

Q4 2026 Outlook

October 1st, 2026

Economy: Economic growth continues to show strength despite interest rates hitting multi-decade highs across much of the yield curve.

- Surging interest rates were the story of Q3 and are likely to shape any discussion of the economy in Q4. The long end of the Treasury yield curve has broken higher to levels not seen since around the turn of the century. Despite higher financing costs, the economy has continued to display powerful growth. Real GDP growth was reported in the mid-2% for the first half of the year and is currently expected to grow to about 3.7% in Q3 as currently projected by the Atlanta Fed's GDPNow model.
- There is a laundry list of forces pushing longer-term interest rates higher in the US and, unfortunately, very few forces pushing in the opposite direction. We believe one of the biggest forces pushing rates higher is the aforementioned economic growth and, more importantly, investment in future growth. A significant amount of GDP growth is coming from investment in technology-related infrastructure that will support the compute needs created by the growth in utilization of artificial intelligence and the increasingly complex models that improve its output. The largest companies in the stock market are investing in this buildout and are leveraging their strong cash flows and balance sheets to issue debt to fund this buildout at low costs. This creates supply that drives prices down and rates up for both the bonds issued as well as other high-quality bonds that might otherwise compete for that capital (i.e. Treasuries). While the jury is still out on what the exact return on that investment will be, if these companies are even partially right their returns should dwarf the 5% to 6% cost of capital tied to these debt issuances. In the meantime, however, the magnitude of issuance may be crowding out demand for US government debt and could be the primary culprit driving Treasury rates higher. These higher rates are not an inherent negative for the economy and markets, and the flat-to-higher stock market performance during Q3, growth in GDP and increasing earnings growth forecasts all reconcile to this notion.
- Other forces that are driving rates higher lead to less optimism. Clearly, inflation expectations have increased since the start of the year, largely due to the Iran conflict's upward pressure on energy prices. Although growing inflation is problematic, a dramatic shift in the trajectory of energy prices, likely tied to a clear resolution of the Iran conflict,

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could cause a quick reversal in rates. A more technical driver could be the unwind of a popular "carry trade" where investors sell short low-yielding debt instruments and buy higher yielding debt instruments. A popular expression of this trade involves shorting Japanese debt instruments to fund the purchase of US Treasuries and other higher yielding sovereign debt. With Japanese rates moving higher they are forced to reverse the trade by selling those higher-yielding holdings to buy back the Japanese debt. It may take time, but once the carry trade has adequately unwound the upward pressure on US rates should abate significantly. Finally, the force driving rates that is most alarming is general concern over the level of fiscal responsibility being demonstrated by the US Government. Some portion of the rise in yields has to do with the US Government's outstanding debt balance growing faster than both GDP and the tax receipts that support the repayment of that debt. If the bond market's revolt against this lack of responsibility becomes the primary force behind rates we would likely see another leg higher in yields with a deceleration in growth and significant negative stock market impacts.

- Policy makers' reactions will be important in Q4 and beyond. The Fed has slowly come to recognize that they need to enact a more restrictive monetary policy to put downward pressure on longer-term yields. GDP growth and strong employment give them enough cushion to begin pushing on the demand side of the economy to lower inflation expectations. With one Fed Funds hike already under their belt, they may need multiple more to make a difference. A further reduction of their balance sheet could also help, especially if they can do so while still supporting demand for longer-maturity bonds. It does not appear fiscal policy makers have the appetite to reduce borrowing/deficits or increase receipts at the moment, so we may need to rely on longer term disinflationary forces once again taking hold. This includes the potential for AI to increase productivity and efficiency in the economy, growing GDP and reducing inflation.
- Private markets are mixed currently. S-1 filings and IPOs are giving VC and PE investors hoped-for liquidity which should drive further flows and recycling of capital into those capital markets. Interest rate sensitive sectors like real estate are clearly challenged as so much of the cash flow and value created in that space relies on the ability to finance at a reasonable cost. High borrowing costs, volatility and uncertainty are causing investors to sit on their hands, which is just a continuation of a 4 year downcycle in that market.

Stocks: Q3 was characterized by mostly sideways, mixed action in the stock market. The S&P 500 ended up gaining 2% during the quarter and is now up 11.8% for the year.

- June, July and August saw notable underperformance from momentum stocks and strategies before the mega cap tech stocks heavily weighted in the S&P 500 and Nasdaq led those major indices to strong September performance. Equal weight and small cap indices began to underperform in August. Notably, small cap, which can be more sensitive to interest rates,

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ended up declining about 7.5% for the quarter as breadth deteriorated, representing a drastic deviation in relative performance for such a short time period.

- Hollencrest's market indicators are mixed to negative as we exit Q3, with interest rates, more restrictive monetary policy and declining breadth all working against the market. On the other hand, many contrarian indicators such as sentiment readings are negative, and shorter-term technicals show the market as being more oversold than overbought, which are often precursors to an advance. Fundamentals also lean positive in our view as earnings growth continues and valuation appears reasonable.
- Seasonal trends seem to be holding this year and could explain some of the lackluster Q3 action. If this holds, Q4 has a lot of promise. Positive seasonality combined with negative sentiment, oversold readings and reasonable valuations could lead to an earnings-driven rally into the end of the year that could push the S&P 500 to 8,000 or beyond.
- With our market indicators leaning negative entering Q4, we remain conservatively positioned with the majority of our target equity allocation in hedged instruments or cash. We realized a win on a sector allocation to software initiated in May and used the sale of that allocation to de-risk as our indicators turned more negative. We are in a position to raise more cash without tremendous tax consequences if market action follows through to the downside, while the flexibility to shift to a more aggressive allocation is there if signals turn positive.

Bonds and Rates: As noted above, it was a very challenging quarter for fixed income.

- The 10-year Treasury's yield surged 83 bps to 5.29% during Q3. It is now up 1.13% on the year and 1.34% from its closing low in early March. The 2-year Treasury's yield ended the quarter at 4.81%, indicating that the Fed is most likely to raise Fed Funds significantly from the current 3.75% to 4% target range.
- Yields have hit a level that should get investors' attention. We have made our first move toward adding fixed income exposure with duration to our portfolios and are looking for stabilization before we consider getting more aggressive. Investment grade credit spreads remain very low, however a philosophical debate has emerged questioning whether the credit quality of a tech institution generating significant cash flow should warrant a yield meaningfully greater than a US Treasury. We are currently inclined to limit credit risk with spreads so low but will continue monitoring for opportunities to add to both duration and credit.

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