BAILEY FINANCIAL GROUP
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October 2026 Market Commentary

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A Changing Market, but a Resilient Economy

October was an interesting month for investors. While the major market averages finished the month modestly lower, the underlying performance of the stock market was considerably better than the headline numbers would suggest. We saw a meaningful rotation away from some of the largest technology companies and into other areas of the market, including energy, health care, utilities, and consumer staples. At the same time, the economy continued to demonstrate resilience, inflation remained elevated, and the Federal Reserve found itself balancing strong economic growth against the possibility that additional interest rate increases may be necessary.

The S&P 500 declined approximately 0.9% during October, while the Nasdaq 100 fell 6.6%. However, the equal-weight S&P 500, which assigns the same weight to each of the 500 companies rather than allocation by size, gained approximately 5%. Nine of the eleven S&P 500 sectors finished the month higher.

We believe this divergence is particularly noteworthy. For much of the past several years, market performance has been driven by a relatively small group of large technology companies. October provided evidence that investors may be beginning to look beyond those companies and recognize opportunities in other sectors of the economy.

Whether this broadening of market participation continues will be something we watch closely as we approach year-end.

Economic Growth Remains Strong, but Inflation Continues to Present Challenges

One of the more encouraging developments during October was the release of third-quarter economic growth figures. According to the Bureau of Economic

Analysis, the U.S. economy grew at an annualized rate of 3.4% during the third quarter, accelerating from 2.2% in the second quarter.

Consumer spending remained strong, increasing 3.8%, while business investment continued to benefit from substantial spending on technology infrastructure, particularly the equipment and computing capacity required to support artificial intelligence.

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Perhaps even more encouraging was the 4.9% increase in real final sales to private domestic purchasers. This measure excludes some of the more volatile components of GDP, including changes in inventories, international trade, and government spending. It provides a useful indication of the underlying strength of private-sector demand.

However, while the economy continues to grow, there are some developments that warrant our attention.

The Federal Reserve's preferred measure of inflation, the Personal Consumption Expenditures Price Index, increased 3.6% over the twelve months ending in September, compared with 3.4% in August. Core inflation, which excludes food and energy, increased 3.1%.

At the same time, inflation-adjusted consumer spending was essentially unchanged in September, while real disposable personal income declined 0.3%. The personal saving rate fell to 3.8%, suggesting that some households are increasingly relying on a smaller portion of their income to maintain their spending.

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We believe these figures may illustrate one of the more important challenges facing the economy. Economic growth remains healthy, but consumers are continuing to absorb the cumulative effects of higher prices and elevated borrowing costs.

We will be looking closely to determine whether consumer spending can maintain its current pace, particularly if inflation remains elevated and interest rates move higher.

The Federal Reserve Faces a Difficult Balancing Act

At its October meeting, the Federal Reserve elected to leave its benchmark interest rate unchanged at a range of 3.75% to 4.00%, following a quarter-point increase in September.

Interestingly, two members of the Federal Open Market Committee voted in favor of another interest rate increase. Their dissent underscores the concern among some policymakers that inflation remains too high and that the strength of the economy may require additional monetary restraint.

While higher interest rates are intended to moderate inflation, they also increase borrowing costs for businesses and consumers. This is particularly important in the housing market, where elevated mortgage rates continue to present affordability challenges for prospective homebuyers.

By the end of October, financial markets were assigning a high probability to another interest rate increase at the Fed's December meeting.

We have discussed the relationship between interest rates, inflation, and economic activity in previous commentaries. While higher interest rates are intended to moderate inflation, they also increase borrowing costs for businesses and consumers. This is particularly important in the housing market, where elevated mortgage rates continue to present affordability challenges for prospective homebuyers.

Higher mortgage rates can reduce housing demand, slow home sales, and affect a broad range of related industries, including construction, home improvement, furniture, and consumer durable goods.

The challenge for the Federal Reserve will be to bring inflation closer to their 2% objective without unnecessarily undermining economic growth.

Thus far, the economy has been absorbing higher interest rates. However, monetary policy often operates with a lag, and we believe it's premature to conclude that the full effects of higher borrowing costs have already worked their way through the economy.

Artificial Intelligence: Investors Begin Asking More Difficult Questions

Artificial intelligence has been one of the most important investment themes of the past several years. As we have discussed, we believe AI has the potential to

fundamentally change how businesses operate, improve productivity, and create significant economic opportunities.

However, October provided an important reminder that technological innovation and investment returns do not always move together.

While demand for these services remains strong, investors are beginning to differentiate between companies that can finance this investment through their existing operating cash flow and those that may need to rely more heavily on borrowing or issuing additional equity.

Investors have become increasingly focused on the extraordinary amounts of capital being committed to artificial intelligence infrastructure. Technology companies are spending tens of billions of dollars building data centers, purchasing advanced semiconductors, and expanding the computing capacity necessary to support AI applications.

While demand for these services remains strong, investors are beginning to differentiate between companies that can finance this investment through their existing operating cash flow and those that may need to rely more heavily on borrowing or issuing additional equity.

This distinction became particularly evident during October's earnings season. Some of the largest technology companies experienced substantial share-price declines as investors questioned the relationship between their capital expenditures, free cash flow, and the eventual return on their investments.

We view this development as a natural evolution of the AI investment cycle.

We remain constructive on the long-term potential of artificial intelligence. However, we also recognize that even transformative technologies can experience periods of excessive investment, unrealistic expectations, and significant market volatility.

In the early stages of a major technological transformation, investors often focus on the size of the opportunity. As the investment cycle matures, attention increasingly shifts toward profitability, capital efficiency, and the ability to generate sustainable returns.

We remain constructive on the long-term potential of artificial intelligence. However, we also recognize that even transformative technologies can experience periods of excessive investment, unrealistic expectations, and significant market volatility.

Ultimately, the companies that successfully translate AI investment into sustainable earnings and cash flow may be better positioned than those that simply commit the greatest amount of capital.

Bond Markets Rebound as Treasury Yields Decline

Following a difficult third quarter, fixed-income markets delivered positive returns during October.

The Bloomberg U.S. Aggregate Bond Index gained approximately 2.4%, while investment-grade corporate bonds returned approximately 2.0%. High-yield corporate bonds also posted modest gains, although they underperformed higher-quality bonds.

Treasury yields were volatile during the month. Early concerns surrounding inflation, federal borrowing requirements, and the possibility of additional Federal Reserve tightening pushed longer-term yields higher. However, yields subsequently declined as investors sought opportunities in fixed income and reduced exposure to some of the more volatile areas of the equity market.

The 10-year Treasury yield finished October just below 5%, down from approximately 5.3% earlier in the month.

Because bond prices generally move inversely to interest rates, declining yields helped support fixed-income returns.

Higher Treasury yields can influence equity valuations, corporate borrowing costs, mortgage rates, and the broader availability of credit throughout the economy.

We believe the bond market will remain particularly important over the coming months. Higher Treasury yields can influence equity valuations, corporate borrowing costs, mortgage rates, and the broader availability of credit throughout the economy.

We will also continue monitoring the difference between yields on corporate bonds and comparable Treasury securities, commonly referred to as credit spreads, and we have written extensively on this topic in past commentaries.

Credit spreads can provide valuable information about investors' perceptions of economic and financial risk. When spreads widen significantly, particularly among lower-quality corporate borrowers, it can indicate growing concern about corporate profitability, refinancing conditions, or the possibility of increased defaults.

While October's bond market performance was generally encouraging, some

widening in lower-quality credit spreads suggests that investors are becoming more selective about the risks they are willing to assume.

We do not necessarily view this as a negative development. A more disciplined approach to credit risk can be healthy for financial markets. However, a sustained and significant widening of spreads would deserve closer attention.

Energy Prices and Geopolitical Risks Remain Important

Higher energy prices can affect the economy in several ways. They increase transportation and production costs for businesses, reduce the purchasing power of consumers, and can complicate the Federal Reserve's efforts to bring inflation under control.

Energy was the strongest performing sector of the S&P 500 during October, gaining approximately 14%, as oil prices increased amid renewed concerns about supply disruptions in the Middle East.

Attacks on Saudi energy infrastructure contributed to volatility in oil markets and reminded investors of the continuing relationship between geopolitical developments, energy prices, and inflation.

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We have seen the markets navigate several significant geopolitical challenges in recent years, and investors have generally demonstrated an ability to look beyond temporary disruptions.

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Nevertheless, a sustained increase in energy prices could create an additional obstacle for both inflation and economic growth.

We will continue to monitor developments in the Middle East, particularly any events that could materially disrupt global energy supplies.

What We Are Watching as We Approach Year-End

As we move into the final two months of 2026, we remain focused on several

developments that we believe will help determine the direction of financial markets.

First, we will be watching whether inflation begins to moderate or whether continued price pressures require the Federal Reserve to maintain a more restrictive monetary policy. Closely related to this will be the direction of Treasury yields and the impact of borrowing costs on the housing market, consumer spending, and business investment.

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Second, we will continue to monitor corporate credit spreads, particularly in the high-yield market, for any indications that financial conditions are becoming more restrictive or that investors are growing concerned about the ability of companies to service their debt.

Third, we will be watching corporate earnings and the evolving investment cycle surrounding artificial intelligence. While we believe the long-term opportunities are substantial, we also believe investors will increasingly demand evidence that the significant capital being invested can produce attractive financial returns.

Finally, we will pay close attention to market breadth. October demonstrated that a decline in the largest technology companies does not necessarily translate into weakness throughout the broader market. A sustained expansion of market leadership could provide a healthier foundation for future equity market performance.

Looking Ahead

Financial markets have navigated an extraordinary number of challenges over the past several years, including significant increases in interest rates, persistent inflation, geopolitical conflicts, volatile energy prices, and considerable uncertainty surrounding economic and monetary policy.

Despite these obstacles, the U.S. economy has continued to demonstrate resilience, corporate America has continued to innovate, and investors have continued to find opportunities.

October was another reminder that financial markets rarely move in a straight

line. Leadership changes, expectations adjust, and investors continually reassess the relationship between risk and potential return.

...we recognize that elevated inflation, higher interest rates, geopolitical uncertainty, and the extraordinary level of investment in artificial intelligence present risks that should not be overlooked.

We believe the broadening of market participation during October was an encouraging development, even as some of the largest technology companies experienced meaningful declines. At the same time, we recognize that elevated inflation, higher interest rates, geopolitical uncertainty, and the extraordinary level of investment in artificial intelligence present risks that should not be overlooked.

As always, our approach remains focused on maintaining discipline, understanding the risks within the markets, and making investment decisions consistent with our clients' long-term financial objectives.

We will continue to monitor these developments closely and adjust our perspectives as economic conditions and financial markets evolve.

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S&P 500 Index is a capitalization-weighted index calculated on a total return basis with dividends reinvested. The index includes 500 widely held U.S. market industrial, utility, transportation and financial companies.

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