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ARGUS ECONOMIC COMMENTARY

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Market Stumbles as Oil Spikes and Midterms Approach

The S&P 500 reached its all-time closing high around 7,800 in mid-August. At that time, the pause in the war with Iran appeared to be holding even though the memorandum of understanding had lapsed. July nonfarm payrolls were weak, signaling less urgency for the Federal Reserve (Fed) to raise interest rates. An uneasy stasis existed in the Strait of Hormuz, with some ships getting through, but at less-than-prewar levels.

By mid-September, the S&P 500 was down about 2% from that peak closing high. August nonfarm payrolls had come in hotter than expected, and bond traders' probability of a Fed rate hike had risen. The war broadened out as Yemen's rebel Houthis seized control of a key port city and island near the Bab el-Mandeb Strait and Iran's Iraqi proxies bombed a key pipeline. Both actions compromised Saudi Arabia's alternative routes to ship its oil.

In the U.S., candidates from both parties are ramping up advertising and personal appearances in advance of the midterm elections in about seven weeks. Efforts by the White House to ban mail-in ballots have been blocked by the courts. Much uncertainty remains about Election Day itself, with inflation and the unpopular war weighing on the GOP and concerns about socialism weighing on the Democratic Party.

New Fronts in the Middle East War

Since the war with Iran began at the end of February 2026, and particularly after the end of the "hot" phase, much of the focus has been on control of the Strait of Hormuz. Prior to the war, up to 20% of the world's oil and huge amounts of fertilizer and other goods flowed through the strait. Iran's southern border wraps around the horseshoe-shaped strait, giving it an advantageous strategic position to control the waterway. The U.S. military has largely impeded flow of any Iranian oil, while a limited amount of oil from other Gulf countries has made it through, mainly by following routes closer to Oman.

Although the memorandum of understanding expired in June, the war did not immediately heat up. Neither side is eager to resume hostilities. Iran's economy is already fragile, with scarcity of most goods and 80% inflation, and the U.S. would rather exert economic pressure than military pressure. But as the world learned in September, neither side holds all the cards.

As the U.S. was preparing to commemorate the 25th anniversary of the 9/11 attacks, Houthi rebels in Yemen seized the port city of Mokha, along with Perim Island, which occupies a strategic position in the Bab el-Mandeb Strait. This strait, which opens into the Red Sea, has been serving as a critical alternative to the Strait of Hormuz for shipping Saudi oil.

In ensuing days, Saudi Arabia's East-West Pipeline was damaged by drone attacks emanating from Iraq. Satellite images confirmed up to six fire hot spots along the pipeline, and the Saudis were forced to shut it down. This pipeline can carry up to 7 million barrels per day and has also been serving as an alternative to the Strait of Hormuz.

Although the Houthis are regarded as part of Iran's proxy network, Tehran denied any involvement in the Houthi actions. By September 14, 2026, the Houthis had occupied both Greater Hanish Island and Lesser Hanish Island in the Red Sea, further jeopardizing use of the Bab el-Mandeb Strait to transport Saudi oil.

Global strategists were shocked that Saudi Arabia provided no air support for the Yemeni forces as the Houthis attacked. The Saudis reportedly asked the U.S. to coordinate strikes on the Houthis; the U.S. offered intelligence assets instead. The U.S. is not anxious to widen its military involve-

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ment in the region at a time when its economic pressure campaign against Iran appears to be working.

Rates Follow Inflation Higher

The upshot of these events is that oil from Saudi Arabia, United Arab Emirates, and other Gulf states is again bottled up, and oil prices are moving higher. As of midday on September 14, the price for Brent Crude oil was up 2% on the day to $106.82 per barrel. That's below the $118 peak reached at the end of March 2026 but up 60% in the past year. The national average retail price of a gallon of gasoline was $4.32 as of mid-September. Because of damage to sites in the Middle East (and in Russia) and scheduled seasonal refinery shutdowns in the U.S., the price of diesel reached a record high of $6.23 per gallon in the U.S. Prices for gasoline and diesel are up a few percentage points just since news of the Houthi attacks.

Heading into September, the CME FedWatch tool showed a 60% probability of a rate hike at the Federal Open Market Committee meeting on September 15-16. By the middle of September, that probability had risen to around 90%. On 9/16/26, the Fed as expected hiked the fed funds rate by 25 basis points. The vote to hike was 12-0. We are not expecting a "one and done" Fed cycle; over the past 30 years, the first hike has been followed by additional hikes in every rate cycle.

By mid-September, that first hike seemed inevitable. Besides the wider war and oil-price spike noted above, multiple factors contributed to the more-hawkish turn by the central bank. Producer Price Index (PPI) and Consumer Price Index (CPI) inflation data for August confirmed that prices are heading higher. The Fed normally pays most attention to core inflation data, which excludes food and fuel; at present, all-items inflation appears to be more concerning. The all-items PPI rose 0.4% month over month and 5.4% year over year, with the annual gain driven largely by higher energy and transportation costs. The all-items CPI for August rose 3.4% year over year, signaling that companies are willing to absorb some of their higher energy costs to preserve market share. The annual change in core CPI actually ticked down to 2.5% in August from 2.6% in July. The August data do not reflect the rise in energy inputs since the successful Houthi attacks in Yemen.

Interest rates have followed inflation higher. On September 14, the 10-year Treasury yield briefly topped 5.0%, its highest level since October 2023, before easing to 4.95%. The 5% level in the 10 year represents a key psychological threshold that investors see as threatening to stocks. The 30-year yield as of September 14 was near 5.38%, its highest level since 2007.

Argus Chief Technical Strategist Mark Arbeter noted that the two-year Treasury yield reached 4.63% on September 11, the highest level since July 2024. Given the pre-hike fed funds target range of 3.5%-3.75%, the Fed was 88-113 basis points below the two-year or, in Mark's words, one or two cuts behind the curve. Even after the September hike, the Fed remains behind the curve.

Fed Chairman Kevin Warsh was appointed by President Donald Trump with an aim to reduce the structural interest rate environment. But the reality is that wartime inflation makes cutting rates all but impossible at present. Although some economists were calling for a 50-basis-point cut at the September FOMC meeting, the Fed likely sought to be circumspect ahead of a major election cycle. All of these factors likely contributed to the Fed's decision.

Conclusion

With the midterm elections now less than two months away, both parties are shifting into a higher gear. Amid the increasing cacophony of ads, investors are trying to make sense of the current environment and to plan into year-end.

On the one hand, the inflation outlook appears to be worsening, and the Fed risks losing the perception of political neutrality if it does not use all tools available to fight the price trend. On the other hand, August nonfarm payrolls showed robust growth. Fully employed consumers have repeatedly carried on through inflation. A new earnings season is coming, and it is likely to show continued corporate profitability growth that supports the stock market at current or higher levels.

Typically, the party in the White House loses Congressional seats in the midterm election; given current slim GOP majorities, the House and/or Senate could tip to Democratic majorities. Wall Street tends to prefer a divided Washington, where neither side can advance potentially disruptive policy.

In the 2026 trading year so far, the S&P 500 has outperformed the typical low-single-digit gain for a midterm election year — historically the weakest in the four-year election cycle. Once the election is past, we will have a better sense of whether the market can build on year-to-date gains or will need to retrace further in a turbulent geopolitical environment.

Jim Kelleher, CFA,
Director of Research

KEY ECONOMIC FORECASTS

- The $32 trillion U.S. economy remains on course for productive long term growth, powered by corporate investments in Artificial Intelligence. Nvidia CFO Colette Kress estimated, in May, that AI infrastructure spending is on track to reach $3 - $4 trillion annually by the end of this decade.
- Real Potential GDP – the sustainable speed limit of the US economy is poised to increase to 2.1%, on average, through 2030 according to the Congressional Budget Office. AI is likely to raise productivity, offsetting slower growth in the labor force from an aging population and reduced immigration.
- Our 2026 gross domestic product growth forecast is 2.2% (up from 2.1%). Our 2027 forecast is unchanged at 2.2%. In an August 2026 speech, Tom Barkin, President of the Federal Reserve Bank of Richmond, cited the low 4.1% unemployment rate and a record 59 months with unemployment below 4.5% as a keys to the economy's resilience despite a "slew of challenges." President Barkin noted, "With jobs, consumers aren't feeling as much pressure to cut back."
- Argus expects S&P 500 EPS to rise almost 25% to $340 in 2026 and increase about 15% to $390 in 2027. EPS is helped by an increase in operating margins to about 19% this year. Growing tech giants such as MSFT and NVDA have higher margins than Dow stalwarts such as Walmart and Caterpillar. Argus expects the S&P 500 to trade in a range of 6,900-8,450 over the next 12 months. Our year-end 2026 price target for the S&P 500 is 8,000 based on a multiple of 20.5-times our 2027 EPS estimate.
- The Misery Index, which is the Consumer Price Index (CPI) inflation rate plus the unemployment rate is 7.45%, below the average of 9.2% since 1949, but up from 6.7% in January. Unemployment is low at 4.1%. Inflation remains elevated at 3.4% in August, but it is below the recent peak of 4.2% in May.
- Gasoline prices at $4.35 a gallon are straining consumers pre-holiday spending. Inflation will be a key issue in fall elections for control of Congress. Looking ahead to 2027, the EIA outlook calls for a recovery in oil supply and ultimately a surplus. If that's the case, West Texas Intermediate likely will resume its secular downtrend. Our preliminary 2027 outlook is $70 a barrel down from $80 in 2026.
- The yield on the 10-year Treasury bond has jumped above 5.0% from 3.95%, on February 27, before the escalation of the conflict with Iran. The 10-year has a bigger and more direct effect on the economy than an equivalent move in the fed funds rate.
- Gold, the ancient safe-haven asset is likely to remain at high levels, in a range of $4,000 - $6,000 in 2026, amid global uncertainty and concerns about the budget deficit.
- The Federal Open Market Committee voted 12-0 in September to raise the federal funds target by a quarter point to 3.75%-4.0%. Argus Fixed Income Strategist Kevin Heal expects one more hike this year, before the central bank moves to the sideline in 2027. We expect the dollar to be to be flat-to-firmer over the next year helped by higher rates and demand for shares of innovative U.S. companies.
- What could go right? Low unemployment, strong S&P 500 earnings, ongoing innovation, spending by wealthy consumers, massive capital investment in Artificial Intelligence, and productivity gains.
- Risks: Higher interest rates, a pause in investment by AI companies, a weak housing market, inflation/strains on affordability, hostilities with Iran, and U.S. budget deficits raising national debt.

CURRENT ECONOMIC RELEASES

Current Economic Releases

Date	Release	Month	Previous Report	Argus Estimate	Street Estimate	Actual
10-Sep	PPI Final Demand	August	**4.8%**	5.2%	NA	**5.4%**
	PPI ex-Food & Energy	August	**4.3%**	4.6%	NA	**4.6%**
	Existing Home Sales	August	4.06 Mln.	4.10 Mln.	3.98 Mln.	**3.98 Mln.**
	Wholesale Inventories	July	**4.4%**	5.7%	NA	**5.7%**
11-Sep	Consumer Price Index	August	3.4%	3.4%	3.4%	**3.4%**
	CPI ex-Food & Energy	August	2.5%	2.4%	2.4%	**2.4%**
	U. Michigan Sentiment	September	51.7	51.0	51.0	**47.8**
16-Sep	Retail Sales	August	5.0%	5.2%	NA	**6.0%**
	Retail Sales ex-autos	August	5.8%	5.6%	NA	**6.9%**
	Import Price Index	August	**6.1%**	6.5%	6.5%	**7.0%**
	Business Inventories	July	**3.1%**	4.2%	NA	**3.8%**
17-Sep	Housing Starts	August	1,239K	1,300K	1,310K	NA
18-Sep	Industrial Production	August	1.1%	1.7%	NA	NA
	Capacity Utilization	August	76.3%	76.5%	76.4%	NA
	Leading Index	August	0.2%	-0.1%	0.1%	NA
24-Sep	New Home Sales	August	607K	615K	610K	NA
25-Sep	Durable Goods Orders	August	12.9%	5.4%	NA	NA

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