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Why the Market Can Rip into Year-End

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Bottom line

There is a credible case for a year-end rally. Yields have repriced higher for a good reason, a Fed hike that is already priced stops being a surprise, the speculative end of the AI trade has been cleared out, hedge funds have already cut risk, and fourth quarters in midterm years have averaged a 6.6% gain, although not every year was positive. The case has one real weakness: the 10-year Treasury yield, at about 5.3%, now roughly equals the S&P 500's earnings yield, so stocks are paying almost nothing extra for their risk. A rally from here needs earnings to keep beating and yields to stop rising. We think that is more likely than not, but the margin for error is thin.

Higher yields reflect a strong economy

The 10-year Treasury yield reached 5.34% on October 5, its highest in roughly two and a half decades (Investing.com). The move is consistent with the data. The Fed's September statement described activity as expanding "at a solid pace" with strong productivity and robust capital investment (Advisor Perspectives), core CPI is running 2.4% (Kiplinger), and analysts expect S&P 500 earnings to grow 32.4% this year (FactSet). Yields that rise because growth is strong are a different problem from yields that rise because inflation is out of control. A repricing that brings yields into line with an economy this strong is healthier than rates held artificially low.

The next hike is already in the price

The 2-year Treasury yield was 4.78% on October 1 (FRED), about 0.9 percentage points above the midpoint of the 3.75-4.00% fed funds range. A 2-year yield that far above the policy rate means the market expects the Fed to keep raising. Advisor Perspectives reports that markets price another quarter-point hike in December and that officials project year-end rates of 4.1-4.4% (Advisor Perspectives).

When a hike is priced, delivering it moves little, while a pause or a smaller path than expected can lift stocks and bonds together. Some caution applies. Investing.com's outlook says the Fed likely pauses, so views differ on the path, and we could not verify live futures pricing. History also says stocks tend to struggle for about four months after a first hike (LPL Research), which would run to mid-January.

The AI trade has already had its correction

The pullbacks in the speculative parts of the AI trade were large, and several happened on good news, which is what a valuation reset looks like:

Group	Decline	Window	Source
Semiconductor index (SOX)	about 29%	June peak to Aug. 24	Leverage Shares
Ciena	40%	June to July 17	Photon Capital
Nokia	40%	June to July 17	Photon Capital
Quanta Services (infrastructure contractor)	14%	May peak to Aug. 10	TIKR

Ciena fell even after revenue rose 40% and it raised its full-year guide; it had risen more than 400% in the prior year. Quanta fell 22% in the month before reporting 41% revenue growth and a record $53 billion backlog. The sell-off was about expectations, not orders. A September bounce in optical stocks was driven by short covering, not news (24/7 Wall St.), a sign that positioning had become one-sided.

Two cautions. The leaders did not correct as much: Micron is still up 243% this year (Invezz), and technology is up 28% (Cetera). And the S&P 500 is only about 1% below its mid-August record, so the index has largely recovered.

Hedge funds have already cut risk

Hedge funds-built leverage into the peak and then reduced it quickly. Goldman Sachs said in May that gross leverage was at record highs for its prime brokerage clients (Goldman Sachs). The reversal, newest first:

Date (2026)	What happened	Source
Aug. 25	Hedge funds cut global equity exposure at the fastest rate in two months. Net leverage was 76.8%, the 27th percentile of its one-year range, and technology gross exposure fell the most in more than two years.	Hedgeweek
Jul. 29	Goldman and JPMorgan issued automatic collateral calls after the AI sell-off, with the semiconductor index down about 25% since late June.	Hedgeweek
Jul. 20	Net sellers of US technology in six of eight weeks, cutting holdings about 10% in market value, the largest retreat in Goldman's data, which go back more than a decade.	Yahoo Finance

This supports the bull case. The funds most likely to sell into weakness have already reduced exposure, and net leverage in the 27th percentile leaves room to add back into year-end. Two limits apply. Hedge funds were only moderately de-risked, not washed out, and we did not find September positioning data, so we cannot say whether they re-added exposure in the September rebound. Providers also measure leverage differently, so we cite changes rather than levels.

Year-end mechanics favor the bulls

In midterm election years, the S&P 500 has averaged roughly flat returns in the first three quarters (-0.5%, -0.6% and -0.1%) and +6.6% in the fourth, with the lift typically starting about a month before Election Day (J.P. Morgan Asset Management via Yahoo Finance). Since 1950, October has risen 73.7% of the time in midterm years, averaging 3% (Yahoo Finance). Across all years since 1945, the fourth quarter has averaged 4.2% and finished higher 85% of the time (Investing.com).

These are averages, and they hide losing years. October fell in roughly 26% of midterm years, and across all years since 1945 the fourth quarter did not finish higher about 15% of the time. Fisher Investments counts eight midterm-year Octobers with declines since 1926 and two negative fourth quarters (Fisher Investments). The J.P. Morgan figures are historical averages across past cycles, not forecasts, and past performance does not guarantee future results.

This year has only partly followed the pattern. The S&P 500 fell as much as 8.9% into late March, then gained 10.5% in April and is up about 13% for the year (ChartRow). The usual weak stretch came early, so some of the seasonal gain may already be in the price. Election Day is November 3, and the Fed meets October 28.

What could end the rally

The bond market is the main risk. The S&P 500 trades at 19.0 times forward earnings, an earnings yield of about 5.3%, while the 10-year Treasury pays about the same. When a risk-free bond yields what stocks earn, investors need earnings growth to justify owning stocks, and a further rise in yields would lower the price they are willing to pay. In our view, the justification is most likely to come from earnings growth as third-quarter reports arrive. Rate-sensitive areas are already weak: in the third quarter small caps fell 7.2% and the broad bond index fell 3.5% (Cetera).

Other risks are a third-quarter earnings season that has to clear a 29.5% growth estimate, a Fed that signals more hikes than priced, the November 3 elections, and the geopolitical and oil pressures that analysts cited in the summer sell-off. Narrow leadership, covered in our concentration note, means the rally could be driven by the same few stocks. We would read a sustained 10-year yield above 5.5% or a cut to 2027 earnings estimates as signs the setup is failing; the 5.5% level is our judgment, not a historical rule.

This article is general market commentary, not personalized investment advice. Past performance does not guarantee future results, and historical averages and seasonal patterns are not forecasts. Figures are drawn from the public sources linked in the text and are stated as of October 5, 2026; several are secondary reports from news or data sites, and each is attributed to the source named.

Sources: Investing.com, Oct. 5 · FRED 2-year · Advisor Perspectives · Kiplinger · FactSet · LPL Research · Leverage Shares · Photon Capital · TIKR · 24/7 Wall St. · Invezz · Cetera · J.P. Morgan via Yahoo Finance · Yahoo Finance, midterm Octobers · Fisher Investments · ChartRow

Hedge fund positioning sources: Goldman Sachs, May 22 · Yahoo Finance, Jul. 20 · Hedgeweek, Jul. 29 · Hedgeweek, Aug. 25

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