WESTEND Advisors
A VICTORY CAPITAL® INVESTMENT FRANCHISE

Economic and Market Commentary

Q3 2026

Macro Drives Markets. WestEnd Knows Macro.

Room for Extended Growth

Cyclical and secular tailwinds persist for now, though geopolitical conflicts and related economic issues present risks. We remain positioned for extended mature-cycle growth while adjusting for shifting risks and opportunities we see ahead.

SUMMARY

- The third quarter of 2026 saw continued economic expansion in the U.S. supported by ongoing tech investment and some broader cyclical improvement despite sluggish job growth, but equity returns were mixed and bonds sold off amid ongoing geopolitical conflict, continued inflationary pressures, and a Fed rate hike.
- We expect AI and tech-related investment can continue to support U.S. growth within our investment horizon, even as some cyclical tailwinds may fade going forward.
- Inflation pressures persist, but conditions are different than in 2022 and limited Fed tightening could help restore disinflation.
- International economies and markets remain mixed, with a stable outlook in Europe, while Asia markets have become increasingly dependent on global tech investment.
- We have modestly adjusted portfolios for shifting risks and opportunities we see, but our portfolios maintain a select mix of economically sensitive and defensive exposures.

Q3 2026 REVIEW

While the Iran conflict and inflationary pressures have dragged on, U.S. economic growth appears to have remained on trend in Q3 2026, driven, in part, by continued AI and tech-related investment, tax policy tailwinds, and a resilient consumer. The labor market sustained modest job growth in a "low-hire, low-fire" environment, while oil prices led a broad range of commodities higher, including gas and diesel as well as some agricultural commodities and metals. Interest rates also rose, tied in part to revived inflation concerns and the Fed's widely anticipated September rate hike, its first in three years.

The S&P 500 index returned 2.3% in Q3. For the broad market, most of the gain came from a brief surge at the start of August amid rising hope for resolution of the Iran conflict and a rebound in AI and tech-related firms. However, the quarter's modest returns masked significant divergence under the surface. Only four U.S. sectors posted positive returns, led by Energy, which rose through most of the quarter along with oil prices. Information Technology, Health Care, and Communication Services also outperformed. The remaining sectors all declined in Q3, including the most cyclical early-phase sectors like Industrials, but Utilities was the worst performer, posting a double-digit decline as a sharp rise in interest rates pressured the sector's valuations.

Mixed Signals in Q3

Market returns were mixed in Q3 as positive trends in AI and tech-related capex contrasted with renewed inflation and interest rate volatility.

Internationally, Europe continued to see gains in private sector activity. PMI surveys suggest both industrial output and service activity were up, with particular momentum in Germany and France. European markets, however, were tempered by inflationary pressures, ECB rate increases, and currency headwinds.

In Asia, Japan outperformed amid robust nominal economic growth and healthy earnings gains. China also outperformed, tied to currency tailwinds and apparent hopes for government stimulus to tackle ongoing economic challenges. Even with the Chinese market gains and ongoing global tech investment, EM Asia as a whole was down slightly in Q3 amid meaningful volatility driven by the region's concentration in semiconductors. More resource-dependent emerging markets outside Asia outperformed on the back of rising commodity prices.

In contrast to equities, bond prices generally fell in the U.S. as rates rose. Corporate bond returns were mixed relative to Treasury returns, with higher investment-grade bonds underperforming as spreads widened and lower-grade outperforming thanks to their higher yields and lower durations at given maturities as well as narrowing spreads.

OUTLOOK

Overview. At a high level, geopolitical tensions remain at odds with secular tech investment trends and, to a lesser extent, recent areas of cyclical improvement. At the start of the year, we saw prospects of broadening activity and market performance tied, in part, to lower interest rates and fiscal stimulus. Today, these tailwinds may be starting to fade, in part due to elevated interest rates and a peak in the growth impulse from stimulus. We still see, however, a path to

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disinflationary expansion extending the current cycle over our typical 6- to 18-month investment horizon. Today's inflation differs from that of 2022, in both magnitude and drivers, and we believe that measured Fed policy seems likely to be a key determinant of how the U.S. economy progresses from here.

Given our outlook, we continue to favor our select U.S. equity exposure over broad international exposure, and Europe appears positioned for continued improvement, while we remain more cautious on Asia (esp. EM Asia), given Asia's heavy economic and market concentration that is dependent on global tech investment at a time when that growth may be peaking. Meanwhile, longer-duration Treasury bonds and certain duration-like real assets could do well in a disinflationary expansion. Commodities, in contrast, offer a potential hedge in the event of continued inflationary pressures.

***U.S.*:** Despite geopolitical headwinds, the U.S. has sustained trend-like growth this year, supported by AI and tech investment, a resilient consumer, and a cyclical upswing over the last 9 months. Though we expect some recent cyclical tailwinds to soften and for consumers to contribute less to economic growth going forward, we see a viable path for disinflationary growth to extend the cycle.

The Path Ahead

While some cyclical tailwinds may fade, we see a path to disinflationary expansion over our typical investment horizon.

We believe the uptick in GDP growth so far this year relative to late 2025 was supported, in part, by tax cuts and accelerated depreciation tied to the One Big Beautiful Bill Act. For consumers, the bill helped increase tax refunds, which were mostly received in the first half of the year. For business investment, the bill restored immediate expensing of qualified capital investment, which helped support capex spending on ongoing tech investment and in more cyclical areas of the economy. The growth impulses from those factors, however, have essentially peaked, in our view. While the OBBBA provisions remain in place, it was likely the *change* in policy from the prior status quo that provided a one-time step-function in the level of spending which, in turn, created a temporary base-effect boost to the rate of growth.

In particular, we believe the consumer will be less supportive of growth going forward. Around the time of publication, the BEA revised Personal Income and Outlays data which revealed higher levels of income, consumption, and savings year-to-date than what was originally reported. However, the trajectory of key data for the consumer has not changed, in our view. While many factors—from wealth effects to inflation—can influence consumption patterns, growth of personal income, derived primarily from worker compensation, makes the labor market a key pillar of sustained consumption growth. With slow job growth and decelerating wage growth, we do not see a likelihood that income growth further boosts consumption.

Additionally, the personal savings rate fell from 7.2% (revised up from 6.4%) at the start of 2024 to just 4.1% in August. For lower-income households, a declining savings rate may reflect financial stress, as rising prices for food, gasoline, and other necessities eat up an increasing portion of their paycheck. With the savings rate ticking down, we believe it will be difficult for them to continue boosting spending via reduced savings. Middle and upper-income households may have been supporting consumption through a higher propensity to spend fueled by the wealth effect after multiple years of double-digit stock market gains. We find it noteworthy that the savings rate is near the levels seen in the late 1990s, and we are mindful of how market volatility and perceived economic uncertainty could limit the wealth effect going forward. Additionally, borrowing costs are rising again.

To be clear, our analysis does not lead us to expect an imminent downturn in consumption. Rather, we believe fading tailwinds limit the prospect of consumption growth accelerating from its recent trend, which already has been at a rate more typical of a balanced economic expansion.

While some cyclical tailwinds may cool, we continue to see strength in other areas of the economy. In particular, we expect significant AI and tech-related investment to continue in the near-term. We also expect other areas with secular growth drivers to help sustain economic growth; for example, Health Care has been one of the most consistent areas of significant employment growth in recent years. In summary, we actually see a path to continued expansion even though some areas of the economy continue to mature.

Along the path to continued expansion, inflation remains an area of uncertainty. The current inflation picture is complicated by the Iran conflict, which is constraining supply of oil and other commodities out of the Middle East, as well as Russia's war with Ukraine, where both sides have been attacking energy infrastructure. The latest focal point for inflation has been record diesel prices, which can impact prices across the economy through higher production and transportation costs (e.g., farmers use diesel to run farm equipment, and diesel trucks and trains transport their goods).

Inflation Not Reprising 2022

Energy supply chain disruptions may echo the post-pandemic era, but markets are adapting, and both fiscal and monetary policy differ significantly from that period.

While supply chain disruptions for energy commodities and related goods, like fertilizer, seem to echo the post-pandemic supply chain disruptions that contributed to high inflation in the 2022-2023 period, key differences exist today. First, inflation is simply not as high as it was in 2022, and the breadth of underlying categories suggests that inflation is not as entrenched as 2022. There is also less fiscal stimulus pushing up demand than there was post-pandemic. Near-term stimulus from the OBBBA was on a much smaller scale than the massive pandemic relief efforts. Further, we see potential for at least a partial resolution of geopolitical disruption of supply chains. Even without a formal end to the Iran conflict, markets and governments

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Mid-Term Election Preview: Big Shift, Limited Impact?

U.S. elections always warrant consideration from a macroeconomic viewpoint, and particularly when they may mark a shift in direction on fiscal policy or the geopolitical backdrop. The upcoming midterm elections are notable both for the increasing probability of a divided-government outcome and that, despite that fact, they may not signal a material shift in the political backdrop for markets.

The party that holds the White House typically loses seats in midterm elections. Given the Republican's narrow majority in both the House and the Senate, combined with the President's downward trend in popularity tied to a variety of issues, it seems increasingly likely the Democrats could take over one if not both houses of Congress.

While investors have historically viewed divided government as a benign or even favorable outcome for markets, much of the recent policy-induced volatility has originated from the executive branch, tied to trade and tariff policy, geopolitics, and immigration, and the election outcome may have limited impact on many of these policy areas. Divided government could create opportunities for bipartisan cooperation in select areas of mutual interest, including national security, AI regulation, and affordability initiatives; or it could lead to increased political turbulence as a Democratic Congress seeks to increase oversight of the Executive branch. However, it is worth noting that it would be nearly impossible for Democrats to achieve a veto-proof majority, so attempts to reign in the Executive may produce more noise than substance. Ultimately, it is unclear that the likely shift to divided government would have much near-term impact on market fundamentals this cycle.

are adapting to the higher-risk environment, and oil exports from Persian Gulf countries are now estimated to be back between about 80% to 100% of 2025 levels.

We believe all this leaves more room for the Fed to help contain inflation through monetary policy without needing to hike rates as quickly or as much as it did post-pandemic. Based on futures pricing, the market is currently anticipating two to three more quarter-point rate hikes over the next six months. This sort of incremental adjustment, in light of the factors noted above, could help restore a disinflationary path by containing some of the demand-based drivers of inflation without extinguishing the late-cycle growth driven by secular trends such as AI and tech investment. In our view, the biggest threat to continued growth over our typical 6 to 18-month investment time horizon would be the Fed taking too hawkish a stance, but we do not see that as the most likely scenario.

Balancing Select Exposures

Across portfolios, we are emphasizing market segments where we see secular growth opportunities along with select defensive exposures, while we are underweighting areas we see facing the greatest headwinds from elevated inflation and interest rates.

From a portfolio perspective, we are approaching this environment with a blend of economically sensitive and defensive exposures. We are emphasizing areas where we see secular growth tailwinds, such as Communication Services and Health Care, and we retain a significant-though-underweight exposure to the Information Technology sector. We are also maintaining underweights to areas that we believe face the most headwinds from elevated interest rates and inflation, including Industrials and consumer-focused sectors.

Most recently, we reduced our U.S. Financials sector exposure. Valuations for the sector remain above their long-term average, and we believe tailwinds for the sector, including capital markets activity, loan growth, and yield curve steepening are at or near peaks. For example, we expect a combination of Fed hikes and easing inflation expectations are likely to flatten the yield curve in the near-term, which can depress banks' willingness to lend and profitability.

We remain underweight to U.S. consumer exposure, in aggregate. We are avoiding the large-cap Consumer Staples sector altogether, given the stresses we have noted on lower-income households and challenges we see to volume growth and pricing for various industries in the sector. We currently view Consumer Discretionary as more attractive than Staples, in part because discretionary spending among higher-income consumers is less sensitive, in our view, to inflationary pressures and wage growth, and also because the largest companies in the sector also offer exposure to secular growth themes including data centers and communications infrastructure.

International. Outside the U.S., we believe Europe's cyclical upturn has continued to develop largely along the lines we described in Q2, with improving activity in areas like industrial goods, machinery, and autos. While Europe faces some of the same inflationary pressures as the U.S., we believe its diversified economy, double-digit earnings growth potential into 2027, and relatively attractive valuations, which remain at a discount to global equities, support a modest overweight of the region.

In contrast, Asia, and particularly, Emerging Asia remains highly dependent on global tech investment. While secular trends to this investment remain in place, a combination of still-elevated valuations and significant market concentration present risks to the region's equities. We believe the sharp July selloff in EM Asia as semiconductor and memory-chip shares reversed illustrates how concentrated index exposure can amplify volatility when a single cyclical industry disappoints. Current industry and company forecasts indicate the fourth quarter may be the peak in semiconductor sales growth, which historically has introduced headwinds to forward returns for the Semiconductors industry. Thus, we continue to underweight Emerging Asia.

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Fixed Income and Real Assets: The upward move in interest rates over the past two quarters has put the yield on 10-year Treasury bonds meaningfully above 5% for the first time since 2007. Despite elevated inflation, the rise in longer-term interest rates year-to-date has been driven primarily by a rise in real yields, in our view, as investors priced in continued economic growth and potential short-term rate hikes by the Fed. While the Treasury yield curve, as measured by the spread between 2-year to 10-year yields, has also flattened this year, it retains a positive slope, with longer maturities providing a yield advantage over shorter-duration bonds. We believe this, combined with high absolute real yields, makes longer-maturity Treasury bonds attractive. While interest rate volatility may persist, we believe a shift toward disinflationary expansion could limit further sustained upside to longer-term interest rates. Thus, we expect Treasury returns to be driven primarily by healthy coupon yields.

Meanwhile, investment-grade credit spreads across all eleven sectors remain near post-GFC lows, and the dispersion between sector-level credit spreads is at the lowest level on record. Current credit spread levels on longer-term corporate bonds have historically preceded neutral-to-weak relative performance versus Treasury bonds. Elevated debt issuance in a maturing investment cycle could also limit credit spread compression. We believe this warrants an underweight of credit exposure and a focus on shorter maturities on the corporate yield curve within balanced portfolios, where we continue to avoid long-duration corporate bonds.

For multi-asset portfolios with broader mandates, we continue to see potential return and diversification benefits from real asset exposure. With continued economic growth and current inflation conditions, our analysis suggests commodity-linked exposure offers a potential hedge against ongoing inflation, as underlying commodities have historically tended to outperform fixed income in periods with similar economic conditions. Other real asset exposures, including energy infrastructure and MLP exposures can provide stable income potential late in the cycle with less economic sensitivity than traditional Energy equities or other economically sensitive sectors.

CONCLUSION

As always, we seek to understand the macroeconomic backdrop and position portfolios accordingly. Seeing potential for a renewed disinflationary expansion to extend this advanced economic cycle, but cognizant of risks, including a range of possible inflation and growth paths, we continue to actively position portfolios with a mix of economically sensitive and defensive exposures. We will continue to adjust portfolio positioning as our outlook evolves, and we invite you to contact us with any questions you may have about our process, outlook, or positioning.

WestEnd Advisors Investment Team | October 5, 2026

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