

October 2026

Quarterly Review and Outlook

Investors in the third quarter faced a number of concerning issues, including the ongoing war in Iran, rising oil prices, inflationary pressures and higher interest rates. The re-escalation of the war in the Middle East increases the chances of higher-for-longer energy prices and stickier inflation. Offsetting these headwinds has been exceptional strength in corporate earnings. The net result of this tug of war has been a stock market that made little progress in the third quarter up 2.3%, but which has held up well on a year-to-date basis with the S&P 500 index up 12.7% through September 30.

Having started over seven months ago, the Iran war shows no signs of ending. The US continues its naval blockade which has been successful in restricting Iran's oil exports. That said, global oil tanker traffic through the Strait of Hormuz remains limited to ~5-10% of prewar levels. The Iranian regime and its allies have responded to US military actions by widening the battlefield. Recent damage caused to a major Saudi oil pipeline caused by drone attacks launched by Iranian proxies located in Iraq combined with the Iranian backed Houthis gaining territory and threatening shipping lanes in the Red Sea have escalated concern about global energy supplies. Consequently, both oil and diesel fuel prices have risen significantly since the start of the Iran war. Higher energy prices, in conjunction with ongoing tariffs, have caused upward pressure in inflation which has been stubbornly above the Fed's target of a 2% rate of inflation. Sustained high oil prices driven by the conflict with Iran pose an ongoing risk of persistent high inflation.

With oil prices rising, inflation running above target and the US economy growing at a solid pace, the Federal Reserve's Open Markets Committee (FOMC) decided at its September 16th meeting to raise interest rates by a quarter of a percent to a Fed funds rate of 3.75-4.00%. The rate rise is the first in three years and the decision to hike was unanimous amongst FOMC members. The new Fed chairman, Kevin Warsh cited stronger economic growth, insufficient improvement in inflation and increased geopolitical risks (a reference to higher oil prices resulting from the Iran war) as the three factors that convinced the committee to raise rate. At the same time, he acknowledged that consumer spending was resilient, productivity was strong and capital expenditures were robust. With the economy strong and the job market stable, the Fed has turned its focus to fighting inflation hence the increase in rates.

The quarter point increase in the Fed funds rate might be the start of a tightening cycle as 16 of 18 FOMC members expect at least one more rate increase by year end. However, it is our view

that the tightening cycle is meant to undo the “insurance policy” the Fed took out last year in the form of lower rates in the face of deteriorating labor market conditions at the time. If the Fed were to take back the three rate cuts of last year and stop there, it would be a more tempered approach than the more full-throated tightening cycles of the past. Such a view would seem to be corroborated by the fact that FOMC members have indicated that after another rate hike or two, they expect interest rates will be stable for most of next year. Reflective of a strong economy, sticky inflation and a tightening Fed, long-term interest rates have also been on the rise. Since the start of the third quarter, the 10-year US Treasury yield moved up to ~5.10%, its highest level in 19 years. Higher interest rates create a headwind for stock investors as they serve to dampen the P/E valuation multiples afforded stocks. Interestingly, some investors view the decision to raise rates as positive for stocks in that it shows the Fed is reemphasizing its focus on controlling inflation.

Macroeconomic headwinds have thus far been offset by exceptional growth in corporate earnings, which has served to buttress the stock market. Strong corporate profit growth has emanated from rising revenues (S&P 500 index revenues are expected to grow ~10% this year) and improved operating margins as management teams focus on boosting corporate productivity using artificial intelligence and other cost saving initiatives. The success of their productivity enhancing endeavors is captured in the 27% increase in operational earnings of the S&P 500 index during the second quarter. This marked one of the strongest rates of organic earnings growth outside of the 2021 post-pandemic recovery. Corporate earnings for full year 2026 are expected to rise ~30% and for 2027 by ~15%. It is earnings growth over time that drives long-term stock appreciation. Importantly, the strength in earnings has been broad based which compares to previous years when it had been more technology focused.

We expect the US economy to continue to be supported by a stable to growing job market and healthy consumer spending. Robust capital spending should also support solid economic growth. The biggest risk factor is that a prolonged energy shock could reinforce already sticky inflation, making the Fed more inclined to tighten monetary policy. If sustained long enough, higher energy prices could eventually weigh on consumer spending and economic growth. Another risk factor would be a government mandated slowdown in the rate of AI model development which could dampen the rate of AI related capital spending and undermine enthusiasm for AI stocks. However, demand for AI computing is increasingly driven by inference and agentic workloads (vs. frontier models) where compute shortages persist.

In this market environment, we have remained true to our investment approach of investing in quality companies with sustainable earnings growth. The fundamental factors which underpin our company investments include a unique and competitively differentiated product or service offering, an excellent management team and a conservative balance sheet. Purchasing stocks at reasonable valuation levels is another key element of our investment process. Areas of our investment focus continues to be technology, industrial, healthcare, financial and select consumer stocks. While higher energy prices and rising interest rates could cause near-term market volatility, we invest for the long term and believe client portfolios are well positioned in that regard.

In the fixed income area, our primary objective is to maximize after-tax returns based on client's tax status. As such, we actively allocate across corporate, Treasury and municipal bonds. Rising yields year-to-date have created short-term headwinds for bond returns, preventing them from acting as a traditional buffer against stock market volatility. This shift has created a highly attractive environment for generating income. With Treasury and corporate yields holding above 5%, investment income is more compelling than at the start of the year. Where appropriate, it is prudent to lock in some of these yields despite the upward pressure we are experiencing with rates. We are also using shorter-term maturities to preserve principal. With this bar bell approach, we are endeavoring to secure income with longer dated maturities and protecting principal with shorter dated maturities. Credit fundamentals remain highly favorable. Corporate credit spreads are healthy, backed by a strong economy and solid earnings growth. Similarly, municipal finances are exceptionally robust, with credit risk sitting near all-time lows. To minimize risk, we continue to focus on the investment grade area of the bond market. Looking ahead, we expect yields to remain "higher for longer". A meaningful pullback in rates would require a cooling of oil prices, which is dependent on geopolitical progress and resolution in the Middle East.

As always, we are grateful for your support and encourage you to reach out with any questions or concerns that you might have regarding your investments or portfolio holdings.

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