
# MARKET UPDATE

Economic Market Update - Second Quarter, 2026

**July, 2026**

- Markets staged a sharp second-quarter rebound, led by renewed enthusiasm around artificial intelligence, easing energy-price pressures, and a broader rally that included strong performance from small- and mid-cap U.S. stocks, emerging markets, and select international equities.

- The outlook remains constructive but uneven, with business investment, especially AI-related capital spending, continuing to support growth while consumer spending, inflation, energy prices, and Federal Reserve policy remain key areas of uncertainty.

- Portfolio positioning continues to emphasize discipline and diversification, with broad equity exposure across geography, size, and style, selective use of active management where dispersion creates opportunity, and a fixed-income focus on quality, liquidity, and flexibility.

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The upper bound of the federal funds rate remains at 3.75%, unchanged since December. For the first time in this cycle, which began in September 2024, the market debate is shifting from a question of how many more rate cuts are coming to whether the next policy move could be a hike. On June 17, in the first meeting overseen by new Fed Chairman Kevin Warsh, the FOMC held rates steady by a unanimous 12–0 vote. But the Summary of Economic Projections released alongside that decision told a very different story from the vote itself: nine of eighteen policymakers penciled in at least one rate increase before year-end, and the median projection for where rates finish in 2026 moved up, not down, for the first time since this easing cycle began. Core inflation, at 3.4%, is at its highest level since 2023.

Underneath the surface, a regime shift that began as the world emerged from the COVID pandemic has been underway. The emerging macroeconomic environment is transitioning away from the disinflationary, globalized, capital-light world that shaped markets through much of the period starting in 1982 through the pandemic, toward something messier: higher real rates, heavier government borrowing, a more assertive state, and a capital expenditure boom large enough to reshape markets. These forces have led to a higher, more structurally embedded cost of capital, a shift we've been talking about for the last few years.

It is worth remembering how unusual the four prior decades were. For much of the period from the peak of Paul Volcker's rate-crushing campaign in 1982 through the eve of the pandemic, investors operated within a remarkably forgiving regime. Inflation and interest rates fell. The Cold War ended, and in the years that followed, China and the former Soviet bloc joined the global trading system. Corporate tax rates across the developed world were cut roughly in half, and defense spending drifted lower for the better part of three decades, driven by the so-called "peace dividend." Labor and energy were abundant and cheap. None of that was merely an accident of markets. It was supported by policy choices and geopolitical developments that are continuing to evolve today.

Layer onto that secular shift a more immediate one. Kevin Warsh, the new Fed chair, has been explicit about wanting a smaller central bank balance sheet, less hand-holding through forward guidance, and a greater role for the market, rather than the Fed, in price discovery. That is a meaningfully different posture from the one investors grew comfortable with over the past decade and a half, and it arrives at a delicate moment: federal debt as a share of GDP has more than doubled since the turn of the century, Treasury issuance remains elevated, and tensions around the Strait of Hormuz—the flashpoint that has periodically pushed oil prices higher since hostilities first broke out earlier this year—remain unresolved.

We could spend this entire outlook on the Fed's pivot alone, and six months ago, we probably would have. But the longer we have sat with the data underneath that pivot, the more convinced we have become that Chairman Warsh's hawkish debut is a symptom, not a cause. It is one visible expression of a much larger regime change that has been playing out for the last several years.

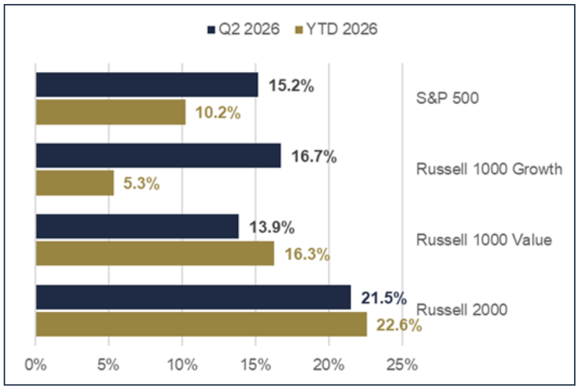
Beginning in the 1980s, the economic environment was defined by disinflation, deregulation, and a wave of globalization that spanned the 1986 Uruguay Round of GATT, the fall of the Berlin Wall, the signing of NAFTA, and China's 2001 entry into the WTO. Corporate tax rates fell across the developed world. Labor and energy costs fell as supply chains globalized. Defense spending fell as the Soviet Union dissolved. Beneath those macro tailwinds, the S&P 500 Index's composition was also shifting. Capital-intensive firms had once dominated the index, and those businesses carried high fixed costs and required continual reinvestment in plant and equipment. Their successors, particularly in technology, did not. A software or platform business could grow revenue without a matching increase in capital spending, and that shift toward asset-light models freed up cash flow for buybacks, dividends, and higher valuations. The cumulative effect was four decades in which financial assets simply became cheaper to own, as the combination of falling discount rates and lighter ongoing capital requirements, in aggregate, did much of the heavy lifting for both stock and bond returns.

The financial crisis broke that machine, but what replaced it, the zero-rate era running from 2009 through the pandemic, still rhymed with the old regime in one important respect: growth was scarce, capital was nearly free, and investors flocked to businesses that could grow reliably in a low-nominal-GDP world. That dynamic concentrated the overwhelming share of equity returns in a narrow set of capital-light, long-duration technology companies, while the so-called old economy, industrials, materials, energy, and value more broadly, lagged behind.

Since the pandemic, the ground has shifted again, and this time the direction of travel is the opposite of both prior regimes. Inflation returned for the first time this century. Real interest rates, not just nominal ones, rose meaningfully. Government debt levels, already elevated by COVID-era stimulus programs, have kept climbing; U.S. federal debt-to-GDP at roughly 99% is roughly triple what it was at the turn of the century, with Washington increasingly competing directly against the private sector for a finite pool of global capital. Barriers to international trade are back at levels not seen since the 1930s. The international order that has governed trade and defense relationships for the better part of eighty years is being actively renegotiated. And beneath all of it, the AI buildout has triggered one of the most aggressive corporate capital spending cycles in modern history. That last point, in our judgment, will be one of the most important investment themes over the next several years.

## Q2 2026 MARKET PERFORMANCE

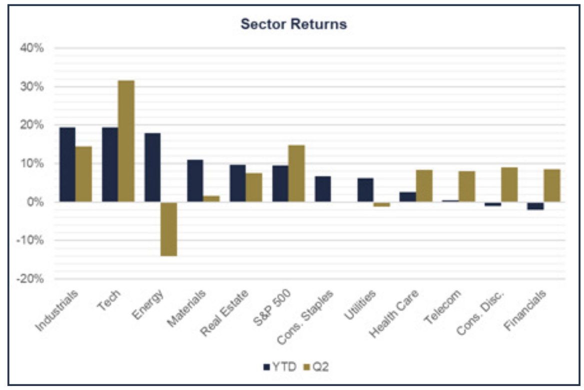
### U.S. Equity




**Q2 2026 delivered one of the strongest single-quarter equity market recoveries on record, as the S&P 500 surged to erase its first-quarter losses and push the index to new all-time highs, driven by a resurgent artificial intelligence trade, the de-escalation of the Middle East conflict, and a broadening of market participation that rewarded the breadth and depth of the U.S. equity market in a way rarely seen.** The S&P 500, the bellwether for U.S. stock returns, finished the second quarter up 15.2%, pushing its year-to-date return to 10.2%, a remarkable turnaround from the index's −4.3% loss through the end of March. The broader Russell 3000 Index rose 15.4% during the quarter, with a year-to-date return of 10.9%. The reversal was catalyzed in early April by the announcement of a ceasefire between the U.S., Israel, and Iran on April 8th, which began the process of reopening shipping lanes through the Strait of Hormuz and brought Brent crude oil prices, which had briefly eclipsed $130 per barrel at the height of the conflict, meaningfully lower. With the energy price shock receding, investor attention rotated decisively back to the structural growth narrative that defined markets in 2023 and 2024: artificial intelligence.

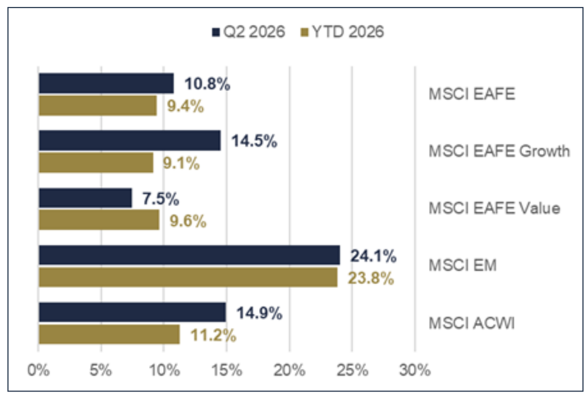
**The most notable feature of the second quarter was the extraordinary outperformance of smaller-capitalization stocks.** The Russell 2000 Index of small-cap stocks surged 21.5% during the quarter, its best single-quarter performance in years, bringing its year-to-date return to 22.6%—the strongest first-half result for small-cap equities since 1991. Even smaller micro-cap stocks performed exceptionally well, with the Russell Micro Cap Index rising 25.6% in Q2 and 27.5% year-to-date. Mid-cap stocks also posted strong results: the Russell Mid Cap Index gained 13.8% in the quarter, with a year-to-date return of 15.3%. Several forces converged to produce this small- and mid-cap surge. Domestic fiscal stimulus measures, including favorable capital investment provisions from legislation passed in the spring, provided an earnings tailwind for domestically oriented businesses. Rate-cut expectations, while not fully priced in given the Federal Reserve's ongoing caution, continued to provide relief to the large share of Russell 2000 constituents carrying floating-rate debt. Perhaps most importantly, small- and mid-cap stocks entered the quarter at a historically wide valuation discount to large-cap peers—a discount that investors began to close as earnings expectations for the asset class accelerated sharply, with consensus estimates pointing to nearly 45% year-over-year earnings growth for small caps in the first quarter of 2026.

The style story of Q2 2026 was a near-mirror image of the first quarter: after growth stocks bore the brunt of the geopolitical selloff in Q1, they staged a powerful recovery in Q2. Within large caps, the Russell 1000 Growth Index returned 16.7% for the quarter, outpacing the Russell 1000 Value Index's 13.9% gain. The disparity was even wider measured by the S&P style indices, with S&P 500 Growth surging 21.9% in Q2 compared to S&P 500 Value's 8.0%. The growth recovery was led principally by the resurgent AI hardware trade: semiconductor and technology hardware companies posted some of the largest single-quarter gains in recent market history as investors priced in the next phase of AI infrastructure buildout, with hyperscaler capital expenditures for 2026 estimated to approach $725 billion. The second quarter's earnings season saw the S&P 500 post estimated year-over-year earnings growth of 23.1%, representing the highest earnings growth rate since Q2 2022. Viewed on a year-to-date basis, however, the rotation dynamic of the past two quarters tells a different story: despite Q2's growth outperformance, the scale of the Q1 selloff in growth stocks was severe enough that value still leads meaningfully through June, with the Russell 1000 Value Index up 16.3% year-to-date compared to the Russell 1000 Growth Index's 5.3%. Within small caps, the YTD gap is far narrower, as both growth and value benefited from the broad small-cap rally; the Russell 2000 Growth Index returned 22.2% year-to-date while the Russell 2000 Value Index gained 23.0%.



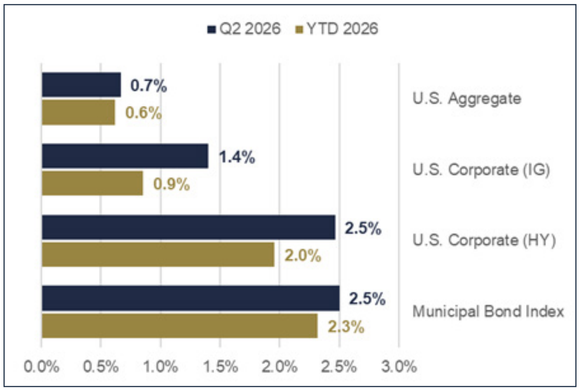

## International Equity

**International equity markets delivered sharply divergent results in Q2 2026, with emerging markets, driven by a small number of memory storage companies that were the beneficiaries of the hyperscaler capex binge, posting an extraordinary quarter while developed European markets were largely left behind, creating one of the widest intra-international performance gaps in recent years.** The. best-performing index globally was the MSCI Emerging Markets Index, which surged 24.1% in the second quarter, bringing its year-to-date return to 23.8%—results that rank among the strongest for the asset class in over a decade. Emerging market strength was broad-based but concentrated in several powerful themes: the AI infrastructure buildout created surging demand for semiconductors and advanced hardware from Asian technology exporters, with South Korean equities leading the charge as the KOSPI posted exceptional gains on the back of strong earnings from memory and chip manufacturers. De-escalating energy prices provided relief to commodity-importing economies across Asia, while earnings growth expectations for the EM universe as a whole approached 29% for 2026, more than double the consensus for the U.S. Japan was another standout within developed international markets, with the MSCI Japan Index advancing 14.2% in Q2 and 15.8% year-to-date, supported by a weaker yen that bolstered exporters' competitiveness, resilient corporate earnings, and the country's exposure to the global technology supply chain.




Developed European markets told a notably different story. The MSCI EAFE Index, which tracks developed international markets in Europe, Australasia, and the Far East, returned 10.8% in the second quarter. European equities continued to face structural headwinds: energy costs, while falling from their peak levels, remained elevated relative to pre-conflict levels; the automotive sector remained under pressure from a combination of EV adoption challenges and tariff-related margin compression; and ECB rate cuts, while providing some monetary relief, were insufficient to fully offset the growth drag from the Iran war's spillover effects on the continent's energy-intensive industrial base. On a year-to-date basis, the MSCI EAFE Index returned 9.4%, with value (9.6%) modestly ahead of growth (9.1%), though Q2's intra-quarter momentum began shifting back toward growth as the AI trade reignited. **Summing up the global stock market in Q2, the MSCI All Country World Index returned 14.9% in Q2 and 11.2% year-to-date.**

## Fixed Income




**The fixed-income market delivered modestly positive returns in Q2 2026, as the de-escalation of the Middle East conflict provided some relief to energy-driven inflation expectations even as the Federal Reserve maintained its restrictive posture and new Federal Reserve Chairman Kevin Warsh's first FOMC meeting ended with rates on hold and a notably hawkish shift in the committee's forward guidance.** The Bloomberg U.S. Aggregate Bond Index, a broad measure of the performance of investment-grade fixed-income markets in the U.S., returned 0.7% in Q2, bringing its year-to-date return to 0.6%—a modest cumulative gain after the near-flat first quarter. At its June 17th meeting, the FOMC voted unanimously to hold its federal funds target rate at 3.50%–3.75%. More significantly, the committee's updated Summary of Economic Projections reflected a hawkish revision to the rate outlook: the median dot for 2026 moved higher, removing the single rate cut that had been penciled in and suggesting that the next move could in fact be a hike, with markets pricing in a possible increase as early as the fourth quarter. The persistence of energy-driven inflation—and the new Fed leadership's emphasis on price stability above all else—kept markets from fully pricing in the bond rally that a resolution of the Middle East crisis might otherwise have delivered. Despite the hawkish tone, the ceasefire and the gradual decline in oil prices from their March highs allowed inflation expectations to moderate somewhat, providing enough relief for shorter-duration bonds to generate modest positive returns. The Bloomberg U.S. Treasury Bill 1–3 Month Index returned 0.9% in Q2 and 1.8% year-to-date, continuing to reward investors who held shorter maturities.

Municipal bonds were the standout performer within the fixed-income complex in Q2. The Bloomberg Municipal Bond Index returned 2.5% for the quarter and 2.3% year-to-date, supported by favorable supply-and-demand technicals, resilient state and local government credit quality, and renewed investor appetite for tax-exempt income. High-yield municipals performed even better, with the Bloomberg High Yield Municipal Index returning 3.4% in Q2 and 4.1% year-to-date. Investment-grade corporate credit also outperformed core government bonds, with the Bloomberg U.S. Credit Index gaining 1.3% in Q2 and 0.8% year-to-date. The Bloomberg U.S. Corporate High Yield Index returned 2.5% in Q2 and 2.0% year-to-date, reflecting the continued resilience of corporate balance sheets and declining default concerns as energy price pressures began to ease. Inflation-linked securities held their ground with TIPS returning 0.9% in Q2 and 1.2% year-to-date, as real yields remained elevated even as nominal breakeven inflation rates declined modestly from their first-quarter peaks. Long-duration Treasury bonds also participated in the modest relief rally, with the Bloomberg U.S. Treasury 20+ Year Index returning 0.9% in Q2, though its year-to-date gain of just 0.6% reflects the significant rate volatility the long end experienced in the first quarter. International fixed income remained a relative laggard for the full first half, as the cumulative effects of first-quarter dollar strength continued to weigh on year-to-date returns; the Bloomberg Global Aggregate ex-USD Index gained 1.0% in Q2 but remained down −0.9% year-to-date. **Summing up global fixed income markets in Q2, the Bloomberg Global Aggregate Index returned 0.9% for the quarter—a modest recovery—but remains down −0.2% year-to-date, a cumulative result that reflects the offsetting forces of a near-flat second quarter and the currency and rate headwinds that characterized the first three months of 2026.**

## ECONOMIC OUTLOOK

Our base case for the second half of 2026 is an economy that continues to grow at its trend rate, with the composition of growth shifting further toward business investment and away from consumer spending. The uneven, K-shaped expansion is likely to continue as one part of the economy is supported by a powerful investment cycle while another becomes increasingly constrained by pressures on income, energy, and borrowing costs.

The assumption undergirding this base case is that the Middle East conflict gradually de-escalates and the Strait of Hormuz reopens, keeping oil prices down from their April peak to remain in the $70 to $80 per barrel range. If this scenario plays out, the most acute source of upside inflation risk abates, the disinflationary impulse from fading tariff passthrough can take hold, and the Fed can sustain its current posture of watchful patience through year-end.

## Capital Expenditures

Business investment is the growth story of 2026, and we expect it to remain so in the second half. The AI infrastructure buildout has its own internal momentum that is largely disconnected from the traditional cyclical drivers of capital spending — interest rates, credit conditions, and the output gap. Hyperscalers* have committed to spending plans that extend for years, and the enterprise adoption wave is adding a new layer of software and R&D investment atop the hardware cycle. We see no signs of a meaningful deceleration in this category.

The One Big Beautiful Bill Act (OBBBA) investment incentives continue to work their way through the system. The provisions most directly affecting capex—accelerated depreciation and expensing of R&D—are front-loaded in their impact, meaning the marginal boost to investment growth from this source will be somewhat smaller in the second half than it was in the first. But the cumulative level of capex is elevated relative to prior cycles, supporting a base of activity unlikely to contract absent a significant demand shock.

The one meaningful risk to the capex outlook is a scenario in which a sustained deterioration in consumer fundamentals ultimately feeds back into corporate revenue expectations, prompting companies to revisit investment plans. For now, management guidance from the first-quarter earnings season shows little sign of this feedback loop forming. Companies flagged concern about the near-term consumer outlook but did not revise capital spending plans in response. The structural nature of AI-driven investment is the primary reason: companies view this spending as competitively necessary rather than discretionary.

## Consumer Spending

The consumer outlook for the second half of 2026 is, in our assessment, where consensus carries the greatest risk of disappointment. The key inputs are all pointing in the same direction: real income growth is negative, the personal saving rate is already very low, the tax refund boost that supported first-half spending is fading, and energy prices—while retreating from their April peak—remain well above year-ago levels.

We expect real consumer spending growth to decelerate in the second half of the year. This is not catastrophic; we expect real spending growth will remain positive, and the economy can absorb it without tipping into contraction, given the strength of business investment. But the deceleration will be visible in the data, and it will show up first in rate-sensitive and discretionary categories—autos, home furnishings, apparel, and experiential services that compete directly with elevated energy costs for wallet share.

The wealth effect will provide some offset, particularly for upper-income households. With equity markets near record highs and household net worth at 800% of disposable income, according to Morgan Stanley calculations, asset-sensitive consumers have a meaningful buffer. But the wealth effect from equities operates with long lags, is concentrated among high-income cohorts who have a lower marginal propensity to consume, and is highly sensitive to the performance of a narrow set of AI-related equities that now account for a disproportionate share of index market capitalization. A correction in AI-related stocks—possible but not our base case—would disproportionately reduce the wealth effect precisely when consumers can least afford to lose another tailwind.

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*Hyperscalers are the largest cloud infrastructure companies, distinguished by their ability to deploy and operate data centers, computing capacity, storage, networking, and artificial intelligence infrastructure at global scale. The term is commonly used to describe major cloud platforms such as Amazon Web Services, Microsoft Azure, Google Cloud, and Oracle Cloud.

## Inflation

Our inflation outlook for the second half of 2026 is more sanguine than the current data might suggest, but that view rests on assumptions that carry meaningful uncertainty. We expect core PCE inflation to moderate by the fourth quarter, as three disinflationary forces gather strength.

First, the fading of tariff passthrough. Tariff-exposed goods prices rose approximately 64 basis points above trend over the past year as Liberation Day tariffs were absorbed by the price system according to calculations by Goldman Sachs. That passthrough process appears largely complete. If prices in tariff-exposed categories stabilize or partially normalize toward pre-Liberation Day trends, Goldman's analysts estimate this could lead to a disinflationary tailwind of up to 70 basis points year over year in the second half. This alone would meaningfully shift the trajectory of core goods inflation.

Second, moderating energy prices. Under our base-case assumption of a gradual reopening of the Strait of Hormuz, Brent crude oil remains largely within the range of pre-conflict prices through year-end. Lower energy prices reduce headline inflation directly and relieve the secondary cost pressures that have been running through chemicals, fertilizers, and industrial materials. The energy component's contribution to core PCE diminishes as the year-over-year comparison becomes more favorable.

Third, shelter disinflation. The methodological disruptions introduced by last year's federal government shutdown, which caused six months of rent and owners' equivalent rent data to be distorted downward due to missing October 2025 data, were corrected in April's reading, making it difficult to get a true picture of shelter cost trends. The updated data, no longer subject to that methodological distortion, confirm that underlying shelter costs, which track private-sector rent growth with a lag, remain in a gradual deceleration as the pandemic-era rental surge continues to normalize.

The primary source of inflation persistence that will limit the pace of deceleration is AI-related price pressure. Strong demand for semiconductors, computer memory, electronic components, and data center infrastructure has put upward pressure on a growing slice of the core goods basket. Unlike the commodity and tariff shocks that are expected to fade, this category of inflation is structural and demand-driven. AI will continue to absorb significant real resources and those resource constraints will continue to exert upward pressure on relevant price indices. We do not expect this channel to reverse in the near term; we expect it to persist.

## The Federal Reserve

The June FOMC meeting crystallized a monetary policy outlook that is, at its core, one of extended patience with asymmetric risk. The Federal Reserve under Chairman Warsh is clearly focused on completing the job on inflation rather than pivoting prematurely toward accommodation. The removal of the easing bias from the policy statement was a meaningful signal; the Fed is actively debating whether the conditions for hikes might materialize.

Markets currently imply at least one 25-basis-point rate hike before the end of the year, with the possibility of more. Our base case, however, is that the FOMC leaves the federal funds rate unchanged at 3.50 to 3.75% for the remainder of 2026, with the first rate move deferred to 2027. The labor market, while somewhat softer than the unemployment rate alone implies, is not deteriorating, a development likely needed to create urgency for accommodation. We expect the labor market to remain stable, which would not represent the kind of weakening that has historically preceded a policy pivot. On the inflation side, our expectation for core PCE by year-end is below the Fed's own projection of 3.3%, which—f correct—reduces the probability that a hike is warranted.

The risk to this view is not trivial. A 9-9 split on the dot plot means that a relatively modest shift in the inflation or activity data could tip the balance toward a majority favoring a hike. The conditions most likely to trigger hikes are clear: sustained core PCE prints above 3.3%, evidence of broadening second-round inflation effects from the oil shock, or a structural upward revision in the Fed's estimate of the neutral rate as a result of the Fed's framework review that convinces Fed officials that current policy is insufficiently restrictive. None of these conditions are currently in place, but none can be ruled out over the next six months.

The institutional reforms Warsh has set in motion—five task forces reconsidering communications, the balance sheet, data reliance, the labor market in an era of AI transformation, and the inflation framework—introduce a layer of regime uncertainty that is itself a form of hawkish signaling. Markets that relied on the prior Fed's forward guidance-oriented communication framework will need to reprice risk premiums to reflect a less predictable reaction function. This is a meaningful development for fixed income markets in particular.

## EQUITY MARKETS

### U.S. Equity Markets

For the past few decades, buybacks have been the easy choice for corporate leaders deciding how to deploy excess cash. For roughly a decade and a half after the financial crisis, companies that returned cash to shareholders were rewarded, while those that plowed it back into the business often were not—a pattern driven by weak nominal growth, abundant capacity, and a market willing to pay up for capital-light, scalable software businesses. That relationship has now inverted, and the data is clear: S&P 500 capital expenditures grew roughly 38% year-over-year in the first quarter of 2026, while buyback growth was barely 1%. Companies are being rewarded for investing and building rather than returning that cash to shareholders, a reversal from the prior decade.

The scale of hyperscaler spending dwarfs any single financing relationship, and the companies funding it carry investment-grade balance sheets and enormous free cash flow of their own. But the broader market is, for the first time, asking a harder question of this spending – is it earning an adequate return? Investors who spent 2023 and 2024 rewarding nearly any company with an AI narrative attached have grown more discerning in 2026, questioning whether the hyperscalers can sustain the premium returns on invested capital that justified the spending in the first place. That emerging skepticism has produced one of the more interesting rotations within technology we have seen in years. Chip and equipment manufacturers, the picks-and-shovels of this buildout, have outperformed, while software and services, whose business models face the most direct disruption risk from the very AI tools their own customers are now building, have been the more significant relative laggards. The valuation premium software once commanded over hardware, north of 100% relative to the broader market only a few years ago, has essentially disappeared.

We think rotation is the more durable story, not a temporary one. For the first time since the early days of the internet build-out, the fortunes of the virtual and physical economies are once again genuinely intertwined. Data centers need power. Based on forecasted demand growth, grid infrastructure investment is needed to ensure supply meets expected demand. That investment will largely flow to the industrial and materials companies that spent the better part of fifteen years being told their growth prospects were structurally inferior to software's. That capex spillover is also showing up in market breadth: the median U.S. stock has meaningfully underperformed the major indices so far this year, a sign that index-level returns are increasingly masking a wide and growing dispersion beneath the surface. For active management, that dispersion is the opportunity—recognizing genuine capex-cycle exposure will likely result in a different set of companies leading the market than we saw in the last cycle is, in our view, the central task for U.S. equity positioning in the second half.

Practically, that argues for resisting two temptations at once: chasing the software-heavy growth narrative that carried the market from 2009 through 2023, and abandoning growth altogether in favor of a broad, indiscriminate value rotation. A more balanced approach is selective and diversified. In portfolios, that means maintaining exposure to high-quality growth companies that are converting investment into durable earnings, while also recognizing that a broader capital spending cycle may create opportunities beyond the traditional software-led market leadership of the prior cycle. Those opportunities may appear across areas such as infrastructure, electrification, industrial production, and other parts of the market with more direct ties to physical investment. The key is not to replace one narrow leadership theme with another, but to ensure that equity portfolios remain diversified across style, size, geography, and implementation, with both passive and active exposures playing a role.

## Global Equity Markets

For the better part of fifteen years, “international diversification” was a phrase investors tolerated more than believed in. From the depths of the financial crisis through 2022, equity markets were defined by a remarkably persistent pattern of leadership, with domestic stocks, the technology sector, and growth-oriented companies each holding a sustained advantage over their respective counterparts. Since 2025, that pattern has reversed. Emerging markets, Japan, industrial metals, and gold have been among the strongest performing major asset classes over that stretch, while the broad U.S. technology-growth complex has lagged.

Some of that is the mirror image of the capex story already discussed: real assets and the old economy tend to do well when capital intensity rises and inflation runs hotter than investors are accustomed to. Some of it is more explicitly geopolitical. Germany and Japan—two countries that spent three decades operating under self-imposed defense constraints inherited from the post-Cold War peace dividend—are now ramping defense procurement meaningfully, a trend visible in German defense order data and in the broader policy-uncertainty index, which has pushed well above its four-decade average. Add a U.S. tariff regime that, by the Commerce Department’s own reckoning, has reached levels not seen since the 1930s, and you have a genuine, not cosmetic, case for regional diversification: the dispersion of country returns is rising, even as the median stock return across most major markets has compressed this year relative to the headline index.

We do not view this as a call to abandon U.S. leadership, which remains structurally important to client portfolios. We do view it as confirmation that the diversification benefit of non-U.S. exposure, which largely went missing for over a decade, has returned. Clients who maintained discipline on global allocation through years when it was unrewarded are now positioned to benefit from a genuinely broader opportunity set.

## FIXED INCOME MARKETS

The U.S. Treasury yield curve is now positively sloped across nearly every maturity pair after years in which inversion, not steepness, was the default condition. Wall Street has named this dynamic “the great steepening”, and the second half of 2026 looks set to extend it.

Core PCE inflation running above 3%—its highest level since 2023—combined with a new Fed chair openly skeptical of an expansive central bank balance sheet, has shifted market pricing away from cuts and toward the possibility of a hike before year-end, which is the most likely market-implied outcome as of the end of June. Layer on to that cyclical issue a secular challenge that is harder to dislodge and, frankly, more important for long-term positioning: government debt-to-GDP has nearly tripled in the United States since the turn of the century and risen comparably across the United Kingdom, the euro area, and China. That borrowing is now competing directly with private capex demand for a limited pool of global savings. German and Japanese 30-year government bonds—which yielded close to zero only a few years ago—now trade in the neighborhood of 4%. The global cost of capital has reset higher, and it should inform how we think about duration for years, not quarters.

In client portfolios, that argues for preserving flexibility. Our fixed-income exposure is generally expressed through a combination of high-quality core bond managers, shorter-duration allocations, and more flexible active strategies that can adjust duration, curve exposure, and sector positioning as the opportunity set changes. The emphasis is on avoiding uncompensated risks: not reaching too aggressively for long-end yield when the path of Fed policy remains uncertain, not relying too heavily on high-yield spreads that offer limited cushion, and favoring managers with the ability to compare opportunities across Treasuries, investment-grade credit, high yield, and loans as relative value shifts. Given where we are in the cycle, we prefer to maintain quality, liquidity, and active flexibility in an environment where the next move in rates may matter less than the market’s longer-run confidence in the broader policy and credit backdrop.

For investors in the highest tax brackets, municipal bonds continue to remain attractive. The municipal market enters the second half of 2026 with a technical and fundamental backdrop that, in our assessment, is meaningfully underappreciated by investors whose attention has been captured by the equity bull market. The asset class offers after-tax yields that compare favorably with taxable alternatives for investors in higher tax brackets, credit quality across the investment-grade universe that remains among the strongest in the bond market, and a demand profile that is improving as equity markets near all-time highs and investors begin to rebalance toward income-generating assets with more predictable return streams.

## BASE CASE AND RISKS TO THE OUTLOOK

We find scenario thinking more useful than point forecasts in such a fluid environment, and the weight of the evidence currently favors our base case, though the range of plausible outcomes remains wide.

### Base Case

The fragile understanding reached between Washington and Tehran holds through the back half of the year, even amid periodic flare-ups, and a durable framework is reached by year-end. Energy prices stabilize off their conflict highs, easing the supply-side inflation pressure behind recent PCE readings. The Fed holds rates steady through year-end, content to let the hawkish dot plot serve as a deterrent rather than act on it. The capex cycle continues to broaden beyond data centers into power, industrials, and infrastructure, and earnings growth, rather than further multiple expansion, becomes the primary driver of equity returns. Bond yields stay range-bound, with the curve holding its modestly positive slope. This is our central expectation for the second half of the year.

### Upside Risks

Diplomatic progress accelerates faster than currently expected and oil prices retreat meaningfully, giving the Fed room to resume cutting rates after all and vindicating the dovish projections that prevailed as recently as March. AI capital spending visibly converts into revenue and margin expansion across a widening set of companies, confirming the bull case for the capex cycle and supporting further multiple expansion alongside earnings growth. Equities and bonds rally together, echoing the favorable correlation regime of the past decade, though we caution that this combination has grown rarer in the current cycle and should not be assumed to be the default outcome.

### Downside Risks

The ceasefire framework deteriorates rather than stabilizes, energy prices spike again, and core inflation proves stickier than the Fed's June projections assumed, forcing Chairman Warsh to convert the dot plot's hawkish lean into an actual rate increase, or more than one. Equity multiples compress further from already elevated levels, particularly in mega-cap technology, while credit spreads widen as the cost of capital squeezes the most-leveraged balance sheets. Energy, defensive, and value-oriented sectors outperform the broader market amid a more difficult earnings backdrop. We would treat this scenario as a buying opportunity for quality assets rather than a reason to retreat from markets, though it would likely be uncomfortable to live through in real time.

### What This Means For Your Portfolio

None of the above changes how we build portfolios, which is rather the point of building them this way in the first place. But it does sharpen where we are leaning within the existing framework as we head into the back half of the year.

In equities, we continue to favor diversified exposure across geography, size, and style, rather than making an all-or-nothing call on any single market segment. Recent changes have increased the passive component of portfolios, providing efficient exposure to the broad market, including the AI-related companies that remain significant drivers of index-level earnings and returns. Around that passive core, we continue to use active managers selectively where dispersion, valuation discipline, capitalization exposure, and regional differences create room for skilled managers to add value. We have also selectively introduced a global infrastructure allocation, which provides a more direct and diversified way to participate in the long-term investment needs tied to power, electrification, transportation, utilities, and other real-asset infrastructure across global markets.

In fixed income, the emphasis remains on quality, liquidity, and flexibility, leaning on a mix of high-quality core bond exposure, shorter-duration strategies, and active managers with broad enough mandates to compare opportunities across Treasuries, investment-grade credit, high yield, loans, and securitized credit as relative value changes.

The common thread across both stocks and bonds is discipline: maintain broad market participation, diversify the sources of return, and use active management where the opportunity set justifies it.

We have worked through major shifts before: the end of the zero-rate era, four years of escalating geopolitical risk, and now a capex boom large enough to reorder how returns are generated across both stocks and bonds. The throughline in each case has been the same. A long-term plan, built around your specific goals, that does not require us to correctly predict every twist in the policy cycle in order to succeed. As always, we welcome the opportunity to discuss how these themes apply to your specific portfolio and circumstances, and we remain grateful for the trust you place in Fulton to do this work alongside you.

# ABOUT THE AUTHOR

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Matthew is the Chief Investment Strategist and Director of Institutional Investments for Fulton Private Bank and Fulton Financial Advisors. He was a National Merit Scholar at the University of Chicago, where he graduated with a B.A. in Political Science. He is a Chartered Financial Analyst (CFA®) charterholder and is a member of the CFA® Institute and the CFA® Society of Philadelphia.



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