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Quarterly Investment Commentary



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A Review of 1Q26

Stocks and bonds retreated in Q1. The S&P 500 fell 4.63%. NASDAQ fell 7.11%, but the Russell 2000 (small stocks) advanced 0.58%. The S&P 500 fell after three consecutive positive quarters, and recorded only the third negative quarter since 2022. Software stocks were notable decliners (Microsoft fell 23.5%), as were private credit-related names. Treasuries were weaker (2-year yield rose 32 basis points [bps] and 30-year yield was up 7 bps), as two and one-half Fed cuts assumed by year-end morphed to a one-half rate increase. Of course, the big news was the war in Iran, spurring WTI crude to a 76.6% rally.

Fourth-quarter earnings were up a strong 14% and 2026 earnings expectations rose. The S&P 500 P/E fell from 23x to 20x as earnings rose and stocks declined. In some ways, it is surprising that the S&P 500 was “only” down 7%, given the huge rise in the price of oil, our “excursions” into Iran and Venezuela, the “noise” around Greenland, a government shutdown, private credit concerns, and the dialogue around Fed Chair succession.

Best sectors were energy (+37.2%) and materials (+9.3%); worst sectors were financials (-9.8%), consumer discretionary (-9.4%), and technology (-9.3%).

The fundamentals

The S&P 500 index delivered better-than-expected earnings for Q425, driven mostly by upside surprises, especially in the technology sector (the tech sector posted year-over-year [y/y] earnings growth of 34%). Guidance trends were reassuring, with more companies issuing positive than negative pre-announcements for the first quarter. However, market reactions to the reports were underwhelming, partly due to elevated valuations heading into earnings season, which set a high bar for results to impress investors. In addition, a host of factors, including uncertainty over a proposed cap on credit card interest rates, fears about AI disruption, and strains in the private credit market sentiment as the reporting season progressed, contributed to a bit of sloppiness and churning in markets.

A strong earnings backdrop has had much to do with the resiliency of the U.S. equity market, and that to get bearish on the year likely requires taking a pessimistic view of how the earnings outlook may be adjusted. The continued climb in the bottom-up consensus S&P 500 EPS forecast for 2026 (which is now tracking at \$323, up from \$313 early this year, for a growth rate of more than 14% y/y) has been driven in large part by the tech sector and the Mag 7, and more recently from increases in energy companies' estimates due to higher oil prices.

Provisions in the recently passed OB3 tax bill should provide support for the consumer in early 2026. That should help sterilize the tariffs and oil-price increases. The recently passed U.S. tax bill should also sustain a boost, more generally, to corporate capital expenditures. Deregulation should also support activity. A short-term growth scare looks manageable (though this is getting riskier); a sustained inflation scare less so.

A big concern is the low level of overall U.S. savings: consumer savings, corporate savings, and the budget deficit. A rise in consumer and corporate savings rates would bear all the hallmarks of a U.S. and global recession. Forces that could trigger the problem: the ongoing closure of the Strait of Hormuz, global geopolitical fracture, concerning demographics, deterioration in private credit, and the AI ecosystem. It has been 18 years since the last real recession. When a cycle lasts that long, imbalances tend to build. This makes old cycles particularly susceptible to shocks. Trump's and the Fed's reaction function to the next downturn may be to debase the currency.

The war

The U.S. and Israeli attack on Iran occurred against a backdrop of accumulating investor concerns that AI euphoria may be overdone, private credit is wobbling, risk assets have little valuation cushion for disappointment, and geopolitical tensions were already heightened. Investor worries were already elevated before the attack on Iran.

We still argue that should the conflict settle down within weeks (not months), the oversupplied market will strip out most of the risk premium in oil prices. However, investors must recognize that military conflicts are inherently difficult to predict and tail risks have risen because of the way the conflict is playing out.

There is the potential for a deal that could make sense for both sides. It could look like this: The U.S. and Israel cease their attacks and in return, Iran opens the Strait and ends its own attacks on its neighbors in the region. In the meantime, both sides agree to hold talks on Iran's nuclear program, its ballistic missile program, and its support for terrorist proxies. Both sides could say they are "making progress" on these issues. Under this scenario, it will be very difficult for investors – perhaps even the two parties – to know the other side's real intentions. This kind of ambiguous outcome is the most likely way the violence could stop in the next few weeks or even the next few months. Absent a deal, Trump is likely to keep up the bombing campaign and maybe take steps to open the Strait by force, even if that means some U.S. troops on the ground.

Asia is easily the largest importer of oil out of the Strait of Hormuz, so naturally the impact on those economies is disproportionate to Europe and especially the U.S., which has the lowest economic sensitivity to oil prices among the major regions of the world.

One of the most surprising developments since the start of the Iran war has been the lack of discussion around a potential recession. The yield curve continues to flatten, and expectations for rate cuts are being pushed out due to persistent inflation concerns. Higher rates may be the most significant concern right now, as they tend to slow credit growth.

There are ways for an economy to manage short-term disruptions (e.g., drawing on consumer saving and inventories, using tax refunds). But it now looks like the conflict in the Middle East will stretch several more weeks at a minimum. The hit to real income due to inflation spiking near-term looks substantial. Longer-term interest rates are rising. That combination of higher rates and oil should slow economic growth as we move through 2026. If there is not significant progress toward normalization in the Strait of Hormuz soon, we will raise our U.S. recession odds in 2026 from 25% to 35% (up from 15% on Jan. 1).

Iran has been the central pillar of a regional order that Beijing assembled, and Operation Epic Fury is now cracking that pillar. Collapse Iran and you remove the single greatest drain on American strategic bandwidth and free the U.S. to concentrate on the Pacific with credibility that 20 years of pivot talk never produced.

Inflation

During the first four weeks of the war, global yield curves have risen significantly, as the fixed income markets have been repricing the deteriorating outlook for inflation. U.S. inflation was stirring even before the conflict in the Middle East (e.g., the PPI up +0.7% month-over-month [m/m] in February). The worst-case economic scenario would be stagflation. The University of Michigan's Consumer Survey showed the median expected inflation rate for the next year is 3.8 percent. The median five-year-ahead expected inflation rate is 3.2 percent.

The consensus view is that inflation will ease back to the subdued levels experienced in the 20+ years leading up to the pandemic. However, consumer price inflation was suppressed during that period by the massive increase in globalization, a powerful household deleveraging wave and resulting economic slack, and productivity gains from technology innovation. It would be a mistake to assume that inflation would sustainably return to such low levels, without these powerful drags returning to their prior intensities, which is most unlikely. Specifically:

1. A sustained period of above-potential economic growth left limited spare capacity in the global economy.
2. The U.S. trade war threatens to unwind the disinflationary gains from increased globalization, particularly for U.S. consumers.

3. Technological innovation is no longer a source of disinflation now that the price of computers, consumer electronics, smart phones, and streaming services have increased meaningfully since the pandemic. While AI brings hope for a future disinflationary tailwind (mostly for services), there is no evidence of this yet and any such outcome likely will take years to gain a head of steam.

In short, the secular forces that helped dampen inflation prior to this decade are no longer present, and most cyclical forces now point to greater (rather than reduced) consumer price pressures.

Private credit

Private credit has grown rapidly over the past decade, evolving from a niche strategy to a \$2 trillion asset class. At its core, private credit refers to loans made by non-bank lenders, typically to mid-sized companies, often backed by private equity sponsors. These loans are not traded in public markets, which makes the market more opaque than high-yield bonds or leveraged loans.

The narrative has started to shift as interest rates have moved higher, economic growth has moderated, and concerns around AI's impact on software, heavily financed by private credit, have increased. The key question today is whether these pressures point to a broader systemic risk or simply reflect the normal stresses of a maturing credit cycle. Our view is that risks are real and rising, but are more likely to show up as a gradual deterioration in credit quality and availability rather than a broad destabilizing shock. Private credit may amplify the next downturn, but we do not see it as the cause of one.

Technical observations

What hasn't changed?

1. Stocks are marginally oversold.
2. We still have yet to see any big flush in lows or sustained stress from put/call ratios.
3. The market's relative preference for the equal weight versus the top of the market and for value versus growth.

The quality of any bounce from here – the internals, the leadership, the trajectory of credit, etc. – will be absolutely critical in gauging the market's longer-term intentions.

The way forward

We haven't seen much movement in consensus U.S. GDP forecasts since the start of the war, which we think reflects the idea that the event has been seen as more of an inflation shock than a potential growth shock, as well as the idea that it is simply too early to know what kind of demand impacts there will be.

While many have commented on the resilient price action in the S&P 500 in March, what has gotten less attention is the compression in the P/E multiple of the S&P 500. The current forward P/E has fallen to 20x (down from 23x at recent peak). While still not cheap (or even back to median), the decline has come as stocks have fallen and earnings estimates have moved up.

"We have consistently and for some time warned that while the top-down macro backdrop was favorable for risk-taking, rich capital market pricing and widespread investor complacency warranted a more tempered investment strategy and asset allocation." – Dec. 2025, 10 Predictions Release

We do not expect the bull market to resume until 1) a resolution to end the war can be reached, 2) the Strait of Hormuz is reopened, and/or 3) capitulation is reached, with investors making a true market bottom (capitulation = big downside flush with appropriate divergences).

The S&P 500 has declined by 9% since its January high, with valuation multiples falling alongside rising earnings estimates. Surging oil prices, interest rates, and geopolitical uncertainty have dragged the S&P 500 P/E multiple from 23x a month ago to 20x today even as analysts have raised their earnings estimates. The upcoming Q1 reporting season will be a key source of information regarding the earnings outlook. The season kicks off the week of April 13, with roughly 70% of S&P 500 market cap reporting by the end of April. Guidance and commentary are likely to be more informative than reported results when 1Q earnings are released.

Concluding observations

1. The war has changed recession probabilities from 15% before the war to 25% after oil exceeded \$100 per barrel, and will rise to 35% if the Strait of Hormuz remains closed for much longer.
2. While earnings estimates have moved up since Jan. 1 (large technology revisions in January/February and then energy companies in March), downward estimate revisions are likely as companies report Q1 earnings.
3. Inflation, aggravated by high oil prices, makes Fed easing much less likely (although we were doubtful before the war).
4. Productivity gains will be essential to avoid long-term structural inflation.
5. OBBB tax benefits are largely being offset by higher oil prices.
6. Large, persistent, and growing deficits are creating challenges for bond and currency markets.
7. The bull market cannot resume until there is some end to the war, the price of oil recedes, and/or the Strait of Hormuz is reopened.

High-risk bull market



Issues

1. War (price of oil, inflation).
2. Integrity of private credit.
3. AI (Capex, ROI).

SO, WHAT TO DO?

We are focusing on companies with below-benchmark price-to-free-cash-flow and above-benchmark return on equity.

Positives

1. Earnings still good (watch carefully).
2. Fed not hostile.
3. Credit spreads not signaling significant problems.

Negatives

1. Still high valuations.
2. Inflation remains sticky.
3. Uncertainty as to longevity of \$100 oil and Strait of Hormuz.

Conclusion

- Bull market on hold while oil is ≈ 100 .
- The upside case for stocks is getting increasingly difficult to make. But downside risk is rarely realized when earnings are advancing and the Fed is easing.

10 Predictions for 2026: Review and update (2Q26)

Introduction (written December 2025)

The U.S. is set to remain the world's growth engine, driven by a resilient economy and an AI-driven super cycle that is fueling record capex, rapid earnings expansion, and unprecedented market concentration. The growth outlook is good, which bodes well for corporate profits and should be supportive of risk asset markets. The recently passed U.S. tax bill (One Big Beautiful Bill – OBBB) should provide a boost especially to capex. Deregulation should also support activity. A combination of the OBBB's impact on both consumer and capital spending, America's hosting the World Cup, and the country's 250th anniversary will all create a tailwind for 2026 economic growth and earnings. Add to that a Fed that seems almost certain to focus more on the full employment part of its mandate rather than inflation and it is difficult to get bearish. However, the downside of good growth may be upward pressure on inflation.

Key:



Heading in the right direction



Heading in the wrong direction



Too soon or too close to call

1



Economic growth in the U.S. improves from approximately 2.0% to approximately 2.5% real GDP.

Our assertion was that the One Big Beautiful Bill (OBBB) along with lagged effects of Fed cuts, improved productivity, and wealth effect benefits would accelerate growth somewhat (say by 50 bps) in 2026 (versus 2025). Clearly, those items are still tailwinds, but an unanticipated headwind (\$100 per barrel oil) has developed. If the war winds down soon and the Strait of Hormuz can be reopened, oil is likely to drop by a noticeable percentage (say to circa \$70 per barrel). That would enable growth to resume here in the U.S. and globally. A longer war not only would dampen growth, but raise the specter of recession. We are hanging tight for now, but uncertainty prevails.

2



Inflation remains sticky, fails to reach the Fed's 2% target, and fails to make much if any progress toward the Fed's 2% target.

Sadly, the immediate consequences of the rise in the price of oil is a new tailwind to the inflation rate dilemma already problematic before the war (February PPI rose to 0.7% m/m). Fed funds futures curve says it all: At the start of the year, two and one-half cuts were priced in, now half of a rate increase. And sadly, the problems are showing up in both goods and services. We reinstate our assertion that the 2-3% inflation ceiling of the 2010s has become the 2-3% inflation floor for the 2020s. The price level ("affordability") will continue to get attention and even more so as the November election draws near.

3



The 10-year Treasury yield trades primarily between high 3% and mid 4% as credit spreads widen (i.e., a "coupon-ish" year).

While rates moved up during Q1, the price action has occurred within our prediction "high 3s to mid 4s." Most observers (ourselves included) forecasted a steepening of the yield curve, but in fact, short rates have moved up more than long rates. Bond investors are cognizant of not only the increasingly sticky inflation problem but also the huge amounts of debt issuance forecast for 2026. Our advice to stay with high quality has paid off as credit spreads have widened somewhat. Much discussion and isolated problems in private credit are to be watched carefully.

4



Earnings growth falls short of consensus +14% and P/E's decline modestly, making it a tougher year to make money.






4Q25 earnings were quite good, causing analysts to raise 2026 estimates. The consensus gain for this year remains +14% (strong 2025 results and increased 2026 estimates registered an unchanged +14% gain for this year). In March, earnings revisions were up again, mainly from raised energy earnings estimates. Most analysts are waiting until Q1 earnings releases and management commentary before further changing forecasts. Our suspicion is that war impacts will necessitate some earnings reductions. Meanwhile, the P/E ratio has fallen from 23x to 20x due to war and oil price impact concerns.

5



Stocks fail to advance by a double-digit percentage for only the third time in 10 years.

As noted when we released our 10 Predictions for 2026, a four-year string of double-digit percentage stock market performance has only happened once over the last 100 years. So, while consensus market assumptions called for another double-digit percentage gain, our view was and remains that this outcome was unlikely, especially because the starting P/E ratio of 22-23x was likely unsustainable. Obviously, the war has compressed P/Es. A cessation of the attacks should enable some recouping of P/E losses, but economic, inflation, and valuation levels make this prediction more likely.

<p>6</p> <p></p>	<p>Technology, communication services, and financials outperform materials, utilities, and consumer discretionary.</p> <p>Well, in the category of “You can’t win ‘em all,” this prediction is headed in a very bad direction. Technology has struggled with AI around financing and other concerns. Communication services has faltered largely because of Amazon and Meta, and financials have been the worst sector performer so far this year. Meanwhile, materials has been a stellar performer. The growth rotation into value and the improved performance of free-cash-flow generators has been noticeable.</p>
<p>7</p> <p></p>	<p>International stocks outperform the U.S. for the second year in a row (first time in 20 years).</p> <p>International stocks did so well relative to the U.S. in January and February, following their stellar performance in 2025. The war abruptly interrupted that outperformance and caused some damage. European economies are more sensitive to the price of oil than the U.S. and Asian economies, even more than Europe. If the war ends soon, we expect a resumption of international leadership due to improved relative earnings comparisons along with longstanding valuation advantages.</p>
<p>8</p> <p></p>	<p>AI continues to be volatile/erratic, creating another year of elevated volatility.</p> <p>War, inflation, and private credit concerns have eclipsed attention to the AI story, but it remains a hot button. Speculation about the ultimate impact of AI on business, employment, and profitability remain. The “circular financing” dilemma remains a point of controversy and consternation. Software companies have been at the brunt of that discussion. Our expectation remains that AI will be controversial, create confusion and volatility, and result in some amazing positive stories and some noticeable losses.</p>
<p>9</p> <p></p>	<p>Faith-based share of industry AUM increases for the tenth year in a row.</p> <p>The faith-based share of money management industry AUM has increased nine years in a row, granted from a very small share. We expect this to be the tenth year in a row, making it a decade of more than doubling market share. Why? More and more individuals, financial advisors, and institutions are desiring to align their portfolios with their values. Investors are both excluding companies that maim, kill, or addict people as well as favoring companies that “do good.” With ample evidence pointing to these investors not having to surrender any investment performance, this area continues to be one of increasing interest.</p>
<p>10</p> <p></p>	<p>Republicans retain control of the Senate but surrender the House, losing at least 20-25 seats.</p> <p>On average, over the decades, the best economic growth in the four-year presidential cycle has occurred in the second year (this year). But it historically (and by a wide margin) has been the worst-performing stock market year. Mid-term elections are rarely good for the party in control. Polls since the war started have not only suggested the Republicans lose the House (perhaps losing 25-35 seats), but that the Senate is now reachable for the Democrats. An end to the war will likely moderate the projected Republican losses, but the increase in inflation (and the focus on “affordability” will not help). The elephant in the room remains the ongoing debt and deficit issue. If this prediction is accurate, it will render President Trump largely a lame duck, making OBDD his most significant second-term achievement.</p>

Final Tally:  **3**  **1**  **6**

In summary (written December 2025)

Equity valuations and widespread investor complacency make the risk-reward trade-off less favorable than the positive top-down view implies. A shift to a defensive position is likely to occur at some point, although the timing is uncertain. Be quick to cut beta exposure if these tail risks surface. These include a spike in bond yields, a renewed intensity of the trade war, and/or if the AI euphoria fades.

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