

Market View October 2026

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Executive Summary

The **bull market remains intact**, although one of its pillars is cracking. In July, we judged this rally against three tests: no bubble, no recession, and supportive Fed policy. The first two still pass comfortably. The third is showing cracks: the Federal Reserve has moved from rate cuts to rate hikes, and markets anticipate a short hiking cycle – a “mini-cycle”.

The **US economy is running at two speeds**. Growth comes mainly from the AI buildout, while consumers and housing weaken under sticky inflation and higher rates. Corporate earnings remain the anchor: twelve-month forward earnings estimates for the S&P 500 are up 30% year-to-date – the second-best year on record. As the third-quarter earnings season gets under way, we expect company fundamentals to take over from macro headlines as the main market driver.

Equities have absorbed higher interest rates through valuations. The **S&P 500 forward P/E has de-rated** from 23x to 19x. Beneath the surface, however, breadth is the weakest since the dot-com era: the median S&P 500 stock trades 17% below its high.

Our template is 1997, when the Fed hiked once and equities moved on. The **risk** we take most seriously is a policy error where the Fed embarks on an **extended hiking cycle**. History suggests it often takes a bond tantrum for the Fed and Treasury to step in or change course. Such a moment may then be a signal to increase risk again.

Regarding our positioning, we **remain overweight in equities** but have slightly reduced our exposure. We keep duration short, watch credit as the canary in the coal mine, and rely on gold and alternative investments as sources of diversification. Recently, we added two-year US and German government bonds to lock in today's elevated yields.

Market Review – Third Quarter 2026

The third quarter was defined by a **sharp repricing of interest rates**. Since February, market pricing has swung from three Fed rate cuts to more than four hikes. Two-year and ten-year US Treasury yields rose by around 70 basis points to 4.80% and 5.30%, respectively. US inflation has proven sticky: CPI stands at 3.4%, core PCE at 3.0%, and producer prices accelerated to 5.4%.

Equity markets absorbed this shock better than many expected – because **earnings kept rising**. Third-quarter earnings growth for the S&P 500 is expected at 27% year-on-year, the third straight quarter above 25%. Unusually, analysts raised their estimates during the quarter rather than cutting them. Among the early reporters, most companies in the S&P 500 have beaten earnings expectations.

Yet **market leadership** has become **narrow**. Four mega caps delivered more than 200% of the S&P 500's third-quarter gain, while the top five stocks now make up approximately 30% of the index. Since mid-August, the equal-weighted S&P 500 has fallen 5%, compared with flat performance for the cap-weighted index – a pattern typical of midterm years. Rate-sensitive sectors such as utilities, materials and real estate saw their valuations de-rate sharply.

Across other asset classes, the picture was mixed. **Oil** was volatile: after falling sharply to around USD 70 per barrel at the end of the second quarter, crude rose as high as USD 110 in the third quarter amid renewed escalation in the Middle East. It currently trades around USD 100, while oil products such as diesel and gasoline reached new highs. With Gulf shipments back near pre-war levels, there are signs that crude may have peaked; the bottleneck has shifted to refined products. **Gold** remained under pressure from high real yields, although we still expect new all-time highs before this cycle ends. The **US dollar** surged, leaving the euro the most oversold since 2015; until the dollar peaks, risk appetite is likely to stay capped. In Europe, the yield spread between ten-year French and German government bonds widened to around 140 basis points, the widest since the euro crisis of 2011–12. In high yield, stress among the weakest borrowers is spreading to single-B issuers – credit remains the canary we watch most closely.

The three pillars revisited

In our July edition, we described this bull market as resting on three pillars. A quarter later, two of them stand firmly – and the third is now being tested.

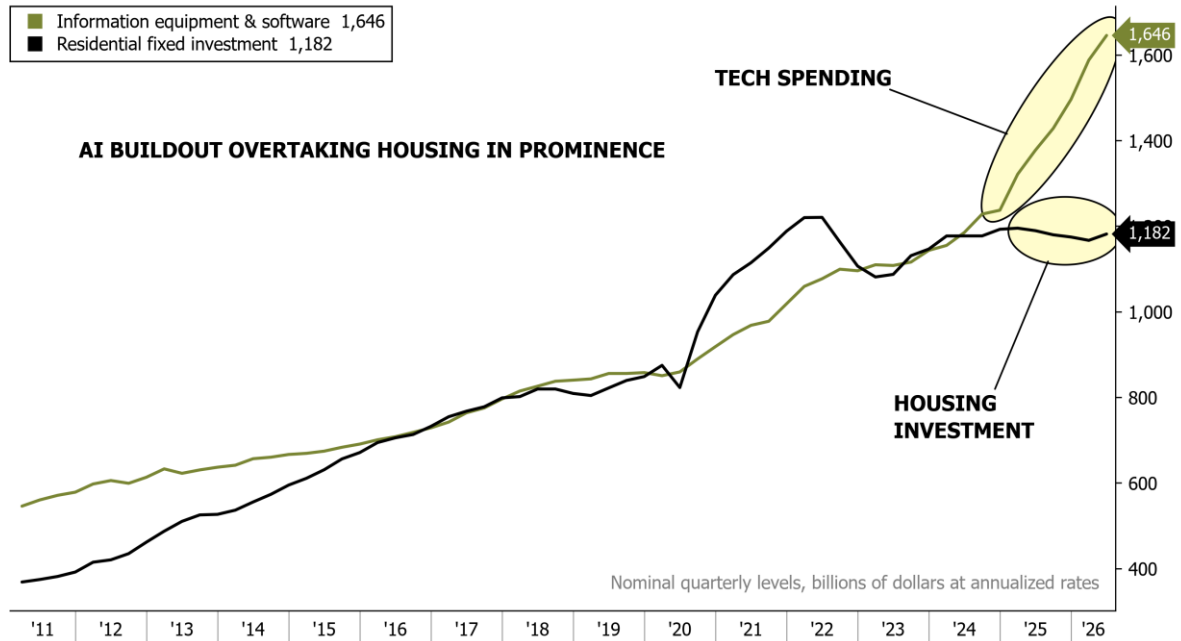
The first pillar: no bubble. The equity correction of recent months has been a valuation story, not an earnings story. The S&P 500 forward P/E fell from its high of 23x to 19x, sitting below its five-year average of approximately 20x. Twelve-month forward earnings estimates rose 30% this year. Without a prior drawdown, forward earnings have risen 37% over the past twelve months – unprecedented in the data since 1991. Put differently, equities have been correcting all year – on valuations rather than on prices. Should the market move sideways until year-end, the de-rating could exceed 20%, a sizeable correction by historical standards. Overall, the market is no longer expensive.



Source: Bloomberg

Earnings quality is high as well. Positive company guidance outnumbers negative guidance by 72 to 44. Interest coverage for the S&P 500 is near a record at 14x, compared with a long-term average of 11x, and equity issuance remains low relative to market capitalization.

The second pillar: no recession. The US economy is K-shaped. On one side, the AI-driven buildout of data centers is booming. Core capital goods orders are up 15% year-on-year. Purchasing managers' indices are firmly in expansion and rising – the US composite stands at 58.4, the Eurozone at 53.1 and China at 52.4. On the other side, consumers are gloomy and housing is weak. The labor market is cooling, not cracking: September payrolls rose by only 29,000, and unemployment ticked up to 4.2%.



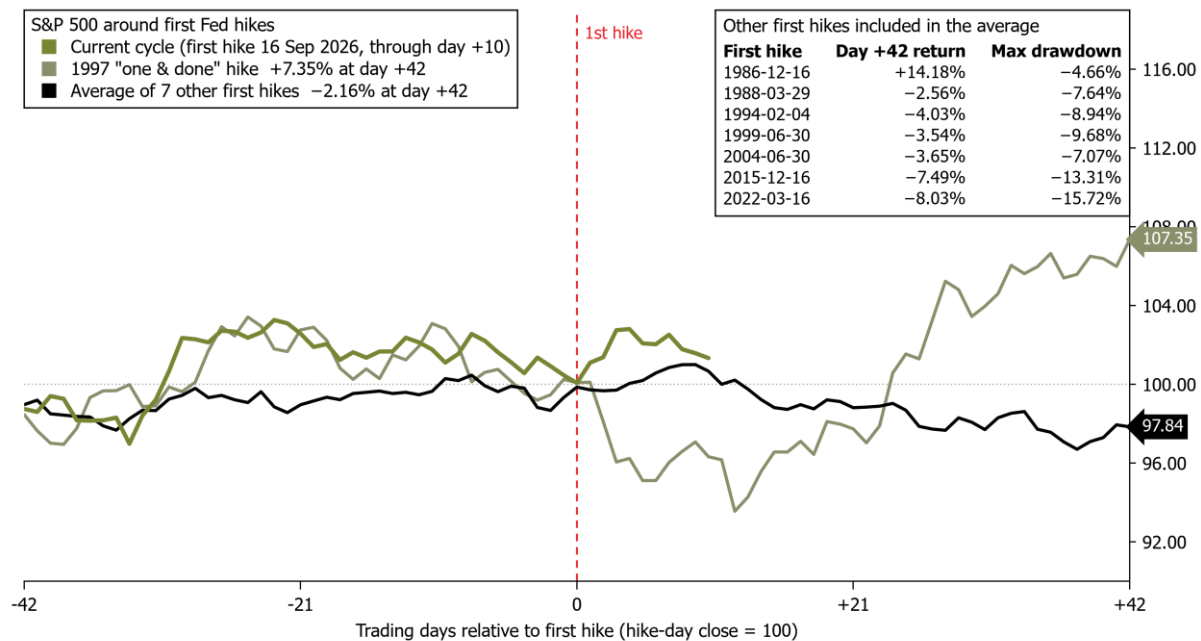
Source: 3Fourteen Research, FINAD

The third pillar: supportive Fed policy. This is the pillar that has cracked. In July, we warned of a repeat of 2018, when a new Fed chair overtightened in a midterm year. With inflation sticky and the economy strong, the Fed has since begun to hike. Yet higher rates barely touch the AI buildout; they mainly hit the parts of the economy that are already weak, such as housing. Monetary policy thus deepens the K-shape. Whether this remains a short mini-cycle or turns into a full tightening cycle will, in our view, decide the path of the equity market over the coming months.

A mini-cycle, not a full cycle – the 1997 template

The Fed has shifted from cuts to hikes. Its own projections, however, set a high bar for more than two hikes: the FOMC sees core PCE inflation at 3.4% and unemployment at 4.1% for years to come. Two influential committee members, John Williams and Philip Jefferson, are already urging patience on the next move. Until recently, markets priced the probability of an October hike at around 70%; it has since fallen to around 20%. A December hike, however, remains largely priced in.

History shows that equities usually struggle early in a hiking cycle. The notable exception is 1997, when the Fed hiked only once. Back then, the S&P 500 was 7% higher 42 trading days after the hike – compared with an average decline of around 2% after other first hikes. For now, we still expect a path similar to 1997. In our base case, the Fed hikes perhaps once more, in December. After that, the task forces set up by Fed Chair Kevin Warsh are due to report, and we expect them to emphasize productivity gains and technology-driven disinflation – which could mark the end of the hiking cycle.



Source: 3Fourteen Research, FINAD

Why are yields rising?

The cyclical drivers are clear: a strong economy and sticky inflation. But structural factors matter just as much:

- Growing worries about fiscal sustainability
- Weaker demand for long-dated Treasuries from institutions and households
- Record bond issuance by the hyperscalers, crowding out demand for government bonds
- An unwinding yen carry trade, as Japanese investors repatriate capital from foreign bonds

Rates close to fair value?

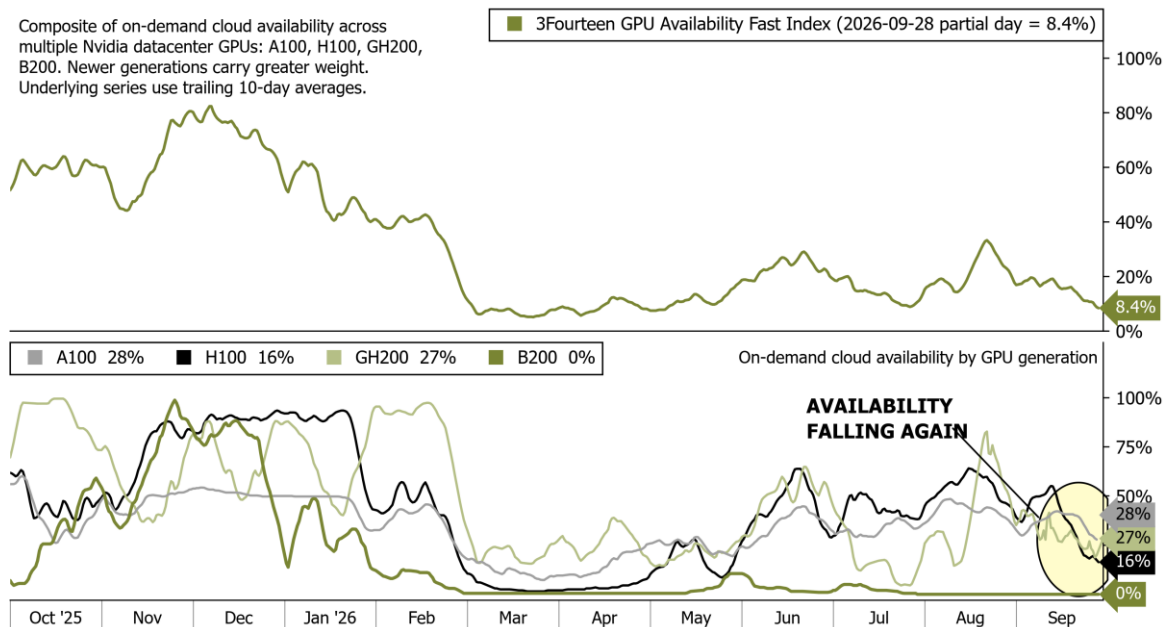
We see two-year yields close to fair value at 4.75–4.85% and ten-year yields at 5.25–5.50%. The two-year yield already trades around 90 basis points above the Fed funds rate, compared with around 50 basis points on average before past hiking cycles – much of the tightening is priced in. We would not rule out an overshoot of the ten-year yield toward 6%, the new “magnet”. Based on nominal GDP growth of 6.6%, a simple regression puts fair value for the ten-year yield at around 5.8%. In a full hiking cycle, the two-year yield would typically keep rising; in a short one, it should drift lower from today's elevated level.

Many investors ask at which yield level equities would break. We believe it is considerably higher than many expect: valuations have already compressed, earnings remain strong, and rising rates barely affect the technology sector. Remarkably, Big Tech has become the market's refuge in this rising-rate environment.

Should yields keep spiking, we expect policymakers to step in. Possible tools include Treasury buybacks funded from the Treasury's cash account, bank deregulation, yield-curve control, or a new Fed–Treasury accord to defend moderate long-term rates. Ahead of the midterm elections, the incentive to cap long-term rates is high. At the same time, heavy short positioning in ten-year Treasuries could trigger a sharp short-covering rally. Such a policy backstop would, in our view, be structurally bullish for equities, gold and Bitcoin.

AI – still the engine

We expect AI and technology to stay in the lead. Micron's very strong recent results confirmed that AI capital spending continues and that demand for chips still exceeds supply. The most telling signals come from the market for computing power: AI chips remain scarce, and their price keeps rising. Availability of Nvidia's B200 processors through cloud providers has fallen to zero, while GPU rental rates are up 31% year-to-date. Amazon Web Services has raised its prices for reserved GPU capacity for the fourth straight quarter, most recently by 15%. Demand for older GPU generations, which softened over the summer, has picked up again. One explanation is the new wave of consumer AI agents such as Meta's Muse, which requires substantial computing power.



Source: 3Fourteen Research, FINAD

This demand is turning into revenue. Estimates for 2027 cloud revenues have been raised by 26% this year, and the annualized revenues of the two frontier labs, OpenAI and Anthropic, now stand at close to USD 150 billion, growing by several billion each month. We would not be surprised to see one of them go public before year-end. Rising rental rates also counter the skeptics' argument that chips must be written off within two to three years without earning a return. So far, the AI buildout has been a highly profitable investment for the hyperscalers. Data center projects remain largely on schedule, although we are watching for bottleneck delays. Electricity is the next constraint: China has left the world behind in power generation, while the US will need a growing share of its capacity for data centers.

AI is also beginning to reshape the labor market. Since mid-2025, the finance and technology sectors have shed around 246,000 jobs, while all other industries added around 812,000. We expect this shift to intensify and broaden next year. In 2027, the labor market could move back into focus: if inflation fears fade, attention may shift to the employment side of the Fed's dual mandate – potentially making the Fed more dovish again.

Positioning

The medium-term set-up remains attractive for risk assets. However, the early phase of a hiking cycle, an unusually narrow market and the risk of a policy error argue for more caution in the near term. We have therefore **slightly reduced our significant overweight in equities**. We remain overweight, but less so than before. This is a risk-management step, not a change in our constructive view. On balance, we continue to give the bull market the benefit of the doubt.

Several factors support staying invested. Earnings quality is high, and seasonality is favorable: historically, equities have rallied in the fourth quarter of a midterm year and continued to do so in the first and second quarters of the following year. Positioning is cautious – net exposure of US hedge funds is low and only 28% of S&P 500 stocks trade above their 50-day average. From a contrarian perspective, this leaves room for a broadening rally.

We see the range of outcomes as wide:

- **Bull case:** The Fed stops after two hikes, yields stabilize, valuations re-expand as the earnings boom continues, and laggards join the rally. A ceasefire in the Middle East would add a further tailwind.
- **Bear case:** The Fed turns more hawkish as inflation stays broad and sticky. A stumble among the largest stocks, credit contagion or renewed oil escalation – with stocks and bonds falling together – would hit the whole market.

Within equities, we continue to prefer global quality large caps with a momentum tilt, supplemented by broad ETFs and active emerging-market managers. In fixed income, we keep duration short. Gold remains our primary diversifier. Alternative investments also remain a sizeable part of our allocation: we invest in selected strategies that aim to be largely uncorrelated with equities – a valuable source of diversification in a phase of higher volatility.

Signals we watch: semiconductor stocks holding their July lows; small and mid caps – if they join banks in their decline, then growth optimism may have peaked; CCC and single-B credit spreads; the French–German bond spread; a peak in the US dollar; and the third-quarter earnings season. A bond tantrum that forces the Fed and Treasury to act could, in our view, be the signal to increase risk again.

Sources: 3Fourteen Research (Q4 2026 Chart Book), 42Macro, Bloomberg, Bank of America, BlueBay, CFTC, Citadel, Deutsche Bank, Duality Research, FactSet, Goldman Sachs, Hightower Advisors, J.P. Morgan Asset Management, Lombard Odier, Wells Fargo, and other research partners.

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