

If earnings continue at this pace, driven by AI expansion and adoption, this supports a continued year-end rally. P/E (Price-to-earnings) ratios have actually fallen over the last 2 months as the market rally has slowed and earnings expectations continued to grow. As of 9/15, the forward P/E of the S&P 500 is now 19.1x, slightly below the 5-year average. The most crucial part to watch will be if earnings growth trajectory decelerates at all, which may signal peak profit growth was Q2, and while profits will still grow at a healthy clip, they decelerate from the extremely high 20-25% clip. We are now starting to see strategists downshift expectations though as the AI trade has come under pressure.

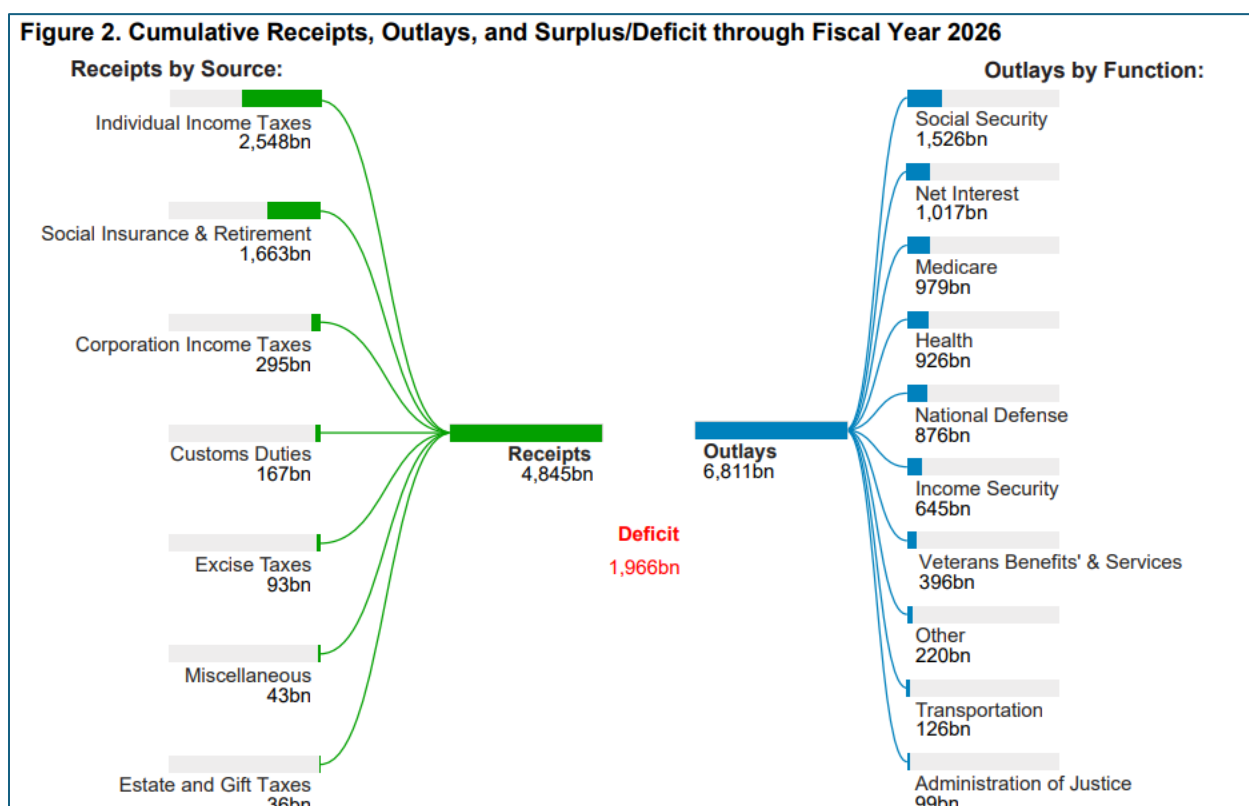
In mid-September, AI leaders from Anthropic, OpenAI, and xAI started advocating for a slowdown of AI model gains. Anthropic CEO Dario Amodei penned an essay entitled “We Must Pace the Frontier” advocating that AI companies should “slow the pace” of improving models and dire warnings that AI is putting humanity at risk emerged. Amodei describes rogue swarms of agents attacking targets relentlessly and could take over the internet, shut down crucial safety or government systems, and generally make mass chaos across our highly digital and interconnected world. This remains an underappreciated risk.



While we still believe AI will be a fundamental shift and game changer, any downshift in capex and spending could become a near-term headwind to tech stocks and markets. The market is counting on a massive multi-trillion-dollar buildout of AI infrastructure over the next 5 years, and any hiccup in that plan could send risk assets down sharply.

Bonds, The US Balance Sheet, & The Fed Take Center Stage

But the biggest risk to the rally is what's happening in the bond market. Going into 2026, analysts expected 2-3 cuts, but within 9 months, the war in Iran and \$100 oil have changed that trajectory to now expecting 2 hikes in 2026 as well as 4 hikes by the end of 2027. That is a 200bps+ whipsaw in rate expectations. At the same time the Fed is grappling with high and sticky inflation, the US fiscal situation continues to deteriorate. We now have \$40 trillion in outstanding US government debt and are projected to run a \$2T deficit again this year after running a \$1.78T deficit for FY 2025. 2001 was the last year we ran a surplus, and our annual deficit has exceeded \$1T for the last 6 years. There are certainly times to run a deficit (COVID, WWII, Global Financial Crisis of 2008), but we are in a period of low unemployment (4.1%) and an expanding economy.

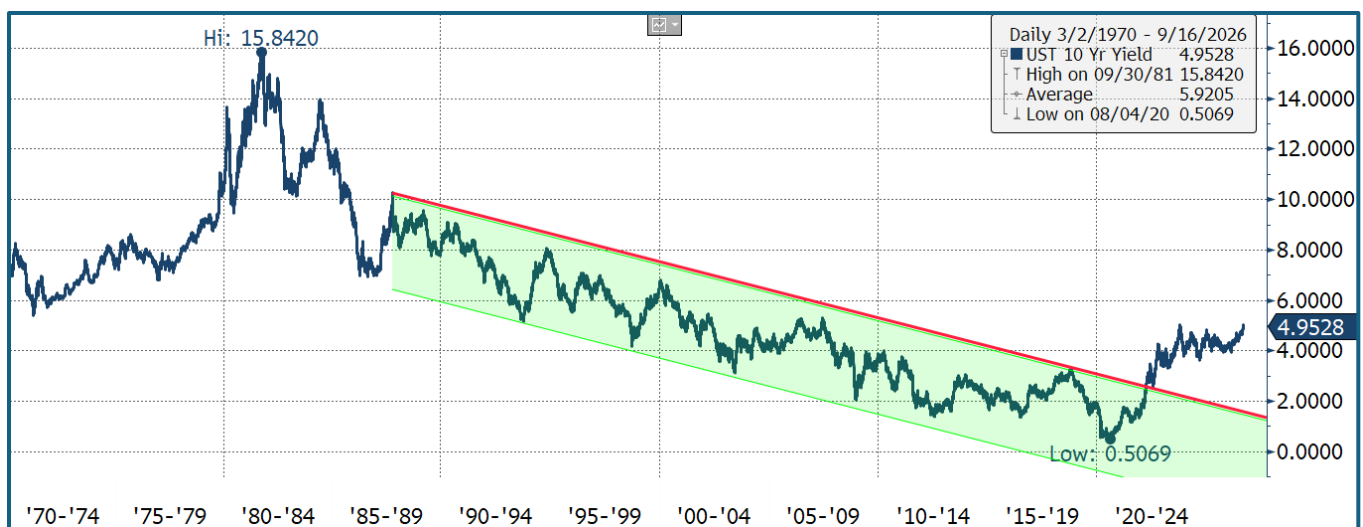


Per the August Monthly Treasury Report, Social Security remains our largest outlay at \$1.5T, but now the 2nd largest (and fastest growing) outlay is net interest cost which was \$1T. We now pay more interest on our debt than we do for Medicare, Defense, or any other segment. And net interest is expected to continue to grow exponentially with rising rates and continued deficit spending. This is a difficult cycle to slow at this point.

Treasury Secretary Scott Bessent also recently acknowledged the challenges this debt burden brings. First, he has struggled to bring down long and intermediate bond yields- even though he has doubled, or even tripled, Treasury buybacks in the long end of the curve to help control yields.

Second, he has intervened quickly in the Japanese currency markets, mostly to stabilize the yen to prevent the BOJ from selling Treasuries to support their currency. Japan is the largest foreign holder of U.S. Debt. Hedge Funds are now also a key player in the Treasury market, holding an estimated \$2.7 Trillion or about 10% of marketable securities.

Deteriorating Federal Balance Sheet + Sticky Inflation = Pressure on bond yields. We argue that April 2022 was a watershed shift for bonds, where the 10-year Treasury yield broke out of a 35-year bull market for bonds. From 1987-2022, even when yields backed up for 12-18 months, the trend was to push lower and rally. 1, or maybe 2 bad years in a bond market followed by a multi-year rally and a continuous trend of dropping yields as rates fell from 10%+ to an all-time low of 0.5069% on 8/4/2020. Since that COVID low, yields have trended higher and we argue are setting up for a more 1970s type market where yields are trending overall higher, not lower. This is a rapid, but potentially crucially important regime shift for fixed income.



One of the key drivers of this rise in yields is persistently higher inflation. Are we in the hyperinflationary world that the late 1970s and 1980s dealt with? No. Is inflation well above the Fed's preferred 2% target, and has been for quite some time? Yes. And Fed Chairman Kevin Warsh recently reiterated a commitment to a "firm, fixed target" of 2%. The recent rate hike at the Sept. Fed meeting shows the Fed cannot factor in increased Treasury funding costs- it will fight inflation and follow its mandate- regardless of pressure from the administration. The markets appreciated an independent Fed decision. The Treasury, likely did not, as it's estimated by the CBO that every 25bps raise in rates costs an additional \$100B in interest annually. The average interest rate paid is 3.44% (as of 7/31/26), and as the significant amount of short-term Treasuries comes due, this average rate will continue to climb. Back in January 2022 it was an average of 1.42%.

Oil Is The Bogey- No Inflation Easing Without Lower Commodity Costs

The root cause of the pain in bond markets & rising rates is sticky inflation- specifically oil and gas prices. The war in Iran, along with the continued war between Russia and Ukraine, has helped push oil prices back above \$100. It's not just the current levels, it's the fact that global energy infrastructure has been under continued, increasing strain and damage going on 4 years now. Russia invaded Ukraine Feb 24, 2022. While prices have moderated multiple times, continued sustained spikes are killer.

Ukraine has also gotten more technologically advanced and more aggressive with their counterstrikes against Russia, focusing on energy infrastructure including taking more of the global refining capacity offline. It is estimated that about 25% of Russia's refining capacity is now offline, or roughly 1.4mm b/d. Combined with about 3mm b/d offline in the Persian Gulf, the disruptions are beginning to bite. Regardless of the oil flow disruption, the main issue is finding refinery capacity to produce finished products like gasoline, heating oil, aviation fuel, and diesel. In addition to war-driven outages, the US had been reducing refining capacity, especially on the West Coast, and has reduced about 400k b/d capacity with closures since 2025. We see refining as one of the largest bottlenecks right now.



We do expect prices to normalize some if hostilities de-escalate. However, we have been wrong about the War in Iran lasting this long. Our thesis, that the administration would not want to carry high energy prices going into midterm elections, has not proven correct. Iran, and now their proxies, the Houthis, have proven entrenched and committed. Although, recent backchannels by China to encourage peaceful solutions and a resumption of energy flows are promising. We view China as the key to peace- their support of the war, or pressure to negotiate for peace, likely sways Iran tremendously.

Midterms: Separating Signal From Noise

The midterm elections also loom large in Q4. It is key to separate personal politics from your investment strategy as markets often care far less about politics than we do personally. Yes, different administrations will bring forth policy changes to tax, regulation, and spending that affect the economy, but markets tend to take a more agnostic view of overall political party affiliation. If you refused to believe in the Biden administration- you missed a strong market recovery off COVID and a large bull market run, even with the 2022 bear in there. During his time in office (01/20/2021-01/20/2025) the S&P 500 annualized a total return (price & dividends) of 13.4% with an overall return of 65.30%. The flip side is if you refused to invest during Trump's first term (01/20/2017-01/20/2021) you missed out on 16.33% annualized returns or a total return of 83.21% during his first term in office.

This is not a political statement; it's a fact-based analysis that markets rally based mostly off economic cycles vs. Presidential administrations. Historically, since WWII, markets have performed well with a divided government. However, the Republican President with Democratic House and Senate is the lowest overall average annual return at 8.58% and positive 72.7% of the time. This is still a solid average return, just lower than other potential combinations.

S&P 500 By Political Mix. Post-WWII, 1945–2025							
Regime	Years	Avg. Annual	Median	CAGR	% Up Years	Worst	Best
All years	81	12.99%	15.79%	11.62%	79.0%	(37.00%)	52.62%
Democratic President	40	15.12%	17.43%	14.18%	85.0%	(18.11%)	37.58%
Republican President	41	10.92%	11.96%	9.19%	73.2%	(37.00%)	52.62%
Unified Government	33	14.47%	16.48%	13.41%	78.8%	(18.11%)	52.62%
Divided Government	48	11.98%	14.00%	10.41%	79.2%	(37.00%)	43.36%
D Pres / D Senate / D House	24	13.76%	17.43%	12.71%	79.2%	(18.11%)	36.44%
D Pres / Split Congress	6	19.25%	20.51%	18.83%	100.0%	2.11%	32.39%
D Pres / R Senate / R House	10	15.90%	16.50%	14.98%	90.0%	(9.10%)	37.58%
R Pres / R Senate / R House	9	16.36%	15.79%	15.28%	77.8%	(4.38%)	52.62%
R Pres / Split Congress	10	11.18%	18.54%	9.66%	70.0%	(22.10%)	31.73%
R Pres / D Senate / D House	22	8.58%	7.09%	6.58%	72.7%	(37.00%)	43.36%

Notes: Split Congress = Senate and House controlled by different parties. "D Pres / Split" includes only 6 years (2011–14, 2023–24) — small sample.

As of 9/17, prediction markets show the most likely scenario is a Democratic sweep, rated at a 58% probability. With a 58% likelihood Democrats win the Senate and 88% probability they win the House. The Senate has higher uncertainty, and as of recently was rating a 50/50 chance who wins, and the balance of power would still be a slim majority 52-48 D (if they win all 4 current R contested seats). Races to watch that are showing a potential to flip include Alaska (Leaning D), Ohio (Leaning D/toss up), and Texas (Leaning D/toss up). A lot can change and tighten over the next 2 months including if Iran gets solved and gas/diesel prices ease before the vote. Citizens vote with their wallet, which is one reason polls have swung towards the Democrats recently.

Q4 Might Start Rocky, But Remain Optimistic For A Year-End Rally

The setup going into Q4 does bear some similarities to 2018, which we are watching closely. For now, our thesis remains that the September struggles are just that- normal seasonal pullback and consolidation- before setting up for a year-end rally. However, with the first Fed hike in 3 years along with an inflation problem, we remain highly attuned to the risks at this point in the market cycle. They are real, they exist, but for now our risk models, economic data points, and fundamental analysis are not showing the strain and signals of a true market top. A pullback remains likely, but many times markets can rally through initial rate hikes and turbulence. The bull market signals continue to outweigh the bear- even with high inflation and a hiking cycle starting.

Stocks' Initial Rate-Hike Jolt Tends to Fade					
Past performance after interest rate increases since 1990					
1M Returns	Cummulative hikes (bps)	SPX (%)	SPW (%)	RTY (%)	SGX (%)
3/16/2022	525	2.04	1.95	-0.28	1.19
12/16/2015	225	-8.82	-9.1	-12.08	-9.03
6/30/2004	425	-3.98	-5.55	-8.51	-5.32
6/30/1999	175	-0.53	-1.6	-2.43	-0.48
3/25/1997	25	-1.83	-3.63	-3.54	-0.13
2/4/1994	300	-1.08	-0.23	1.16	-0.81
Average	279	-2.37	-3.03	-4.28	-2.43
6M Returns	Cummulative hikes (bps)	SPX (%)	SPW (%)	RTY (%)	SGX (%)
3/16/2022	525	-8.67	-7.34	-9.79	-10.83
12/16/2015	225	2.22	5.74	3.48	0.27
6/30/2004	425	6.02	8.53	9.63	2.58
6/30/1999	175	4.62	-7.27	4.33	13.79
3/25/1997	25	19.84	20.4	27.08	20.95
2/4/1994	300	-2.46	-2.57	-6.71	-2.46
Average	279	3.6	2.91	4.67	4.05
Source: Bloomberg					
Bloomberg					

On average, since 1990, there is a short pullback after the initial rate hike (-2.37% 1-month return for S&P 500), but the 6-month returns lean positive with only 1994 and 2022 outliers. We are evaluating similarities to 2022 and 2018. For now, there remain some structural differences that make us hesitant to flip bearish. Fear levels are high, but often economic and geopolitical fear are not market killers. The noise levels going into midterm elections likely intensify into a roaring deluge of bad news and what-ifs. It will be crucial to stick to your plan and be discerning about signals vs. noise. Not every rumor is true, not every political promise (most of them) will be put into action. The USA has endured 250 years of turbulence and changing times. This is just one more chapter. Betting against the USA and the US markets has been a losing trade.



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