

GLOBAL MARKETS Commentary



Private Wealth

BMO Nesbitt Burns

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Script Flip

"If you're not a little confused about what's going on, you don't understand it."

– Charlie Munger (1924–2023), businessman, investor and philanthropist

In the third quarter of 2026, several prevailing narratives – both positive and negative – moved farther and faster than expected. The script flipped (and back again, for some) on AI, central bank rate hikes, and where bond yields can go before upsetting the economic or equity-market apple cart.

The AI economy is powering ahead; one day that's great, the next it's doom. All new technologies feature this dichotomy. Central banks have turned hawkish and are now seen as potential spoilers. Such shifts typically provoke a broad market reaction. However, this time the bond market went wild while most other assets remained remarkably calm.

That divergence is striking because bond yields help determine the price of virtually every asset. Despite the sharp rise in bond yields, most global equity markets added another 1% to 3% to year-to-date gains in Q3. This cooling from the torrid pace set earlier in the year is hardly a sign of distress.

Year-to-date gains for North American equity indices hover around 12%. Small- and mid-cap equities were hurt in Q3 yet remain up 13% in the U.S. and 19% in Canada. Emerging markets (MSCI EM) were softer by 1% in Q3, but lead year to date, posting a 21% gain. International developed markets (MSCI EAFE) added 0.3% in Q3 to deliver an 8% year-to-date return.

Bond yields break out

Bond yields rose sharply on the back of strong economic data that coincided with a return to elevated oil prices after the collapse of the Iranian ceasefire. Global central banks could not ignore the combination. Some began raising rates and all reinforced their commitment to keeping inflation under control. This pushed the narrative around rate hikes to an extreme.

Still, we're not seeing a replay of 2022. Canadian bond yields moved from the low 3% range toward the low 4% range; U.S. Treasury yields are roughly one percentage point higher. The U.S. Federal Reserve raised rates, while the Bank of Canada remains on hold for now. The FTSE Canada Universe Bond Index fell 3% during the quarter, flipping the yearly gain to a 0.8% loss.

Resilience remains the key theme for equities. Stocks continue to absorb higher oil prices, rising real yields and political uncertainty because global growth and corporate earnings keep surprising to the upside.

The question for markets is no longer whether good things are happening. Instead, the question is whether there is too much of a good thing.

Good things

The global economy is showing broad-based strength. Global growth is supporting profits across countries and industries. Earnings have moved from merely good to outstanding, consumers (including many lower-income households) remain resilient, unemployment is low, and corporate margins are holding up despite supply shocks, tariffs and cost pressures.

Business spending on AI is evolving from a technology-centric trade into a much broader capital-investment cycle. Spending on AI innovation and infrastructure continues while corporate investment downstream is becoming increasingly evident thanks to technology adoption by businesses large and small.

Manufacturing and service-sector businesses are adopting AI, developing applications for it, or purchasing this new general-purpose technology. The AI-ecosystem is also generating mergers and acquisitions, initial public offerings and debt-financing needs. The economic spin-offs are mounting.

Too much of a good thing

The main risk is that there is too much of a good thing: all this activity could cause the global economy to run too hot and push it beyond its capacity. Shortages could slow the expansion, intensify inflation and force central banks to raise short-term rates more aggressively. Adding another layer of uncertainty are concerns about excessive data-centre construction and security breaches, plus heavy use of water, land and electricity.

Demand for funds is rising because of accelerating private-sector borrowing and still-elevated government financing needs. The price of anything rises in the face of increased demand; bond yields – the price of money – must adjust accordingly. Traditional long-term buyers are becoming less dominant while investors who are more price sensitive are emerging and insisting on greater compensation for holding bonds for a longer period in addition to taking on fiscal and inflation risks.

Higher yields are not inherently bad. If economic demand is driving them then the higher price of capital can encourage more efficient decisions by governments, businesses and households. In our view, yields remain within a range where that feedback is constructive rather than destructive.

Tighter policy brings consequences

Interest rate increases are a blunt instrument. They will weigh most heavily on rate-sensitive areas (e.g., real estate and lower-income consumers) although those are not the parts of the economy running hot.

Tighter policy will dampen some growth and may slow the broadening of the expansion. Still, borrowing costs are not expected to rise enough to derail the AI buildout itself. Inflation may cool to reflect weakening demand elsewhere, but not necessarily in the sectors creating the most pressure.

The inflation signal embedded in higher yields is also less straightforward than the headlines suggest. Demand-driven inflation, elevated oil prices, tariffs, reshoring and weather-related pressures from the “super” El Niño remain prominent concerns. Nevertheless, market-based inflation expectations remain subdued as central banks use hawkish rhetoric and recent rate hikes (plus the threat of more) to tamp down longer-term inflation expectations.

This summer, we characterized potential central bank rate increases as “credibility hikes,” meaning that central bankers are increasing rates to broadcast their independence from political interference and signalling that they are paying attention to inflation pressures. That remains our view.

The cure for high yields is high yields

In our view, the narrative shift on inflation and interest rates is too dogmatic, one-directional and widely held. The bond market is pricing in more policy tightening than we believe will be necessary. Market-implied odds in the U.S. and Canada point to overnight rates roughly one percentage point higher by the end of spring 2027. That is happening even though the bond market is already doing part of the central banks’ work: key North American bond yields have risen 75 to 150 basis points year to date. Market pricing has reached a point where a positive surprise on inflation and rate-hike expectations is possible.

Imagine this scenario: fast-forward three quarters (maybe only three months) and inflation is less of a problem than expected (which doesn’t mean it is good, it’s just not accelerating). Or, what if economic growth and labour markets show signs of strain? In either scenario, the narrative from central banks will flip again and we could be back to talking about rate cuts, especially if policymakers have made some hikes in between.

If rate cuts are back on the table, the reason will matter a lot. Should inflation end up being less of a concern than currently expected – and central bankers can return to looser policy – then stocks and bonds are likely to respond well.

If impaired growth or unemployment are the reason central banks turn dovish, that sounds a lot like a typical mid-cycle slowdown, which is familiar territory for capital markets and the business cycle. Stock markets would be unhappy with this situation; mid-cycle slowdowns typically see equity market declines in the 10% to 15% range. Not pleasant, but not a rout or unusual (stocks dropped 9% earlier this year). This is not our base case scenario. Central banks have only just turned hawkish. Numerous rate hikes contemplated today are on paper only, so nothing is baked in yet.

Are yields really high?

Headlines emphasize that yields are at multi-year highs. That is true. Even so, the better question is whether today’s levels are unusually high or are we simply adjusting after a period of ultra-low yields? We favour the latter interpretation. Yields are normalizing from historic lows that were artificially depressed by tight monetary policy.

In a world of robust real growth and above-target inflation, yields from the 3% range to the high 5% range across the U.S., Canada, Europe and Japan broadly reflect, as they should, nominal economic growth in those economies.

Equities smooth on top, valuations adjusting underneath

Nominal and real yields have moved decisively through levels once thought to be hazard zones for stocks. U.S. 10-year Treasury yields are above 5% and TIPS (Treasury Inflation-Protected Securities) real yields are approaching 3%. Many suggested that 5% was a threshold where stocks would stumble; in the past, real yields above 2.3% posed a problem for stocks.

The fact that bond yields have crossed levels once considered red lines for stocks (and brought minimal disruption) suggests the yield levels remain digestible. That is at the top index level, however, and needs to be put into context. Under the surface there is volatility. This suggests equity markets aren't whistling past the graveyard – they are aware of and reacting to central bankers' newfound hawkish tendencies and the realities of higher bond yields.

The main casualties of higher bond yields are equity-valuation multiples. Global equity markets have posted meagre gains over the last three months, despite exceptionally strong earnings growth and significant surprises. The result is a moderation in equity valuations.

There are two ways to lower price-to-earnings multiples: reduce prices or increase earnings. Stocks are making both adjustments, sector by sector and stock by stock, as they should.

In Canada, only three sectors posted a quarterly gain: information technology, materials and energy. It is notable that the S&P/TSX gained 2% while eight sectors declined, showing deference to the rising yield backdrop. In the U.S., market breadth was better; five sectors drove the S&P 500 to a 3% quarterly gain; yet here, too, the sector winners largely lined up along inflation or AI themes.

U.S. small caps and interest-rate-sensitive sectors were hit hardest, declining between 6% and 9% during the quarter. These results are consistent with the sharp rise in bond yields.

Asset mix considerations – fixed income is becoming more attractive

Our outlook remains constructive on risk assets. Equities are still our recommended source of return generation. Higher bond yields are improving the prospective return profile of fixed income.

We continue to recommend favouring Canadian and U.S. equities, where earnings fundamentals remain strong and sector exposures are complementary. Canadian equities provide exposure to financials, energy and commodities, while U.S. markets continue to benefit from technology leadership and innovation.

Asset mix recommendations

	Income			Balanced			Growth			Aggressive Growth		
	Recommended Asset Mix	+ / -	Benchmark Weights	Recommended Asset Mix	+ / -	Benchmark Weights	Recommended Asset Mix	+ / -	Benchmark Weights	Recommended Asset Mix	+ / -	Benchmark Weights
Cash	3	(-2)	5	3	(-2)	5	5		5	5		5
Fixed Income	67	(-3)	70	40	(-5)	45	20	(-5)	25	0		0
Equity	30	(+5)	25	57	(+7)	50	75	(+5)	70	95		95
Canadian Equity	16	(+3)	15	28	(+3)	25	38	(+3)	35	40		40
U.S. Equity	7	(+2)	5	17	(+2)	15	22	(+2)	20	35		35
EAFE Equity	5		5	5		5	5		5	10		10
Emerging Equity	0		0	7	(+2)	5	10		10	10		10

Having remained patient with updating our price targets throughout the volatility of the year so far, we remain comfortable with our 2026 year-end price targets of 7,800 for the S&P 500 and 36,800 for the S&P/TSX.

The bottom line: Freely functioning capital markets can find the right equilibrium

The global economy is heating up and AI investment is already running hot. If cooling is required, properly functioning bond markets will deliver the higher yields that slow demand. At the same time, higher bond yields give investors more choice and more attractive return prospects.

It's important to note that conditions now are different than they were in 2022. Yields are not starting from near zero, inflation is not in the high single digits, and there is no talk of stagflation. Four years ago, these conditions produced the double whammy of poor stock and bond returns; the setup is not the same today.

Bond yields have moved higher; that adjustment may be exactly what the global economy needs to relieve the pinch points created by its own strength.

The beauty of bonds is that moving to higher yields is painful, although higher yields make bonds more attractive thanks to the increased income they offer. Plus, they bring added upside potential if yields retreat.

Charlie Munger's quote, "if you're not a little confused about what's going on, you don't understand it," is tongue-in-cheek (like many of his observations). We agree that the current environment can seem confusing. Yet, no matter what happens, we are alert, vigilant and confident about the appropriate recipe for investment: stay diversified and disciplined, rebalance when/if necessary.

Please contact your BMO Nesbitt Burns Investment Advisor if you have any questions or would like to discuss your investments.



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