

PCA Quarterly Commentary and Outlook

Q3 2026



Markets sent mixed signals in the third quarter. Interest rates rose, oil prices rose, and the Federal Reserve raised rates for the first time since 2023. Despite these headwinds, large cap stocks held up well on strong corporate earnings while small cap stocks declined under the pressure of higher interest rates. International equities were mixed with developing markets outperforming emerging markets. The most important move for the quarter was the increase in interest rates with 10-year government bond yields hitting the highest level since 2022. Below we walk through what happened, why it matters for your portfolio, and how we are responding.

To put this in perspective, year to date, the S&P 500 is up almost 12%, the Nasdaq 100 is up more than 15%, international equities are up over 8%, and emerging markets are up more than 20%. The U.S. Aggregate bond index is down 2.66%.

Index	3Q 2026	YTD 2026	One-Year	Three-Year
S&P 500	2.3%	12.7%	15.7%	22.9%
Russell 1000	1.8%	12.3%	15.0%	22.5%
ACWI	1.7%	13.4%	17.2%	22.3%
US Agg Bond	-3.5%	-2.9%	-1.8%	4.1%

Source: Orion

U.S. Stocks: strong earnings, narrow leadership

What happened. The S&P 500 gained about 2%, but gains were driven by a few contributors, with Microsoft up 37.5% and Meta up 28.75%. Energy was strong up 16.5%, while more rate-sensitive areas like utilities, industrials, and real estate were down 13%, 10% and 6% respectively. Small caps (Russell 2000) fell 7.5%, and semiconductors retreated 11.4% after an astonishing positive 230% run over the prior six quarters.

Why does it matter to your portfolio. The index looks healthier than the typical stock. The equal-weighted S&P 500 fell, and the share of S&P 500 companies trading above their 50-day moving average dropped from over 60% to 25%. The top 10 companies represent about 40% of the index.

How we're responding. We remain constructive on equities because the earnings backdrop remains strong with 86% of S&P 500 companies beating expectations in Q2, and Q3 earnings growth expectations rising from 26% to 29%. Valuations are reasonable, with the S&P 500 at 19.0x forward earnings, below its 5- and 10-year averages. We are not ignoring the concentration risk. We continue to advocate diversifying into international equities which have outperformed U.S. equities on a one-year and year-to-date basis. For clients with lower liquidity needs, adding private equity to widen the opportunity set is also a recommended allocation.

Bonds: a rare opportunity, if you pick your spot

What happened. US treasury yields posted the largest quarterly increase since 1994. The 2-year yield moved higher closer to 5% on further expected Fed hikes. The 10-year and 30-year bonds reached their highest yield levels since 2002. Three forces were behind the move, strong economic growth, the Fed's shift to hiking, and higher energy prices. Investors are also bracing for a wave of new bond issuance from the U.S. government, which is financing a growing deficit, and from companies funding AI capex spending.

Why does it matter to your portfolio. Rising yields hurt bond prices, which is why the Aggregate index fell 3.5% in the quarter. On the other hand, bonds now pay far more in yield than they did for most of the past decade. Ten-year yields above 5% will be new to some investors, but it was quite common from the 1990s until the 2008 financial crisis.

How we're responding. We think the best value is at the short end. A 4.88% yield on the 2-year Treasury is attractive, and we don't believe investors are paid enough to extend to the 10-year at 5.27% or the 30-year at 5.62%, with heavy government and corporate bond supply still coming. Within fixed income, we favor diversification across government, asset-backed, and corporate bonds, and private credit where appropriate to enhance yield. We believe bond returns should be more attractive going forward than at any point in the last five years.

The Fed: a hike we see as prudent

What happened. In September, the Fed raised rates by 0.25% to a range of 3.75%–4.00%, its first increase in three years. Core PCE inflation is 3.3% against a 2% target, and unemployment is at a low 4.1% level. Markets now expect another three to four hikes by September 2027.

Why does it matter to your portfolio. Rate hikes make borrowing costlier and can pressure interest-rate-sensitive stocks like utilities, real estate, and small caps, as we saw this quarter. However, the Fed raising rates is usually a response to a strong economy. Over the past seven hiking cycles, the S&P 500 gained an average of 9% in the 12 months after the first hike, with positive returns every time except 2022. Past results don't guarantee future ones but based on recent history, the first hike is no cause for alarm in our view.

How we're responding. We view this hike as reasonable, given inflation, and at this point we don't see it as a reason to move away from stocks. We believe short-term bonds are a good diversifier in client portfolios given the current yield and low correlation to equity returns.

Energy and the war in Iran

What happened. Hopes for a U.S.-Iran peace deal faded, and WTI crude jumped 30% to above \$100 a barrel for the first time since April.

Why does it matter to your portfolio. Higher oil prices feed into higher inflation, causing the Fed to increase interest rates to mitigate the effects. Historically, Fed hikes slow future economic growth with a lag.

How we're responding. We are watching energy prices closely, since it affects both inflation and our interest rate view. However, we are also mindful of the fact that any anticipated increase in Middle East oil flows or end to hostilities would ease pressure on prices and should support risk asset performance.

What is the Treasury doing?

The Treasury made two unusual interventions in the financial markets in the third quarter to slow the increase in bond yields. First, it sold euros to buy yen to help support the Japanese currency and raised its monthly buyback of long-term bonds from \$2 billion to \$6 billion. The yen action has been effective so far in stopping the weakness in the yen versus the dollar. However, the increase in the bond purchase size has not stopped the rise in 30-year yield as they have climbed from about 5.30% to 5.67% as we write. We'll keep monitoring any further moves by the Treasury or the Fed to contain rising yields.

Our outlook and strategy for the fourth quarter

We are watching two main factors that will drive the performance of financial assets over the near future.

- **Earnings.** We expect strong third-quarter results, with profit margins at record highs. Consensus 2027 earnings growth is still a healthy 14%.
- **Higher Interest Rates.** Continued higher interest rates from higher energy prices and increased borrowing will have a negative effect on borrowing costs, economic growth and equity valuations.

We will also be keeping our eyes on:

- The outcome of the Fed meetings in October and December
- The war in Iran, resolution or escalation
- Midterm election results
- Credit spreads to determine the effect of higher rates on corporate health

What does this mean for your portfolio. Our core approach hasn't changed:

- **Stay diversified** for the long term.
- **Reduce concentration risk** by owning international and emerging market equities, and private equity where appropriate.
- **Earn today's higher yields** with a focus on shorter-term bonds, diversified across government, asset-backed, and corporate bonds, plus private credit where suitable.

If you'd like to talk about how this applies to your own plan, please reach out to your Pallas advisor.

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