Strength That Demands Discipline

What The Economic Reports Are Really Signaling

by John E. Chapman

October delivered two pieces of news that, on the surface, appear to tell a comfortable story. On October 28, the Federal Reserve left interest rates unchanged, and the very next morning the Commerce Department reported that the economy grew at a 3.4% annual pace in the third quarter, its fastest in a year and well ahead of what many had expected.

A pausing Fed and a strong economy sound like the opening lines of a soft landing. I believe the correct interpretation is a bit more nuanced than that. In my judgment, both reports point to an economy with more momentum, and more inflation pressure, than most investors had planned for at the start of the year. That is not a reason for alarm. It is a reason for discipline, and it shapes how we are positioning portfolios for the final weeks of 2026 and for 2027.

What I Saw Beneath the GDP Headline

The 3.4% figure actually understates the strength of private demand. Two large and volatile items nearly canceled each other: rebuilding inventories added 1.61 percentage points to growth, while a surge in imports subtracted 2.64 points. Set those aside, along with government spending, and we see that spending by American households and businesses grew at a very strong 4.9% rate, the fastest pace since the spring of 2021. Equipment investment rose at a 20.9% pace, the highest since 2020, as the artificial intelligence buildout moved from announcements to purchase orders. Consumer spending held at a solid 3.8%.

The figure I am focused on, however, is not the real growth rate. It is nominal growth, which rose by 5.6%. Nominal growth measures the economy in today's dollars, before inflation is removed, and because interest rates are quoted the same way, it is the fairest yardstick for judging whether rates are high or low. When the nominal economy is growing at better than 5%, and the 10-year Treasury yields a little under 5%, monetary policy is not considered to be "tight". In other words, it is not restraining economic activity in a meaningful way. That single comparison explains a great deal about why the Fed is not finished, and why I believe investors should stop measuring current data trends against the low-rate world of the last decade.

It is also important to be candid about what the quarter did not show. The economic strength in the GDP numbers was concentrated in July and August. In September, inflation-adjusted disposable income fell 0.3%, and inflation-adjusted spending was flat, with some households drawing on savings to keep up. Employers added only 29,000 jobs in September, and the unemployment rate stands at 4.2%. Consumer sentiment registered 48.0 in October, near the lowest readings on record, and 56% of respondents said high prices were hurting their finances. The economy visible in the GDP report and the economy many families experience at the gas pump are both real. One is powered by corporate investment and by households with assets; the other is squeezed by gasoline above $4 a gallon.

Many of our clients live on the asset-owning side of that divide, and I think it is important to recognize that this gap is now shaping politics, policy and, ultimately, markets.

Why I Do Not See the Pause as a Pivot

The Fed held its benchmark rate at 3.75% to 4%, a month after raising rates in September for the first time since 2023. The details matter more than the decision. Two members, Governor Lisa Cook and Cleveland Fed President Beth Hammack, dissented in favor of another quarter-point increase. The statement upgraded the Committee's description of the economy from solid to strong and closed with a sentence that potentially telegraphs their next move: "The Committee will deliver price stability."

Futures markets now assign roughly an 80% probability to a hike at the December meeting. With consumer prices up 3.7% over the past year, core PCE inflation at 3.1%, and household inflation expectations at 4.7% for the year ahead and 3.5% over the long run, I view October as a pause for additional information and timing, coming days before an election, rather than a change in direction.

The conventional playbook says a central bank should look through an oil shock, since higher energy prices slow growth on their own. Brent crude finished October at about $117 a barrel, up nearly 14% for the month and far above its level of roughly $72 before the conflict with Iran began. This Fed is choosing not to look through it, because demand is strong and expectations are drifting. President Trump has indicated something meaningful relative to the conflict with Iran could emerge immediately following the midterm elections. Reading between the lines, many think this signals a significant uptick in military activity and further near-term pressure on higher oil prices.

All of this is a meaningful departure from the past decade, and investors should treat it as such.

Two other comments from Chairman Warsh deserve more attention than they received. First, he suggested that recent stock market declines could themselves help cool inflation by slowing spending among wealthier families. We should take that comment seriously. It potentially signals that the level of market weakness that would prompt the Fed to come to the rescue is further away than investors have grown accustomed to in recent years. Second, he said he is confident productivity gains can let the economy grow faster without generating as much inflation. If he is right, 2027 could be a very good year. If he is wrong, more rate increases will follow.

Finally, the Fed announced it will hold fewer policy meetings beginning next year. Combined with the Chairman's stated reluctance to offer forward guidance, I expect fewer policy clues from the Fed and larger market reactions around each decision.

The way I read all of this is that we do not need to know exactly how these details play out; we need to position portfolios for a wider range of possible outcomes.

What I Believe Markets Are Telling Us

The S&P 500 slipped 0.9% in October, while the Nasdaq Composite fell 5.3%, its worst month since March 2025, and the Dow Jones Industrial Average rose 1.7%. Disappointing results and heavier spending plans from several of the largest technology companies prompted the selling pressure. Meanwhile, energy, financials, utilities, and healthcare all advanced, and the S&P 500 remains up roughly 10.7% for the year.

This said, I do not interpret October's weakness among the technology names as a rejection of the artificial intelligence story. The GDP report makes plain that the investment is real and large. What I see is a market beginning to separate companies that can fund their ambitions from their own cash flow from those that must borrow to keep pace. Earlier this year we described the AI buildout as a credit story as much as an equity story, and October was the first month in which equity investors priced it that way. I consider that healthy. Leadership that broadens beyond a handful of names is a sturdier foundation than leadership that narrows.

The bond and gold markets offered an even more interesting signal. In September I described gold and the 30-year Treasury as the market's running verdict on the Fed's resolve. In October both rendered a provisional judgment in the Fed's favor. The 30-year yield fell from 5.60% on October 9 to 5.31% at month end, and the 10-year returned below 5%. Gold declined about 7% for the month and now sits well below its January peak.

Put simply, a central bank willing to raise rates was rewarded with lower long-term borrowing costs and less demand for protection against monetary drift. That is how credibility is supposed to work, and it is one of the more encouraging developments I have seen this year.

What I Am Watching for 2027

As we turn toward the new year, I am less interested in a precise forecast for the S&P 500 than in the conditions that will determine whether this expansion continues on sound footing. Four things stand out.

The first is the interest rate picture itself. I expect short-term rates to remain higher than many investors hope, while long-term rates may prove more stable if the Fed keeps its credibility.

For the first time in many years, high-quality bonds and cash reserves are earning a genuine return after inflation, and that changes the arithmetic of a balanced portfolio.

The second is the shift in artificial intelligence from promise to proof. In my view, 2027 is the year when the enormous capital commitments of the past two years must begin to show measurable returns, and I expect a wider gap between winners and laggards than the market has priced.

The third is energy. A durable easing of the conflict in the Middle East would be the single largest disinflationary surprise available to the economy and could allow the Fed to stop sooner than markets expect; a further escalation would do the opposite. I would not build a portfolio around forecasting either outcome, but I would be sure it can absorb both.

The fourth is the American consumer. Falling real incomes and shrinking savings cannot support spending indefinitely, and I will be looking closely for signs that the wealth effect from higher asset prices is fading.

Finally, the midterm elections take place on November 3, and as we discussed last month, I believe their market consequences will be felt through fiscal negotiations, trade policy and confirmations over many months rather than on election night.

How We Are Preparing Portfolios

Our approach is grounded in the conviction that a strong economy with stubborn inflation rewards patience, quality and diversification more than it rewards bold predictions. We are rebalancing portfolios toward their long-term targets after a year in which a narrow group of companies drove much of the gains, and we are paying particular attention to concentrated positions that have grown beyond their intended weight.

Within fixed income, we are locking in today's yields in high-quality bonds where it fits each client's plan, while keeping appropriate liquidity in short-term Treasuries. We have also reviewed taxable accounts for opportunities to harvest losses created by October's volatility. As we do every year, we are completing required minimum distributions from retirement accounts and helping clients complete charitable and family gifts before the calendar closes.

If you would like to review any of these steps or simply talk through what the year ahead may mean for your family, I hope you will reach out to your Clearwater advisor or to me directly. Thank you for the trust you place in us to help you make good decisions in our ever-changing world.

With gratitude and warm wishes for Thanksgiving,

John Chapman
Chief Executive Officer
Chief Investment Strategist



THIS COMMENTARY HAS BEEN PREPARED BY CLEARWATER CAPITAL PARTNERS. THE OPINIONS VOICED IN THIS MATERIAL ARE FOR GENERAL INFORMATION ONLY AND ARE NOT INTENDED TO PROVIDE OR BE CONSTRUED AS PROVIDING LEGAL, ACCOUNTING, OR SPECIFIC INVESTMENT ADVICE OR RECOMMENDATIONS FOR ANY INDIVIDUAL. ALL ECONOMIC DATA IS DERIVED FROM PUBLIC SOURCES BELIEVED TO BE RELIABLE. TO DETERMINE WHICH INVESTMENTS MAY BE APPROPRIATE FOR YOU, PLEASE CONSULT WITH US PRIOR TO INVESTING. INVESTING INVOLVES RISK WHICH MAY INCLUDE LOSS OF PRINCIPAL.

This material is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities, insurance products, or to adopt any investment strategy. The opinions expressed are as of the date of writing and may change as subsequent conditions vary. The information and opinions contained in this material are derived from proprietary and nonproprietary sources deemed by Clearwater Capital Partners to be reliable, are not necessarily all-inclusive and are not guaranteed as to accuracy. Past performance is no guarantee of future results. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader. Investment involves risks. International investing involves additional risks, including risks related to foreign currency, limited liquidity, less government regulation and the possibility of substantial volatility due to adverse political, economic or other developments. Index performance is shown for illustrative purposes only. You cannot invest directly in an index. S&P 500 is a registered trademark of Standard & Poor's Financial Services, a division of S&P Global ("S&P") DOW JONES, DJ, DJIA and DOW JONES INDUSTRIAL AVERAGE are registered trademarks of Dow Jones Trademark Holdings ("Dow Jones"). NASDAQ-100 Index®, NASDAQ-100®, NASDAQ Composite Index® are registered trademarks of The NASDAQ OMC Group, Inc. The two main risks related to fixed-income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. Private Market investing is for Accredited Investors and Qualified Purchasers only. Private market investing involves liquidity risk as well as operational risk. Private debt is subject to credit and interest rate risk.

Investment Advice Offered Through Clearwater Capital Partners, A Registered Investment Advisor.