U.S. MARKET REPORT

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Stocks Jump with Economic Resilience

The S&P 500 had a negative return of 4.4% in the first quarter of 2026, but in the second quarter the index had a remarkable 15% total return. Part of the S&P's performance during the first half of the year reflects the start of war with Iran on February 28th. As we wrote in our last report, these geopolitical events usually don't have lasting effects on the markets. Stocks swooned when the fighting started, but as markets gained confidence that Trump was backing down from a prolonged conflict, stocks began to rebound. But of course, the real engine of stock returns has been the resilient U.S. economy, and strong earnings growth for U.S. businesses. Real GDP growth for the first quarter of 2026 was recently revised upward to a 2.2% annualized rate. New job growth has continued despite nail biting over the possible effects of AI, and unemployment remains low at 4.2%. Furthermore, the consensus estimate for 2026 earnings growth for the S&P 500 has been ratcheting up all year and now stands north of 20%.

There is no longer much talk about the "Magnificent Seven." Technology stocks continue to have a supersized impact on the indexes, but the companies with notable performance have both shifted and expanded. While some of the big names like Microsoft and Meta have stalled lately, semiconductor companies, have really exploded in price. Micron Technologies, one of the big three global producers of memory chips was up 242% during the 2nd quarter. Advanced Micro Devices and Intel, both producers of microprocessors, were up 186% and 216%, respectively. And Applied Materials and Lam Research, two of the big companies that manufacture the equipment used to build semiconductor factories, were up 112% and 103%, respectively. The strength of these stocks reflects the massive spending by the so-called hyper-scalers, those Mag 7 companies building the massive data centers used to run AI models. In other words, the excitement has broadened out from the gold miners to the businesses selling the picks and the shovels.

The strength in U.S. business, at its core, is being fueled by the growing confidence that artificial intelligence will transform the way goods and services are produced and delivered. Furthermore, *growth is being strengthened by the tax cuts* under the "Big Beautiful Bill" signed one year ago on July 4, 2025. Recall that the tax bill extended businesses ability to immediately expense research and development (R&D) spending. Also, business spending on equipment and many structures can be immediately expensed for tax purposes, and that includes the costs for building data centers and manufacturing facilities. These changes have had a significant effect since they incentivize business spending and essentially become a source of funds for business investment. The five so-called hyperscalers, Amazon, Google, Meta, Microsoft and Oracle, have collectively guided towards more than $700 billion in capital spending this year. For perspective, nominal spending (NGDP) increased $1.8 trillion over the past year. Furthermore, total capital spending within the S&P 500 is projected at about $1.3 trillion, so that capital spending by the hyperscalers account for a bit more than half. And we're not even counting private companies and governments. The good news is that most of this investment is being made out of operating cash flows. For example, the five hyperscalers are expected to issue about $175 billion in new debt this year, or about a quarter of capex spending.

Areas of Concern

Investors are jubilant, as evidenced by the strong stock market performance this year, but there are areas of concern: 1. The S&P 500's valuation appears stretched regardless of the measure used; 2. Earnings estimates have been rising all year and 2026 is now forecast to experience earnings growth of more than 20%. But behind the scenes that growth rate looks inflated; 3. Inflation has stayed stubbornly high; 4. There is a new Chairman of the Federal Reserve and the risk to interest rates is to the upside. Despite these concerns and other issues as well, we caution that history has shown that market timing doesn't work. Investors are likely best served by staying invested in this AI driven supercycle.

According to Factset, a widely used information technology data source used in the investment field, the price/earnings (P/E) ratio for the S&P 500 is 22 times the consensus earnings estimate of 338.34 for 2026, which would be a stunning 25% increase in earnings from 2025. There are two issues here. First, the net profit margin, which is earnings as a percentage of revenues, is forecast at 14.8%, the highest level since Factset started tracking earnings in 2009. It is also well above any level previously reported by S&P Global. This could be a good estimate—we'll talk more about this later, or it could be inflated. But even if the earnings estimate is accurate, the P/E of 22 is richer than the 69 year average of about 16. There are good reasons why the market should be more expensive than the average. AI boosting productivity and the economy and profits growing strongly in the years ahead is one. But valuation is a risk.

There are reasons to argue that earnings for the S&P 500 are inflated. Anthropic, one of the leading edge AI companies, is private and it raised new capital at a much increased valuation in the '26 first quarter. Both Amazon and Google made past investments in Anthropic. Accounting rules require such investments be "marked-to-market." In other words, if the investment changes in value, you have to record the changes as a gain or loss on your books. Because of the capital raise and the rise in Anthropic's valuation, Amazon recorded a pretax gain of $16.8 billion, versus operating income of $23.9 billion. Google recorded unrealized gains of $37.7 billion, almost as much as its operating income of $39.7 billion. University of Florida finance professor Baolian Wang has estimated that such gains were equal to about 12% of the S&P 500's first quarter earnings. If valuations fall sometime in the future, these companies could record investment losses rather than gains.

The accounting treatment for depreciating equipment is another factor that has to be considered with regard to earnings growth. As we mentioned earlier, these hyperscalers can buy technology and put it in huge buildings and deduct those costs immediately on their tax bill. However, under generally accepted accounting principles, those capital expenses are not immediately expensed. Instead, on the books given to shareholders, the cost of that equipment is written down over a period of years. Servers and networking equipment is commonly written down over 5-6 years, while data center buildings are depreciated over 20 to 40 years. What does this mean for the S&P 500 or the market as a whole? If Amazon buys $1 billion worth of equipment from Nvidia, Nvidia records that $1 billion as revenue immediately. However, on its books, Amazon does not immediately record that $1 billion as an expense. As noted, such equipment is depreciated in small increments over a period of years. The market is in a place now where the good stuff (revenues) is recorded immediately, and the bad stuff (expenses) are capitalized and depreciated over a long period. As the capital spending boom eventually slows, revenue growth will slow just as depreciation expense accelerates due to cap spending in years past.

Interest Rates & Inflation

To understand the recent reacceleration in inflation, we need to realize the Federal Reserve's powers are limited. The Fed has no factories and produces no services. All they can do is create money and credit and manufacture nominal spending. The Fed can change the price of credit by increasing or decreasing liquidity in the banking system. The chain of causality goes like this: Fed Policy tightens or loosens money and credit >> spending growth (changes in nominal GDP) accelerates or decelerates >> inflation accelerates or decelerates. We saw this perfectly during the pandemic when the Fed cut interest rates to zero in March 2020 and helped accommodate the administration in sending out checks (money). No surprise that the GDP Deflator, the broadest measure of inflation, rose at a staggering 14.6% rate in the last quarter of 2021 while consumer prices accelerated to a 9% year-to-year rate by June 2022.

Looking plainly at the current situation, it is difficult or impossible to imagine any reason for the Fed to cut interest rates anytime soon, and in fact the next move is likely to be upward. The news media commonly talks about tariffs or the spike in energy prices as being the "cause" of the recent uptick in inflation. But such supply-side effects are transitory and not what we would call a permanent rise in the price level—inflation. Looking back, what now seems very odd is that the Fed cut interest rates by an oversized 0.50% on September 18, 2024, a month and a half before the election. Cutting rates at that time now seems odd since the most recent reading of consumer inflation, in August 2024, showed a year-over-year increase of 2.6%, still well above the Fed's maximal 2.0% target. What was the hurry in cutting rates? And that 0.50% interest rate cut was followed by five 0.25% cuts between November 7, 2024 and December 10, 2025. Milton Friedman, the monetarist economist, famously noted that monetary policy typically works with a variable 18-to-24 month lag. <u>Maybe, therefore, we shouldn't be surprised to see nominal spending (GDP) and inflation now reaccelerating after such a lag.</u>

The impact of former Fed Chairman Powell's 2024/2025 rate cuts can be seen in the long-term charts below. On the left in Chart 1, you can see the blue line, the Fed Funds lending rate turning down. With the lag already discussed, nominal spending, the black line has started turning back upward. So naturally, in Chart 2, we can see inflation (the blue line) turn upward along with spending (the black line).

Chart 1

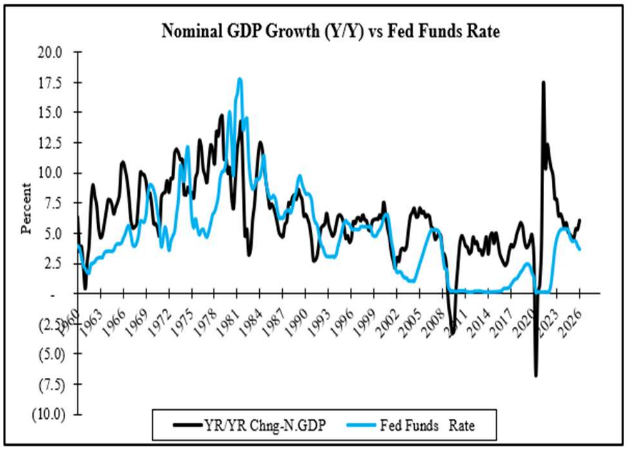
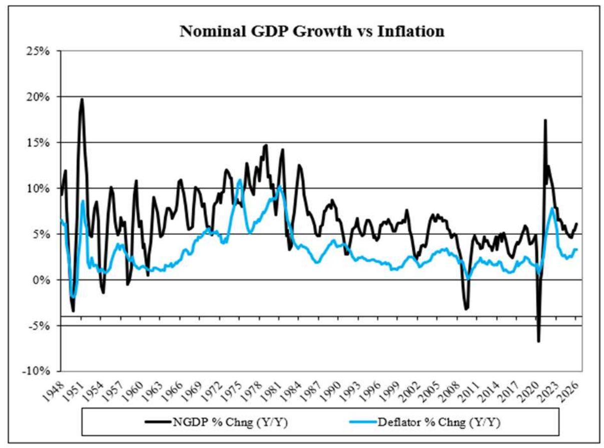


Chart 2



The very good news is that the Federal Reserve has a new Chairman by the name of Kevin Warsh. Known for his hawkish views on monetary policy, including a goal of shrinking the Fed's balance sheet to a more historically normal size, Warsh has also developed a reputation as a reformed minded outsider. Warsh has established five independent commissions intended to help him overturn Fed operations and practices, such as "forward guidance," that has led to such sub-optimal results over the past five years. It is possible that even merely having a tough reformist Fed Chair will help moderate inflation expectations. Currently, the futures contracts on the Chicago Mercantile Exchange indicate a better than even chance that the Fed will raise the Fed Funds rate by September. We view this favorably. There is nothing more important for the Fed than to use its tools to lower inflation. We will all—especially the working and middle classes--be better off if we take some pain of tighter money and credit now, rather than let the inflation issue continue to fester.

The U.S. dollar and the Euro have mostly been in a trading range for the past ten years and we don't expect that to change much. Europeans visiting North America for the World Cup probably have been unhappy to find that lodging and food is expensive when perceived in Euro terms. Indeed, on a purchasing power basis the USD is expensive. The OECD puts the USD's purchasing power exchange rate versus the German Euro at about 1.4. But just as Switzerland is expensive, so is the U.S. likely to remain expensive. This can occur because, while exports and imports of goods and services totaled $7.8 trillion (annual rate) in the 2026 first quarter, USD gross capital flows can total more than a $100 trillion in a year. The U.S. population is only 4.2% of the total world population, but the U.S attracts an oversized interest in foreigners who wish to invest in the U.S. Also, a substantial portion of non-U.S. world trade and debt financing is conducted in dollars. Ultimately, the demand for dollars is determined by the willingness of so many foreigners to hold USD for reasons beyond U.S. trade.

Oil and Gold

The Iran war led to quite a little roller coaster ride for oil, and it may not be over. On February 27th, the day before the war began, Brent crude oil was trading at $71 per barrel. The loss of crude shipments through the Strait of Hormuz led to a price spike to $138/bbl on April 7th, but prices steadily declined thereafter. Coincidentally, the price of Brent closed again at $71/bbl on July 2nd. The closure of the Strait has been called the greatest energy supply disruption in history, and cumulative losses in shipments have exceeded 1.3 billion barrels. For comparison, the world uses about 103 million barrels per day. But the disruption was mitigated by several factors, such as the joint decision for many nations, including the U.S., to sell 400 million barrels of crude oil out of their strategic petroleum reserves. Middle Eastern nations also found ways to ship via pipelines and other methods. Also, commercial inventories have been drawn down by about 3.8 million barrels a day since the war's start. But the surprising factor is that China has cut back its oil imports by some 40%, or 4.6 million barrels a day. The Chinese apparently have been accumulating massive reserves and have become an important swing supplier in times of market stress. This all seems to imply lower oil price volatility going forward. But we're still left with the issue that inventories and reserves will be rebuilt going forward. This should provide a floor under crude oil prices, but a big spike is unlikely unless war resumes.

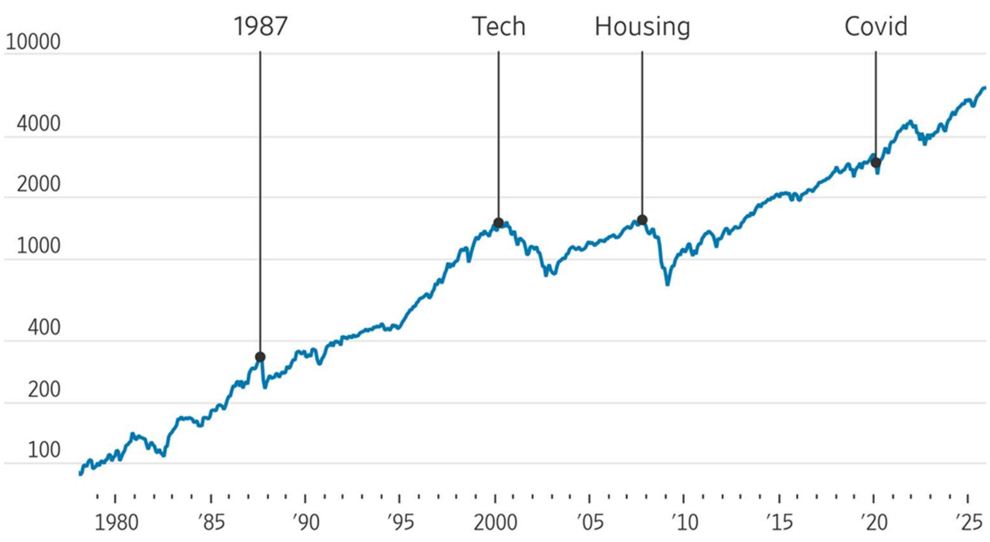
New York Gold hit a peak of $5,318.4 an ounce on January 29, 2026, which, coincidentally, is the same day we put out our market report on the yellow metal. Since that time, gold has steadily declined and is now priced at about $4,100 per ounce, down 23% from the peak. There really is no way of knowing where the price of gold will go in the months ahead, but the prospect of rising interest rates will put downward pressure on gold, which pays no interest and has no earnings. It's what economists call opportunity costs. And, from a technical perspective, there does appear to be minor support at $4,000, but it wouldn't surprise us to see it fall through that. The big run in the gold price started at the beginning of 2024 when it was priced at $2,000. Under Dow Theory, trend corrections regularly retrace between 1/3rd and 2/3rds of the original move, with 50% the midpoint. If that occurs this time, we would see gold back in the $3,600/$3,700 price range before it gains major support.

Strategy for a Hot Stock Market

With greater clarity over time, we see that AI will be one of the greatest technological advancements in human history. However, along with such developments come mistakes. We've already noted a few areas of concern including high valuations, potentially inflated earnings, and the prospect that interest rates will be heading higher. Nonetheless, we caution against attempts at market timing. Very often the market will begin to head lower and an investor will sell their stocks. But when stocks start to rise, they fail to get back in and end up seeing the market quickly at new highs. It's painful and difficult to get back into stocks when you sold at a lower level. And with enough time, stocks always go to new highs. People who want to see real (inflation adjusted) increases in their wealth have to invest in equities. Corrections and bear markets are just part of the agreement. Our strategy is to reduce exposure to very highly valued stocks and redeploy capital into business that may be out of favor and inexpensive. Managing risk through capital rotation is a better strategy than stepping out of the markets out of fear because there is always something to fear. Since the 1987 crash, the S&P 500 has experienced four bear markets with a peak-to-trough decline of at least 30%. It happens, but don't be fearful. The markets always go to new highs again.

Peak	Trough	Decline	Approx. duration
Black Monday	Aug. 25, 1987 → Dec. 4, 1987	-33.5%	~3 months
Dot-com crash	Mar. 24, 2000 → Oct. 9, 2002	-49.1%	~31 months
Global financial crisis	Oct. 9, 2007 → Mar. 9, 2009	-56.8%	~17 months
COVID-19 stock market crash	Feb. 19, 2020 → Mar. 23, 2020	-33.9%	~1 month

S&P 500 Index with declines of at least 30%



Note: Data are shown on a logarithmic scale.
Source: FactSet