

Quarterly Market Update

Third Quarter, 2026 | October 6, 2026

UP-AND-DOWN Q3; MORE FUN AHEAD

A roller coaster quarter. With the benefit of hindsight, the third quarter was one of the most consequential in recent memory. In the last three months, investors had to contend with a “let him know you’re there” selloff in Tech stocks in July; the dissolution of the memorandum of understanding between Iran and the U.S.; the reemergence of trade tensions, particularly with Canada; a not-insignificant increase in the 10-year Treasury note; the Treasury Department’s attempt to slow down the rise in yields via repurchases; Meta’s \$12-18 billion settlement with parents who held the company responsible for harming their children; the growth of data center construction as a meaningful political issue; and finally, the first Fed tightening since July 2023. And this leaves out the media’s criticisms of new Fed chair Kevin Warsh. Whew!

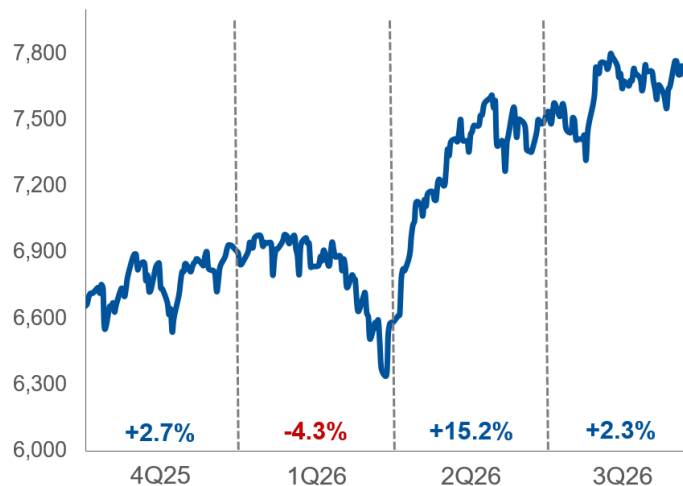
Profits a ballast. Despite it all, the S&P was up 2.3% in the quarter. Naturally, a 50% year-over-year increase in second quarter earnings can expiate a lot of sins. With earnings growth so far outpacing price appreciation, the S&P 500 starts the fourth quarter quite a bit “cheaper” (as measured by price/earnings) than it started the third.

Looking ahead. Only time will tell what the fourth quarter will bring. The only thing we know for sure is that two Federal Reserve meetings and the midterm elections will add some fun to the game. As it stands now, estimates put third quarter earnings growth at +30% and third quarter real GDP growth at close to +5%. That said, further Fed tightenings and nominal economic growth of ~8% does not portend good things for the bond market as we approach the end of the year. Still, the biggest wildcard for stocks is likely to be data center construction and growth in the use of AI: can the spending continue...and will the productivity follow?

Placing our bets. Given the moves in the bond market and concentration of Tech and Tech-adjacent companies in the Index, we continue to prefer the equally-weighted S&P over the S&P 500 itself. We are overweight Energy, Industrials, and Utilities as all three stand to benefit from a more supply-constrained and security-focused world that comes with higher energy investment, increased reshoring and infrastructure spending, and surging electricity demand from AI and automation. Health Care has also started to merit our attention.

Prepared by Baird Strategas LLC, FINRA member

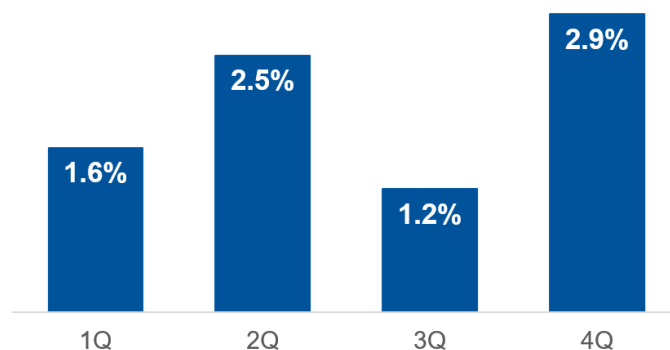
S&P 500



Performance by Asset Class

Asset Class	Representative Benchmark	Q3 2026 Total Return	Year-to-Date Total Return
US Large Cap	Russell 1000	1.8%	12.3%
US Small Cap	Russell 2000	-7.2%	13.7%
International	MSCI AC World ex-USA (USD)	0.6%	14.7%
Commodities	Bloomberg Commodity	16.2%	32.9%
Gold	LBMA Gold PM (\$/ozt)	3.7%	-4.4%
Municipal Bonds	Bloomberg Municipal Bond	-6.4%	-4.2%
Taxable Bonds	Bloomberg US Aggregate	-3.5%	-2.9%
Cash	Bloomberg 3-Month T-Bill	0.9%	2.7%

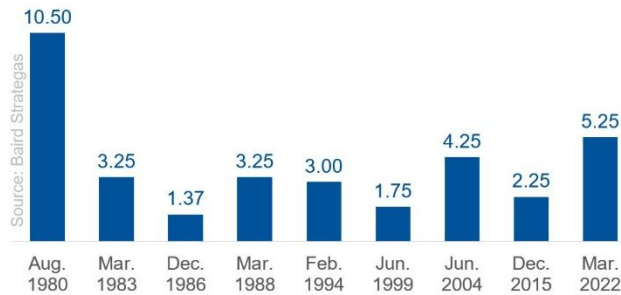
S&P 500 Average Quarterly Return (since 1928)



Source: Data for this page come from data-provider Factset.

Past Tightening Cycles: Total Change

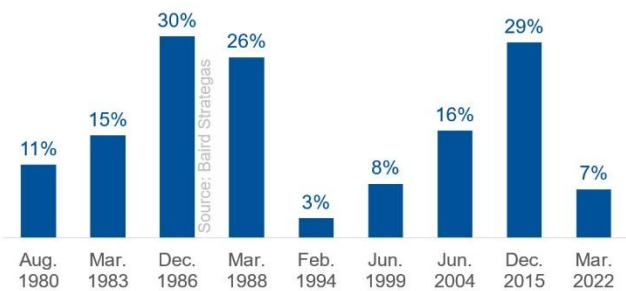
Total change in fed funds rate (in percentage points)



A common view we hear is that this tightening cycle will be just 2–3 hikes, totaling 50–75 basis points, making it more of a mid-cycle adjustment. While this view is understandable given the anxiety that tightening cycles can create, previous cycles have tended to involve more rate hikes. The biggest variables today are the wars in Iran and Ukraine. If those conflicts end and energy prices fall, we would expect to see some relief from inflation. If nothing changes in the wars, however, it is difficult to see how inflation slows without a corresponding slowdown in economic growth.

Past Tightening Cycles: Returns

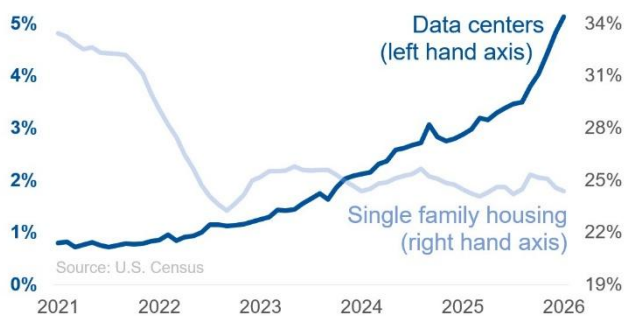
S&P 500 cumulative return (in percentage points)



The first rate hike has not historically been detrimental to equity markets. On average, the S&P 500 gains 5.7% in the six months following a cycle's first rate hike. In fact, stocks have done well (or at least finished in the black) for the full length of every tightening cycle – first hike to last hike – back to 1980. There is also a common assumption that a hiking cycle will weigh on corporate profits, but history shows that forward earnings estimates move higher through these cycles. Higher interest rates remain a headwind and can increase volatility (over 11 tightening cycles since the early 1970s, the median drawdown was -13.7%), but they are not insurmountable for stocks.

Housing and Data Centers

Data centers are gaining as a percent of total construction



In the construction world, it is a tale of two subsectors. Housing remains weak, with new home starts and building permits near cycle lows amid high and rising mortgage rates and other affordability issues. Capital spending, however, looks more structural and less rate-sensitive, particularly in the AI space – and it is driving overall U.S. economic growth higher. From these aggressive (peak?) growth rates, a slowdown is likely given persistently higher oil prices, Fed tightening, higher long-term rates, etc. These are meaningful headwinds, based on history. But this slowdown will likely not be a recession because 1) credit conditions look benign; 2) consumer net worth is rising; 3) firing remains restrained; 4) gig work is still available; 5) new business formation is up; and 6) trend productivity growth is accelerating.

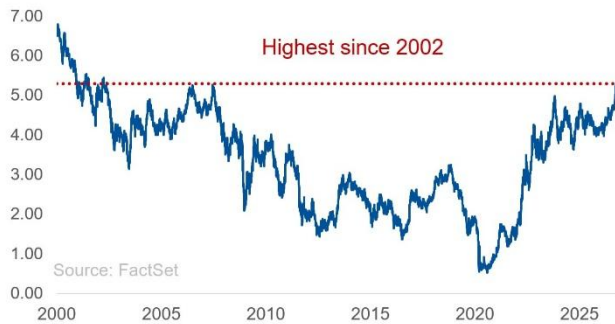
AI Stocks vs "Average" Stock

AI stocks have reasserted themselves



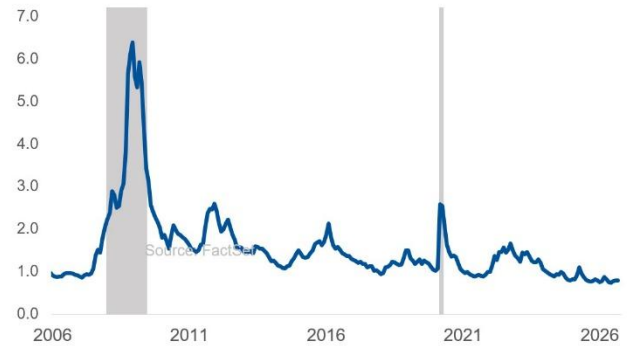
To begin Q4, Technology has returned to the top of our sector rankings, dethroning Energy (now third) and just ahead of a strong Healthcare sector (second). The quiet strength that had been building in the Magnificent 7 over the last several months got louder toward the end of Q3 with the group breaking out from a roughly 12-month trading range. There's real anxiety out there regarding deterioration of breadth and weakness from the equal-weight indices, but we'd note that our work shows a still-solid 63% of S&P 500 stocks remain in an uptrend by our work. That may not be as robust as a few months ago, but it's nowhere near as narrow as other major market tops (such as March 2000, when only 25% of stocks were in uptrends).

Higher Long-term Yields: The Story of Q3



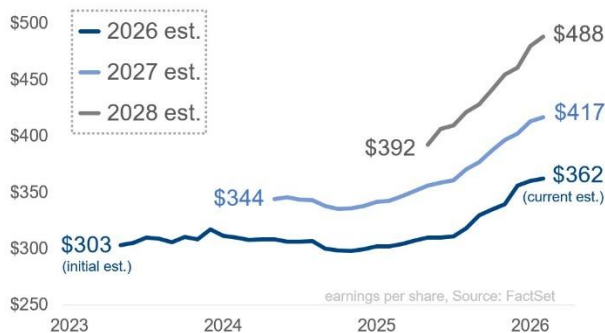
For forecasting the 10-year Treasury yield, the idea has been that the yield should be roughly equivalent to nominal GDP (the total value of everything the U.S. economy produces, in today's prices). This makes sense in theory: if the government wishes to sell bonds, it needs to provide a yield of at least what an investor could earn in the economy. This is important, because nominal GDP was north of 6% in the second quarter and is tracking to be in the same ballpark for Q3. This suggests to us that the path of least resistance for Treasury yields is higher from here. We dive into greater detail on the outlook for rates and its potential impact on the national debt and budget deficit [here](#).

IG Credit Spreads Remain Tight



Despite plenty of potential headwinds, investment grade credit spreads (above) are near the tightest they've been in two decades. Tight credit spreads imply investors are willing to lend money for only a small premium above U.S. Treasuries, which usually signals that credit is readily available and financial conditions are supportive of growth. Looking at the breakdown by rating quality, spreads have been largely unchanged for the year across nearly all ratings, with AAA through B moving within roughly ± 15 bps. CCC (i.e., deep junk) is the notable exception, with spreads widening by nearly 300 bps. Notably, spreads in the Technology sector (software and semis) have barely budged in recent weeks.

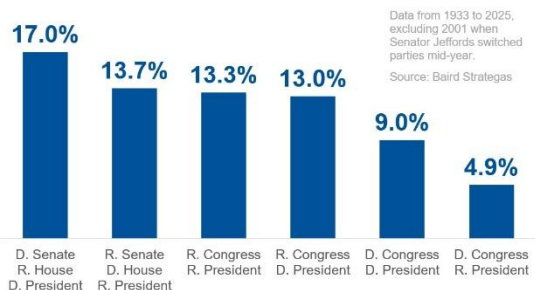
S&P 500 Earnings Estimate Progression



The year-over-year change in next-12-month earnings estimates at the end of September stood at 37.5%, which is in line with the type of growth typically seen during recessionary recoveries when earnings are coming off trough levels. This growth rate could move even higher if the capital spending cycle continues to expand. The parabolic nature of the move is something we keep in mind, but we take some comfort from the pause the market has experienced. The headline S&P 500 index holding up relatively well is largely a function of the market's concentration; beneath the surface, the deterioration has been more pronounced. That has caused the underlying market to cheapen even as the fundamental backdrop remains strong.

Market Returns and Political Party

The S&P 500 has moved higher across all combinations of Republican and Democrat control in Washington



A frequently requested chart at the start of an election year is how stocks perform under different political party control scenarios. Not surprisingly, stocks have managed to go up no matter which party is in charge. Even the worst-performing combination – a Republican president and Democratic Congress – has been positive in 8 of its last 10 years, with its average return pulled down by the 2008 Great Financial Crisis. We continue to believe that the key metric for investors is which sectors or companies receive an earnings benefit from policy changes post-election. These changes can be meaningful, such as Health Care's earnings profile changing under Obama or Trump's tariffs on China starting the move to more onshoring.

S&P 500 Index (Large Cap / U.S. Stocks): A sample of 500 leading companies in leading U.S. industries, of large capitalization (generally \$7 billion plus market cap) with growth and value characteristics. • **Russell 2000® Index (Small Cap / Small Core):** Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. These are equities of small capitalization. • **MSCI EAFE Index Net (International / Developed Markets):** A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US and Canada. As of December 2024, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. • **BBgBarc Aggregate Bond Index (Taxable Bonds / Bonds):** Composed of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years. • **BBgBarc Muni Bond Index (Municipal Bonds):** Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least \$3 million, part of a transaction of at least \$50 million, issued after December 31, 1990, and have a year or longer remaining maturity. • **FTSE 3-month T-bill Index (Cash):** This index measures monthly return equivalents of yield averages that are not marked to market. It consists of the last one-month and three-month Treasury bill issues, respectively. • **Bloomberg Commodity Index (Commodities):** Composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Subindices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs.

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