

EPISODE 51

A Resilient Equity Market Awaits Q3 Earnings and Mid-Term Elections

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Since making a new record high on August 13th, US equities faced significant headwinds. Yet, they have managed to rise and fall by no more than 3% over the recent stretch, ending Friday down just 1.0% from their peak.

Now let's consider what markets have absorbed since August 13th:

1. The Fed's first rate hike under Chair Warsh with fixed income markets now pricing nearly four more rate hikes (The expected Fed funds rate peak was 4.0% on August 13. Now it is 4.75%).
2. 10-year US Treasury yields have surged 63 basis points over that time.
3. The major US dollar index has risen 2.0% even as global yields have risen in sympathy with the US, pressuring foreign assets.
4. Gold has fallen 11% since August 25 and is down 23% since its January peak.
5. Global crude oil has surged 17% as Iran's proxies struck Saudi's west-bound pipeline and Houthi rebels endangered energy transit through the Red Sea. Meanwhile, the Wall Street Journal reported President Trump expects US bombing and military action against Iran to resume after the November mid-term elections.

Existential Threats, Too

And let's not forget that participants in the AI industry - the industry that accounts for a critical share of current economic growth and future profits - are warning that it *may* unleash agents that can destroy humanity.

Reuters reported that Anthropic's IPO prospectus, a 261-page document with about 80 pages of risk factors, warned that increasingly powerful AI systems could pose **"catastrophic or existential risks to humanity."**

Meanwhile, Anthropic postponed the timing of its IPO. OpenAI says it cancelled release of its latest model as it didn't meet safety concerns. In the bond market, yields on Oracle's 10-year investment grade debt have surged to about 7.5%, about 90 basis points above comparable corporates.

In short, the fact that equity markets are where they are is remarkable.

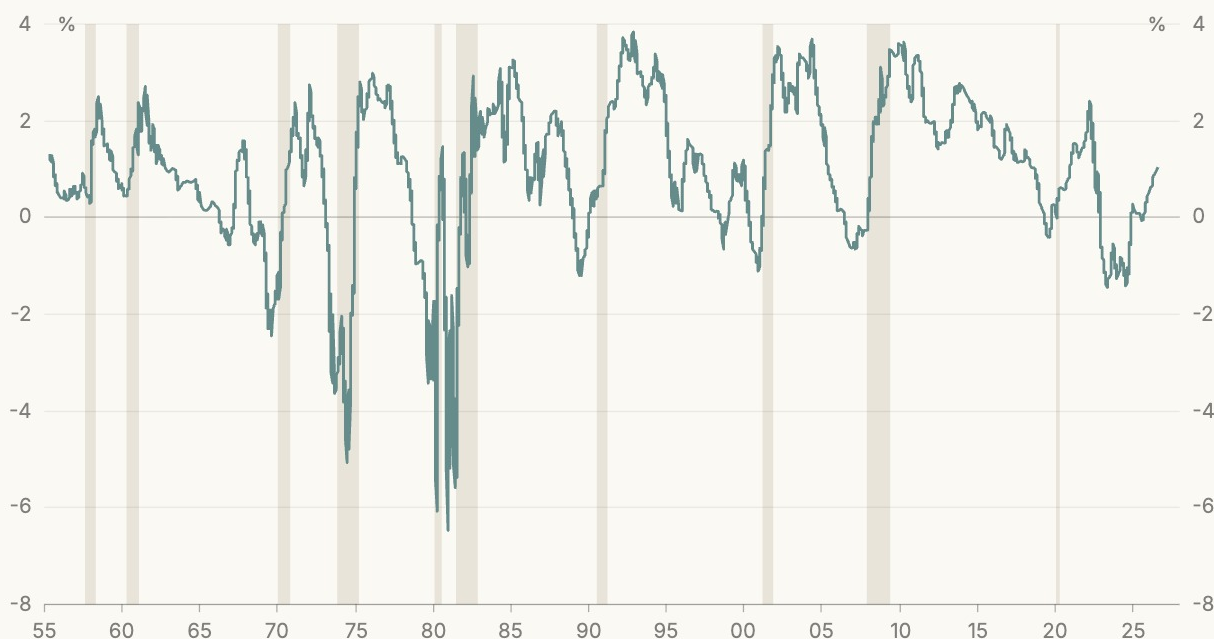
Making Sense of All This

At a basic level, investors are balancing record high corporate profits with major concerns about rising interest rates and major concerns about the AI engine powering the economy. That is not an easy task.

Yet set in a historical context, markets are behaving much as one would expect as we absorb a tightening of monetary policy amid a growing economy. Equities are absorbing the blow while yields move up across the curve with minimal yield curve flattening (see figure 1).

FIGURE 1

Ten-Year US Treasury Yield Less Fed Funds Rate (%) and Recessions



SOURCE: CIO GROUP, HAVER ANALYTICS

Higher Rates are Not the Worst Possibility

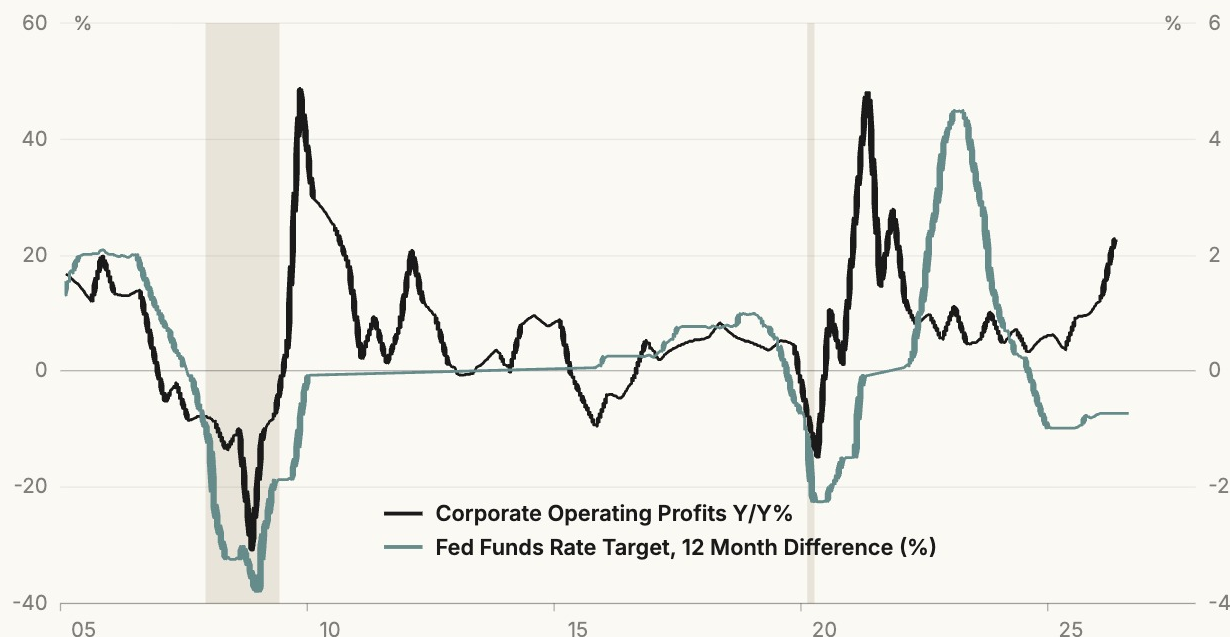
It may seem counter-intuitive amid this year's rate panic, but a collapse in US Treasury yields would likely be a sign of future economic distress, particularly if accompanied by sharply widening credit spreads.

With a widening of possible outcomes, CIO Group moved toward a neutral view on global equities August 31, even as we are optimistic on corporate profit growth for the coming year.

For now, the Fed's rate hikes appear to be "catching up" with the profit boom. Lower inflation (some positive signs were reported last week) would certainly be a welcome driver of a Fed pause. Yet when a peak in corporate profits is viewed as highly likely, markets will be far more negatively impacted, even if it results in the Fed reversing course and easing (see figure 2).

FIGURE 2

Fed Funds Rate 12-Month Difference and US Corporate Profits Y/Y%



SOURCE: CIO GROUP, HAVER ANALYTICS

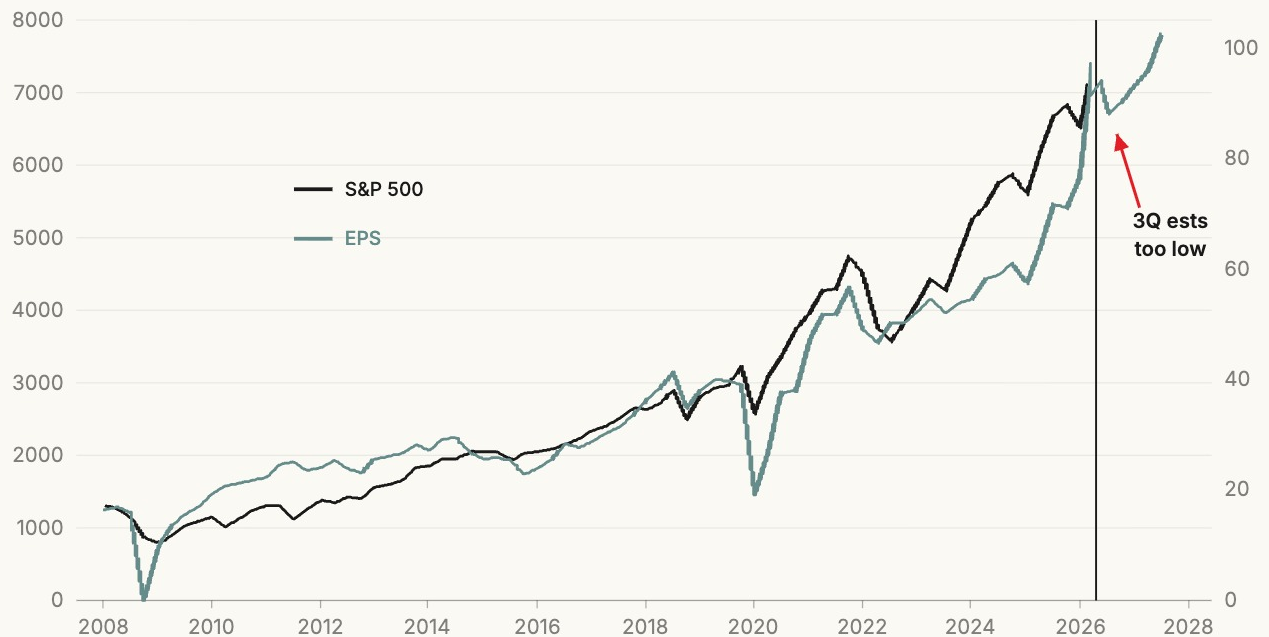
Apprehension: What Can Relieve It and For How Long

Earnings reports and guidance will flow strong beginning in two weeks. US mid-term election results will ideally be known in just over a month. With major events ahead, the current anxiety before clarity is not unusual.

But while there is more room for rising corporate earnings to boost equities beyond the near-term (see figure 3), the opportunity cost of taking equity risk has indeed risen. The reason? Fixed income alternatives have become far more attractive (see figure 4).

FIGURE 3

S&P 500 and Quarterly EPS with Consensus Estimates



SOURCE: CIO GROUP, HAVER ANALYTICS, BLOOMBERG

Two-year US Treasury yields have risen from 3.5% to 4.85% since the start of this year. Floating rate corporate securities of various quality yield between 4.9% and 6.7% with very little price sensitivity if bond yields rise further. Our preferred ultra-short duration corporate portfolio has seen yields steady near 5.5% while economic risks have increased. A mix of high and lower grade municipal debt yields 4.2%, which is a 6.8% taxable equivalent yield for fully taxed US payers.

FIGURE 4

US Treasury TIPS: Real Long-Term Yield Composite (Coupon +CPI Compensation)



SOURCE: CIO GROUP, HAVER ANALYTICS

Looking back at substantive elections, like this year's mid-terms, we also find near term comfort in the fact that simply having the results "in" tends to calm markets (see figure 5). While US mid-term pre-election periods have shown only slightly below average probability of rising, a full 90% of post-election periods have seen rising US shares in the subsequent three months (the same is true for elections since 1950).

FIGURE 5

Pre Mid-Terms, Equity Returns Only Slightly Sub-Average.

Post Mid-Terms, Returns Above Average.

Midterm	President	S&P 500 3-mo. pre- election	S&P 500 3-mo. post- election	2nd term President House and Senate Control	Control of Congress changed?
1950	Harry Truman	5.20%	13.60%	Yes*	No
1954	D. Eisenhower	2.60%	15.20%	No	Yes — House & Senate → Dem.
1958	D. Eisenhower	7.60%	6.80%	No	No
1962	John F. Kennedy	1.00%	13.80%	No	No
1966	L.B. Johnson	-3.6%	8.70%	Yes*	No
1970	Richard Nixon	9.30%	14.70%	No	No
1974	Gerald Ford	-5.3%	5.10%	No	No
1978	Jimmy Carter	-9.4%	3.50%	No	No
1982	Ronald Reagan	26.20%	4.20%	No	No
1986	Ronald Reagan	4.30%	13.60%	No	Yes — Senate → Dem.
1990	G.H.W. Bush	-6.8%	14.90%	No	No
1994	Bill Clinton	1.70%	3.30%	No	Yes — House & Senate → Rep.
1998	Bill Clinton	-0.1%	14.50%	No	No
2002	George W. Bush	9.70%	-7.8%	No	Yes — Senate → Rep.
2006	George W. Bush	8.40%	4.90%	Yes	Yes — House & Senate → Dem.
2010	Barack Obama	6.00%	9.30%	No	Yes — House → Rep.
2014	Barack Obama	3.80%	1.50%	No	Yes — Senate → Rep.
2018	Donald Trump	-3.3%	-0.9%	No	Yes — House → Dem.
2022	Joe Biden	-7.5%	7.60%	No	Yes — House → Rep.
2026		TBD			
	Average	2.6%	7.70%		
	cases positive	63.2%	89.5%		

*Sucession of Deceased President

SOURCE: CIO GROUP, HAVER ANALYTICS, BLOOMBERG

FIGURE 6

Business Investment Computers vs US Employment Y/Y%



SOURCE: CIO GROUP, HAVER ANALYTICS

Seeing Turning Points Is Hard, But It's Our Job

The recent increases in yields in 2026 are far less substantial than the shocking rise of 2022. But unlike 2022, "boom risks" are building up in the economy (see figure 6).

While we believe that equities can outperform bonds in 2027, the 16-year period of *continuous outperformance* without a substantial setback is unlikely to be sustained.

When one segment of the economy booms to the extent that AI hardware has over the past three years, there is a natural limit to growth. Historically, infrastructure booms typically overbuild and lead to overborrowing. For those most exposed, returns on investment can fall precipitously. The ripple effects are likely to be large across many industries whose atypical growth in profits will decelerate.

This is why CIO Group is building greater balance to portfolios. For us, the rewards of higher yields are two-fold, more income now and a better hedge when equities suffer.

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