

Investment Review & Outlook

Oil Prices & Rising Rates Temper Equity Markets

The market enters the fourth quarter supported by a resilient economy and strong earnings, but continued gains will depend on how those strengths hold up against higher rates, energy costs, and geopolitical uncertainty.

THIRD QUARTER REVIEW

Markets were volatile in the third quarter, but the capitalization-weighted S&P 500 Index still advanced as strong corporate earnings and a resilient economy pushed the benchmark to new highs despite rising oil prices and surging Treasury yields. Ironically, the majority of the market struggled during the quarter. The equal-weighted version of the S&P 500, the Dow Jones Industrial Average, and the Russell 2000 indices all posted negative returns.

July began with concerns about valuations and spending across the artificial intelligence (“AI”) infrastructure industry. Despite a strong second-quarter earnings season, aggressive capital investment plans raised questions about sustainable demand for AI components. Investors worried AI stocks had risen too far, too fast. Geopolitics also added to the pressure. On July 13, the United States reimposed a blockade on the Strait of Hormuz, triggering renewed attacks between the U.S. and Iran. The ceasefire collapse lifted oil prices and pushed down stock prices. Late in the month, strong hyperscaler earnings and encouraging comments about revenues from AI investments helped restore confidence. Money flowed back into technology, allowing the S&P 500 to recover nearly all its July losses and finish unchanged.

The momentum carried into August as AI enthusiasm continued and attacks between the U.S. and Iran stopped. Encouraging growth and inflation data helped push the S&P 500 to a record high on August 12. The rally then stalled as persistent inflation raised expectations for Fed rate hikes, a message reinforced by new Fed Chair Warsh at the Jackson Hole Economic Policy Symposium. Geopolitical risks resurfaced in late August when the Iran-backed Houthis advanced toward the Yemeni coast and threatened shipping near the Bab el-Mandeb Strait. Oil prices and Treasury yields rose, pressuring stocks, although the S&P 500 still finished August with a 2.7% gain.

The above pressures intensified in September. Further Houthi advances increased risks to tanker traffic, while Iranian-aligned groups sabotaged Saudi Arabia’s East-West pipeline, disrupting another route for oil exports.

Why the Current Economy Does Not Exhibit the Classic Recession Setup



A question we are often asked is about the duration of bull markets and the potential catalyst(s) that may cause a bull market to end. Historically, economic recessions are the killer of structural bull markets. Recessions do not typically begin simply because economic growth slows for a quarter or because one isolated economic indicator weakens. Historically, a genuine U.S. recession develops when the private sector begins to contract in a broad and self-reinforcing way. **Three of the most important signals are declining corporate earnings growth, declining capital expenditures, and rising unemployment.** These indicators matter to investors because they connect directly to the fundamental drivers of stock prices: corporate profits, business investment, and household income. At present, the evidence does not show the combination of conditions that has historically accompanied the onset of a recession.

The first and perhaps most important condition is declining corporate earnings growth. Ultimately, businesses drive the economy, and profits provide the fuel for continued expansion. When corporate earnings begin to deteriorate materially, management teams become more defensive. Companies reduce hiring, cut discretionary spending, postpone expansion projects, and become increasingly focused on preserving cash. Historically, sustained weakness in corporate profits has been an important characteristic of recessionary periods. The current environment, however, looks fundamentally different. Aggregate U.S. corporate profits have continued to rise, rather than entering the broad contraction that would normally be expected ahead of a major recession. For investors, this distinction is crucial: An economy in which corporate earnings are still expanding is fundamentally different from one in which businesses are experiencing a widespread collapse in profitability.

The second major condition is declining capital expenditures. Capital spending is one of the

The Federal Reserve raised interest rates by 0.25% and signaled additional increases could be likely. Strong economic data, higher oil prices, and expectations for further tightening drove the 10-year Treasury yield to a multi-year high. Rising yields weighed on stocks, leaving all the diversified equity indices with a monthly loss.

US EQUITY INDEXES	Total Return 3Q 2026	Total Return YTD 2026
S&P 500	2.30%	12.73%
S&P 500 Equal Weighted	-1.87%	10.01%
DJ Industrial Average	-2.34%	7.19%
NASDAQ Composite	2.61%	16.09%
S&P 500 Dividend Aristocrats	-3.16%	5.86%
Russell 2000 (Small Cap)	-7.19%	13.87%
MSCI EAFE (International Developed)	0.91%	10.91%
MSCI Emerging Markets	-0.40%	23.52%

Source: Bloomberg Professional (9/30/2026)

Why Rising Interest Rates Are a Headwind to Equity Markets

We are often asked why an increase in market interest rates negatively affects stock prices. While the answer might be a bit nuanced for differing individual stocks versus the broad equity market, there is a behavioral, fundamental, and theoretical component to the explanation.

From a behavioral standpoint, rising interest rates can create a headwind for equity markets because they make fixed-income securities relatively more attractive to investors. As interest rates increase, newly issued bonds and other fixed-income investments generally offer higher yields, providing investors with greater income and, in some cases, lower perceived risk than equities. As a result, investors may have less incentive to allocate capital to stocks, particularly when equity valuations are elevated. This relative shift in the attractiveness of fixed income can reduce demand for equities and place downward pressure on stock prices.

Fundamentally, higher interest rates can also increase the cost of capital for businesses, which can negatively affect profitability



clearest expressions of corporate confidence. Businesses do not commit billions of dollars to factories, equipment, technology, data centers, transportation infrastructure, and other productive assets unless management expects those investments to generate future economic returns. In previous recessions, capital expenditures have typically weakened substantially as companies respond to deteriorating demand and falling profits. That process can then amplify an economic slowdown because reduced investment means less spending, less hiring, and less future productive capacity. Yet there is currently no broad-based collapse in business investment. Today, business investment remains an important contributor to economic activity, suggesting that corporate America continues to spend for the future rather than retreating into recessionary defensive behavior. From an investment perspective, continued capital spending is particularly significant because it indicates that businesses are still acting on expectations of future demand.

The third condition is rising unemployment. Employment is the critical transmission mechanism between the corporate sector and the consumer. When businesses begin laying off workers on a sustained basis, household income falls, consumer spending weakens, and declining demand can force additional layoffs. This creates the negative feedback loop that characterizes a true economic contraction. That is not what the current labor market is showing. Unemployment remains relatively low, and payroll employment continues to expand. The labor market may certainly cool without producing a recession, but cooling is not the same thing as the sustained deterioration in employment that has historically accompanied major economic downturns.

For investors, the significance of these three indicators is straightforward. Declining profits weaken businesses; declining capital expenditures reduce investment; and rising unemployment undermines consumers. When all three occur together, the economy can move from deceleration into contraction. When none

and earnings. Companies that rely on debt financing face higher interest expenses when borrowing costs rise, while businesses seeking to finance new investments, acquisitions, or expansion may face higher costs for capital. These increased expenses can reduce profit margins and constrain investment, potentially resulting in slower earnings growth. Because equity valuations are influenced by expectations for future corporate earnings, a deterioration in profitability or earnings growth can weigh on the value investors are willing to assign to stocks.

Finally, according to investment theory, higher interest rates can reduce the present value of future corporate cash flows, which can directly affect equity valuations. Investors value a stock based, in part, on the discounted value of the cash flows and earnings they expect the company to generate in the future. When interest rates rise, the discount rate applied to those future cash flows generally rises as well, causing their present value to decline. This effect can be particularly significant for companies whose valuations depend heavily on earnings or cash flows expected many years in the future. Together, the reduced relative attractiveness of equities, higher corporate financing costs, and lower discounted values of future earnings help explain why rising interest rates can serve as a headwind for equity markets.

US BOND INDEXES	Total Return 3Q 2026	Total Return YTD 2026
Bloomberg US Aggregate Bond	-3.51%	-2.91%
Bloomberg US T-Bill 1-3 Month	0.93%	2.75%
ICE US T-Bond 10-20 Year	-7.01%	-6.41%
ICE BofA US High Yield Index	-1.81%	0.04%
S&P National AMT-Free Municipal Bond	-5.78%	-3.79%

Source: Bloomberg Professional (9/30/2026)



of these are occurring, the fundamental case for an imminent recession is considerably less apparent.

This does not mean that a recession is impossible. Economic conditions can change rapidly, and financial markets can decline for reasons that have little to do with an imminent recession. Nor should investors assume that today's conditions will persist indefinitely. But the key point is that **the classic recessionary ingredients are not currently present.** Corporate earnings are not broadly contracting, business capital expenditures are not collapsing, and unemployment is not surging.

For investors, that distinction matters. A market correction, valuation concern, geopolitical shock, or temporary slowdown should not automatically be interpreted as evidence that a recession has begun. The more important question is whether the underlying economic engine is actually deteriorating. By the three fundamental measures discussed above, the evidence currently points to an economy that is still expanding rather than one exhibiting the classic characteristics of a recession.

FOURTH QUARTER OUTLOOK

We enter the final quarter of 2026 with clear challenges: the ongoing U.S./Iran conflict, rising bond yields, and the prospect of additional Fed rate hikes. Yet two powerful forces continue to support stocks—resilient economic growth and strong corporate earnings. Both helped the S&P 500 overcome those headwinds during the third quarter.

Economic activity remained strong, supported by healthy employment, resilient consumer spending, and accelerating manufacturing and services activity. The Atlanta Fed's GDPNow estimate reached 5.0% in late September, providing a solid foundation for the market's year-to-date gains.

Corporate earnings also strengthened. Following the second-quarter earnings reporting season, analysts again raised 2027 S&P 500 earnings estimates, with expected growth remaining well above historical averages. Rising profit expectations helped support valuations despite higher stock prices, keeping the index below its five-year average valuation during the third quarter.

These strengths matter, but several risks warrant close attention.

The U.S./Iran and Russia/Ukraine conflicts continue to disrupt energy markets and keep oil, gasoline, and diesel prices elevated. Prolonged disruptions could further weigh on consumers, affecting corporate margins and economic growth. Meaningful diplomatic progress that restores energy flows could lower prices and provide a catalyst for stocks.

Higher Treasury yields present another challenge by increasing borrowing costs and competition for investment dollars (as discussed above). Rising energy prices have contributed to inflation concerns and upward pressure on yields. Lower oil prices could help ease that pressure, although economic growth, government borrowing, and Fed policy will also influence rates.

Investors expect additional Fed rate hikes in 2026 and 2027. Further tightening could pressure markets initially, but successfully containing inflation would support the longer-term outlook. Softer inflation readings in the fourth quarter could reduce expectations for additional hikes in 2027 and help stabilize Treasury yields.

The sustainability of AI spending also remains in focus. Comparisons with the dot-com era are understandable, but evidence that AI



investments are generating revenue offers an important distinction. Further progress would strengthen confidence in the buildout and support technology shares. Investors will be watching whether revenues and profits justify the spending.

In summary, the market enters the fourth quarter supported by a resilient economy and strong earnings, but continued gains will depend on how those strengths hold up against higher rates, energy costs, and geopolitical uncertainty. At SlateStone Wealth, we remain focused on what this means for your portfolio and long-term investment goals. We will continue to assess the above-mentioned opportunities and risks, making adjustments when appropriate.

Thank you for your continued confidence and trust. Please **contact us** with any questions or to schedule a portfolio review.

Sincerely,

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