

Rates Hit Multi-Decade Highs. Will Growth and Earnings Keep the Rally Going?



Exhibit 1: Trailing Returns as of September 30, 2026

Index/ETF	1-Mo	3-Mo	YTD	1-Y	3-Y	5-Y
Equities						
US Growth (SPYG)	1.9%	3.6%	15.8%	18.4%	28.4%	14.9%
US Large-Caps (SPY)	-0.3%	2.4%	12.7%	15.7%	22.7%	13.7%
Broad-based Emerging Markets (SPEM)	-1.6%	0.0%	11.7%	13.5%	18.7%	7.2%
International Developed Equities (SPDW)	-2.9%	-0.4%	14.7%	21.2%	21.0%	10.2%
US Value (SPYV)	-3.1%	1.0%	8.9%	12.5%	16.2%	11.7%
US Mid-Caps (SPMD)	-4.2%	-6.4%	9.9%	11.7%	14.5%	8.0%
US Small-Caps (SPSM)	-5.6%	-8.0%	14.1%	16.0%	14.8%	6.2%
US Fixed Income						
US Aggregate Bond Index (SPAB)	-2.6%	-3.5%	-2.8%	-1.9%	4.0%	-0.7%
Treasury Inflation Protected Notes (SPIP)	-2.8%	-3.4%	-2.2%	-2.3%	3.5%	-0.3%
High Yield Credit (JNK)	-2.9%	-2.1%	-0.3%	1.1%	7.8%	3.0%
Investment Grade Corporate Bonds (SPBO)	-2.9%	-4.1%	-3.1%	-2.4%	5.2%	-0.3%
US Treasury 7-10 Year (IEF)	-3.4%	-4.6%	-4.6%	-3.7%	2.9%	-2.1%
Municipal Bonds (MUB)	-3.5%	-5.3%	-3.6%	-2.0%	2.6%	0.0%
Commodities						
Crude Oil (USO)	8.9%	36.8%	110.6%	97.6%	21.6%	22.6%
Broad-based Commodities (BCI)	0.6%	15.8%	32.5%	39.6%	15.2%	10.6%
Gold (GLD)	-6.8%	3.4%	-3.9%	7.1%	30.4%	18.3%
Silver (SLV)	-9.3%	1.9%	-15.4%	28.7%	38.8%	21.6%

Source: FactSet. Data as of September 30, 2026. 1-Y, 3-Y, and 5-Y numbers are annualized. Past performance is not indicative of future results.

Modest Q3 Gains as Participation Narrows and Yields Hit Multi-Decade Highs

Despite rising Treasury yields, persistent inflation, and the Fed's first rate hike since July 2023, the S&P 500 Index posted a 2.3% gain in Q3 amid strong corporate earnings and economic growth, though market participation narrowed. During the quarter, US growth (+3.6%) was among the best performers, followed by US large-caps (+2.4%) and US value (+1.0%), while US small-caps (-8.0%) and US mid-caps (-6.4%) lagged. Bonds struggled as municipal bonds fell 5.3%, 7-10 year US Treasuries declined 4.6%, and investment grade corporates decreased 4.1%. Commodities produced positive returns as crude oil surged 36.8%, broad-based commodities increased 15.8%, gold rose 3.4%, and silver gained 1.9%.

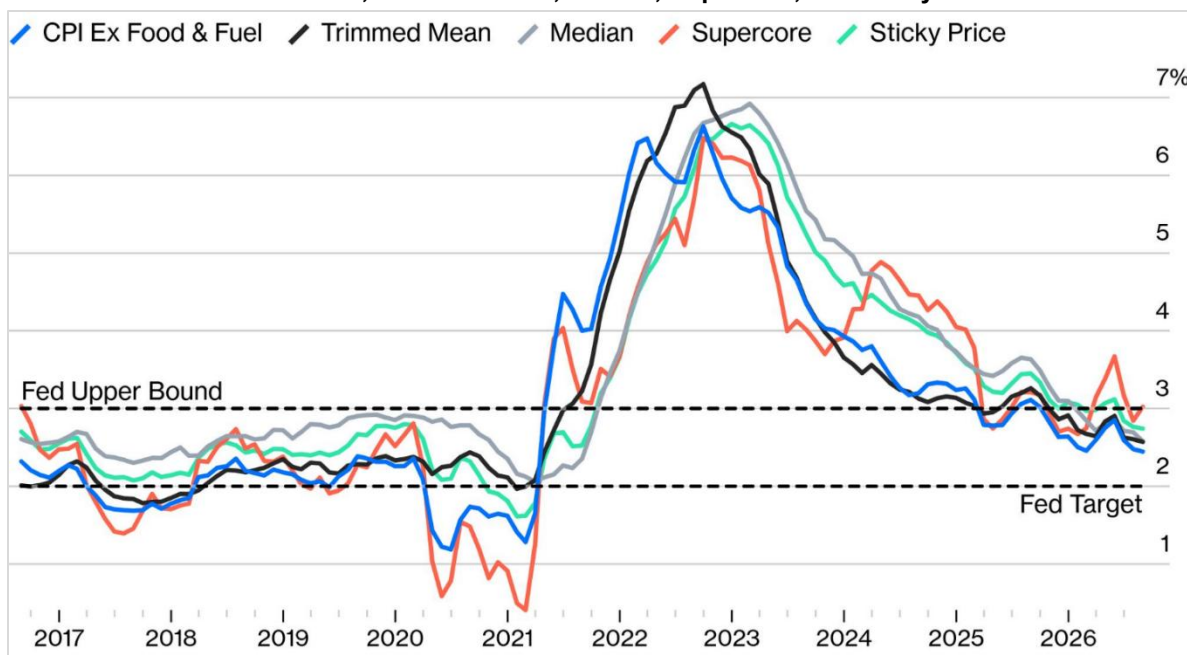
Fed Hikes for the First Time Since 2023

The Federal Reserve raised the federal funds rate by 25 bps at the September FOMC meeting, lifting the target range to 3.75–4.00% in a unanimous 12–0 vote. It was the Fed's first hike in more than three years and a decisive shift from July, when the committee held rates but drew three dissents. Chair Kevin Warsh described the move as removing "a dose of accommodation," declining to offer forward guidance and instead explaining why the Fed acted now after pausing in July. He was blunt about the motivation, telling reporters that "the plain fact is that inflation is too high and has been for too long," and cited a strengthening economy, inflation trends that had not improved enough, and shifting geopolitical risks as the reasons for acting. The data backed the decision. August Nonfarm Payrolls rose 162,000, well above the roughly 60,000 expected, and the unemployment rate held at 4.1%. August Headline CPI rose 3.4% year-over-year on higher energy prices, though core CPI was cooler at 2.4%. The updated Summary of Economic Projections turned more hawkish, with officials penciling in one more hike this year, which lifted the median year-end funds rate to 4.1% from 3.8% in June and nudged the longer-run neutral rate up to 3.2%. They also raised their 2026 growth forecast to 2.3% from 2.2%, lowered the year-end unemployment estimate to 4.1% from 4.3%, and lifted their core inflation projection to 3.4% from 3.3%. However, after a softer-than-expected August PCE reading released at the end of September, the CME FedWatch Tool now puts the odds of an October hike near 35%, down from as much as 70% a week ago.

Energy Keeps Pressure On, but Inflation Cools Beneath the Surface

The Fed's hike came against a two-sided inflation backdrop. On the headline side, energy is back at the center of the story. With conflicts in the Middle East and Ukraine constraining global fuel supplies, WTI crude climbed back above \$90 a barrel and the national average price of diesel reached a record nominal high of over \$6.50 per gallon in late September, while headline CPI rose 0.4% in August to hold at 3.4% year-over-year. Beneath the surface, though, the picture is more encouraging, as several measures designed to filter out noise cooled in August. The Cleveland Fed's trimmed-mean and median CPI, which set aside the most extreme price moves, both slowed, as did the Atlanta Fed's sticky-price CPI, which tracks items whose prices change infrequently and tend to reflect longer-term expectations (Exhibit 2). The main exception was supercore CPI, or core services excluding housing, which moved back up toward 3%, though part of that reflected a one-off spike in wireless phone service prices. Even so, the Fed had reason to look past the softer CPI. Core PCE, its preferred gauge of underlying inflation, told a hotter story, running at 3.3% as of July, the latest reading available before the meeting, well above the 2.4% pace of core CPI. Energy costs also tend to seep into services with a lag, and transportation services prices were already up 0.5% in August. The August PCE report, released yesterday, brought some relief, with core PCE easing to 3.0% and headline PCE measure slowing to 3.4% from 3.7%, though both remain above goal.

Exhibit 2: CPI Ex Food & Fuel, Trimmed Mean, Median, Supercore, and Sticky Price



Source: Bloomberg. Data as of September 14, 2026.

Yields Climb, but Growth Is Strong and Earnings Are Expected to Follow

Treasury yields rose across the curve in September, with the 10-year reaching its highest level since 2002 and the 30-year topping 5.4%. Although fiscal strain and heavy Treasury issuance have drawn attention, the move likely owes more to oil and stronger nominal growth than to doubt about the government's ability to fund itself, with the term premium staying contained. Oil appears to be the immediate driver, as yields have tracked crude closely this year, a 0.96 correlation, and a renewed spike would likely push rates higher at equities' expense. Growth has been the other force. Nominal GDP, which captures both real growth and inflation, is running close to 7% on a five-year trailing average and has reaccelerated this year on OBBBA capex incentives and demand for AI compute. Even at a 19-year high, the 10-year yield remains below that pace of GDP growth, which suggests rates are not excessive relative to the economy's growth. For equities, much of the adjustment has already come through valuations, and notably the forward multiple has derated through higher earnings rather than falling prices. Forward earnings estimates have climbed on roughly 29.1% expected third-quarter growth, pulling the S&P 500's forward P/E down to about 19.2x even as the index has held up. That multiple implies an earnings yield of about 5.1%, in line with the current 10-year yield (Exhibit 3). Even if the 10-year climbed to 5.2%, the same framework would point to a multiple near 16.7x, about a 13% valuation haircut, but continued earnings growth would more than offset that, limiting the risk of a 2022-style drawdown.

Exhibit 3: 10 Year US Treasury Yield and 5 Year Nominal US GDP

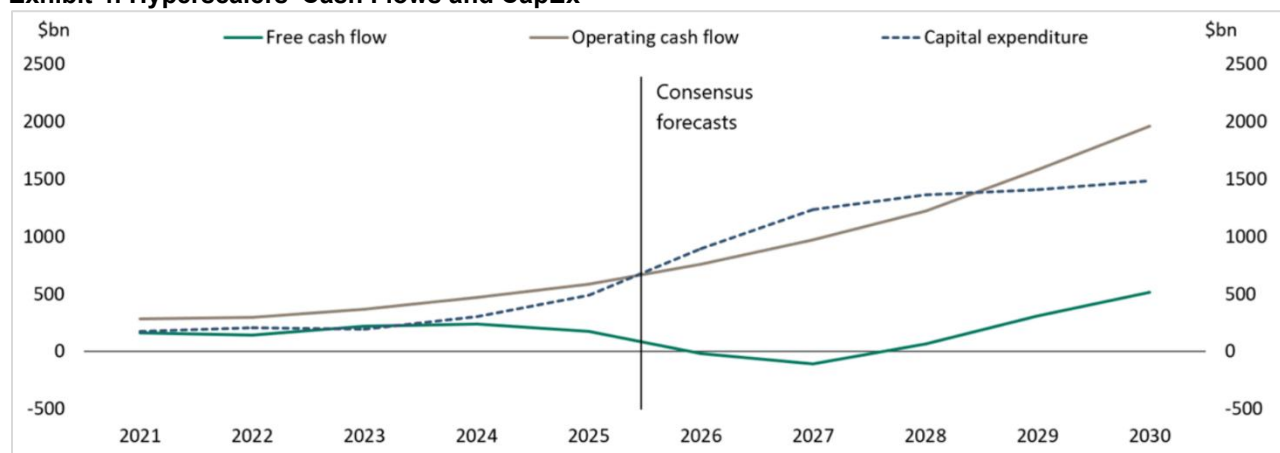


Source: Bloomberg, Morgan Stanley Research. Data as of September 28, 2026.

Growth Leans on AI Spending. Can Hyperscaler Cash Flow Keep Pace?

With the Fed now tightening and energy keeping pressure on long-term yields, AI investment has become a central driver of US growth. Excluding equipment and intellectual property investment, the components most tied to AI, real GDP grew at just a 0.3% annualized rate in the first quarter and was flat in the second. That spending is increasingly funded with debt. Consensus estimates that capex for Alphabet, Amazon, Meta, Microsoft, and Oracle will exceed operating cash flow in 2026 and 2027. That leaves aggregate free cash flow below zero, a gap the consensus expects to close only as operating cash flow roughly triples, from about \$600 billion in 2025 to \$2 trillion by 2030. The AI story rests on that single assumption. But if that story doesn't happen, credit spreads could widen and capex plans could be scaled back, with potential spillover to broader US growth.

Exhibit 4: Hyperscalers' Cash Flows and CapEx



Note: Hyperscalers are Google, Meta, Amazon, Microsoft and Oracle. Sources: FactSet, Apollo Chief Economist

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