REGIONS ASSET MANAGEMENT

# Investment Strategy Outlook

SEPTEMBER 2026

## THE ECONOMY

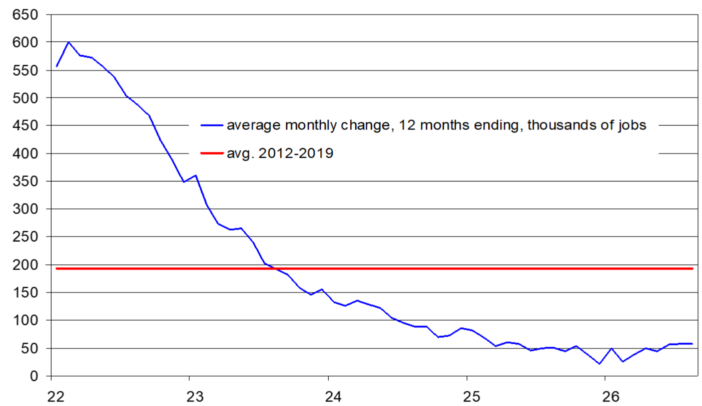
## Real GDP Growth: That Old Familiar Feeling?

Revised and more complete source data leave Q2 real GDP growth at an annual rate of 1.5 percent, matching the original estimate from the Bureau of Economic Analysis (BEA), with some shuffling of the underlying details amounting to a wash in terms of the headline growth rate. Real consumer spending is now reported to have grown at an annual rate of 3.4 percent, up from the initial estimate of 3.2 percent. Much of that upward revision, however, reflects growth in spending on health care being revised meaningfully higher, while at the same time growth in spending on goods was revised downward. Growth in real business fixed investment was revised modestly higher, but this mainly reflects a smaller contraction in business spending on structures than initially estimated while real outlays on equipment and machinery grew at a slower pace than initially estimated. The revisions yield growth in real private domestic demand, combined business and residential fixed investment and consumer spending adjusted for price changes, of 4.2 percent on an annualized basis, up from the initial estimate of 3.9 percent, which is the fastest quarterly growth rate since Q1 2023.

Recall that last month we discussed the blistering pace of revenue growth in Q2. At that point BEA had not released their estimates of Q2 corporate profits, which came alongside their revised estimate of Q2 real GDP. Using the GDP measure most consistent with how profits are estimated in the S&P 500 measure shows before-tax corporate profits increased by 9.6 percent in Q2, with after-tax profits up 8.9 percent, yielding year-on-year increases of 29.4 percent and 28.2 percent, respectively. This leaves pre-tax profit margins at their widest since 1951 and after tax margins wider than at any point in the life of the GDP data. To be sure, robust revenue growth is in part a reflection of the pace at which prices have been rising over recent years, but healthy profit growth is freeing up cash that is, in turn, helping support business capital spending, with cap-ex growth extending beyond AI related investment.

One storyline which has gone largely unnoticed is that real GDP growth has settled back into the same trend rate that we all came to know but not necessarily love over the decade-plus prior to the onset of the pandemic. Which may help account for why this may not seem like much of a story given that two words routinely used, including by us, to describe the pace of growth over what was the longest U.S. economic expansion on record were "frustratingly slow." Either way, over the past eight quarters, real GDP growth (measured as the year-on-year percentage change in not seasonally adjusted real GDP) has averaged 2.25 percent which, as you may recall, was the average pace of real GDP growth over the pre-pandemic expansion. We come neither to bury nor to praise 2.25 percent real GDP growth, though we could point to a few developed countries in which that pace of growth would feel like living in the fast lane. We could also point out that sustaining a steady pace of growth in light of the various shocks the economy has been subjected to over the past few years is quite an accomplishment.

**Private Sector Nonfarm Employment**




*Source: Bureau of Labor Statistics; Regions Economics Division*

Clearly, though, not all segments of the economy are moving in the same direction, let alone at the same pace, with the net result being that the economy almost seems destined for real GDP growth at or around that 2.25 percent pace. One reason so much attention is given to AI investment is that AI holds the potential to shift the trend rate of economic growth into a higher gear while pushing down the trend rate of inflation by fueling faster labor productivity growth. The reality, however, is that as we sit here today, no one knows for sure when those benefits will come or the magnitudes to which growth and inflation will be impacted, and many question whether the massive sums being directed toward AI investment will ultimately yield an adequate return. We are in the camp that believes AI will ultimately foster a faster sustained rate of productivity growth which, in turn, will boost real GDP growth while pushing the rate of inflation lower. Until then, real GDP growth is likely to bounce along at a rate not too different, in either direction, from the longer-term trend rate of 2.25 percent.

After hitting a more than four-year high in July, the Institute for Supply Management's (ISM) index of manufacturing sector activity settled back a bit in August. At 54.6 percent, however, the headline index showed an eighth straight month of expansion, and over this span growth has become more broadly based across the factory sector with fifteen of the eighteen industry groups included in the ISM's survey indicating growth in August. Order books continue to expand at a healthy clip which, along with still-expanding backlogs of unfilled orders, suggests continued growth in employment and output in the factory sector over coming months. One potential red flag, however, is that comments from survey respondents were far less upbeat on continued orders growth than had been the case over the prior several months, reflecting concerns over renewed hostilities in the Middle East and renewed salvos in trade battles amid the latest spat between the U.S. and Canada.

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At the same time, the ISM's survey continues to show persistent and broadly based upward pressure on input prices, with the prices paid index now having been above seventy percent for seven straight months. The story is much the same in the broad services sector. The ISM Non-Manufacturing Index rose to 55.4 percent in August, indicating ongoing expansion, and order books continue to grow while backlogs of unfilled orders continue to build, suggesting continued expansion in the services sector in the months ahead. Unfortunately, the story is also much the same when it comes to input prices, with the prices paid index in the ISM Non-Manufacturing Index also showing persistent and broadly based upward pressure on input prices. At a time when inflation remains firmly above the FOMC's two percent target rate, the ISM's monthly surveys show little relief from the early-stage price pressures that ultimately work their way into the broader inflation measures.

Total nonfarm payrolls rose by 162,000 jobs in August, handily topping our forecast of 121,000 jobs and blowing past the consensus forecast of 55,000 jobs. At the same time, prior estimates of job growth in June and July were revised up by a net 55,000 jobs for the two-month period. Job growth was notably broad based in August, with the one-month hiring diffusion index, a measure of the breadth of job growth across private sector industry groups, jumping to 55.6 percent – you have to go back to January 2024 to find a higher reading. Aggregate private sector wage and salary earnings rose by 0.7 percent in August, leaving them up 4.3 percent year-on-year. While the labor force participation rate ticked up by two-tenths of a point, the unemployment rate held at 4.1 percent as there was a similarly large increase in household employment. The broader U6 measure, which also accounts for underemployment, fell to 7.7 percent in August from 7.9 percent in July, largely owing to a sharp drop in the number of those working part-time for economic reasons.

Upon reading the preceding paragraph, you might be tempted to ask, "what's not to like?" about the August employment report, to which our answer would be "plenty." For starters, payrolls in leisure and hospitality services are reported to have risen by 62,000 jobs in August, with local government payrolls up by 50,000 jobs, accounting for a large chunk of the increase in total nonfarm payrolls. If these two industry groups sound familiar, they should, as we've routinely flagged them as primary sources of the seasonal adjustment noise that has plagued the monthly estimates of nonfarm job growth. Aside from being heavily concentrated amongst these two industry groups, August's increase in nonfarm payrolls follows a net increase of just 52,000 jobs over the prior two months.

That the monthly estimates of job growth have been so volatile and so riddled with seasonal adjustment noise has only increased our reliance on the longer-term trends in the not seasonally adjusted data, and on that basis job growth has been notably stable, even if not all inspiring. For instance, the unadjusted data show over the most recent twelve months nonfarm payrolls have increased by an average of just over 57,000 jobs per month, in line with the average pace that has prevailed since early-2025. While this pace is far below the pre-pandemic trend pace of job growth, it is nonetheless more than sufficient to keep the unemployment rate steady given a barely growing labor force. To that point, the unemployment rate held at 4.1 percent in August.

With a "low hire-low fire" labor market having largely stabilized, inflation is the main focus of the FOMC, yet the Committee remains sharply divided heading into this month's meeting. The FOMC's dilemma: inflation remains stuck well above their target rate but is being mostly sustained by supply side factors beyond their reach. The recent run-up in longer-term market interest rates is in part a reflection of market participants' concerns that the FOMC has fallen behind the curve and will, at some point, have to rush to catch up. As such, while we do not expect a Fed funds rate hike at this month's meeting, neither would we be surprised by one.

*Sources: Bureau of Economic Analysis; Institute for Supply Management; Bureau of Labor Statistics*

## STOCKS

# Potential Headwinds Converging, But U.S. Indices Remain On Firm Footing

After marking time in June and July, U.S. equity indices did better in August with the S&P 500 rising 2.6% and the small-cap Russell 2000 eking out a 0.8% gain. The equal-weight S&P 500 rose 2%, but rotation remained the story within the S&P 500 as some of July's worst performing sectors returned to favor in August. Meaningful upside was concentrated in three sectors with energy, health care, and information technology each rallying at least 4.7% on the month, while the industrial sector dropped 2.5%. Information technology sector continued to dominate headlines as earnings results rolled in, and the sector notched a 6.2% gain after falling 7.9% the month prior. But for the second consecutive month software, not hardware, garnered inflows; the S&P 500 Software industry group rose 13.6% in August as earnings releases out of the group put to rest for the "SaaS-pocalypse" narrative that made the rounds earlier this year.

In stark contrast to software, semiconductor stocks, which experienced a 20% drawdown in July, saw a more muted recovery as the Philadelphia Semiconductor index, or SOX, gained just 2% last month. The semiconductor industry mustered only a half-hearted recovery in August after July's selloff despite surprisingly strong sales guidance out of semiconductor stalwart Nvidia (NVDA) late in the month. After a positioning shake-out and deleveraging in semiconductor and memory stocks in July and with more reasonable valuations to be found, we would have expected robust guidance to offset negativity surrounding recent returns on AI-related investments and broadening pushback related to the data center buildout. There have been signs of improvement in perceived AI beneficiaries at the start of September, but if semiconductor stocks continue to run in place, tougher sledding will lie ahead for the S&P 500.

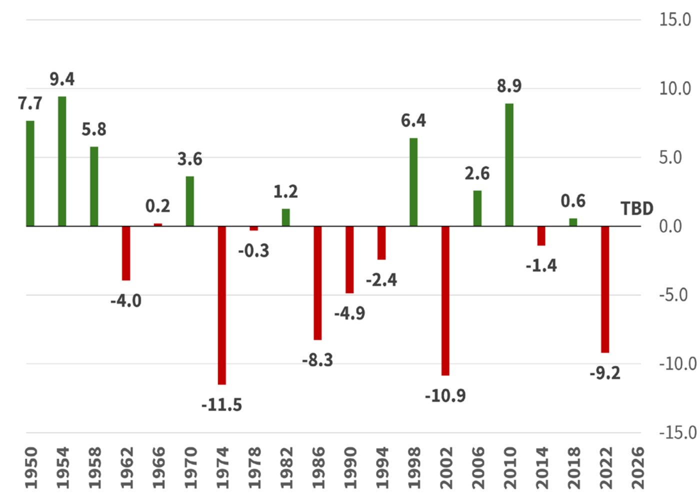
As the information technology sector has floundered in recent months, the energy and health care sectors have provided market leadership. The energy sector posted back-to-back monthly gains totaling over 20% while health care just closed out its fourth straight month in positive territory. The S&P 500 energy sector gained another 6.5% in August, and what may be most notable is that the sector's return easily surpassed 1.2% and 2.9% monthly gains in the price per barrel of West Texas Intermediate (WTI) and Brent crude oil, respectively. This is potentially a sign that investors view the situation in the Middle East as unlikely to be resolved in the near term, limiting downside for commodity prices and boosting the profit outlook for companies positively correlated to higher crude oil prices. While the energy sector could remain dependent upon the path taken by crude oil, it remains an appealing diversifier and a valuable, albeit imperfect, hedge against geopolitical risk. Within the health care sector, both pharmaceutical and biotechnology stocks started strong out of the gate in August before giving ground into month-end as rising rates weighed on valuations and clouded the outlook for mergers and acquisitions (M&A). Health care offers a blend of offensive and defensive characteristics, and the sector has historically performed well in midterm election years, but if Treasury yields fail to stabilize, investors could look to play defense elsewhere.

The fundamental outlook for U.S. stocks remains constructive, but rising Treasury yields, seasonality, and midterm elections could pose near-term headwinds for equities. Rising yields could negatively impact investor sentiment and risk appetite, particularly if the 10-year yield makes a run at 5% and could also impact how investors position portfolios into midterm elections in early November. Historically, slower growing and relatively higher yielding sectors have performed well on a relative basis in September and October of midterm election years. But if Treasury yields continue to rise, market participants could turn to shorter-dated bills/notes to generate income and get more defensive. Higher yields could also act as a drag on valuations of longer duration information technology stocks and heavily levered small cap stocks as well, so the path forward for yields could dictate the direction of travel for U.S. stocks.

Lastly, while we don't want to overstate its potential importance, seasonality has not historically favored bulls in September. The S&P 500 has, on average, fallen 1% during the month since 1928, with outsized moves not uncommon in midterm election years. More recently, the S&P 500 fell 9.3% in September of '22 and rose 8.7% in September of 2010, highlighting just how volatile the month can be. It is notable that in years in which the S&P 500 is higher by 10% or more through August, stocks haven't fared as poorly, which gives bulls hope and a reason to stay invested. Rising rates could pose a more durable headwind for stocks, but the other two hurdles facing stocks (midterms, seasonals) will be fleeting, and any material weakness could be an opportunity to tactically adjust portfolios.

**Emerging Markets Share In Semiconductor Success And Carry More Attractive Valuations.** The 'reversion trade' went global in August as beleaguered semiconductor stocks listed in South Korea and Taiwan rebounded from a steep selloff in July. The broader MSCI EM index notched a modest 3.2% advance during the month as capital rotated out of Latin America and China and back into Korea and Taiwan, leading to a 6.8% rally in the former and 6.5% bounce in the latter. The broad MSCI EM benchmark entered September with an 11.6 forward price-to-earnings (P/E) multiple, its cheapest valuation since September of 2022. The bears might chalk this cheaper valuation up to semiconductor exposure by suggesting these companies are near their earnings peak, but the MSCI EM index carries a 25% allocation to the semiconductor subindustry, while the NASDAQ 100 is over 30% semiconductors and trades at more than double the multiple with a 25.3x forward-PE ratio.

**Outsized Moves In September Typical In Midterm Election Years**




*Source: Bloomberg*
*Past performance is not indicative of future results.*

The comparison between U.S. large cap technology companies and those found in the MSCI EM is imperfect to say the least, but to us cheaper valuations and faster growth tells us the sub-asset class has room to rally and remains under-owned in global portfolios. The technical setup leaves us more cautious as the asset class built up momentum in August while breadth narrowed, showing a lack of confirmation as just 51.8% of the index traded above its 200-day moving average. In summation, the fundamentals have us optimistic on emerging market stocks, but we have yet to see the sort of broad-based strength that could potentially warrant an overweight allocation. ▲

## BONDS

# Will Policymakers 'Panicking' Mean Fixed Income Investors Don't Have To?

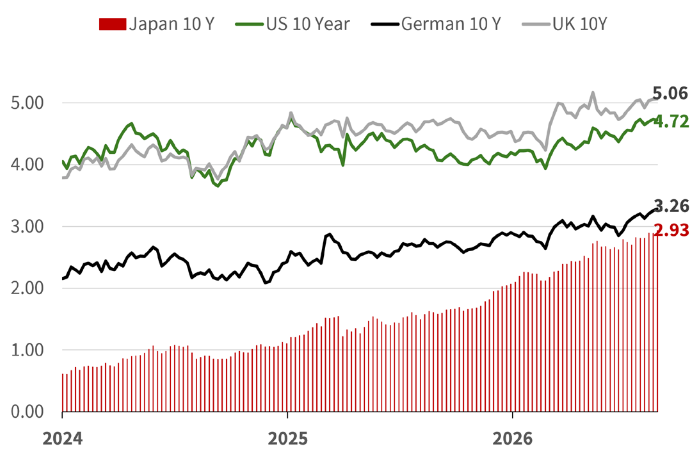
Yields across the U.S. Treasury curve rose in the back-half of August with the 2-year yield closing the month at a year-to-date high and the 10-year yield hitting a level last seen in January of 2025. The rise in yields stateside has coincided with a global lift in sovereign bond yields and is a result of a confluence of factors including energy prices remaining elevated as tensions in the Middle East continue to simmer, sticky inflation potentially forcing the FOMC to hike the funds rate this month – and perhaps again before year-end, along with concerns surrounding where demand for long-term U.S. government debt might come from if deep pocketed investors abroad develop a home country bias amid the global lift in sovereign bond yields.

Brent crude closed August at $90.49 per barrel, barely above the $90.12 level where it traded at the end of July, and well below its March 31st high of $118.35 per barrel. On the surface, the price action in crude oil doesn't stand out as a catalyst for the upward push in bond yields last month. But with no off ramp to the ongoing conflict in the Middle East in sight, market participants see little near term downside for energy prices and, in turn, few reasons for inflationary pressures to ease materially or quickly. The stickiness of crude oil prices at current elevated levels makes it difficult for the 'doves' on the FOMC to argue that inflationary pressures will ease and for the Committee to stand pat on rates, which increases the likelihood that policymakers in the U.S. come off the sidelines to tighten monetary policy.

FOMC Chair Kevin Warsh struck a 'hawkish' tone at the Kansas City Fed's annual Jackson Hole Economic Policy symposium at the end of August, and following his speech, Fed funds futures shifted and priced in around a 70% likelihood of a September rate hike. This contributed to an immediate 12-basis point rise in the 2-year Treasury yield and a 4-basis point rise in the 10-year yield. Higher short-term yields imply that bond investors expect the FOMC to hike the funds rate to bring inflation closer to its 2% target, but the rise in long-term yields hints at doubts that those hikes will ease inflationary pressures. There's a market adage that goes, "bond investors stop panicking when policymakers start panicking." If this holds true, bond investors may cheer a rate hike this month and long-term yields could stabilize or potentially move lower. However, a single 25-basis point hike is unlikely to break the back of inflation and the new bond vigilantes could push long-end rates higher still, forcing the FOMC and/or Treasury to do more.

On the topic of 'panicking policymakers,' in early August, the U.S. Treasury and the Bank of Japan (BoJ) intervened to support the Japanese yen, which had weakened materially relative to the U.S. dollar. After the initial short-covering, traders appeared to wade back into short yen positions mid-month before 'hawkish' commentary from BoJ Governor Ueda seemed to all but guarantee a hike at the BoJ's September 18th meeting The potential for short-term rates to move higher wasn't enough to cap yields on the long end of the curve as 10-year Japanese Government Bond (JGB) yields moved higher for the seventh consecutive month as global rates drifted higher in sympathy. The move higher in long-end JGB yields coincided with climbing U.S. yields, as the 30-year U.S. Treasury yield edged above 5.3%, prompting Treasury Secretary Bessent to announced that the U.S. Treasury would increase the size of its monthly buybacks of off-the-run 10- to 30-year bonds to improve liquidity. But since that announcement was made, yields in the 10- to 30-year portion of the curve have remained stubbornly elevated and market participants appear skeptical that this move will successfully cap long-end rates.

**Yields Pushing Higher Around The Developed World**

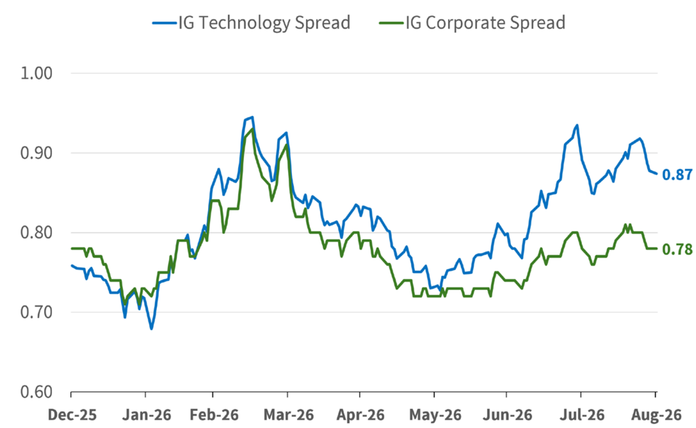



*Source: Bloomberg*
*Past performance is not indicative of future results.*

This remains a challenging backdrop for fixed income investors to navigate. Higher yields on long-dated bonds hold greater appeal for those seeking income, but with the U.S. government's debt burden now north of $40T and sticky inflationary pressures, a patient and measured approach is required for those looking to lock-in higher yields. We continue to champion diversification within fixed income portfolios and our belief in active management, while maintaining allocations in-line with our long-term benchmark as we await dislocations and opportunities to tactically tilt portfolios.

**Jump In Corporate Credit Issuance Could Provide A Test Of Investor Demand.** September is setting up for a supply surge from investment grade issuers that could test investor appetite after what has been insatiable demand for public debt in recent months. At the time of this writing, dealers are projecting approximately $215B in new paper to hit the market this month, which could be a test for the investment-grade segment. Market participants have stepped up their yield and spread requirements in recent months due to expectations of continued elevated issuance to fund the AI infrastructure buildout. Tech-sector option-adjusted spreads (OAS) have diverged from the broader corporate bond market since May as growing supply and valuation concerns have investors taking a more discerning look at new deals, and even though credit spreads for technology sector bonds tightened last month as earnings impressed, they remain elevated compared to the broader investment grade index. Rising issuance and wider spreads in technology sector bonds could start to weigh on broader investment grade valuations in the coming months, making active credit selection increasingly valuable. ▲

**Tech Sector Valuations Diverging From The Investment Grade Index**




*Source: Bloomberg*
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