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Third Quarter 2026

Economic and Market Outlook

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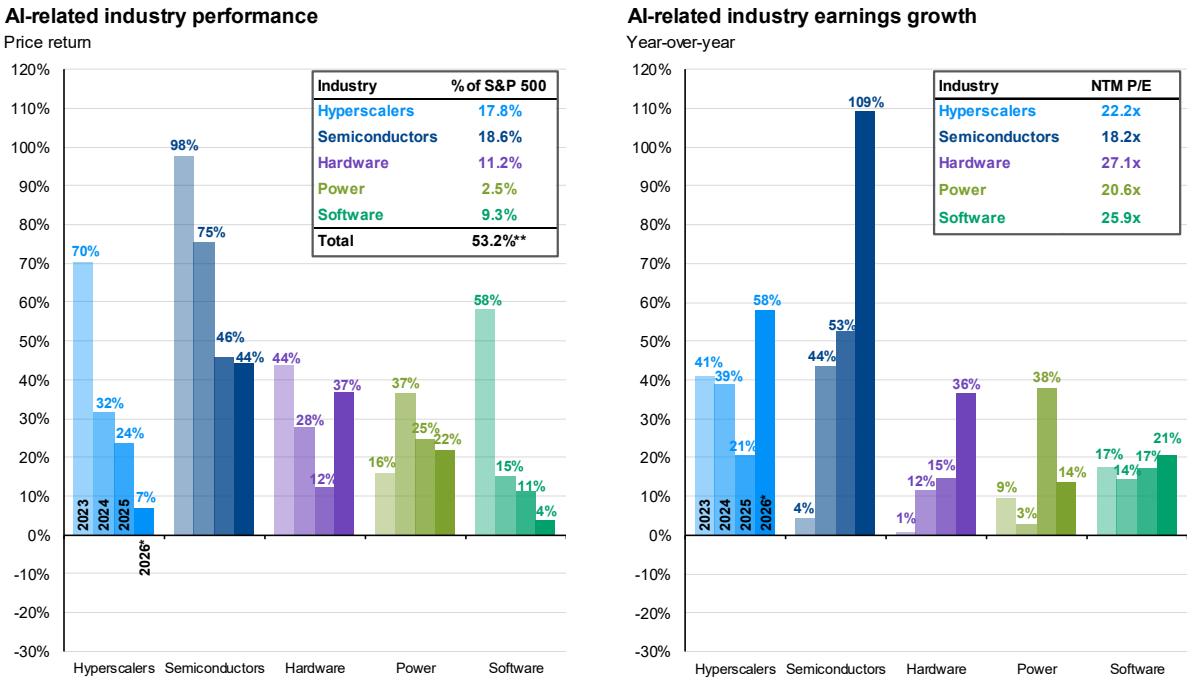
Third Quarter 2026 Economic and Market Outlook

As of September 2026, the U.S. economy continues to grow, but the balance of risks has become less comfortable. Consumer spending and business investment remain supportive, while the labor market has cooled and inflation remains elevated. The Federal Reserve's September rate increase reflected this tension: policymakers are trying to restrain inflation without placing unnecessary pressure on an economy that is already showing signs of slower job growth.

For equity investors, earnings remain the most important source of support. The AI investment cycle continues to generate meaningful demand for semiconductors, memory, cloud capacity, power, and data-center infrastructure. At the same time, the market is becoming more discerning. Companies that can demonstrate a clear return on their AI spending have generally been rewarded, while those with rising capital expenditures but less visible near-term payoffs have faced greater scrutiny. This healthier distinction may create more uneven returns within technology, but it can also broaden the opportunity set beyond a handful of market leaders.

Exhibit 1 illustrates the dominance of AI related industries in the S&P 500, which now represents more than 50% of the market. Semiconductors have been among the strongest performers so far this year. Furthermore, software stocks rebounded strongly in the quarter as the perceived AI threat faded slightly and earnings growth for key companies in the sector remained resilient.

Exhibit 1: AI Related Industries: Performance and Earnings Growth



Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as of September 30, 2026. FactSet, MSCI, Standard & Poor's. *2026 price return is year-to-date, and earnings growth reflects 2026 consensus estimates as provided by FactSet. Past performance is no guarantee of future results.

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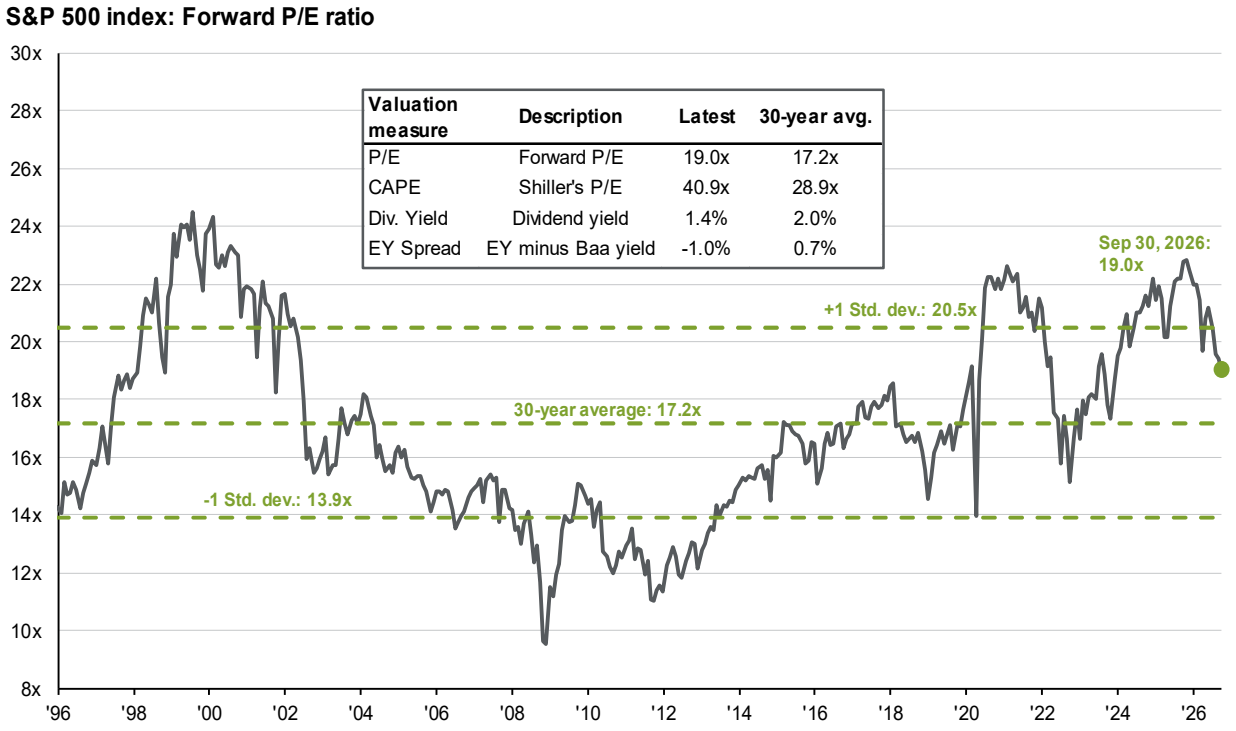
There are also meaningful risks. Equity valuations remain elevated in parts of the market, and higher Treasury yields create a more demanding hurdle for long-duration growth assets. **Exhibit 2** shows that while valuations have come off their highs if measured using forward earnings estimates, the earnings yield spread between stocks and bonds has turned negative – suggesting that bond markets now offer competitive returns to stocks markets on a forward-looking basis. In addition, persistent inflation, heavy government borrowing, and large corporate financing needs for AI infrastructure. could keep interest rates higher and markets more volatile than investors became accustomed to during the years of very low rates.

At the same time, equity market leadership has become less uniform. Emerging markets remain strong for the year, while returns among U.S. technology companies have diverged as investors distinguish between businesses already benefiting from AI and those that may face disruption or delayed returns on spending. We view this dispersion as an argument for selectivity and diversification and have constructed portfolios accordingly.

Exhibit 2: S&P 500 Valuation Measures Remain Stretched and Reliant on AI Industries



Source: J.P. Morgan Asset Management. Guide to the Markets – U.S. Data are as of September 30, 2026. Bloomberg, FactSet, Moody's, Refinitiv Datastream, Robert Shiller, Standard & Poor's Forward P/E ratio is the most recent S&P 500 index price divided by consensus analyst estimates for earnings in the next 12 months.

Today's elevated market valuations suggest that investors are already paying for a favorable earnings outlook, leaving less room for disappointment. Valuations alone are not reliable timing tools, but higher starting prices have historically been associated with more modest long-term returns and greater sensitivity to weaker earnings, persistent inflation, or higher interest rates.

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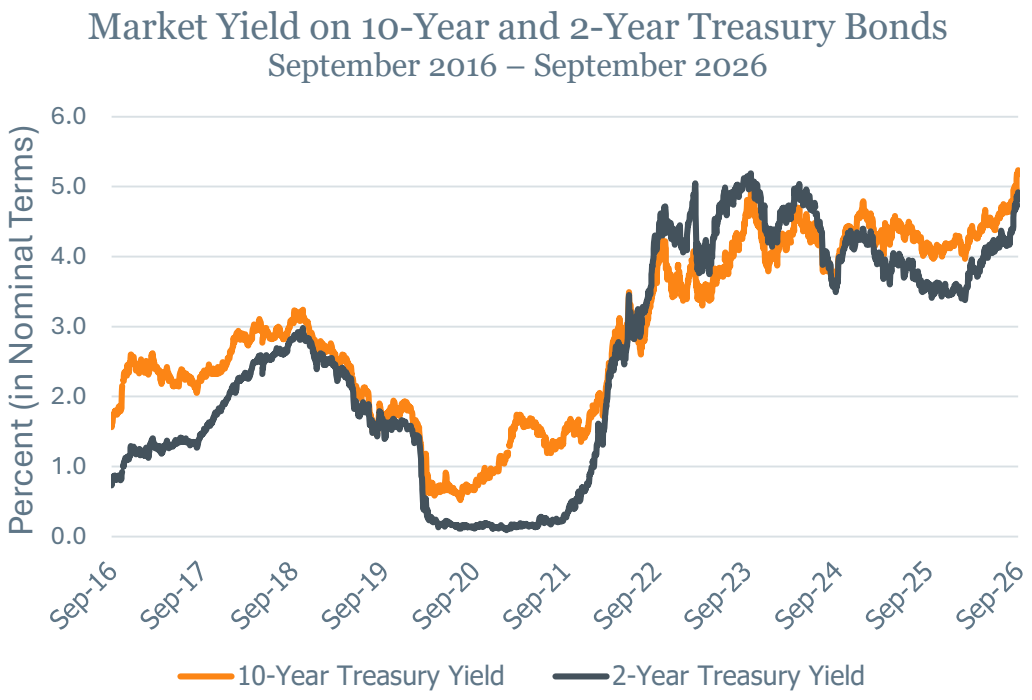
Geopolitical and Fiscal Risks Remain

The conflict between the U.S. and Iran remained a major source of uncertainty during the quarter. Renewed hostilities disrupted energy markets, kept oil prices elevated, and added to inflation pressures at a time when the Federal Reserve was already struggling to bring inflation back toward its target. Separately, rising federal debt and heavy Treasury issuance placed additional pressure on longer-term yields as illustrated in **Exhibit 3.** These risks may not move markets in a straight line, but they reinforce the importance of maintaining liquidity, managing interest-rate exposure, and avoiding portfolios that depend on a single economic outcome.

The upcoming midterm elections may add to near-term headline risk. However, the market impact is likely to be limited, unless the results materially change the outlook for taxes, spending, regulation, or trade. Markets may increasingly price in divided government and legislative gridlock, which could reduce the likelihood of major policy changes over the balance of the presidential term. Although election-related uncertainty can contribute to short-term volatility, history suggests that economic growth, inflation, interest rates, and corporate earnings tend to be more important drivers of longer-term market returns.

Exhibit 3: Higher Starting Yields: More Income and a Stronger Outlook



Source: Board of Governors of the Federal Reserve System (US), Market Yield on U.S. Treasury Securities at 10-Year Constant Maturity, Quoted on an Investment Basis [DGS10] and Market Yield on U.S. Treasury Securities at 2-Year Constant Maturity, Quoted on an Investment Basis [DGS2], retrieved from FRED, Federal Reserve Bank of St. Louis.

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Looking Ahead

Looking ahead, the combination of slower job growth, persistent inflation, higher oil prices, and elevated bond yields gives the Federal Reserve little room for error. Markets are likely to remain sensitive to each new inflation report, employment release, earnings announcement, and geopolitical development. We do not believe the right response is to make an all-or-nothing bet on the next Fed decision or the next market leader. Instead, we continue to favor a balanced portfolio with multiple sources of return, thoughtful exposure to interest-rate and inflation risk, and enough diversification to remain resilient when conditions change. That approach may feel less exciting than chasing the latest winner, but we believe it is better suited to helping our clients reach long-term goals through a wide range of market environments.

Past Performance is No Guarantee of Future Performance.

Reminder: The returns for your accounts are affected by the timing of new investments, cash flow patterns (deposits, withdrawals, and transfers), client-specific asset allocation policies and retained individual securities. All of these variables may cause dispersion among returns, as compared to our Models.

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Wescott returns are calculated assuming annual rebalancing each January and reinvestment of all dividends and capital gains. The model returns assume that the portfolio remained invested for the entire period, with manager changes reflected, but with no deposits or withdrawals. Clients' individual portfolio returns are influenced by cash flow patterns, the timing of transactions, "client-held" securities or managers and client specific asset allocation policies. Investor returns vary due to cash flow patterns and portfolio customizations.

Benchmark returns used in this analysis are net of the underlying managers' fees and trading costs. Wescott returns are also net of the underlying managers' fees and trading costs, but gross of Wescott's management fee. Clients' returns will be reduced by such fees, which are described in the Firm's ADV Part 2A Disclosure Brochure.

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