



Market Update

Third Quarter 2026

Bond Market Shaken and Stirred

For the past two years, the frenzy surrounding Artificial Intelligence and the associated massive capital spending boom has dominated U.S. equities. While these trends continue, this quarter the stock market confronted surging diesel prices and a bond market temper tantrum. For much of the period, investor uneasiness also mounted as market participants eagerly awaited the outcome of the September meeting of the Federal Reserve and whether the new Chairman would bend to pressure from the White House to lower interest rates or act independently to tackle inflation. Given Chairman Warsh's public preference for less official communications, the market's apprehension was legitimate.

The confluence of higher interest rates, surging fuel costs and continued tariff problems significantly clouds the outlook for U.S. equities. The global bond market, often considered a significant arbiter of fiscal well-being due to its size and breadth, has fallen sharply and sent yields surging. This repricing reflects not only concern over growing U.S. fiscal deficits, but also rising risks that energy prices will stay elevated and inflationary pressures will spread. The severity of the increase in yields has rattled both government officials and foreign holders of U.S. debt.

During the third quarter, the S&P 500 index gained 2.3% despite the unresolved conflict with Iran and rapidly rising bond yields. In the period, the yield on 10-year U.S. Treasuries surged to over 5.34%, a 24-year high. Energy stocks led the market higher as Brent crude oil rose 42% to over \$100 a barrel, lifting companies throughout the industry.

In September, the Federal Open Market Committee (FOMC), under new Chairman Kevin Warsh, voted unanimously to raise the federal funds rate. While the 25 basis point rate hike was small, its signaling effect was most important. Through its actions, the Fed demonstrated that it is aware of the inflation problem, that it is willing to confront the issue (even in the face of pressure from the White House to lower interest rates), and that it was unified in its actions. Despite Chairman Warsh's prior comments about the Fed's future communication practices, the Board of Governors made its current position and future direction very clear.

Unfortunately, while the Fed might be able to suppress inflation when robust economic activity is driving prices higher, in this instance, it is likely unable to address the underlying cause of the current inflationary pressures: rising energy prices related to the war with Iran. Surging diesel and

persistently high gasoline prices are uniquely problematic for inflation, as transportation costs affect virtually all goods and services. Raising interest rates will also put further pressure on consumers and slow broader economic activity, without alleviating the root cause of the inflation problem. Even if Iran and the U.S. can cease hostilities and resolve the current conflict quickly, supply chain and storage issues mean it will take months before energy costs reflect any changes in market dynamics. Assuming the Fed knows the limitations of its action, its action may also have helped dispel concerns that it would succumb to political pressures.

The bond market is also adding its own aggravations for U.S. equity investors. The U.S. government needs to issue massive amounts of debt to finance its large and growing deficits. With U.S. government spending accelerating due to the Iran conflict, global bond investors are seeking higher rates as compensation for the expanding fiscal situation in the U.S. The Trump tax cuts, though economically stimulative in some ways, also reduce tax receipts, further pressuring the deficit. This comes at a time when the companies behind the AI datacenter buildout are raising capital from fixed-income investors, competing with other issuers and driving up rates. Nor is this only an American issue; as government bond yields around the world are surging. As these dynamics work through the U.S. yield curve, the end result is rising mortgage rates, higher auto loan rates, an overall reduction in the velocity of money, and brakes on the economic engine.

The Trump administration's pursuit of "Tariffs 2.0" continues to destabilize the global economy. The initial round of tariffs enacted under "emergency powers statutes" was ruled as unconstitutionally imposed, and refunds of these levies have acted as an incremental stimulus for the past few months. But these refunds, which boosted corporate profits, are drying up, and efforts to reimpose tariffs through other means continue. A high-profile trade war with Canada may have only a minor impact on overall U.S. GDP, but for border states, the local impact is significant.

The economic data for the past two quarters have remained healthy. Employment has held steady, despite a slew of revisions, and GDP growth has remained above 2 %. Earnings from semiconductor companies and others related to the AI buildout have been very strong. Supported by accounting changes under the One Big Beautiful Bill Act (OBBBA) and tariff refunds, overall corporate earnings and margins have remained robust. But economic data is backward-looking, and these indirect stimuli are temporary.

In our opinion, the overall result of higher energy prices, inflationary pressure, renewed tariff risk, fading refunds, and rising interest rates is an increasingly fragmented U.S. equity market. AI-related companies, including technology businesses and industries supporting data-center construction and power generation, may continue to benefit from elevated AI-related capital spending. The extent of those benefits will depend on the durability of investment demand, competitive conditions, valuations, and companies' ability to generate attractive returns on their investments. Consumer-related sectors, however, beholden to increasingly strained consumers, tighter lending standards, and rising costs, appear subject to margin pressure. Certain healthcare stocks, already well-versed in inflation, could persist due to strong demographic trends and quiet innovation. Meanwhile, the banking sector must balance the income benefits they receive from higher net interest margins against the stresses higher rates place on the broader economy.

We continue to believe that certain sectors remain attractive and that a recession isn't yet fully evident. Certainly, the longer the economy must endure higher interest rates and energy prices, the larger the risk of a broader economic slowdown. We have long stated that the stock market is essentially apolitical. Therefore, we doubt the midterm election will affect the equity market outlook much, even if control of Congress changes hands. Gridlock is essentially a form of stability. That said, reopening the Strait of Hormuz and ending the Iranian conflict would be highly beneficial for implied inflation expectations and a meaningful step toward lower energy costs.

Given the unique risks that energy prices exert on the economy and the Fed's inability to address the cause of inflation, we believe a tilt toward high quality and stability is increasingly important. The stock market and the economy often diverge; they are different animals, even if they are related. The strong secular trends behind AI will continue, regardless of the economy, and AI adoption will proliferate. We favor secular trends over cyclical ones.

Thank you for your investment with Oak Associates.

Regards,



Robert Stimpson, CFA
Chief Investment Officer
Oak Associates, Ltd.

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