AUGUST: MARKETS CLIMB A WALL OF WORRY
WILL RISING INTEREST RATES THREATEN GROWTH?

Figure 1: 8/31/2026 Returns (source: FactSet)

Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	YTD	1YR	vs. 52-wk High	vs. 52-wk Low
US Aggregate Fixed Income	AGG	0.4%	-0.2%	1.9%	-4.0%	0.3%
Investment Grade Corp Bonds	LQD	0.4%	-1.0%	1.2%	-6.0%	0.7%
U.S. 20+ YR Treasuries	TLT	0.7%	-2.8%	-0.3%	-10.5%	1.7%
Muni Bonds	MUB	-0.2%	0.0%	3.9%	-3.6%	1.2%
US High Yield	HYG	0.9%	2.4%	4.6%	-1.9%	1.6%
Non-US Corp Bonds	IBND	0.4%	-1.6%	-0.7%	-6.3%	1.8%
Emerging Markets Bond LC	EMLC	1.1%	2.9%	7.5%	-3.8%	3.3%
Global Equity						
ACWI Global Equity	ACWI	2.7%	14.3%	22.3%	-1.3%	22.2%
ACWI Global Equity ex US	ACWX	2.9%	16.6%	26.7%	-1.3%	25.1%
International Developed	EFA	1.8%	13.7%	21.5%	-1.3%	19.3%
Emerging Markets	IEMG	5.3%	22.5%	35.0%	-5.5%	33.1%
Global Equity by Region						
United States	VTI	2.7%	13.5%	20.2%	-1.8%	21.8%
Europe	IEUR	1.1%	11.4%	19.9%	-1.8%	18.3%
Asia ex-Japan	AAXJ	5.5%	25.8%	38.2%	-6.5%	37.1%
China	MCHI	-1.9%	-8.3%	-9.1%	-18.8%	9.7%
Japan	BBJP	3.7%	17.4%	26.0%	-3.0%	20.9%
Latin America	ILF	-1.3%	16.1%	33.6%	-9.4%	31.3%
US Equity						
US S&P 500	IVV	2.7%	13.1%	20.3%	-1.6%	21.9%
NASDAQ 100 QQQ	QQQ	4.2%	17.0%	26.3%	-4.3%	29.0%
US Large Growth	IWF	3.7%	3.9%	10.6%	-5.0%	20.0%
US Large Value	IWD	2.0%	23.0%	29.5%	-1.3%	29.0%
US Eqwt S&P 500	RSP	2.0%	15.5%	18.2%	-1.8%	20.5%
US Mid Cap	IJH	0.1%	14.7%	17.2%	-4.3%	21.1%
US Small Cap	IJR	-0.6%	20.8%	24.0%	-4.1%	29.0%

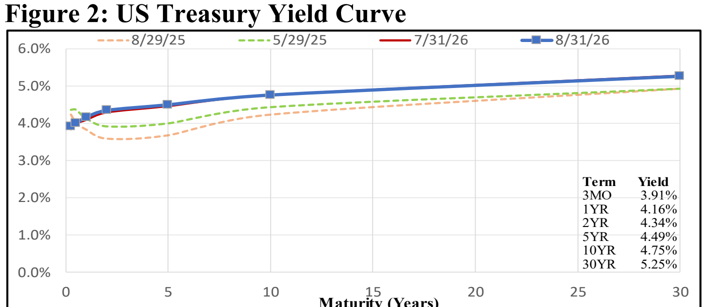
Stocks rose early in the month amid strong corporate earnings reports and held onto those gains despite renewed Middle East tensions, rising oil prices and inflation, and volatile bond yields. Performance highlights for August and year-to-date (YTD) follow.

- **Bonds:** The US Aggregate index (AGG) rose 0.4% this month (-0.2% YTD) as interest rates stabilized. Long-term Treasuries (TLT) are most sensitive to interest rates, gaining 0.7% (-2.8% YTD). Corporate bonds (LQD) rose 0.4% (-1.0% YTD). Non-US bonds outperformed as the US dollar weakened.
- **Global equity:** ACWI rose 2.7% in August (+14.3% YTD).
- **US Equity:** The broad market (VTI) gained 2.7% (+13.5% YTD), and the S&P 500 (IVV) was up 2.7% (+13.1% YTD). Small stocks underperformed this month but have been very strong this year (IJR +20.8% YTD). Energy stocks (XLE) rose 7.4% (+45.0% YTD) as oil prices spiked amid the on-going Iran conflict; tech stocks (XLK) rose 6.4% (+29.9% YTD) led by rebounding software stocks. Declining sectors included utilities (XLU -4.8%, +0.2% YTD), industrials (XLI -2.6%, +13.5% YTD) and real estate (XLRE -2.1%, +11.0% YTD).
- **Non-US Equity:** Non-US equities continue to outperform (ACWX +2.9%, +16.6% YTD). Developed markets logged gains (EFA +1.8%, +13.7% YTD) led by Japan (BBJP +3.7%, +17.4% YTD) as the yen stabilized. Emerging market stocks rose sharply this month (IEMG +5.3%, +22.5% YTD), led by a sharp rebound from July's selloff in the tech-heavy markets of Korea (EWY 15.1%, +86.0% YTD) and Taiwan (EWT +11.9%, +70.0% YTD). Weaker markets include China (MCHI -1.9%, -8.3% YTD) and India (-0.2%, -8.0% YTD).

Interest Rates and the Economy

Interest rates were volatile this month amid elevated inflation and a surprise bond buyback by the US Treasury but ended the month only slightly higher versus last month. The Federal Reserve Open Market Committee (FOMC) did not meet this month, but Chairman Warsh's hawkish comments at their annual conference in Aspen calmed bond investors who feared that the Fed would fail to hike rates in time to stave off stubbornly high inflation. Longer-term bond yields have moved higher in recent months due to worries about inflation, US debt, deficits and Fed credibility. The yield curve (Figure 2) plots interest rates for various US Treasury maturities. The US 10-year bond now yields 4.75%.

Figure 2: US Treasury Yield Curve

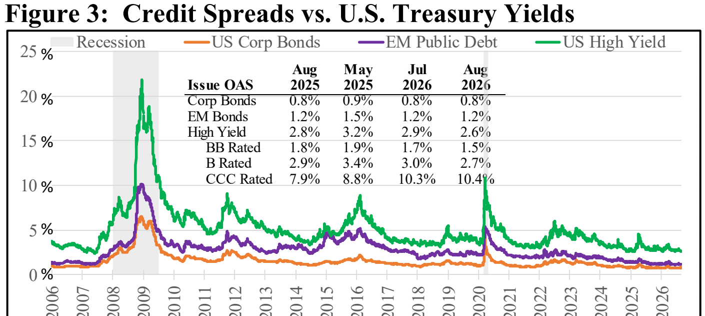


Source: Board of Governers of the Federal Reserve System via St. Louis Fed (FRED)

For bonds other than US Treasuries, we track the option-adjusted spread (OAS) relative to Treasuries of comparable maturity (Figure 3). Low or narrowing spreads signal optimism; high or widening spreads signal fear. Spreads narrowed this month and are historically low, reflecting the "risk on" market tone.

- Investment grade corporate bond spreads were stable at +0.8% and are basically unchanged over the past year.
- High yield (non-investment grade) spreads narrowed to +2.6% last month and remain historically low. Spreads of the riskiest bonds (rated CCC & below) increased to +10.4% and have widened materially from +7.9% over the past twelve months.
- Emerging market spreads were stable at +1.2% and have been stable over the past year; investors see low risk in EM debt.

Figure 3: Credit Spreads vs. U.S. Treasury Yields

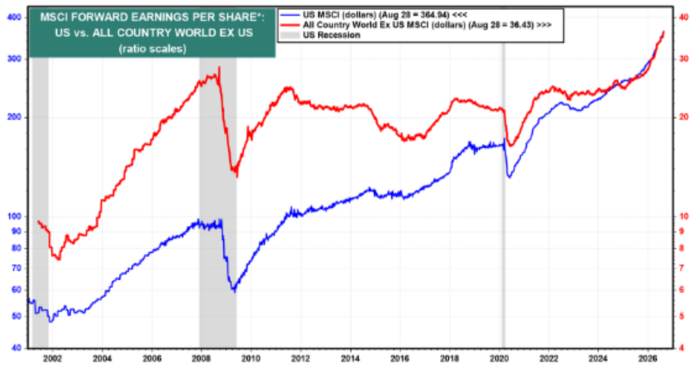


Source: Ice Data Indices, LLC via St. Louis Fed (FRED)

Will Rising Rates Threaten Growth?

US and global stock markets continue to perform well and are within 2% of all-time highs, powered by strong corporate earnings growth as the AI buildout fuels global economic growth. Figure 4 compares the consensus one-year forward earnings forecasts for US and non-US equities.

Figure 4: Global Earnings Forecasts



Source: LSEG Datastream and © Yardeni Research.
* Time-weighted average of consensus estimates for current year and next year.

While strong equity returns have clearly been supported by fundamental earnings growth, markets have been volatile recently due to concerns about rising interest rates amid persistent inflation and rising government debt and deficits.

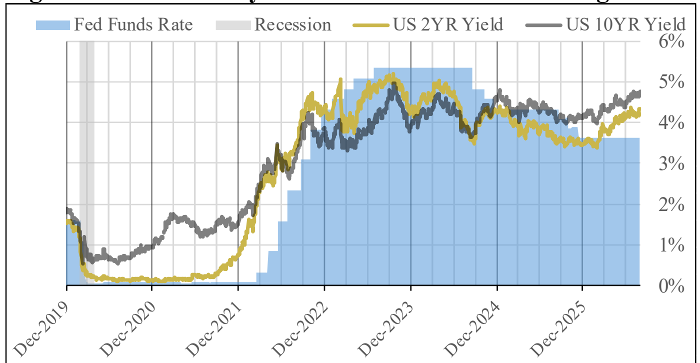
- Inflation remains stubbornly elevated, largely due to high oil prices (Iran conflict); the Fed's preferred inflation metric (Core Personal Consumption Expenditures excluding volatile food and energy) is 3.3% year-over-year, well above their 2% target.
- US government debt has surpassed $40 trillion (over 120% of GDP) and is rising, with a federal budget deficit of $2 trillion per year; interest on this debt is projected to cost over $1 trillion this year, which is more than we spend on national defense.

There is a clear conflict between the Fed's primary tool to bring inflation down to target (rate hikes) and the recognition that the US government is on an unsustainable fiscal path, which is exacerbated by higher interest rates. Despite resurging inflation, the Fed has not yet hiked rates, which has led to questions about their credibility. Meanwhile, the US Treasury Department has taken several steps recently in order to push long-term rates lower at a time when the Fed is expected to hike short-term rates.

- Treasury Secretary Bessent announced large purchases of Japanese government bonds in order to help stabilize the Japanese yen; the move was likely meant to help Japan defend the yen so that they would not need to sell off some or all of their $1.2 trillion US Treasury holdings (3% of US debt), which would drive US bond prices lower and yields higher.
- Bessent also announced that the Treasury would accelerate their purchases of long-dated US Treasuries, hoping to push those yields down and lower the cost of US debt service.

With the Fed and the US Treasury seemingly working at cross purposes, the bond market will be the arbiter. We must remember that while the Fed sets short-term interest rates, the market determines longer-term US Treasury bond yields based on supply and demand. Treasury yields have moved higher this year as the "bond vigilantes" have expressed their preference for rate hikes to fight inflation as well as concern over US debt levels. Figure 5 plots the yields for 2-year and 10-year Treasuries versus the Fed Funds target rate over the last seven years. As usual, the bond market appears to be leading while the Fed follows.

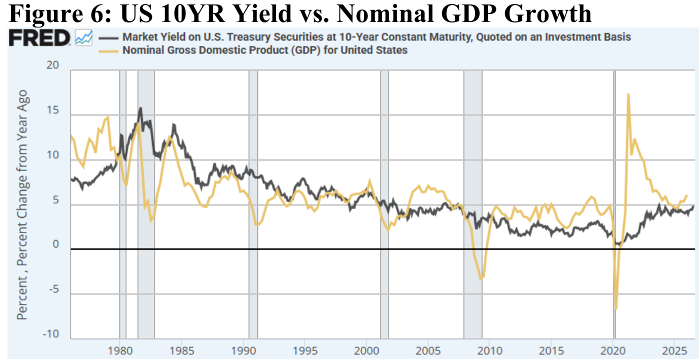
Figure 5: US Treasury Yields vs. the Fed Funds Target Rate



Source: Board of Governors of the Federal Reserve System via FRED

But is a debt crisis looming? Historically, the US 10-year Treasury bond yield has been highly correlated with the nominal GDP growth rate (year-over-year US Gross Domestic Product growth <u>not</u> adjusted for inflation) except during crises or recessions. While the real GDP growth rate (adjusted for inflation) is currently around 2%, the nominal growth (not inflation-adjusted) is around 6%. Given this context, it appears that current interest rates are consistent with "normal" economic growth, but a material increase in yields from here could have negative repercussions for the economy as well as for US and global stock prices.

Figure 6: US 10YR Yield vs. Nominal GDP Growth



Sources: Board of Governors of the Federal Reserve System (US); International Monetary Fund via FRED®

Bottom Line

US and global markets have been volatile amid heightened uncertainty (geopolitics, war, tariffs/trade, AI spending, etc.) but are still within 2% of all-time highs. Earnings growth continues to be very strong in the US and around the world, fueled by the global artificial intelligence buildout. Meanwhile, the bond market is flashing warning signals. Despite stubbornly elevated inflation, the Fed has, so far, been reluctant to hike interest rates, raising questions about the Fed's credibility. Adding to the confusion, the US Treasury Department has taken significant steps to drive long-term interest rates lower at a time when investors and markets expect the Fed to raise rates as early as September.

"Bond vigilantes" have taken matters into their own hands, pushing longer-term yields higher, effectively doing the Fed's job for them. We believe that current Treasury yields reflect "normal" economic growth and do not yet raise the risk of a debt crisis, but there is no question that the US is on an unsustainable fiscal path which must be addressed soon. Given rising rates, volatility will likely continue. Portfolio diversification remains critical.

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