

Will Higher Rates Cramp the Markets?

QUARTERLY LETTER FROM THE DIRECTOR OF RESEARCH

OCT 2026

Anyone who has run a marathon knows the last six miles are brutal — no matter how well the first 20 miles went, it's really about how each runner can handle the cramps and pain of the remaining course. The outcome tends to be rather binary — it's either the worst running experience of someone's life (mine) or when the strongest push through and finish strong (one of our research colleagues in this year's Chicago marathon).

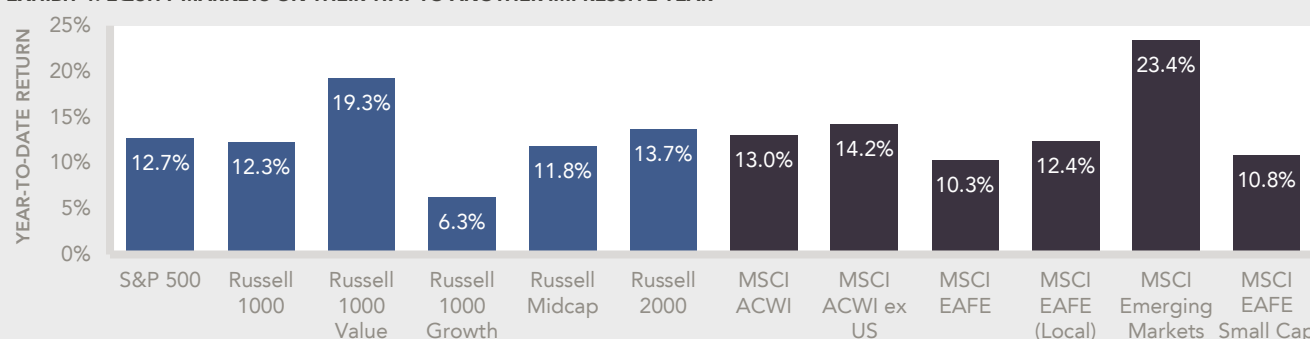
This year's market feels similar. Through September 30, most stock indices are headed for their fourth consecutive year of double-digit returns (*Exhibit 1*) but the massive run-up of rates in the third quarter reminds us how quickly

markets can change. Nothing will be final until we cross the finish line on December 31.

U.S. interest rates rose sharply in the third quarter for a variety of reasons, starting with the Fed's decision to hike short-end rates at its September meeting. Furthermore, sticky inflation, high government spending coupled with a growing deficit, and rising oil and energy prices pushed the belly and back-end of the curve higher. (*Exhibit 2*)

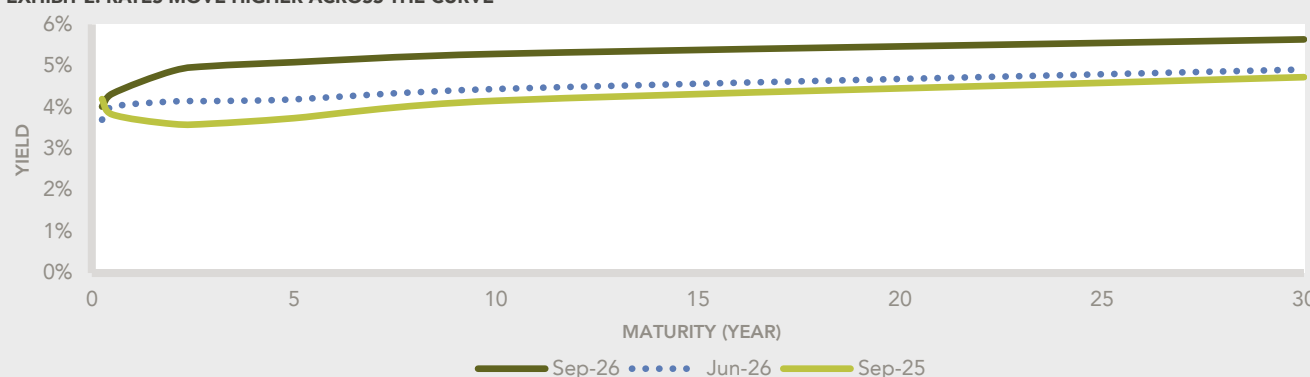
The immediate reaction was felt in the bond markets — particularly for investment grade and Treasury bonds, as well as for U.S. small-cap stocks which are most sensitive to rising rates

EXHIBIT 1: EQUITY MARKETS ON THEIR WAY TO ANOTHER IMPRESSIVE YEAR



Source: S&P Dow Jones Indices, FTSE Russell, MSCI as of September 30, 2026

EXHIBIT 2: RATES MOVE HIGHER ACROSS THE CURVE



Source: U.S. Department of the Treasury as of September 30, 2026

given their higher exposures to floating rate debt and longer-term profitability paths. (*Exhibit 3*)

It should also be noted that higher rates are not just a U.S. trend. Globally, bond markets are under pressure as fiscal deficits, heavy debt supply, and rising real yields push long-term borrowing costs higher. The European Central Bank ("ECB") raised its key benchmark deposit rate to 2.5% on September 10 while the Bank of Japan ("BOJ") increased its benchmark interest rate to 1.25% on September 18. These are likely not the last rate hikes we will see as projections suggest rates will move even higher as the calendar turns to 2027. (*Exhibit 4*)

Higher rates can have both short-term and long-term impacts on the economy and market. As was seen in the bond and small-cap markets, higher rates are inversely related to present value

calculations which are used to determine bond and stock prices. In the case of stocks, companies whose valuations are based on longer-term paths to profitability — growth indices and small caps in general — are most sensitive. Longer-term, higher rates make it more expensive for individuals and companies to borrow, which can hurt the consumption and investment elements of GDP growth. This of course has a lagged effect and will not be felt for several quarters, but should remain on the radar as something to monitor.

The good news is that equities have remained resilient, both domestically and abroad. The S&P 500 returned 2.3% in the third quarter despite the Fed's rate hike and as an example of strength abroad, Japanese equities moved higher in spite of the BOJ's September hike. (*Exhibit 5, next page*)

EXHIBIT 3: YIELDS UP, SMALL CAPS DOWN

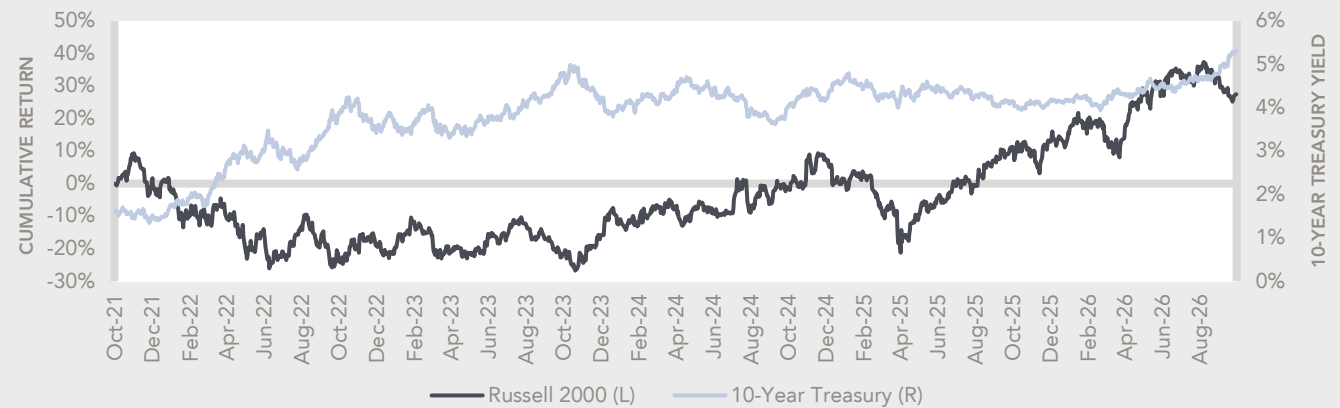


EXHIBIT 4: INTEREST RATES PROJECTED TO MOVE HIGHER

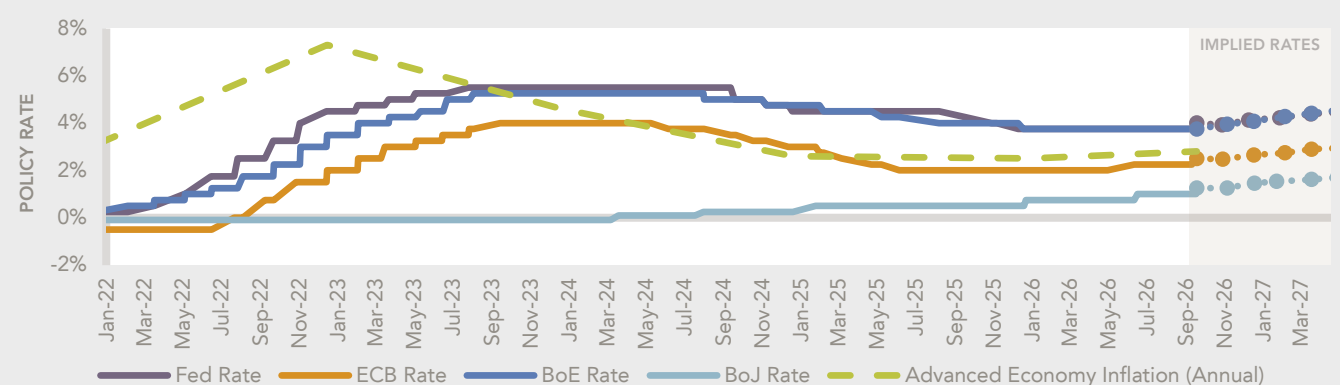
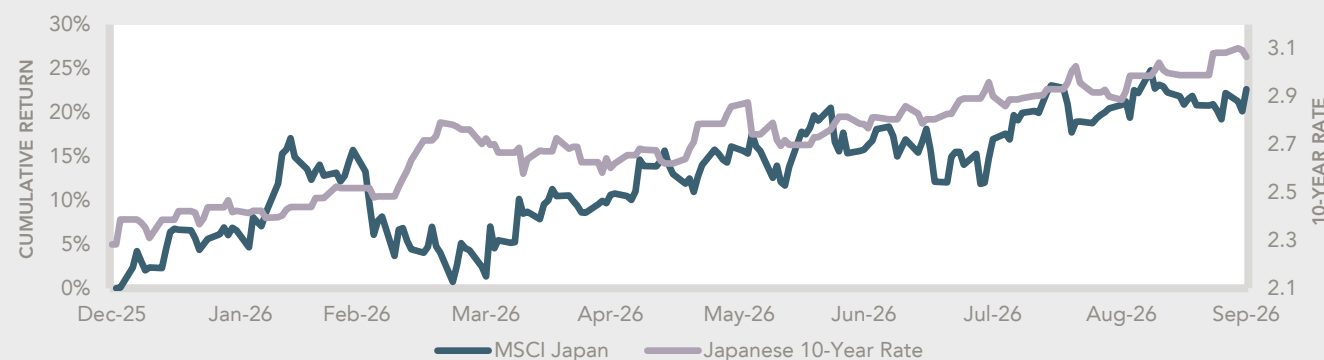


EXHIBIT 5: JAPANESE EQUITIES RESILIENT IN THE FACE OF HIGHER INTEREST RATES



On the economic front, U.S. consumer spending — with the caveat that it is highly bifurcated across income quintiles — continues to grow. Given its overwhelming weight to GDP growth, this is notable. Consumer spending rose in August at its fastest pace in over a year to power the economy and if this pattern continues, markets stand to benefit. (*Exhibit 6*)

As we squint towards the finish line, the stock and bond markets don't have us seizing up in pain.

For bonds, while the move higher in rates has led to disappointing returns for 2026, elevated yields offer higher levels of income from this point (*Exhibit 7*). The best indicator of future returns for bonds is starting yield; given that default rates are expected to remain low, both investment grade and below investment grade bonds should support portfolio returns on a go-forward basis. (*Exhibit 8, next page*)

EXHIBIT 6: U.S. CONSUMER SPENDING RISES BY MOST IN A YEAR

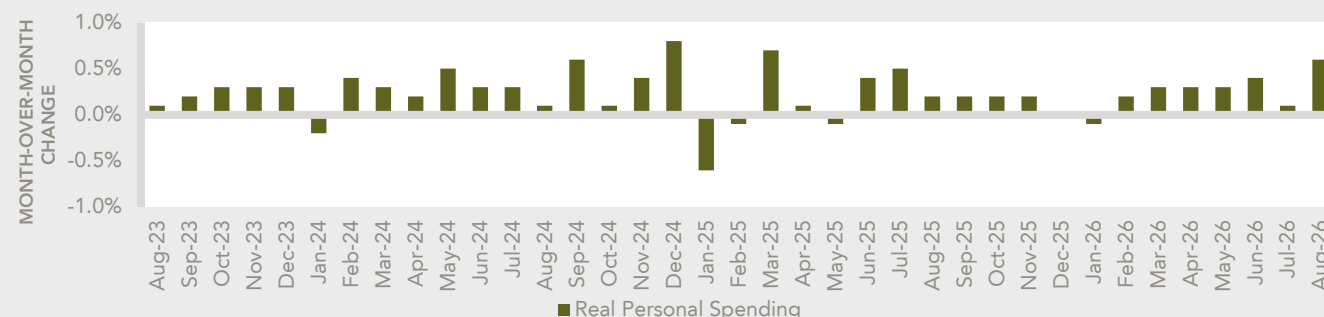
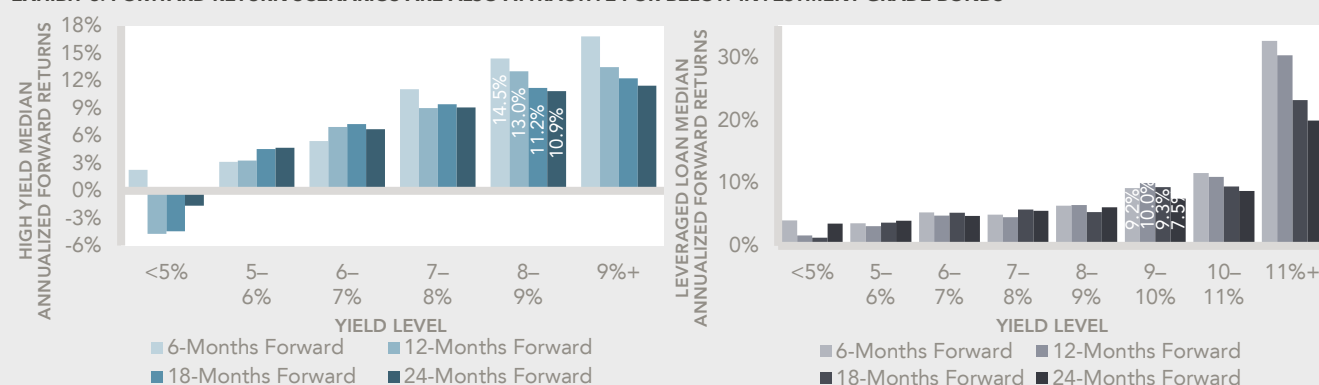


EXHIBIT 7: INVESTMENT GRADE FIXED INCOME SHOULD BE POSITIVE ACROSS MOST RATE AND SPREAD SCENARIOS

TOTAL RETURN 12 MONTHS FORWARD		SPREAD MOVEMENT (BPS)								
		-100	-75	-50	-25	0	25	50	75	100
TREASURY YIELD MOVEMENT (BPS)	-100	17.0%	15.6%	14.1%	12.7%	11.3%	9.9%	8.5%	7.1%	5.7%
	-75	15.5%	14.1%	12.7%	11.3%	9.9%	8.5%	7.1%	5.7%	4.3%
	-50	14.1%	12.7%	11.3%	9.9%	8.4%	7.0%	5.6%	4.2%	2.8%
	-25	12.6%	11.2%	9.8%	8.4%	7.0%	5.6%	4.2%	2.8%	1.4%
	0	11.2%	9.8%	8.4%	7.0%	5.6%	4.2%	2.7%	1.3%	-0.1%
	25	9.7%	8.3%	6.9%	5.5%	4.1%	2.7%	1.3%	-0.1%	-1.5%
	50	8.3%	6.9%	5.5%	4.1%	2.7%	1.3%	-0.1%	-1.5%	-3.0%
	75	6.9%	5.5%	4.0%	2.6%	1.2%	-0.2%	-1.6%	-3.0%	-4.4%
	100	5.4%	4.0%	2.6%	1.2%	-0.2%	-1.6%	-3.0%	-4.4%	-5.8%

Source: U.S. Department of the Treasury as of September 30, 2026

EXHIBIT 8: FORWARD RETURN SCENARIOS ARE ALSO ATTRACTIVE FOR BELOW INVESTMENT GRADE BONDS



Source: J.P. Morgan as of September 30, 2026; Median returns are measured on a post-GFC basis since 2010

For equities, we always come back to earnings. They are the essential foundation for extended market rallies so if earnings remain positive — meeting or exceeding market expectations — investors should expect a strong finish to the year. Even more encouraging is that as the year has gone on, earnings estimates for both U.S. and non-U.S. stocks have moved higher, suggesting that market strength is not fading. (*Exhibit 9*)

That said, the dependence on AI spending and profitability coupled with the subsequent market concentration remains at the top of our list for equity market risks. Current valuation levels across equity markets remain toward their historical highs, so any material disruptions from market expectations could create unwelcome headwinds as we approach the end of the year.

At our investment committee meeting last week, I asked our senior analysts if they are more optimistic or pessimistic about markets for

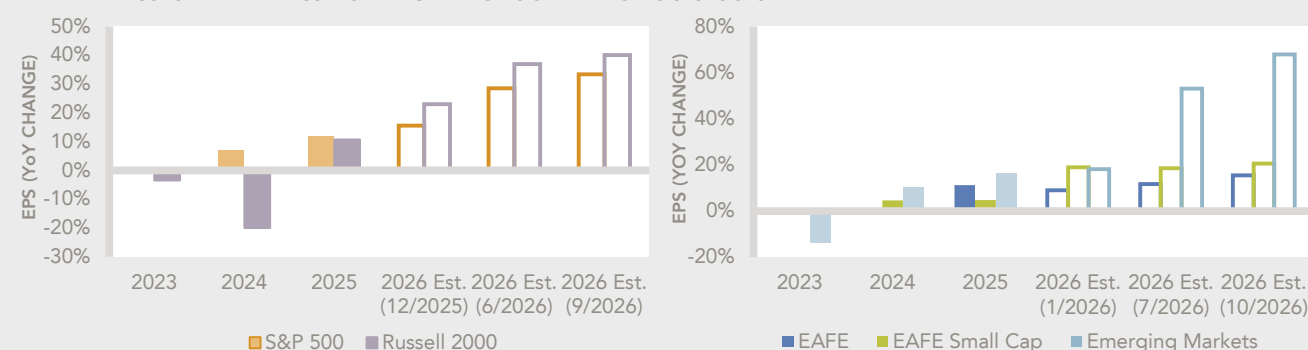
the rest of the year — particularly against the backdrop of higher rates. The consensus was that in spite of the new rate environment, markets appear poised for a strong finish. There might be some uphill portions and a few potholes along the way, but we do not expect portfolios to be undone by debilitating cramps as 2026 races to a finish.

Here's to a strong finish this year and see you in January.

Until next time,

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EXHIBIT 9: PROJECTED EARNINGS MOVE HIGHER FOR U.S. AND NON-U.S. STOCKS



Source: S&P, FTSE Russell, MSCI as of September 30, 2026 and October 7, 2026

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