

Separating seasonal scares from lasting fundamentals

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 **TIAA** Wealth Management

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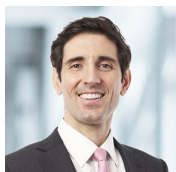
EXECUTIVE SUMMARY

- **Energy remains the top near-term risk.** High crude oil prices driven by Middle East tensions are testing depleted strategic reserves and tightening global supply chains, with risks skewed further upside absent a diplomatic off-ramp.
- **Higher-for-longer rates are reshaping markets.** Persistent inflation, mounting fiscal deficits, and a surge in AI-related corporate debt issuance have pushed yields higher.
- **The Fed has resumed tightening.** A unanimous rate hike and hawkish tone from Chair Warsh signal further increases are likely, with policy remaining sensitive to energy-driven inflation risks.
- **AI investment remains robust but faces rising scrutiny.** Capex could approach \$1.3 trillion in 2027 according to analysts and early monetization signs are encouraging, but political, regulatory, and safety concerns are likely to introduce greater volatility and dispersion.
- **Midterms add noise, not direction.** Regardless of outcome, checks like the veto and Senate filibuster limit policy shifts; fundamentals, not election results, should continue to drive portfolio decisions.
- **Bottom line:** While near-term risks warrant caution, the enduring drivers of market returns, earnings growth, innovation, valuations, and economic resilience, remain firmly in place.



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October has always had a flair for surprises—and it's not just the Halloween costumes and candy. This month carries a reputation as one of the market's most volatile, and this year's edition arrives with plenty of crosscurrents already in motion.



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Energy markets are being tested by geopolitical tensions in the Middle East. Bond yields are marching higher as investors reassess inflation, fiscal deficits, and the growing capital demands of the AI build-out. The Federal Reserve (Fed) has returned to tightening mode, raising questions about how far rates may ultimately rise. At the same time, artificial intelligence (AI) remains both a powerful market tailwind and a growing source of regulatory and political scrutiny. Layered on top of it all is an approaching midterm election that is commanding headlines, even as fundamentals continue to matter more for long-term investors than election outcomes alone.

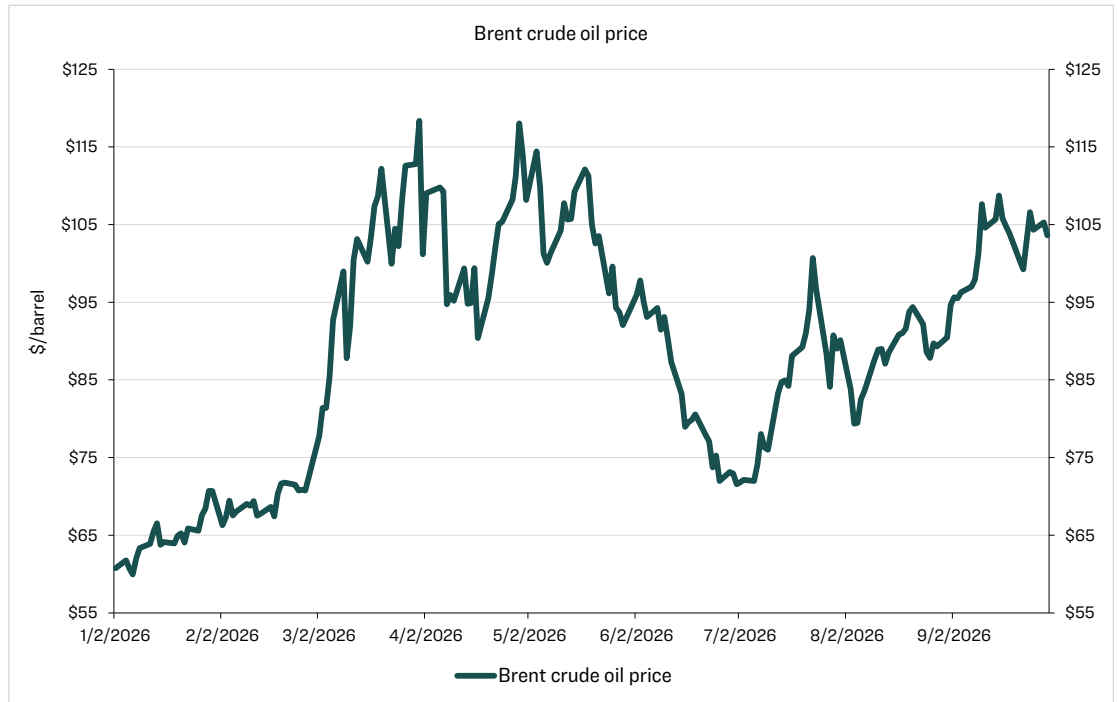
While equity markets have delivered strong results this year, with the S&P 500 up nearly 12% year to date (YTD)¹ following last year's 17% gain, several developments are casting longer shadows over the outlook. Yet investors must look beyond the headlines and distinguish between temporary market "frights" and risks that could have more lasting implications for portfolios. Below, we examine five themes shaping risk and opportunity as we move into the last quarter of 2027.

Crude awakening: Energy markets test their limits

Energy markets sit at the center of investors' attention, and for good reason. Crude oil prices rose roughly 30% in the third quarter alone, and are hovering near \$90 a barrel at the end of September (Figure 1). While no shortage of potential market scares is competing for investors' attention this October, the primary risk facing the global economy and markets remains elevated oil prices tied to the ongoing situation in the Middle East.

FIGURE 1

Brent crude oil prices rose roughly 30% in the third quarter alone.



Source: Bloomberg, TIAA Wealth Chief Investment Office. Data through 9/29/2026.

What makes this episode particularly notable is the unusually high level of simultaneous disruption across energy markets. Exports through the Strait of Hormuz have been constrained, flows through the Red Sea were reduced, the global tanker market is tight, and freight rates are near record highs. Refining capacity disruptions have pushed diesel prices to all-time highs, while natural gas and heating oil inventories across Europe are below seasonal norms.

For much of the past six months, markets absorbed these shocks relatively well, aided by higher U.S. exports, reduced Chinese imports, and healthy inventory levels. But those buffers are eroding. Strategic Petroleum Reserve releases are likely nearing their end, with the reserve now down to roughly 285 million barrels—the lowest level since 1984. Recent developments, including Saudi Aramco curtailing deliveries to Europe and Houthi strikes on Saudi Arabia, have raised concerns about diminishing cushions against further shocks.

Tax refunds initially helped cushion the impact of higher energy prices on U.S. consumers, but that support has now been exhausted. This suggests the drag on consumer spending could become more pronounced through the remainder of this year and into next. Much depends on how negotiations evolve and what kind of off-ramp emerges from the current standoff. For now, the situation remains fluid, and risks to oil prices remain skewed to the upside. Energy prices remain among the most consequential dynamics confronting investors in the near term, and one that our team is monitoring closely.

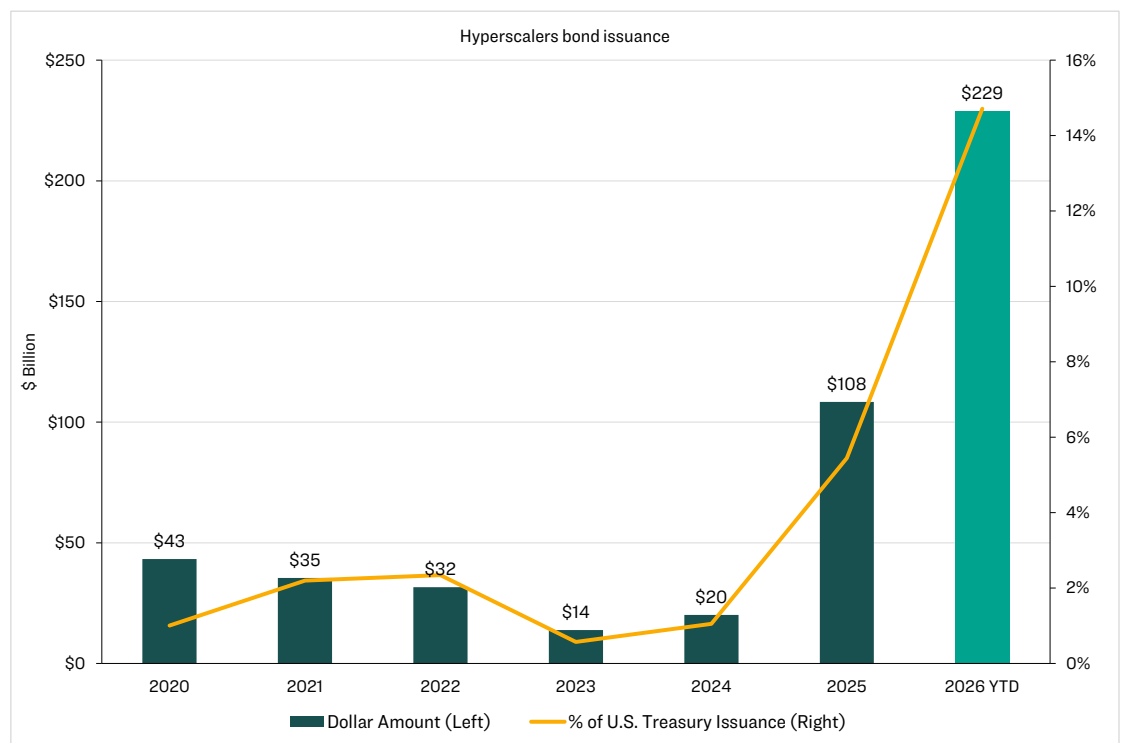
Interest rates: A higher-for-longer reality

Of all the shadows hanging over markets this autumn, higher-for-longer interest rates may prove the most difficult to ignore. Long-term interest rates have become a focal point for investors, and several forces are converging to push yields higher. Central banks globally have adopted a more hawkish posture, with the Fed, Bank of Japan, European Central Bank, and Bank of England all expected to tighten further in the coming quarters. Inflation has proven stubborn, kept elevated by energy costs and robust AI-related spending. Meanwhile, fiscal strains continue to build, with the U.S. deficit now running at 6.3% of GDP and national debt at \$40 trillion.

Compounding this is a relatively new phenomenon: a wave of technology-sector debt issuance tied to the AI build-out that is beginning to crowd out government borrowing. Hyperscalers have issued nearly \$230 billion in debt so far in 2026, a dramatic increase from roughly \$32 billion in 2022 (Figure 2). This dynamic distinguishes the current cycle from previous periods of rising rates. AI infrastructure companies appear willing to absorb higher borrowing costs because they anticipate that returns on these investments will exceed the cost of capital, and global asset allocators are increasingly favoring AI-linked corporate debt over Treasuries, drawn by relatively healthier balance sheets.

FIGURE 2

Hyperscaler spending is changing the supply/demand balance for both credit and equity markets.



Source: Bloomberg, TIAA Wealth Chief Investment Office. Data through 9/29/2026.

So where does this leave long-term yields? If energy markets stabilize, the 10-year Treasury yield is likely to move lower to around the 4.5% level and stay elevated compared to pre-war levels to reflect a modest premium for geopolitical risk and prospects for firmer inflation. A meaningful decline further in bond yields, however, would likely require a slowdown in inflation or economic activity greater than markets currently expect—and that shift could take time. Conversely, should the Middle East conflict persist, the balance of risks tilts higher given the likelihood of additional central bank rate hikes alongside continued sovereign and corporate issuance.

Looking beyond near-term market signals and headlines, higher yields carry a silver lining for savers and income-focused investors: high-quality bonds now offer their most attractive income potential in nearly two decades, presenting a compelling opportunity to construct portfolios built around dependable income.

The Fed: One and done, or just getting started?

A central question on investors' minds is how to interpret the Fed's latest policy move: does it mark the beginning of a new hiking cycle, or was it a "one and done" scenario? The Fed raised rates in September for the first time since July 2023, and the decision came on a unanimous 12-0 vote. Policymakers are increasingly wary that inflation expectations could become unanchored, a concern reinforced by the fact that core PCE has now run above the Fed's 2% target for 65 consecutive months, the longest such stretch since the target was adopted.

Chair Warsh's hawkish² tone during the post-meeting press conference had meaningfully shifted market pricing. Barring a significant softening in the labor market, investors now anticipate nearly four additional rate hikes over the next 12 months, with at least one more expected before year-end. Warsh characterized the recent move as a continuation of the process of withdrawing policy accommodation, signaling that the Fed may continue to tighten financial conditions to prevent the risk of elevated entrenched inflation.

Notably, Warsh also referenced geopolitical risk and its impact on energy and commodity prices as a meaningful input to the Fed's outlook—a departure from the central bank's traditional tendency to look past energy-price fluctuations. In a world characterized by more frequent supply shocks, oil prices are likely to remain an important factor in the policy outlook going forward, meaning rate expectations will likely stay sensitive to energy-market developments. The Fed appears to have drawn some clear lines: Officials spoke hawkishly for some time, have now acted hawkishly, and are signaling they intend to remain hawkish. We expect the Fed to maintain this tightening bias until core inflation moves closer to around the 2.5% range, or until the labor market weakens meaningfully—a less favorable scenario for the broader economy and markets. For investors, the risk is not a surprise policy shock, but rather a higher-rate environment that proves more persistent than markets currently expect.

From hype to scrutiny: AI's next chapter

Artificial intelligence (AI) has arguably been the single most important driver of the economy and markets over the past several years, and enthusiasm around AI-related capital expenditures by hyperscalers continues to underpin market performance. Looking ahead, though, the AI narrative is likely to be defined increasingly by dispersion and greater volatility, driven by intensifying scrutiny around monetization, disruption risk, and safety concerns.

The scale of investment remains staggering. The largest technology companies are expected to spend nearly \$800 billion on capital expenditures this year, rising to approximately \$1.3 trillion next year, according to industry analysts. With each passing quarter, investors are asking more pointed questions about when returns on these investments will materialize. Historically, investment cycles of this magnitude run five to seven years, suggesting full monetization may not be evident until 2028 or 2029. That said, early evidence is encouraging: the three major cloud providers³—Google Cloud, Microsoft 365, and AWS—continue to deliver robust revenue growth and strong margins, suggesting that enterprise adoption is accelerating and that returns on AI-related investments are beginning to emerge, even if the story remains in its early chapters.

Politics and regulation represent an increasingly important watchpoint for the sector. Public sentiment toward AI and data centers has shifted noticeably in recent months, as communities push back against local datacenter development due to concerns over electricity and water consumption, noise, and heat. These tensions are surfacing in political campaigns and prompting responses from state and local governments. Simultaneously, concerns are building within the AI community itself regarding the pace of development, spurred by recent headlines involving security breaches and national-security considerations.

We expect the regulatory landscape to evolve steadily, becoming a central theme heading into the 2028 election cycle. Safeguards will likely emerge through some combination of incremental government involvement, self-regulation by frontier labs,⁴ industry coordination, and potentially a U.S.-China understanding on timely disclosure of emerging threats. The key question is whether this regulatory scrutiny slows the pace of capital spending and frontier-model development. It may—but this could represent a healthy trade-off that ultimately supports more sustainable long-term growth for the industry.

Importantly, signs of a broader slowdown in AI spending and adoption remain scarce. Technology-sector earnings are expected to rise 63% year-over-year in the third quarter of 2026 (Q3 earnings will be reported in October and November), with record net margins of 32%, according to FactSet. The share of U.S. businesses adopting AI continues to climb, as does the share willing to pay for AI services. Token pricing⁵ has been falling amid growing adoption of cheaper open-source models.⁶ The overall AI story remains strong, though investors should brace for greater volatility and dispersion as political and regulatory scrutiny intensifies.

Beyond the ballot: Why fundamentals still rule markets

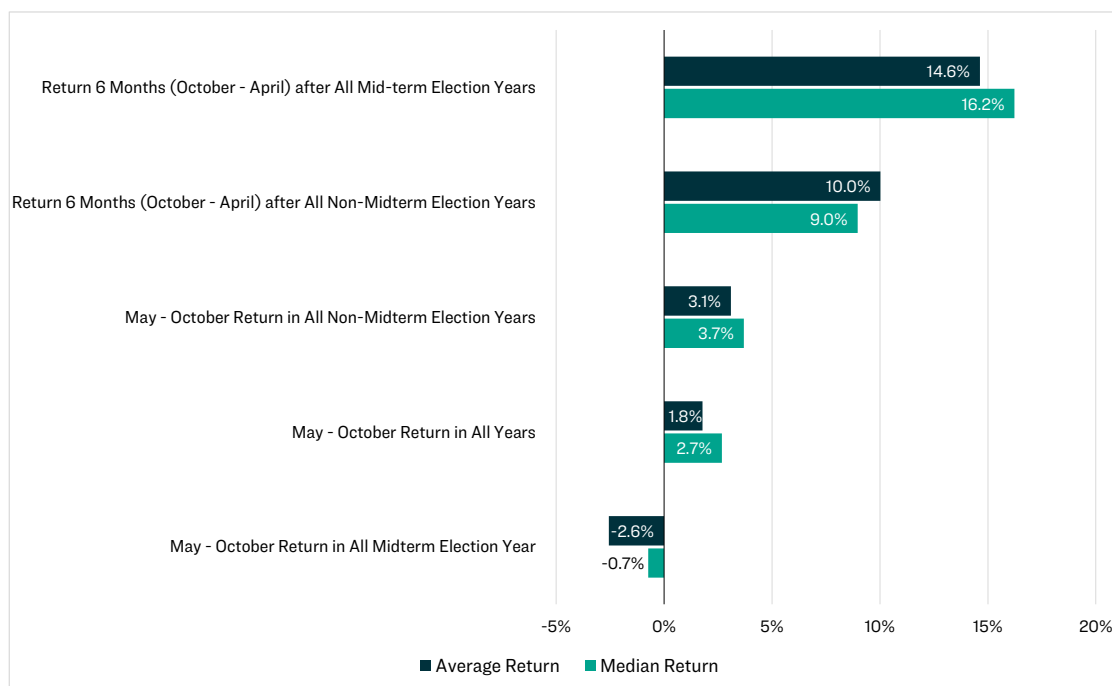
As is typical during election season, questions about the midterm elections and their market implications have become increasingly frequent. Our consistent counsel to clients is not to base investment strategy on election predictions, as markets tend to respond more to fundamentals and actual policy outcomes than to political forecasting. That said, historical context and current polling data offer useful perspective.

From 1934 to 2018, in 22 midterm elections, the president's party lost an average of 28 House seats and 4 Senate seats.⁷ Prediction markets currently assign Democrats roughly a 90% probability of winning the House, while the Senate remains a toss-up featuring several competitive races. Republican-held seats in Texas, Alaska, North Carolina, Ohio, and Maine appear closely contested, as does a Democratic-held seat in Michigan. Democrats would need to flip at least four seats to secure a Senate majority.

From a market perspective, history suggests the S&P 500 tends to soften ahead of midterms before rebounding afterward, rising roughly 14% on average in the six months following the election (Figure 3). Different outcomes carry distinct implications. Should Republicans retain the House—a less likely scenario per current prediction markets—investors may anticipate further deregulation and continuity of existing policy priorities, including support for domestic manufacturing and tariffs, alongside potential bond-market volatility if additional fiscal stimulus is pursued.

FIGURE 3

Equity market performance is historically below average ahead of midterm elections before rebounding afterward.



Source: Bloomberg, TIAA Wealth Chief Investment Office.

If Democrats win the House, as currently expected, gridlock becomes the base case. Major policy shifts would be unlikely, with attention shifting to must-pass legislation such as the budget, debt ceiling, and defense authorization. The administration would likely lean more heavily on executive action, particularly in foreign policy, where unilateral authority is greater. Notably, gridlock has historically coincided with slightly stronger S&P 500 returns than periods of unified government.

A third scenario—Democrats winning both chambers—has gained modest probability in recent weeks, though the distinction between full Democratic control and a split Congress may be smaller due to presidential veto power over legislation and the Senate’s 60-vote threshold for most bills, including spending measures. Even under the narrowest Democratic majority, meaningful Republican cooperation would still be required to advance most legislation.

Positioning for what lies ahead

Taken together, these five themes create a genuinely complex backdrop for investors in the final months of 2026. We believe that risks to equities have increased in recent weeks amid concerns about AI disruption, safety scrutiny, and the potential for further Fed tightening. Historically, equities have tended to pull back at the outset of Fed hiking cycles, and we would not be surprised to see volatility increase from here.

That said, there remain reasons for constructive positioning over the next 12 to 18 months. Median-stock earnings growth has climbed to the mid-teens, and the breadth of S&P 500 earnings revisions continues to improve—a bullish signal, particularly against a backdrop of lingering skepticism about the rally. As this cycle unfolds, we favor higher-quality positioning, with a current preference for large caps over small caps and a slight tilt toward value, while looking for opportunities to increase exposure to large cap growth given the durability of the earnings story.

We also continue to favor select international markets, including emerging markets—buoyed by improved fiscal positions, reasonable valuations, and meaningful AI-related exposure through markets like Taiwan and South Korea—as well as developed international equities, which could outperform meaningfully should a Middle East ceasefire take hold.

October may be known for surprises, but successful long-term investing has never been about reacting to the scare of the moment. The months ahead are likely to bring additional volatility, unexpected developments, and no shortage of shifting narratives. Yet periods of uncertainty often create opportunities for long-term investors willing to look beyond the immediate headlines. While some of today's concerns may ultimately fade, the enduring drivers of market returns, earnings growth, innovation, valuations, and economic resilience, remain in place. In the end, not every shadow signals danger, but neither should every risk be dismissed as a passing scare. For investors, the challenge is separating the noise from the fundamentals and positioning accordingly.

Endnotes:

¹ Through September 28, 2026.

² A hawkish monetary policy approach puts inflation control and price stability ahead of near-term growth concerns. Central banks taking this stance generally push interest rates higher and pull back on the money supply, even if that means slowing economic activity in the process.

³ Cloud platforms are internet-based environments that provide shared computing power, storage, and networking resources on demand.

⁴ Frontier AI labs are leading-edge artificial intelligence organizations that build and train the most advanced, general-purpose foundation models.

⁵ AI token pricing is a consumption-based (or usage based) model where customers pay for AI services based on the number of tokens processed. Instead of paying a flat monthly fee or a seat-based fee, customers pay proportionally to what they consume.

⁶ Open-source and open-weight AI models allow developers to download, modify, and self-host foundational artificial intelligence, offering transparency, data privacy, and low-cost serving.

⁷ Britannica, [2026 U.S. midterm elections](#).

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CIO: PERSPECTIVES

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