

Q3 2026

# Capital Markets Perspective

**thrivent**<sup>®</sup>  
Asset Management

# Steady growth, stubborn inflation: Q3 2026 outlook

U.S. economic data is generally outperforming expectations, resulting in solid economic growth supported by a resilient consumer, massive capital spending on artificial intelligence (AI) infrastructure, productivity gains, lower tax rates and tax law changes promoting business investment.

A stronger labor market has been an encouraging development, with the last three monthly employment reports showing job growth averaging nearly 190,000 per month, after accounting for revisions. Additionally, the weekly initial jobless claims data, which only counts individuals who file for unemployment for the first time that week, have been near their lowest levels since the late 1960s.

Our base case is U.S. economic growth will remain solid, but the ability of AI leaders to monetize their investments and increase earnings enough to justify their rich valuations remains uncertain. In the long run, we think AI will not just provide ongoing productivity gains but will ultimately prove revolutionary. Nevertheless, expectations are high, and bouts of uncertainty will lead to volatility, such as the sharp decline in the S&P 500® Index in early June.

Inflation remains an ongoing concern. It has been above the U.S. Federal Reserve's (Fed) 2% target since 2021, raising concerns that inflation expectations could rise, risking a self-fulfilling prophecy. Despite excluding the more volatile food and energy prices, the Core Consumer Price Index (CPI) and Core Personal Consumption Expenditures (PCE) Price Index have risen steadily since February. While oil prices have fallen recently, we expect continued uncertainty about the conflict in the Middle East, solid consumer spending and strong demand for AI infrastructure, such as semiconductors and computing equipment, to keep core inflation above the Fed's 2% target.

After the Fed's June meeting, new Chairman Kevin Warsh was notably more hawkish (focusing more on inflation risks than stimulating economic growth) than the market was expecting, with nine of the committee's 18 members projecting at least one interest-rate hike by the end of the year, including six members who projected more than one hike. We believe the Fed is likely to raise rates this year, possibly as soon as the September meeting, given the recent rise in core inflation and our expectation that Chairman Warsh will want to signal his commitment to combating inflation.

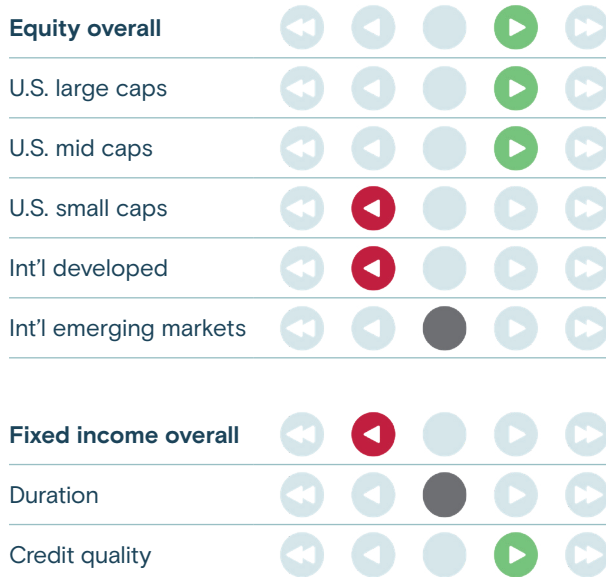
Given our broadly constructive outlook, we continue to recommend maintaining exposure to U.S. equities, favoring an overweight to large-cap stocks and a moderate overweight to mid-cap stocks as we expect continued strength to broaden. In fixed income, we expect modest flattening of the yield curve, favoring longer-dated Treasury securities and higher-quality corporate bonds. Investment-grade corporate bond spreads (the yield paid over comparable Treasuries) are relatively narrow, but as their absolute yields remain attractive, we expect continued demand.

## Key points

- + **U.S. Federal Reserve:** New leadership and persistent higher inflation measures signal changes coming
- + **Capital spending:** Increase in AI-related capital spending is starting to switch to erosion of free cash flow
- + **Signs of rotation:** Markets are starting to broaden beyond large-cap technology stocks
- + **Earnings:** Strong earnings have been a key positive driver of equities this year

## Asset class weighting

### KEY

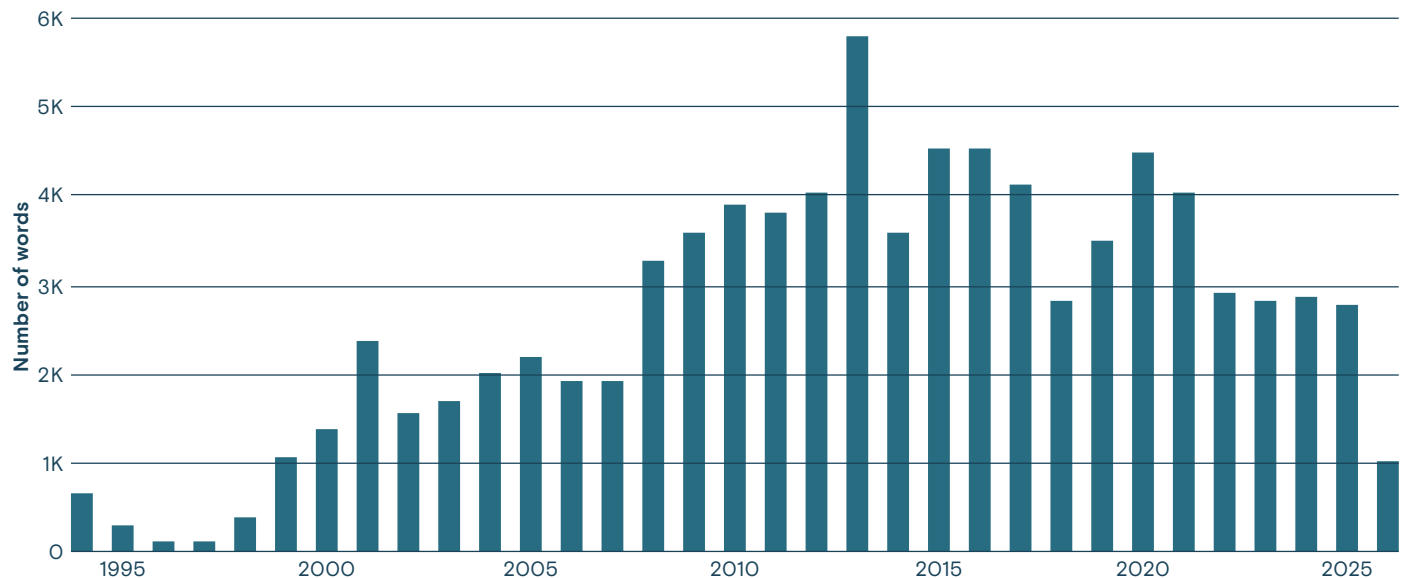


# Quarterly Highlights

## Less Fed communications may equal more volatility

FOMC policy statement word count

1994 – 2026



Source: Federal Reserve, Bloomberg

Kevin Warsh, the chair of the U.S. Federal Reserve (Fed), has been clear the Fed will offer less guidance on the expected future path of the Federal Funds rate. Both the first policy statement and the first press conference under Chair Walsh were brief and lacked clear guidance on Fed policy.

One likely result of less communication is more volatility in the market's assessment of the future path of the Fed Funds rate. This could in turn bleed into higher volatility in the U.S. Treasury market overall.

Volatility in the 2-year Treasury, which is very sensitive to the Fed Funds rate, steadily declined from Alan Greenspan's tenure as Fed chair (1987-2006) through Jay Powell's tenure, until volatility spiked with COVID-19 in 2020.

A key reason why volatility fell was increased forward guidance on the expected path of the Fed Funds rate in the wake of the financial crisis. The Fed communicated more, including the introduction of the so-called "dot plot" chart that

detailed forward estimates from each member of the Fed's rate-setting committee. The dot plot, which the market often watches very closely, also may be a casualty of more spartan Fed communication.

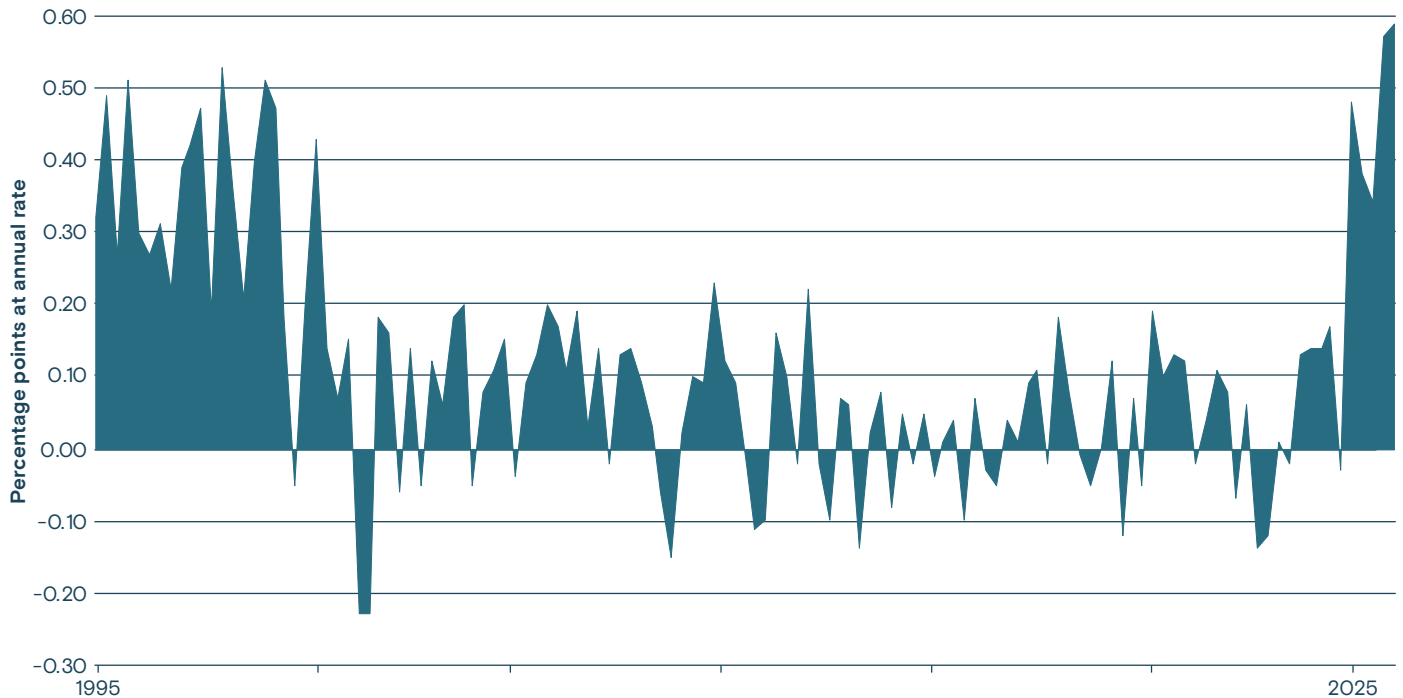
The word count of the first policy statement under Chair Warsh fell significantly versus previous FOMC statements. We may also see Fed committee members and regional presidents be cautious in their public statements. This shift in communications means market participants would have to make do with less information and do more work and develop their own views of where the Fed Funds rate will be based on broader economic and market data.

# Quarterly Highlights

## Capital spending

### Contributions to percent change in real GDP

1995 – 2025



Source: U.S. Bureau of Economic Analysis via FRED®

Capital spending, especially in AI-related companies, has provided a large tailwind to U.S. economic growth. Estimates of 2026 capital spending related to AI are as high as nearly 2% of U.S. GDP. This includes software, research and development, semiconductors, data centers, manufacturing facilities and other equipment.

AI leaders plan to ramp up future spending even higher. AI-related capital spending through 2030 could reach \$5.5 trillion dollars, according to some Wall Street estimates. The insatiable demand for semiconductors, data centers and equipment also is driving up prices, fueling inflation in electronic components. Most of this capital spending has previously been financed out of operating cash flows.

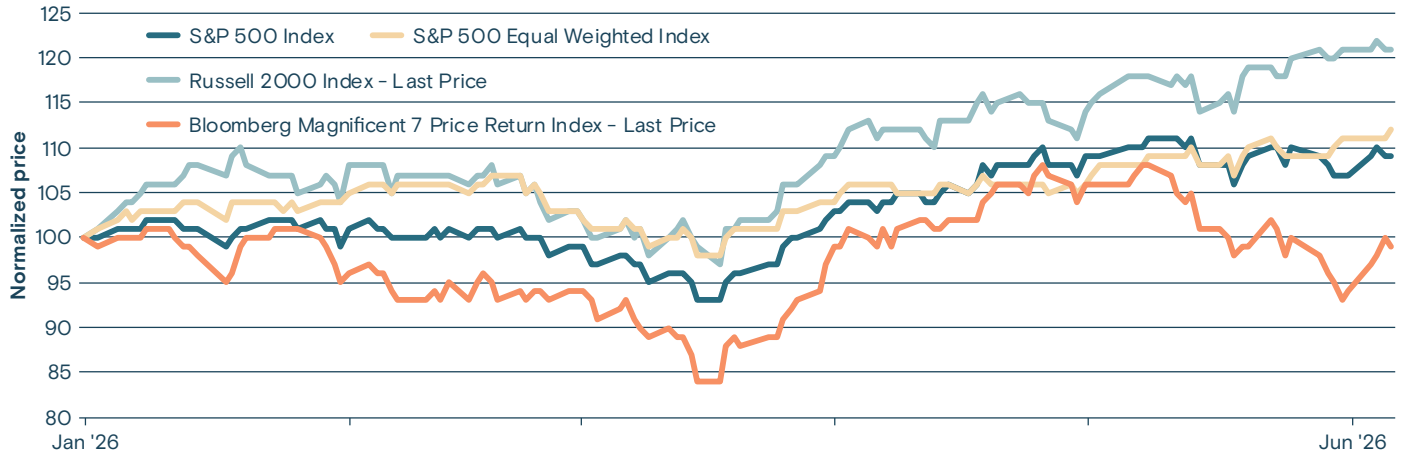
This is changing, however, as capital spending begins to erode free cash flow. As result, the so-called “hyperscalers” (Microsoft, Google, Meta, Amazon and Oracle) have started to tap debt markets to fund their expansion, increasing balance sheet leverage in the process. Hyperscaler balance sheets generally remain solid. For example, credit default swaps prices (a market-based indicator of default risk) on Oracle have increased significantly. So far, however, debt markets have absorbed the surge in debt issuance but are closely watching leverage and whether the hyperscalers will be able to produce enough AI revenue and earnings to justify the heavy capital spending.

# Quarterly Highlights

## Signs of rotation

### Historical comparison of indexes

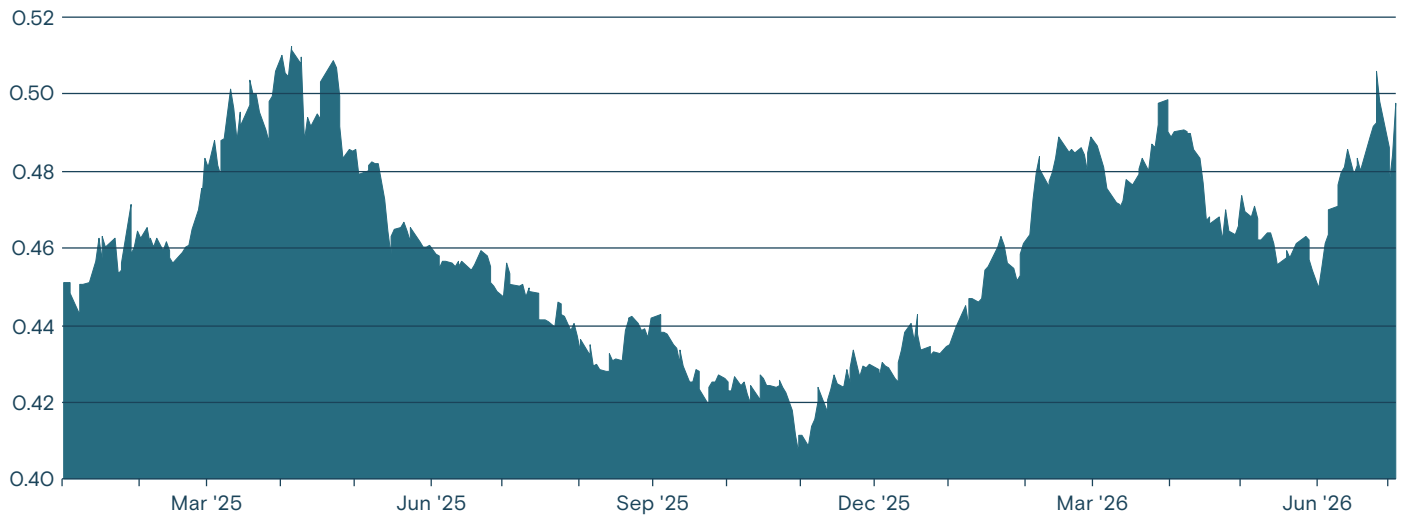
January 2026 – June 2026



Source: Bloomberg

### Russell 1000 Value and Russell 1000 Growth ratio

January 2025 – June 2026



Source: Bloomberg

The S&P 500® Index returns and earnings have been driven much of the past year by the mega-cap technology stocks. The top 10 stocks by market capitalization, which are largely technology names, have accounted for around 40% of the S&P 500's market capitalization. Technology stocks also have driven strong earnings. S&P 500 earnings grew about 20% in the first quarter. Without technology stocks, earnings growth would have been roughly cut in half.

Markets, however, have started broadening beyond large-cap technology. Earnings expectations are increasing for small-cap and mid-cap companies.

The performance of value stocks has also improved as investors seek to diversify away from artificial intelligence leaders due to concerns over high valuations. Additionally, the equal-weighted S&P 500 index also has started to outperform the market-cap weighted index. This broadening has been supported by better than expected economic growth, with data surprising to the upside.

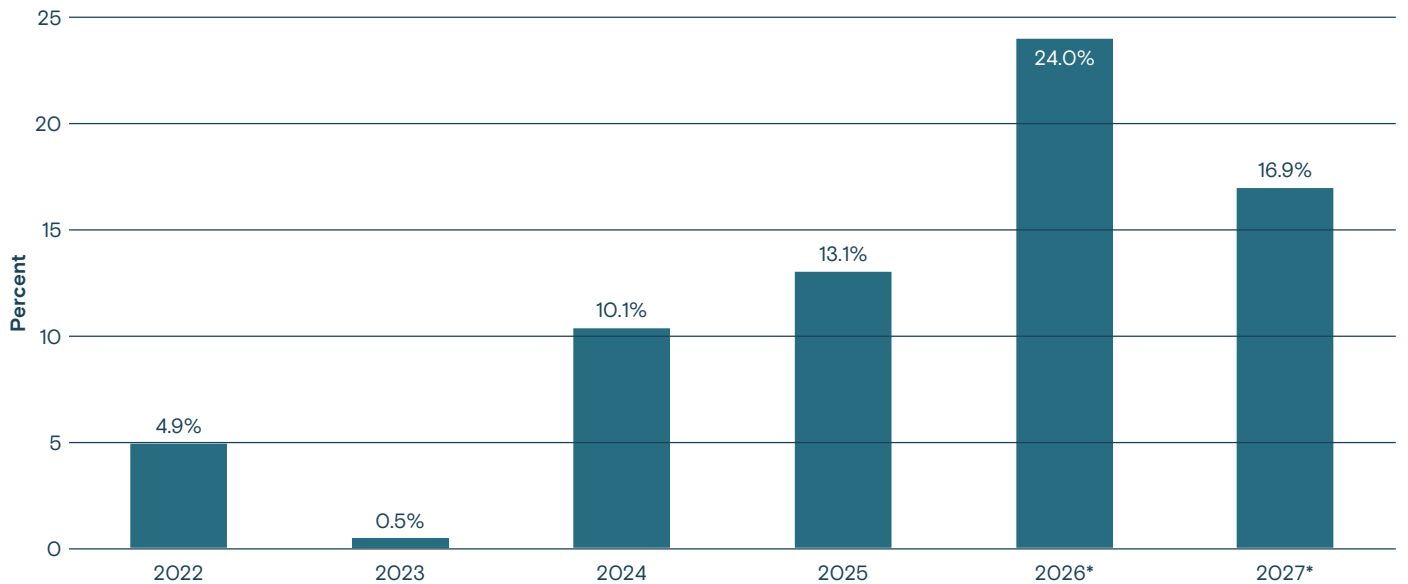
We expect broadening to continue as investors seek to diversify away from concentration in a handful of mega-capitalization stocks.

# Quarterly Highlights

## Earnings

### S&P 500 Index annual earnings growth

2022 – 2027\*



Source: Bloomberg

\*Estimated

Strong earnings have been a key positive driver of equity markets this year. Solid economic growth and the AI boom have fueled earnings growth. Second quarter earnings are expected to grow 23% year over year on 12% growth in sales, resulting in expanding profitability and margins. The robust pace of earnings also is expected to continue through 2026 and into 2027, with estimates of 24% and 17% growth.

Much of the growth has been driven by mega-cap technology and AI stocks. For example, in the first quarter the so-called Magnificent 7 grew earnings by 63%, versus 17% for the other 493 stocks in the S&P 500. Solid earnings growth, however, is broadening beyond large-cap growth into small caps and value stocks. One impact of stronger earnings growth is that it mitigates rich valuations, such as the widely watched price to earnings ratio (P/E).

Micron Technology offers a good example of this phenomenon. After Micron reported better than expected Q1 earnings and raised guidance on forward earnings, its stock rose nearly 16%. Normally, a price jump of that magnitude would dramatically increase the P/E ratio, but forward earnings expectations increased sharply. The result was a lower valuation multiple, not a higher one.

We expect continued solid earnings growth into the third quarter, supporting equity markets. Over time, earnings drive equity markets.

# Overall Views

## Equity vs. fixed income

▶ Overweight equities ◀ Underweight fixed income

The second quarter served as a reminder of how quickly market narratives can shift. After a soft start to the year, including a challenging March, the S&P 500 rose 14.9% in Q2, its strongest quarterly performance since the 20% rebound that followed the 2020 shutdown.

The rally was initially fueled by an easing of Middle East tensions, before AI, earnings and an improving economic picture took over. While the AI trade remains the dominant narrative, it is worth acknowledging that, as of this writing, the S&P 500 Equal Weight Index, which is far less affected by the AI and mega-cap technology trade, is setting all-time highs.

The economic landscape improved as well. The nascent acceleration we described in our Q2 outlook gained traction, with manufacturing sentiment, production data, retail sales and the labor market building on their Q1 improvement. At the same time, inflation remains a concern, as does the housing market and consumer sentiment. Even so, spending has held up. While consumer sentiment surveys range from poor to very poor, consumers continue to spend. In fact, excluding the

post-shutdown recovery period, the most recent retail sales report showed the strongest year-over-year gain in more than a decade.

The market is in something of a consolidation phase. The second-quarter gains were not only strong, but unusually consistent. After a move of this nature, a period of consolidation is not just healthy, it's necessary. Without it, the market risks becoming stretched and vulnerable to a sharper pullback.

A new Fed chair has added another factor for investors to digest. The more hawkish-than-expected tone of Kevin Warsh's first press conference raised the odds of a rate hike before year-end. For now, however, the more likely near-term impact is elevated market volatility around inflation data releases.

Against this backdrop, we maintain a modest equity overweight in asset allocation strategies. Improving earnings, economic momentum and market breadth support continued equity exposure. At the same time, inflation risks, Fed uncertainty and the speed of the rally argue for measured positioning.

## Equity: U.S. versus international

▶ Overweight domestic ◀ Underweight international

The S&P 500® Index outperformed developed international equities by 4% in Q2 and by 1% over the prior 12 months. In contrast, emerging market equities outpaced the S&P 500 by 9% in Q2 and 22% over the past year, driven largely by outsized gains in South Korea and Taiwan, whose markets have a large concentration in AI-related stocks.

We maintain an overweight to domestic equities, a modest underweight to developed international markets primarily via the Eurozone, and a neutral stance on emerging markets. Structural headwinds in the Eurozone, including larger demographic challenges, higher regulatory burdens and less innovation and investment, remain intact.

In the near term, Eurozone fixed investment has pulled back, sentiment is subdued and inflationary pressures reappeared after energy prices rose due to the war with Iran. However, energy prices fell meaningfully in June, and further resolution to the conflict could support a short period of Eurozone outperformance. As such, we are looking for a more attractive opportunity to increase our underweight to the region.

Our neutral positioning in emerging markets reflects a balance between the potential durability of the rally in AI infrastructure and the elevated risk of a meaningful reversal with such a narrow market driven by only a few companies in a couple countries.

## Equity: Market cap

◀ Underweight small caps ▶ Overweight mid caps ▶ Overweight large caps

Large caps, as measured by the S&P 500 Index, underperformed the Russell 2000 by 6% in Q2 and 19% over the past year. A one-year return gap of 20% or more in favor of the Russell 2000 versus the S&P 500 is uncommon, occurring only about 3.5% of the time over the past 30 years using daily data.

This has coincided with a rising risk appetite in the market, as evidenced by continued meaningful outperformance of lower-profitability companies. We continue to believe that the ability of smaller, fast-growing companies to remain private for

longer, enabled by deep private markets, results in a structural advantage for large caps in public markets.

Historically, periods of significant low-quality, low-profitability outperformance are typically followed by a return to leadership from higher-quality, more profitable companies, which are more heavily represented in large caps.

As a result, we are somewhat underweight public small caps, moderately overweight mid caps and overweight large caps domestically. In addition, our private equity allocation is concentrated in smaller companies.

# Overall Views

## Fixed income: Duration and rates

● Neutral duration

Interest rates rose across most of the Treasury curve in the second quarter. Short-term rates, such as the 2-year Treasury, rose the most. Short-term rates are more sensitive to expectations for the Fed Funds rate, which increased as the market fully priced in a Fed rate hike for 2026. The benchmark 10-year rate rose moderately while long-term rates such as the 30-year rate fell slightly due to lower inflation expectations and a lower term premium, which describes the additional return investors require for holding bonds of longer maturities.

The benchmark 2-year yield to 10-year yield Treasury curve spread flattened in the quarter as the 2-year rate rose while the 10-year rate increased less. Year-to-date Treasury rates have risen across the curve with short rates up the most and long-term rates up marginally. Short rates increased as the market began to expect Fed rate increases after oil prices rose due to the war with Iran.

By the end of the second quarter the market was pricing in more than one 0.25% rate increase as the Fed appeared to shift toward a more hawkish outlook given persistent

inflation. The Fed's favored inflation measure, the core Personal Consumption Expenditures (PCE) price index, has been higher than the Fed's 2% target since 2021. Core PCE excludes volatile elements such as food and energy, but persistently high energy prices can bleed into the prices of broader goods and services as they push up input costs.

We expect the Fed to hike once this year to send a signal that it will no longer tolerate consistently missing on its 2% inflation target. The new chair of the Federal Reserve, Kevin Warsh, has emphasized keeping inflation under control.

We expect short-term rates to rise only moderately as the market already has priced in Fed hikes. We also expect long-term rates to remain at a high level.

As a result, we are positioned for a flatter curve with a moderate duration overweight on the long-end of the Treasury curve as hedge for a risk-off move in markets. We are underweight duration on the short end of the curve due to a hawkish leaning Fed.

## Fixed income: Credit quality

▶ Overweight investment-grade corporates ◀ Underweight high-yield

Fixed-income credit spreads, which refers to the difference in yield compared to government bonds of the same maturity, tightened in the second quarter. This was a reversal from the first quarter, in which war-related uncertainty led to spreads widening.

Investment-grade corporate spreads narrowed in the quarter, along with emerging markets debt spreads. High-yield credit spreads also decreased from wider levels. Year to date investment-grade credit spreads are tighter along with emerging markets debt spreads. High-yield spreads are moderately wider, however, due to concerns over the impact of AI on the software sector and increasing debt loads in the technology sector to fund capital expenditures.

Spreads entered the year at tight levels and have contracted further into the richest decile of long-term historical levels. Rich spread levels, however, are supported by strong corporate fundamentals, an improving economic outlook and strong demand for credit. While spreads are tight, yields are at attractive levels, sparking demand from investors. Returns in the quarter were in the mid- to low-single digits, driven by tighter spreads and income, which were offset in part by higher Treasury rates.

Looking ahead we expect credit to remain in a range supported by a solid economy and strong earnings. However, continued high debt issuance to fund the build out of artificial intelligence could pressure credit spreads wider, with estimates of 2026 capital spending from the leading AI large-cap companies running as high as \$750 billion or more.

Credit markets so far have absorbed the new debt but there are growing concerns over increasing debt levels and deteriorating fundamentals due to capital spending absorbing more of operating cash flow. Also, the chance of renewed conflict in the Persian Gulf remains a risk to oil markets and credit quality. We remain moderately overweight credit—favoring high-quality credit, such as investment-grade credit, securitized credit and investment-grade emerging markets debt.

We also favor collateralized loan obligations (CLOs) over leveraged loans. We are underweight lower-quality credit, such as leveraged loans and high yield, which have weaker fundamentals and would be pressured by higher interest rates.

**Financial professionals: contact your Thrivent Asset Management Consultant to learn more.**

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All information and representations herein are as of 7/8/2026, unless otherwise noted.

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