The Federal Reserve Is Behind The Curve As Stock Gains Narrow Further

Market Update From Advanced Asset Management Advisors

September 30, 2026

Here we are again. We're three quarters of the way through 2026, and the six-month moving average of the Fed's favorite measuring stick, the super-core PCE inflation rate, remains above 3.5%[1] — well ahead of the 2% target. Broad-based inflation indices that include food and energy have also spiked, as higher energy costs have simply exacerbated the pre-war inflationary environment.

As we have suggested over the last year, the Fed's rate cuts in late 2025 were premature and likely driven by Powell's desire to protect his legacy. Legacy aside, Fed economic and inflation forecasts are notoriously inaccurate.

We think the Fed would be much better off looking at the two-year Treasury (see chart on the next page). It is the bond market's forecast for short-term rates, representing the collective wisdom of the entire world of bond investors, and probably the best single indicator of where the Fed Funds target rate should be set.

Topics

Prices, the **Fed Funds rate**, and what the **two-year Treasury yield** tells us about what the Fed should be doing.

What **ten-year bond yields** tell us about long-term inflation expectations and how higher yields can impact real estate, private equity, and private credit.

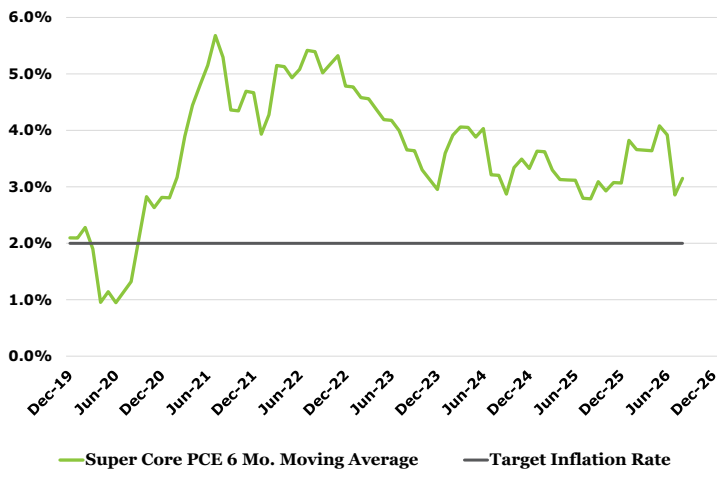
Concentration in the stock market, and the influential shift from Magnificent 7 leadership to semiconductor dominance.

The historic increase in **expected profits**, led by semiconductors.

Paper profits from huge investment in artificial intelligence companies, and unprecedented **earnings growth expectations**.

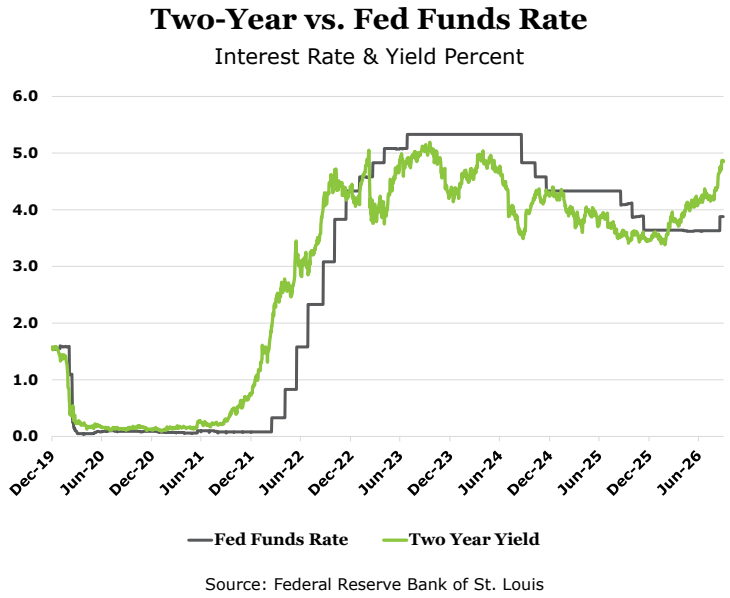
Super Core PCE

Six Month Moving Average



Source: Bureau of Economic Analysis

Note how the Fed Funds rate tends to follow the two-year, but with several months lag. Six months ago, the two-year Treasury rate jumped above the Fed's target rate and has not looked back. It currently sits at 4.85%[2], a full percentage point higher than the Fed Funds rate. Either the world's bond investors are wrong, or the Fed is behind the curve. Given the persistence of reported inflation, we tend to side with the world's bond investors.



Source: Federal Reserve Bank of St. Louis

Global bond investors continue to push bond prices lower across longer maturities as well, to compensate for higher anticipated inflation. We can see this in the ten-year, where yields have steadily risen above 5.25%[2].

Also exacerbating the rise in ten-year yields are the persistent federal budget deficits (with rising Federal borrowing) and sizable bond supply in support of datacenter financing.

Some analysts shrug off the rise in yields, pointing out that a 5.25% ten-year is below the 73-year average of 5.75%. However, it is double the financially-repressed average of 2.5% seen in the 10 years following the Great Financial Crisis[2]. Ten years of low interest rates formed the basis of many investments in real estate, private equity, private credit, and low-quality bonds that are gradually facing refinancing at significantly higher rates. Not all those investments have survived or will survive refinancing.



Source: Federal Reserve Bank of St. Louis

The Economy

Despite persistent inflation, economic growth has remained steady. In the second quarter, GDP rose at an annualized rate of 2.2%[1]. Steady growth looks to continue into the second half of 2026, as estimates for the 3rd quarter remain strongly positive. One trend to follow is consumer confidence, which recently fell to a multi-year low. Lower confidence can translate to lower consumption, the largest driver of GDP growth. To date, consumers have displayed resilience in the face of higher prices.

Whether spending will falter in the latter half of the year in response to sustained inflation and higher interest rates remains to be seen.

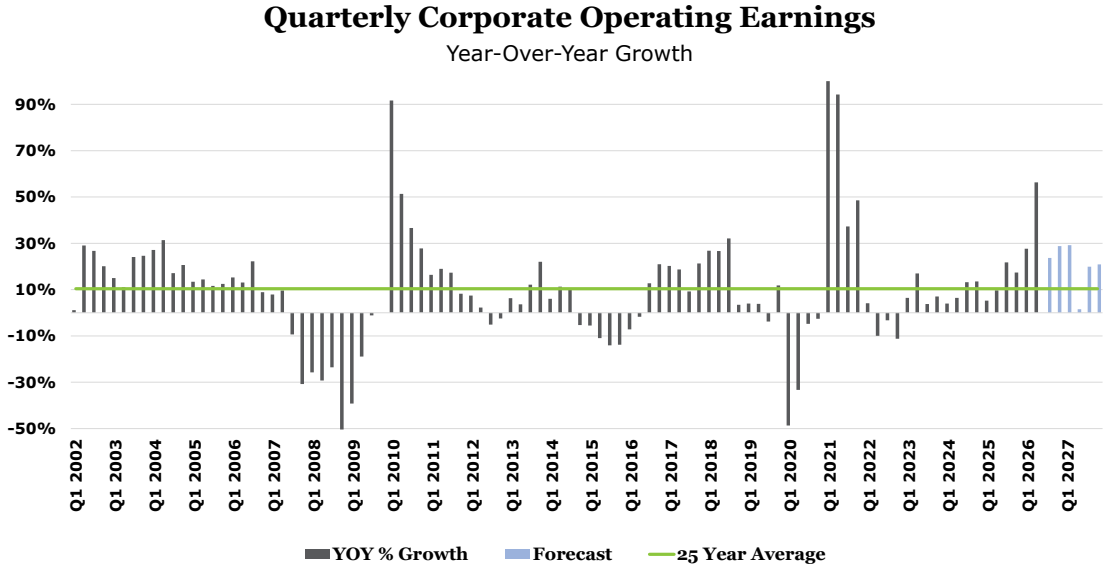
The Stock Market

As measured by capitalization-weighted indices, the stock market has shrugged off the higher interest rates (The S&P 500 and Nasdaq 100 are at or near all-time highs). However, as we have seen during much of the post-pandemic stock market rally, the gains are still concentrated. Currently, more than 50% of S&P 500 stocks trade below their respective 200-day moving average[3].

The last 12 months are telling. If you recall, the "Magnificent Seven" stocks had led the stock market for years, but finally lost their leadership position last fall as a few semiconductor companies became the new darlings. Over the last 12 months, the S&P 500 has returned 15.7% with gains concentrated in the semiconductor industry (up 110%). The old Mag-7 leadership has lagged with a gain of 12.1%. Defensive sectors often favored by dividend stock portfolios have offered little in comparison, with the average stocks within the utility sector down 5.7%, consumer staples up 1.5%, communication services down 14.7%, and financials up 1.6%. The energy sector performed well (up 38.9%) due to sharply higher global energy prices[4]. Diversification among quality stocks, including technology and energy issues, has been important over the last year.

Corporate Profits

Profits have been robust in 2026. The recently completed second quarter posted a 53% year-over-year increase in operating profits[3,5]. Profits were heavily impacted by the technology sector, especially the semiconductor industry. This is the largest earnings gain in the last 25 years, excluding periods when profits rebounded from depressed, recessionary levels. Forecasts for the next six quarters average 21% growth.



Source: Standard & Poor's, FactSet

Paper Profits And Historic Growth Projections

There are two further observations that are significant. First, reported profits have been even higher than operating profits because public companies are required to include estimated gains or losses on investments in private companies. Large technology companies have made large investments in private artificial intelligence companies — companies that are estimated to be worth significantly more than their cost, creating "paper profits". Anticipated initial public offerings will either challenge or validate the estimated valuations. Lower public valuations would negatively impact reported earnings in the technology sector. We always focus on operating earnings to eliminate the impact of the "paper profits".

Second is the inflection of long-term growth estimates. Consensus for long-term earnings growth has reached an unprecedented 27%[3]. Even during the dot-com euphoria, long-term expectations never exceeded 20%. Earnings growth over the last 25 years has averaged 10.4%. Growth in 2026 is estimated at 33% (heavily influenced by the second quarter and the technology sector) and growth in 2027 is estimated at 17%.

Likely the largest factor influencing the historically high 27% future growth consensus is artificial intelligence. The questions we raised last quarter remain:

> *"AI spending has been driving the economy, technology earnings expectations, and stock prices, as the future success of AI is widely assumed. We agree that AI will be successfully adopted for certain applications. However, our key question remains: When will future revenues justify the capital expenditures, if ever? Many investors suggest we should simply trust the rosy forecasts, but there are hurdles. There are continued questions about the accuracy of complex AI applications (how intelligent are they?), speed (can they work fast enough in critical situations?), and costs (are they worth it?). — AAMA Q2 2026 Market Commentary*

Now, markets are focusing on new questions about the "safety" of AI. We believe the jury is still out on the ultimate gains to be expected from AI, and it is unlikely that long-term earnings growth meets expectations.

Last, we will quote from our March comments about energy prices and the Strait of Hormuz: "It will take time to know". The "time" is still ethereal.

Rising interest rates continue to devastate long-term bond prices and we remain comfortable with short-term bonds. Rising interest rates, potential disappointment of future corporate earnings relative to optimistic forecasts, and elevated global energy prices pose risks to equity market valuations. We continue to position equity portfolios in high-quality companies across diversified sectors with allocations favoring more defensive sectors.

[1]Bureau of Economic Analysis [2]Federal Reserve Bank of St. Louis [3]FactSet [4]Morningstar [5]Standard & Poor's

Disclosures

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