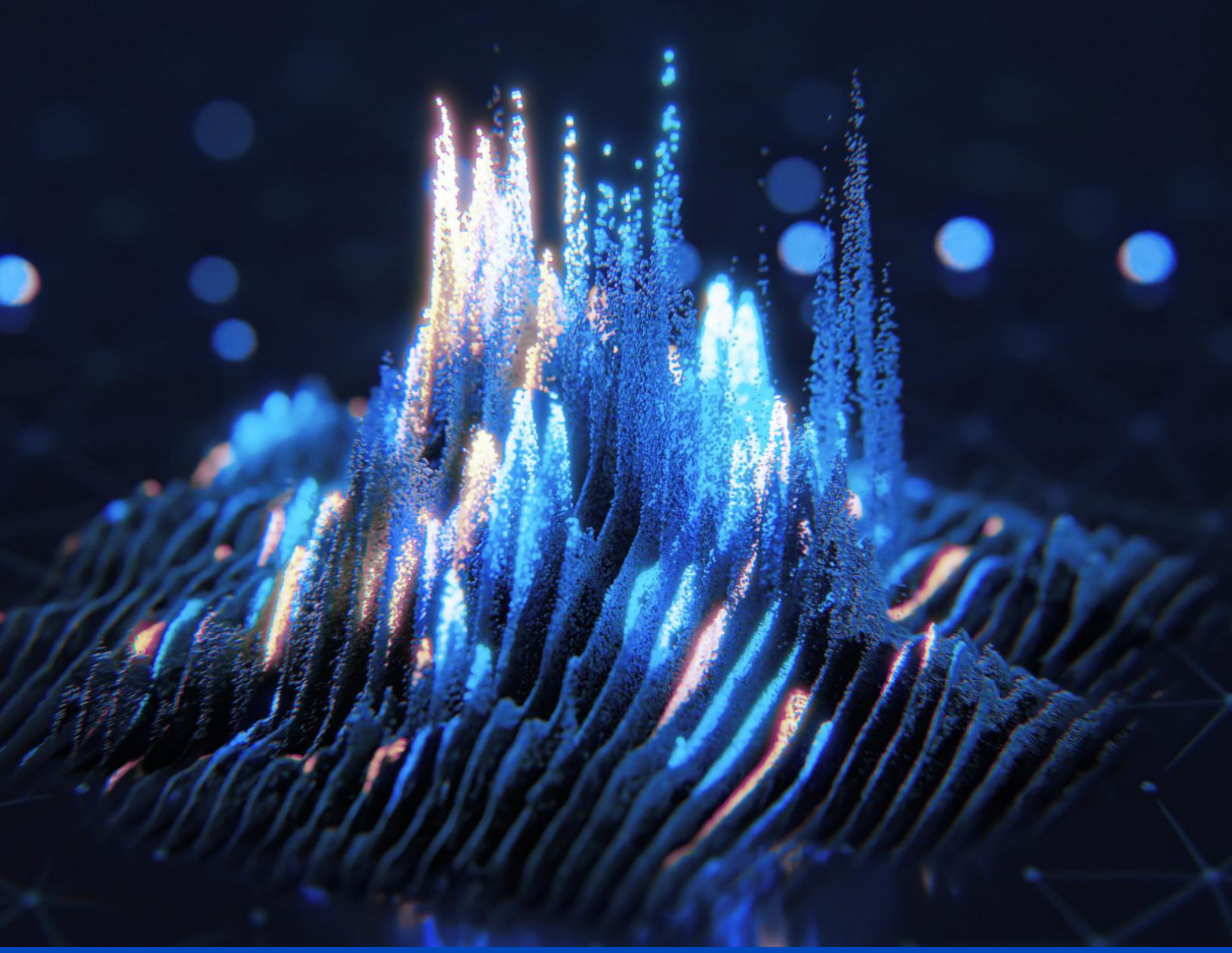

2026 Economic & Market Outlook

Investing in a 5% World

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WisdomTree®

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Key Takeaways

- Middle East news should continue to be in the headlines, but our base case still sees 'good' growth and 'above-target' inflation.
- The September rate hike underscored that the Fed's primary mission is focused on the inflation side of its dual mandate. Any potential future rate hikes will be geared towards reversing last year's rate cuts.
- Despite the recent rate hike, the forces pushing the Treasury 10-year yield higher remain in place, keeping rates and volatility higher heading into year-end.
- We believe the bond portfolio decision-making process could benefit from limiting duration and volatility risk by taking a barbell approach anchored by zero-duration strategies.
- Many investors are concerned about the headwinds from rising rates, but history and today's fundamentals suggest current levels can be digested by markets.

The Macro Backdrop

Remaining on the 'Good' Growth Path

One of the hallmarks for the U.S. economy over the last few years has been its resiliency. This calendar year has been no exception as the war in the Middle East led many a market prognosticator to pencil in the potential for a recession stemming from the effects of the Middle East war. Needless to say, not only has a downturn failed to materialize, but overall growth has continued on a good, moderate path, with no caution or danger signs evident on the horizon.

Oftentimes, investors look towards the labor markets for signs of not just where current economic activity stands, but also where things could be going in the months ahead. Interestingly, the monthly employment report's nonfarm payrolls and unemployment rate are certainly not leading economic indicators; rather, they are coincidental, at best. Nevertheless, the markets did receive a potential scare a couple of months ago. Indeed, new hiring came in on the negative side of the ledger in July, accompanied by downward revisions to the prior two months. This development re-ignited concerns of the previous two summers when cooler than expected jobs numbers pushed the Fed into rate cuts.

> "Household spending has continued to provide underlying support for the economy, even in the wake of higher energy prices."

Interestingly, this labor market backdrop was completely reversed in August, and even though the September report was somewhat softer than expected, it was not soft enough to alter the markets' economic and rate outlooks. There is little doubt that this changed the labor market outlook considerably. In addition, weekly jobless claims, which are a leading indicator, remain about 100,000 below the levels seen before prior recessions over the last forty years, or so.

That brings us to the two primary cylinders of the growth engine: personal consumption and investment. Household spending has continued to provide underlying support for the economy, even in the wake of higher energy prices. Given the recent robust reading for retail sales, it looks as if the consumer is going to remain in a supporting role.

The other cylinder of the economic engine, fixed investment, is also providing a positive contribution to the overall economy. The massive build-out within the AI space is showing up in the categories one would expect as part of the Bureau of Economic Analysis' GDP reports, and we anticipate this trend continuing.

All in all, the underpinnings of the U.S. economy still seem to be on a relatively solid note and should help keep overall growth moderately positive during the final three months of the year.

Inflation: Can the 2% Target Ever be Attained?

In last quarter's Outlook publication, we posed the same question we are asking now: Can the Fed's 2% inflation target ever be attained? Following the news of the Memorandum of Understanding (MOU) a few months ago, energy prices fell back to almost pre-war levels and inflation readings, such as core CPI, were revealing a modest disinflation trend.

Well, we all know what has recently occurred on the energy front with crude oil back above the $100 per barrel threshold while the recent readings for both CPI and PPI revealed that the moderation in price pressures stopped.

That brings us to the Fed's preferred inflation gauge, the core PCE deflator. Unlike core CPI, this measure had actually not revealed any disinflationary tendencies during the summer. Indeed, the year-over-year reading has consistently stood at +3.0%, or above, as of this writing. This figure is a full percentage point above the Fed's target.

"Either way, the Fed's 2% target will more than likely continue to be elusive."

From a core inflation perspective, renewed concerns of pass-through effects from higher energy prices to the broader macro landscape could linger and take more time to potentially reverse course. Demand pressures from the AI buildout perspective will remain a dominant force as well.

Either way, the Fed's 2% target will more than likely continue to be elusive.

Fed Policy: Finally, 'Walkin' the Walk'

The Federal Open Market Committee (FOMC) decided to raise rates by a quarter-point, bringing the new fed funds trading range to 3.75%-4.00%. The money and bond markets had been pricing in a potential rate hike at this gathering, and Warsh & Co. ultimately realized that such a move was warranted. That being said, the 'rate hike' story does not end here. In fact, you can make the case that this is not over by any means whatsoever and the bond market will continue to challenge the Fed to stay the course, of course data permitting.

> "There is no question that inflation is now job #1 of the Fed's dual mandate."

Interestingly, Chairman Warsh had been 'talkin' the talk' and giving off the impression that he's an inflation hawk, but it wasn't until this Fed gathering that he finally was 'walkin' the walk'. It must be noted, however, that getting to this point was not a smooth ordeal. In fact, the Chairman put himself into this position due to his prior rhetoric, and perhaps most importantly, his refusal to provide any forward guidance at all, and based upon Warsh's Jackson Hole comments, the hawkish tenor he set forth provided him with no wiggle room.

The perception now is that the September FOMC meeting resulted in a 'hawkish' rate hike. Warsh's acknowledgment of a strengthening in economic activity and non-restrictive financial conditions was noteworthy. There is no question that inflation is now job #1 of the Fed's dual mandate.

There's an age-old motto: When you see a chance, take it. Well, the Fed took it and now the question becomes: What next? If upcoming data continues to show good growth and above-target, sticky inflation, we don't necessarily see this rate hike as the beginning of a new tightening cycle, but rather just removing some of the rate cuts that occurred during the September-December period of last year.

Searching for GeoAlpha

Over the course of the third quarter, the issues facing the market remained broadly the same as the second quarter. The U.S.-Iran conflict dragged on following the collapse of the Memorandum of Understanding. Though it evolved from kinetic to a predominately stalemate "wait-and-see" phase, the Strait of Hormuz issues and the involvement of the Houthis in Yemen continued to elevate energy prices globally. This was compounded by the continuation of the Ukraine War, and the destruction of refining capacity in Russia. Between the two, dislocations have happened across numerous important products. Everything from diesel to aviation fuel has seen price spikes, not to mention plastics and fertilizer.

With risks come opportunities. And that means there is plenty of opportunity. While the energy-related risks garner most of the headlines, there is also the U.S.-Canada trade relationship, the U.S.-China trade relationship, and the looming midterm election. Putting these together with the current situation around energy might feel daunting. But taking each in turn shows a bit of a different picture.

The U.S.-Iran conflict's evolution from kinetic to stalemate is a marginal net positive, and—following the UN General Assembly—there are renewed efforts around mediation. While nothing happens quickly (whether it is diplomacy or rebuilding refining capacity), the directionality is positive. This is compounded by the push from the Trump Administration to have Ukraine and Russia cease hitting energy infrastructure. The slow and steady mitigation of these issues is the most likely outcome, creating a needed tailwind to the consumer-focused names into the holiday season. And a much-needed headwind to inflation into 2027.

The other risks are far more "headline and fade" risks and opportunities. The U.S.-Canada trade relationship can be solved rapidly if and when the two sides agree to a resolution. The U.S.-China trade relationship remains in a détente. Following the state visit by Xi to the U.S., the agreement to continue to talk was the primary takeaway. The midterms are the most "known of the known" risks with the outcome polled to oblivion with a substantial lead time. Investors should be prepared for these opportunities but know they will be short-lived.

U.S. companies have mitigated many of the geopolitical risks over the course of the year, and the earnings growth is evidence of this phenomenon. Will these shocks change that trajectory? Probably not. In the end, these are mostly opportunities to incrementally reallocate to areas of the market that have been out of favor due to the headlines. That is a continuation of the turn from "headline risk to bottom line risk", something investors should embrace.

> "The slow and steady mitigation of these issues is the most likely outcome."

Equities: On Hikes and Highs

Most developed-market central banks are now raising short-term rates to contain inflation on account of higher energy prices. The Fed hiked on September 16 for the first time since 2023, and the 10-year Treasury yield touched 5.13% this month, its highest level since 2007. Despite those headwinds, the S&P 500 sits within roughly 2.5% of the record it set in August and Japanese equities recently set fresh all-time highs. We think equities can still deliver positive returns through year-end.

Who Is Hiking, and How Far Will They Go?

> "We think equities can still deliver positive returns through year-end."

Since May, the Reserve Bank of Australia, the Reserve Bank of New Zealand, the European Central Bank (ECB), the Bank of Japan (BoJ) and the Fed have all raised rates. The Riksbank and the Bank of England (BoE) are expected to follow shortly. Many of these moves reverse cuts made in 2025. In the Fed's case, it is unwinding the "insurance cuts" it made when the U.S. labor market wobbled late last year. In our view, the reason for a hike matters. Unwinding insurance cuts is a very different exercise from chasing runaway inflation. As long as volatility at the long end of the curve stays anchored, we believe staying overweight stocks versus bonds is the right call.

Don't Stocks Struggle When the Fed Hikes?

In the short run, yes. Goldman Sachs looked at seven Fed hiking cycles over the past few decades. The S&P 500 averaged a -2% return in the three months after the first hike, then gained an average of 9% over the following 12 months, with positive 12-month returns in every cycle except 2022.[1] The 1997 cycle is the extreme case: the S&P 500 fell 10% around a single 25 basis point (bp) hike. Even then, stocks bottomed once the market stopped pricing more tightening and reached new highs within three months.[1]

Based on our current views, a sharp correction is not our base case. Still, as long as oil prices and U.S. rates keep rising, we expect volatility to stay elevated. For us, that means opportunities to buy stocks at a discount. Our recommendation is to know what you want to own before those opportunities show up (more on that below). Rates may stay choppy, but we are more confident that stocks can find their footing before year-end, for three reasons.

Earnings Matter More Than Rates

The S&P 500's forward P/E has compressed from 22x at the start of the year to 19x, even as the index trades near its record high.[1] That means forward earnings estimates have done the lifting. Some of the compression reflects higher rates, and some reflects skepticism about AI and how durable recent earnings strength is. Relative to bonds, stocks look about the same as they did a year ago. The gap between the S&P 500 earnings yield (5.2%) and the real 10-year Treasury yield (2.6%) is roughly 270 bps, and outside of brief drawdowns it has held steady for two years.[1] Put another way, P/E compression has mostly tracked real yields, and investors have not demanded a bigger risk premium to own stocks.

[1] Source: Goldman Sachs Global Investment Research, as of 9/11/26.

How much further can yields rise before earnings stop carrying the market? Many strategists reduce stocks versus bonds to the Fed Model, which compares the equity earnings yield with the nominal 10-year yield. We are less convinced. However, as the 10-year approaches 5.5%, it is true that equity multiples have tended to come under pressure. In our view, the best way to navigate that ceiling is to focus on quality companies with high returns on equity and assets.

Turning to the balance sheet, most U.S. large-cap debt is fixed-rate and long-dated, so net borrowing costs have risen only modestly. According to Goldman Sachs, interest coverage for the aggregate S&P 500 ranks in the 99th percentile of the past 20 years, and coverage for the median stock ranks in the 68th.[1]

Finally, we think rate volatility matters more than the level of rates. Stocks have usually posted positive returns alongside rising yields unless the move was fast enough to upset the apple cart. Today that works out to about 50 bps in a month or 30 bps in two weeks.[1] The speed of September's Treasury selloff helps explain why stocks wobbled. A broader hiking cycle that pushes long yields sharply higher would weaken the earnings anchor.

> "We think rate volatility matters more than the level of rates."

All Stocks Are Not Created Equal

Goldman calculates that a company needs two percentage points of extra long-term growth to offset a one percentage point rise in its cost of equity.[1] Companies with high returns on capital that fund capex and research and development from internal cash flow are best placed to clear that bar. In our view, companies that screen well on both growth and profitability may weather this cycle better than most.

The shape of the yield curve matters too. Bear-flattening episodes, like the one around the Fed's September meeting, have historically favored Technology. Bear-steepening episodes have tended to favor cyclicals such as Energy and Financials. Over time, Financials have tended to benefit from higher rates through wider net interest margins, even though their performance over the past month was less compelling.

Japan: A Rising-Rate Beneficiary

After decades of near-zero rates and deflation, Japanese companies still have some of the lowest nominal borrowing costs in the developed world. That is true even after the BoJ lifted its policy rate to 1.25% on September 18, the highest since 1995.[2] Gradual normalization supports bank earnings and signals confidence that wage and price gains are sticking.

[2] Rate and currency data: Federal Reserve, Bank of Japan, Bloomberg, as of 9/22/26.

Historically, higher U.S. rates meant a weaker yen, which helped exporters by lifting yen-denominated sales. The yen has since become a political issue in both Washington and Tokyo, but Japanese companies do not necessarily need a weaker currency to grow. Their forecasts are conservative. Major manufacturers assumed ¥151.4 per dollar for fiscal year 2026. After the BoJ's September hike, the yen traded near ¥157, leaving a healthy cushion relative to the forecast.

In our view, the policy paths of the Fed and BoJ will be a key driver of the exchange rate. With the Fed at 3.75% to 4.00% and the BoJ at 1.25%, U.S. short rates hold an advantage of roughly 250 bps or more. For a U.S. investor, that gap is roughly the annual carry earned from hedging the yen. An unhedged position only comes out ahead if the yen appreciates by more than about 2.5% per year, every year, which is not our base case.

Many investors are concerned about the headwinds from rising rates, but history and today's fundamentals suggest current levels can be digested by markets. The next few months bring a busy calendar: third-quarter earnings season, the inflation reports ahead of the Fed's December meeting, and further decisions from the ECB and BoJ. Each one is a chance for markets to reprice, and pullbacks around them may offer better entry points for investors with a shopping list ready. In our view, patience and selectivity should be rewarded more than trying to time the peak in rates.

"Japanese companies do not necessarily need a weaker currency to grow."

Fixed Income: The Bond Market Is Just Doing Its Job

The sell-off in the U.S. Treasury (UST) market, especially for longer-dated maturities, has created a bonanza of headlines for investors to choose from. Interestingly, many of the recent stories have been trying to find a primary culprit or reason for the increase in yields. However, the primary drivers for the rise in rates is not due to one factor, but rather a confluence of factors coming together at the same time. Instead of getting all worked up over the current and prospective state of the fixed income arena, our advice is to filter out the noise and just chalk it up to the bond market is just doing its job.

For many bond investors the yield levels for the UST 10 and 30-year maturities are coming as a bit of a sticker shock, but as we have previously noted, they are only coming back to more 'normal' historical readings. The convergence of good growth, sticky inflation, Fed policy uncertainty and supply considerations (Treasury and AI-related) has created an environment where the bond market had to re-price itself in order to better reflect these changing dynamics. In other words, against this shifting investment landscape, concessions need to be made in order to establish a yield level that will attract buyers. It is merely added compensation for the fixed income investor for a more challenging backdrop. This development is not new and is what historically has occurred when there are no zero interest rate policies, quantitative easing (QE), financial crises or pandemics to consider as being part of the equation.

An important aspect to this run-up in UST yields has been that it has thus far transpired in an orderly fashion. Indeed, there have been no liquidity or funding issues to elevate anxiety levels more than what has already been observed just for the increase in rates themselves. In other words, it is just the bond market being the bond market.

> "...it is just the bond market being the bond market."

The UST 10-year yield has now crossed the widely debated 5% threshold, and make no mistake, one rate hike may not necessarily be the final arbiter for where longer-dated Treasury yields wind up. In fact, the aforementioned forces pushing longer-dated yields higher have not gone away, and any potential duration rallies will more than likely be short-lived.

Against this backdrop and given the track record for long duration over the last two-year period, as well as our macro-outlook and relative value analysis, we would consider holding off on the "long duration" trade with a preference for a barbell approach for fixed income portfolios, anchored by zero-duration strategies.

Fixed Income Allocation: Emerging Income Opportunity amid Continued Uncertainty

The bond market sell-off has made yields more appealing for investors with medium- and long-term horizons. Geopolitical tensions, disruptions to energy supplies and a surge in borrowing to fund artificial intelligence projects remain near-term risks. Still, current yields offer more income for the interest rate risk investors take than they have in some time.

> "Current yields offer more income for the interest rate risk investors take than they have in some time."

Investment-grade corporate bonds yielded 6.04%, as represented by the Bloomberg U.S. Corporate Index as of September 30. Baa-rated corporate bonds offer 6.21% in yield-to-worst, with the 1-5 year maturity sector marking 5.75%. Broad-based high yield corporate bonds now offer over 8.35%. Contrast that with five years ago (September 30, 2021), when investment grade corporates, Baa-rated corporates, and high-yield corporates were yielding 2.12%, 2.34%, and 4.04% respectively. While spreads to Treasuries remain tight reminiscent of the period between 2004-2007, corporate bonds remain supported by strong fundamentals and robust earnings growth.

Technology companies, particularly the largest cloud and technology providers, are issuing more bonds to fund artificial intelligence infrastructure. Investment grade corporate issuance is on track for a record year. Many of these deals are unrelated to mergers, so investors have less warning before large new issues reach the market. These companies are also borrowing for longer periods, making their bonds more sensitive to changes in interest rates. Investors holding broad investment grade portfolios may therefore have more technology exposure as in the coming months if AI issuance continues at its pace.

Markets have taken note. In credit, hyperscalers have underperformed the broader investment-grade index on a spread basis, while their 10s30s curves have steepened meaningfully. This is a sign that investors are demanding more compensation for duration risk from these bonds precisely where issuance has been heaviest.

However, there are still bright spots in today's market. We are nowhere near the interest rate risk levels we saw in the year after the COVID-19 pandemic. In December 2020, the Bloomberg Investment Grade Corporate Index's duration peaked at 8.84 years; it currently rests at 6.34 years.

We also believe comparisons with the telecom bubble of the late 1990s go too far. Heavy spending is reducing the free cash flow of today's largest technology borrowers, and their growing debt is a concern. But they entered this spending cycle with stronger balance sheets and higher profit margins than many telecom companies had before the downturn at the turn of the century. The rapid growth of hyperscaler debt issuance hints at the continued importance of security selection in generating alpha in the coming months.

In other parts of the Fixed Income market, Municipals endured a painful third quarter with rising Treasury rates and heavy supply, including record issuance in August. The silver lining is that the sell-off has left municipal bonds with higher taxable equivalent yields and better value compared with other bond sectors. The 4.78% yield on the Bloomberg Municipal Index suggests taxable equivalent yields from 7% to 8% for affluent investors (those exposed to the higher marginal income tax brackets).

Overall, we believe the recent sell-off in Fixed Income markets has created more attractive long-term income opportunities for fixed income investors, but investors still need to navigate near-term headwinds – punitive energy costs, persistent high inflation, increasing debt supply and Geopolitics tensions.

> "All-in yields across both investment-grade and high-yield corporates remain attractive."

Current Positioning: Yield Now, Pursue Later

Within fixed income, we remain confident in our current positioning, which reflects a deliberate balance between income generation and capital preservation:

+ **Duration: NEUTRAL**
  Even though risk-free interest rates have risen sharply in the past few weeks, and we are at levels not seen in years, we maintain a neutral duration stance. We acknowledge the fact that the positioning and sentiment is extremely bearish for treasuries and a bounce back cannot be ruled out, however, our duration stance is rooted in our conviction that investors will continue to demand higher rates from borrowers due to ever increasing debt supply, persistent high inflation and strong economy. Overall, this positioning provides flexibility. We remain generally underweight Treasuries.

+ **Credit Exposure: NEUTRAL with an Income Tilt**
  While tight valuations limit scope for further spread compression, all-in yields across both investment-grade and high-yield corporates remain attractive. Corporate fundamentals are healthy, and we continue to favor investments in quality-screened high-yield debt over longer-duration investment-grade corporate bonds.
+ **Securitized Assets: OVERWEIGHT**
  We retain a modest overweight to securitized credit, taking advantage of the broad opportunity set with structural protections, and high-quality underlying collateral. Investments in non-agency residential mortgage-backed securities and asset-backed securities are particularly attractive.
+ **Emerging Market Local Debt: NON-CORE POSITION**
  Emerging market local debt remains an attractive source of income, supported by solid macroeconomic fundamentals. We continue to favor overweight positions to select Latin American countries, which feature high interest rate carry and strong fundamentals. We are carefully monitoring the situation with rising dollar and Diesel shortage and how it might impact our relative positioning between EM countries.
+ **Municipal Bonds: OVERWEIGHT**
  Within tax-sensitive accounts, we continue to favor municipal securities. After-tax income has become more compelling while credit fundamentals across the sector remain solid.

Risks to the Outlook

Recent market developments reinforce the importance of remaining nimble. The ability to identify and respond to risks as they develop is just as important as getting the broad macro thesis right. The shifting dynamics of the Iran conflict and the reactionary efforts of the administration to counter its effects are just two facets uncertainty investors are currently navigating.

Add in the Fed pivot to raising rates, elevated sovereign debt, AI debt expansion, and questionable seasonality impacts in economic data, there are a myriad of factors for fixed income to digest. These imbalances have a way of being absorbed until a catalyst forces a reassessment. Maintaining a diversified, income-oriented, tactically flexible posture remains the most prudent way to manage through it.

WisdomTree Asset Allocation Views

Equities	Negative	Neutral	Positive
Equities vs. Bonds			⊕
U.S. Equities			⊕
U.S. Large-Cap Growth		●	
U.S. Large-Cap Value		●	
U.S. Mid/Small-Cap			⊕
Developed International	⊖		
Emerging Markets	⊖		

Fixed Income	Negative	Neutral	Positive
Duration		●	
U.S. Treasuries	⊖		
Investment-Grade Credit		●	
High-Yield Credit		●	
Securitized Credit			⊕
Non-U.S. Developed Government Bonds	⊖		
Local EM Debt			⊕

Alternatives	Negative	Neutral	Positive
Systematic Trend / Managed Futures			⊕
Real Assets / Commodities			⊕

Source: WisdomTree, as of 9/30/26. Evaluations are subject to change as market conditions change. This is for illustration purposes only and does not represent investment advice. All evaluations are on a relative and not an absolute basis. Red = a negative relative evaluation; gray = a neutral relative evaluation; green = a positive relative evaluation. **Past performance does not guarantee future results.**

Please see the WisdomTree Glossary for definitions of terms

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