AVITY Investment Management Inc.®

PERSPECTIVE

October 2026

Financial markets navigated a complex third quarter as resilient economic growth and strong corporate earnings withstood persistent inflation, rising interest rates, and geopolitical uncertainty. U.S. equities rose modestly for the quarter and have appreciated considerably for the year, supported by business investment and healthy consumer spending. Gains were achieved despite a spike in yields which typically pressures valuations and increases volatility. Fixed income markets faced declining bond prices as Treasury yields rose, but the reset in rates created more attractive income opportunities across high-quality government, corporate, and municipal bonds. The U.S. economy continued to outperform many global peers as conditions abroad remained more subdued. Looking ahead, sustained innovation and solid economic fundamentals provide a constructive long-term backdrop, while the prospect of lingering inflation and higher interest rates warrants disciplined portfolio positioning.

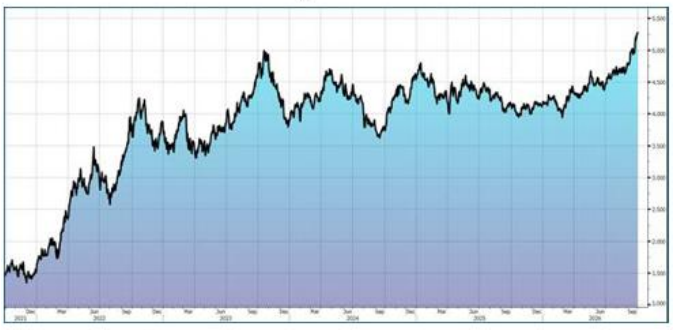
ECONOMIC BACKDROP

The U.S. economy remained buoyant through the third quarter of 2026. Economic activity expanded at an annualized pace likely exceeding 3%, supported by substantial investment in artificial intelligence infrastructure, improving productivity and durable household spending. Capital investment has been a key engine of growth, fueled by tax incentives and a spending boom in semiconductor manufacturing, power generation and data-center infrastructure. The labor market remained firm with unemployment at 4.2% and job growth healthy in recent months. Consumer activity was particularly robust with retail sales posting their strongest growth in more than two years despite depressed confidence readings. The U.S. economy maintained its sturdy trajectory even as inflation concerns mounted during the quarter, with the Consumer Price Index increasing 3.4% year-over-year in August. Economic conditions abroad were more challenging. Europe continued to struggle with sluggish growth as elevated energy prices and weak industrial activity constrained output. Many developing economies faced pressure from higher borrowing costs and a strong U.S. dollar, limiting investment and financial flexibility. In China, manufacturing activity has stabilized, but declining property values and severe youth unemployment have restrained broader economic momentum. Looking ahead, the domestic outlook is encouraging despite headwinds. Productivity improvements tied to artificial intelligence adoption are becoming increasingly evident and may help sustain stronger economic growth without a commensurate increase in costs. As energy markets stabilize, consumer spending and surging business investment in technological innovation should continue to provide a favorable foundation for economic expansion into next year.

HIGHER-FOR-LONGER INTEREST RATES

A forty-year bull market in bonds culminated during the pandemic, when U.S. interest rates fell to historic lows. Since then, the 10-year U.S. Treasury yield has risen markedly, reaching levels not seen in more than two decades. Stubbornly high inflation has been an important factor. Pandemic-era supply disruptions and massive government stimulus fueled a drastic rise in prices in 2022. Inflation has moderated significantly but has failed to return to the Federal Reserve's target of 2%. Successive supply shocks of higher energy prices from the Iran conflict, capacity bottlenecks created by strong demand for artificial intelligence infrastructure and lingering effects from global tariffs have kept prices elevated. Consequently, the Fed raised rates last month for the first time in three years and investors now expect the Fed's target rate to move higher, a reversal from expectations earlier this year that the Fed would ease monetary policy in 2026. Another variable supporting higher rates is the growing supply of debt that markets must absorb, with heavy Treasury issuance to fund large federal deficits and sizable

U.S. Ten-Year Treasury Note Yield – Past Five Years



Source: Bloomberg

corporate borrowing to fund the AI buildout. Additionally, major sources of demand have weakened, as the Fed has been reducing its bond purchases and international investors have been diversifying away from U.S. government debt. Foreign central banks are also tightening policy, and as interest rates have risen in Japan, large investors who borrowed Japanese yen to purchase U.S. government bonds as part of a carry trade have been forced to sell Treasuries to unwind those positions. These developments suggest a departure from the abnormally low-rate environment that prevailed for much of the last two decades.

Higher interest rates have broad implications across asset classes and economic activity. In fixed income, rising yields have caused bond prices to decline, with the greatest impact on longer-maturity bonds and lower-coupon issues. However, bonds also offer compelling returns for investors willing to hold high-quality issues to maturity and provide a viable alternative to riskier investments. For equities, increasing discount rates reduce the present value of future cash flows, which tends to weigh most heavily on stocks with the highest growth prospects. From an economic standpoint, increased borrowing costs can disincentivize business investment, pinch corporate profit margins and make heavily indebted companies more vulnerable. Households face more expensive home, auto and credit card loans. As U.S. Treasuries mature, the government will face higher financing costs at a time when liabilities stand at a record. Notwithstanding these challenges, the interest rate environment today reflects underlying economic strength and strong demand for capital. Markets currently expect the Fed to contain inflation without allowing a damaging wage-price spiral to push yields higher, but the path of interest rates merits close attention.

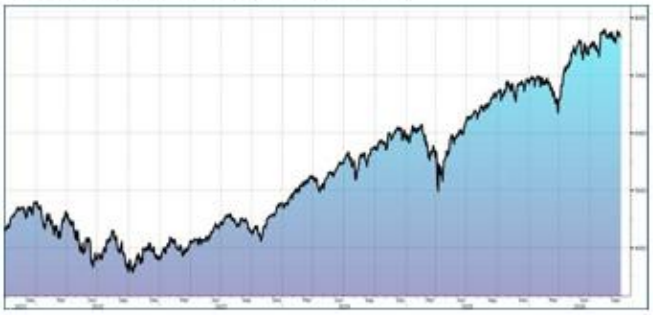
FIXED INCOME MARKETS

Bond markets faced pressure during the third quarter as investors adjusted to persistent inflation and an increase in the Fed's overnight lending rate to 4%. The 10-year U.S. Treasury yield has risen by over 1% this year to finish last quarter at a twenty-four-year high of 5.3%, reflecting investors' reassessment of growth and inflation expectations. The increase in yields across the maturity spectrum broadened income opportunities for investors. Conditions in the corporate bond market remain favorable though certain sectors are reflecting strain, as technology companies have significantly increased borrowing to fund AI spending and real estate firms contend with higher refinancing rates. Yields on municipal bonds have risen relative to Treasuries, resulting in particularly attractive after-tax yields. The rise in rates has limited the returns for bonds this year, but fixed income investments continue to play a valuable role generating income and serving as a ballast for portfolios.

EQUITY MARKETS

U.S. equity markets were resilient during the quarter despite elevated interest rates and ongoing geopolitical tension. The S&P 500 posted a return of 2.3% during the third quarter and gained 12.7% for the year-to-date. International equity markets modestly lagged U.S. performance during the period. An historic surge in corporate profits has underpinned the gains in equity prices, supported by AI investment, robust household spending, and

S&P 500 Index – Past Five Years



Source: Bloomberg

productivity-driven margin expansion. With profits advancing faster than stock prices, equity valuations compressed during the year to levels closer to their long-term average. Technology, health care and energy were the best performing sectors while more interest rate sensitive areas, like utilities and industrials, underperformed. Software stocks, including cyber security vendors, staged a recovery after being out of favor for much of the past year due to AI threats, while semiconductors digested their sizable gains from the first half of 2026. Despite potential headwinds, equities have historically proven to be among the most effective long-term hedges against inflation, as well-managed businesses adapt by passing along costs, improving productivity and growing earnings over time. Although rising rates could lead to a temporary pullback, the secular tailwinds underpinning the domestic economy and corporate fundamentals continue to support a constructive outlook for long-term investors.