



MARKET COMMENTARY

Back to the Narrow Breadth

Eric Sterner, CFA, CAIA, FRM, CIPM

Chief Investment Officer, Apollon Wealth Management and Apollon Financial

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2026 so far has been another incredible year for the markets as the S&P 500 has closed at a record high 27 times this year with the most recent occurring on October 6. In the first half of the year, we witnessed a widening breadth as 9 out of 11 sectors produced positive returns, which has been powered by an incredible run of strong quarterly corporate earnings. As inflation was slowly easing, small cap stocks broke out of their earning recession, and the Russell 2000 was up over 20% in the 1st half. However, the market narrative has changed over the past several weeks. An ongoing war in the Middle East has reignited inflation concerns as well as a possible new series of rate hikes from the Fed. Additionally, mid-term elections are creating a cloud of uncertainty which has paused some rallies in certain areas of the market.

Last month 9 out of the 11 sectors had negative returns with only Communication Services and Technology producing gains. In fact, September was the S&P 500's 13th worst month for breadth since 1990 as measured by the cumulative advance/decline line. While the S&P 500 was able to come out almost flat for the month, a -0.35% return, roughly 78% of the S&P 500 individual stocks finished lower. We saw a similar market narrative reversal earlier this year. During the first two months of the year, we saw a market rotation amongst sectors, but that changed when the US-Iran conflict broke out. For the two-month following the conflict outbreak (March – April) we saw 6 sectors produce negative returns, but the



S&P 500 was up 4.54% as Communication Services and Technology led the way. These trends do not surprise me as investors flock to Quality during periods of high uncertainty and/or rising bond yields. The leading companies in the Communication Services and Technology sectors fit that Quality criteria due to their strong balance sheets, earnings, and cash flows. I believe we will continue to see this narrow market breadth until oil prices and inflation ease, which may, in turn, also settle down bond yields.

While rising bond yields and geopolitical tensions may have some investors concerned, it's hard not to ignore the incredible run of strong corporate earnings. As of now, the S&P 500 is expected to report year-over-year earnings growth of 29.5%, which would be the third straight quarter of earnings growth above 25% and the 8th straight quarter of earnings growth above 10%. From an earnings perspective, the broadening story is still intact as all 11 sectors are expected to produce earnings growth as well as revenue growth. However, the positive market returns have temporarily stopped broadening as government bonds' yields are at multi-decade highs.

While a strong economy and federal deficit concerns are two reasons for rising bond yields, other contributing factors include elevated inflation and expectations of multiple Fed rate hikes. I believe the Fed's last rate hike was not warranted, but the Fed was forced to hike as Fed Chairman Warsh has abandoned forward guidance and instead wants the market to dictate interest rate decisions. Since the market had priced in a 92% probability of a rate hike due to a hot inflation, retail sales and inflation report, the Fed painted itself into a corner. While we clearly still have elevated inflation, most of the pressures are on the supply side with oil spiking due to the US-Iran conflict. Higher energy prices are also feeding through to transportation and warehousing costs as well as airfare costs. However, a 25-bps rate hike does not open the Strait of Hormuz. There are plenty of disinflationary



trends in place now as shelter inflation is taming, tariff effects are fading, and wage growth has been subdued for months. Inflation will most likely remain elevated until the fighting in the Middle East ends. If this conflict continues into 2027, my concern will certainly grow as these higher energy prices will continue to bleed into other components of inflation. While food inflation has recently been tame, diesel is very important to food prices as most farming equipment and trucks moving goods to grocery stores rely on diesel. I expect food inflationary pressures to build in the coming months if fighting continues. Diesel prices can affect food prices with up to a 9-month lag based on the timing of the planting versus harvest season.

The odds of a rate hike in October dropped to approximately 20% after a cooler than expected September labor market report. The labor market is still relatively healthy, but it's cool enough to take some pressure off of the Fed. I will have more concerns about the labor market if the Middle East conflict continues into 2027 and the Fed hikes rates multiple times. Smaller companies are more interest rate sensitive and higher rates could impact their hiring plans. Small firms (less than 50 employees) have contributed heavily to the rebound in the labor market since the middle of last year, accounting for more than half of all private job gains. Higher rates could unwind that momentum.

Consumer spending has held up this year even with elevated inflation. At an aggregate level, consumer spending is up 6.1% on a yearly basis through August. That is very welcome news given that the latest job report from September showed that average hourly earnings increased by only 3% over the past year, the slowest annual increase since 2021. I expect CPI to come in higher than 3% later this week, which would mark the sixth consecutive month of declining real wages. With that trend in mind, it's more likely that the wealth effect is fueling consumer spending as some investors have seen their net worth substantially increase due to the markets' strong returns over the past few years. However, that



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wealth effect typically only applies to the higher end consumer who has more exposure to the markets. These trends of rising markets but declining real wages is further driving the K-shaped bifurcation of consumer spending, which is a risk to the economy as consumer spending is only being fueled by a small subset of the population.

Overall, I remain bullish as corporate earnings remain healthy. The market breadth may remain narrow until bond yields settle down. It appears that Iran wants to draw out this war longer to apply political pressure on President Trump with the midterm elections around the corner. This war is generally not popular, and affordability will be a major theme to these elections, so elevated inflation and energy costs will cause more financial pain to the US consumer, and, in turn, may hurt President Trump politically. Once a lasting ceasefire is in place, I believe inflation will trend downwards and the market broadening may reassume. Diversification is an investor's best friend during these periods of heightened volatility.



Eric Sterner

CFA, CAIA, FRM, CIPM

CHIEF INVESTMENT OFFICER

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