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MARKET COMMENTARY

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Domestic equity markets edged higher in the third quarter, although the path was bumpier than the final number suggests. The S&P 500 gained 2.3% for the quarter, bringing the year-to-date return to 12.7%. Beneath the surface, breadth was weak. The equal-weight version of the S&P 500 actually lost 1.9%, a reminder that a handful of large companies did most of the heavy lifting. September, however, was a different story. The S&P 500 slipped 0.3% for the month, and the Nasdaq Composite (up 1.9%) was the only major index to finish in positive territory. The Dow Jones Industrial Average fell 4.1%, and the Russell 2000 dropped 5.3% in September alone.

Small-cap stocks took the brunt of the damage, with the Russell 2000 losing 7.2% over the quarter and mid-caps falling 3.0%. Higher interest rates were the culprit, as smaller companies tend to rely more heavily on borrowed money. Even so, small caps remain ahead of where they started the year at 13.7%, a point better than the S&P 500 year to date. It is a reminder that a single quarter rarely tells the whole story, and that the leaders of one period have a way of becoming the laggards of the next.

Looking at style, large-cap value stocks held the edge for the quarter, gaining 2.6% versus 0.9% for growth. Value led early as growth stocks sold off in July and August, growth recovered some of that ground later, and September saw growth rising 2.2% while value fell 3.1%. Over the trailing twelve months, the gap remains wide, with value up 23.8% and growth up just 7.5%.

Breaking down domestic equity returns by sector, energy was the clear leader for the quarter, gaining 17.2% and bringing its year-to-date return to an eye-catching 40.3%. Technology (+7.2%), health care (+6.5%), and communication services (+3.6%) also finished ahead of the market. Technology is up 28.4% so far this year, and it was the only sector to finish September in positive territory, with semiconductor and hardware companies leading the way while software and data companies lagged. On the other end of the spectrum, utilities lost 12.4%, and industrials fell 9.7%, with real estate (-5.6%) and consumer discretionary (-5.1%) also under pressure. Rising interest rates are particularly unkind to utilities and real estate, which tend to be valued for their dividends and carry a good deal of debt. Over the past twelve months, only two sectors have lost ground: utilities (-7.0%) and consumer discretionary (-5.2%).

Commodities were the standout asset class once again. The S&P GSCI Total Return Index rose 25.1% in the third quarter and is now up 55.2% year to date, with another 4.8% gain coming in September alone. Oil did most of the work, with West Texas Intermediate crude surging more than 30% as tensions in the Middle East flared back up and efforts at a diplomatic solution stalled. Diesel prices rose nearly 50% heading into the harvest and heating seasons.

Gold added 3.7%, and silver gained 3.1%, but both finished well off their highs for the quarter as interest rates moved higher, since metals that pay no income are less attractive when bonds and cash are paying more.

Turning to international markets, developed-market stocks (as measured by the MSCI EAFE Index) gained 0.9% in the quarter, trailing the S&P 500, while emerging-market stocks slipped 0.4%. Emerging markets remain the leading major equity index so far this year, with a gain of 23.4%, and are up 29.2% over the past twelve months, so the pause was hardly a setback. International stocks have been a welcome source of diversification in 2026, but the third quarter showed they are not immune to the effects of rising oil prices and interest rates worldwide.

The bond market is where investors felt the most pain. Yields rose across the entire Treasury curve in September, with the 10-year Treasury climbing 54 basis points to 5.29%, up from a low of just under 4% back in March. The 2-year rose 54 basis points to 4.88%, and the 3- and 5-year maturities rose by 60 basis points each. The longest end of the curve (20- and 30-year) is yielding in excess of 5.6%, with the 30-year reaching its highest level since 2002. Higher yields mean lower bond prices, and the Barclays Aggregate Bond Index fell 3.5% in the quarter, leaving it down 2.9% for the year. Treasuries lost 2.9% for the quarter, investment-grade corporate bonds fell 3.9%, and municipal bonds fared worse, declining 7.0%. The selloff was global, so there was little shelter to be found by looking overseas.

Within bond funds, duration was the enemy. In September, the 1-3 month T-Bill ETF was the only fund in our group to finish positive, while the 20+ year Treasury ETF (TLT) fell more than 5% for the month and is down nearly 9% over the past twelve months. Credit offered no shelter either, as both high-yield and investment-grade corporate bond funds declined by roughly 3% in September. Over the past year, cash has been a better place to hide than bonds, with short-term T-Bills returning 3.7%.

The Federal Reserve raised short-term interest rates by 0.25% in September, taking the upper end of the target range to 4.00%. It was the first increase since July 2023 and the first major decision under the Fed's new Chair, Kevin Warsh, whose speech at Jackson Hole had already tipped his hand. The move is not a shock given the data. Headline inflation is running at 3.4%, and the Producer Price Index is up 5.4% from a year ago, something that has historically fed through to consumers with a lag. Core inflation, which strips out food and energy, is more contained at 2.4%, and the gap between the headline and core figures largely reflects the commodity story outlined above. With inflation running well above the Fed's comfort zone on the headline measures, it is difficult to argue the central bank had much choice.



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The economy itself is showing little sign of cracking. The unemployment rate is a healthy 4.1%, although the labor force participation rate has slipped to 61.6%, a trend we will continue to monitor. Businesses are hiring cautiously but also not letting many people go, which has kept unemployment in a comfortable range. Both the ISM Services (55.4) and ISM Manufacturing (54.5) indices are comfortably above the 50 line that separates expansion from contraction, with manufacturing finally joining services after spending much of the past few years below it. The downside of a strong economy is that it gives the Fed little reason to stop raising rates, and higher rates are beginning to show up in places that families feel directly

While the third quarter was an uncomfortable one for investors, the best course of action remains the same as always. Allow your goals, time horizon, and financial plan (not financial news) to drive your decisions. After all, a pilot doesn't turn the plane around because of a little turbulence over the Rockies. The destination hasn't changed, and neither should the plan to get there.