Market Update & Commentary

July 2026 | Data as of June 30, 2026 Unless Otherwise Stated

If there is one theme that defined the first half of 2026, it is that nearly every corner of the market now seems to be priced, either directly or indirectly, as an AI trade. That is obvious with semiconductors and technology, but also emerging markets (driven by chipmaker-dominated countries like Taiwan & South Korea which make up ~50% of the MSCI EM index[i]), commodities and energy (data center power demand), SpaceX (data centers in space & xAI), and even old-line industrial stocks like Caterpillar and other companies selling generators, turbines, and cooling equipment. Understanding what is genuinely benefiting from the AI buildout (versus what is purely narrative-driven) has become the central question as investors think about where to put their money next. That framing is useful because the first-half return scoreboard looks diversified on the surface, but much of the leadership still traces back to AI-adjacent earnings, power demand, and capital spending.

First-Half Scoreboard: Returns and Rates. Through June 30, global stocks outside the U.S. led the way, returning +13.7% year-to-date versus +10.9% for U.S. stocks. Emerging markets were the standout at 23.9%, with Asia-Pacific close behind at +21.5%, while Europe returned a more modest +7.8%. Beneath the surface of the U.S. market, leadership was unusually lopsided: technology gained +32.7% (and now represents nearly 38% of the S&P 500), energy rose +20.4%, and industrials +20.0%, while communication services, financials, and consumer cyclicals were flat to negative. Large-cap value (+15.2%) meaningfully outpaced large-cap growth (+6.4%), a reminder that “AI winners” and “growth stocks” are no longer the same list. Some of this reflects the fact that AI beneficiaries now extend beyond traditional growth indexes, into energy, industrials, infrastructure, and overseas markets tied to chip production. U.S. real estate returned 10.2%, U.S. investment-grade bonds were roughly flat at +0.6%, and global bonds slipped slightly **(Slides 2-4)**.

Rates. With the Federal Reserve having cut in December 2025, the effective fed funds rate sits near 3.6%, down meaningfully from a year ago. The 10-year Treasury ended the quarter at 4.44%, 20- and 30-year Treasuries continue to hover around 5%, and the 30-year mortgage remains near 6.5% **(Slide 5)**. The result is a wider term spread (short rates falling while long rates hold firm), which matters for both bond positioning and equity valuations.

How We Use (and Don’t Use) Short-Term Indicators. Returns tell us what has happened; the harder question is whether recent strong performance (i.e., momentum) still justifies taking the same level of risk from here. As a reminder, we do not build portfolios around short-term market signals. We do, however, monitor them to inform our assessment of investing risk relative to asset valuations and what those suggest about future long-run return expectations. When short-term indicators are deteriorating at the same time equities carry high valuations, that combination is additional ammunition to tread with caution. When short-term indicators are constructive, they can help justify valuations that would otherwise look stretched. Today, the picture is genuinely mixed:

Politics and midterms. Generally speaking, political factors are especially unreliable inputs for investment decisions. The strongest political correlation we have found relates to midterm election years, like 2026, which pose larger risks to near-term returns. Since 1930, midterm years have produced negative calendar-year returns about 42% of the time (versus 26% for all years) and averaged +7.2% annual returns (versus 10.2% across all years). That is a real and measurable headwind, but not remotely reliable enough, in isolation, to justify sitting out of the stock market this year **(Slide 8)**.

Consumer Confidence. Consumer sentiment remains abnormally depressed, down roughly 18% from a year ago and sitting near historic lows. Counterintuitively, this has historically been a contrarian positive: troughs in sentiment have often been followed by strong 12-month forward returns, while sentiment peaks have preceded weak ones **(Slide 9)**.

Leading Economic Indicators. The Conference Board's LEI, while still slightly negative year-over-year, is clearly improving, and Franklin Templeton's "Anatomy of a Recession" dashboard has shifted to a broadly expansionary overall signal, with most consumer, business activity, and financial inputs flashing green **(Slides 11-12)**. Credit card and auto delinquency rates have also leveled off in the past two years after meaningful upticks in 2024, which is a good sign **(Slide 13)**, but personal savings rates continue to decline, which suggests consumers are running out of runway to maintain the consumer spending that traditionally drives the bulk of US economic growth **(Slide 14)**.

Valuations: The Earnings Behind the Multiple, and a Critical Timing Mismatch. U.S. valuations remain very elevated. The S&P 500 trades at roughly 20.3x forward earnings versus a 16x historical average **(Slide 16)**, and that multiple is supported by earnings growing at roughly 20% year-over-year, nearly triple the historical norm of around 7% **(Slide 17)**. *That abnormal earnings growth can be largely explained by three things: semiconductor/AI companies, oil and energy companies, and near-term tax cost declines flowing from the OBBBA Act*. BlackRock's data makes the concentration stark: AI-related stocks' earnings growth estimates for 2026 were revised from 41% to 68% this year, while "everything else" in the S&P 500 is growing earnings in the mid-single digits **(Slide 18)**.

On the surface, stocks became somewhat cheaper during the quarter due to this earnings growth. Investors are now paying less for the S&P 500 per dollar of earnings being generated. Whether that improvement is substantive or temporary depends heavily on the endurance of the AI capital spending cycle. One issue we believe is underappreciated is the timing mismatch between the companies selling data center components and the companies buying them. When a hyperscaler buys $10 billion of GPUs, high-bandwidth memory chips, and networking hardware, the sellers generally recognize that revenue immediately, with the associated profit margin flowing into current-year earnings. The buyer, by contrast, capitalizes the hardware and depreciates it over several years, so only a fraction of the cost hits current-year earnings. The cash outlay is immediate, but the expense recognition is delayed. As a result, aggregate S&P 500 earnings can look stronger, and valuation multiples more reasonable, than the underlying economics may ultimately support if the AI buildout slows or depreciation begins catching up faster than revenue growth. This same dynamic can be observed in a different way by looking at free-cash flow yields ("FCFY") on the S&P 500 (operating cash flow less capital expenditures). Yields are incredibly depressed due to the recent surge in capital spending with S&P 500 FCFY at 25-year lows.[ii] While we wish we could take credit for flagging this "risk" to the market via our own independent thinking… we can't. This dynamic has been studied and debated heavily in recent months after the world-famous "Big Short" investor, Michael Burry, issued warnings about this risk in his Substack titled "Cassandra Unchained".

International Developed Valuations. These measurements remain a bright spot in that they are more in line with historical norms. The discount between broad U.S. and Foreign equities has narrowed with this year's ex-USA outperformance, but it remains elevated versus 20-year averages **(Slide 19)**. Developed international markets and emerging markets also trade near their long-run average forward earnings multiples **(Slides 20-21)**. Looking at PEG ratios, emerging market indexes may actually be cheap when normalizing P/E for expected earnings growth, but, like the U.S., much of this forecasted growth is tied to a sustained boom in technology hardware sales **(Slide 22)**.

Bonds and Interest Rates. Across much of the yield curve, investment-grade bond yields sit near the top of their range since 2009, roughly 4.7% on the U.S. Aggregate index and 5.2% on investment-grade corporates **(Slide 25)**. As the Fed cut short rates, 20- and 30-year Treasuries have held near 5%, resulting in term spreads widening. Investors are finally being paid something to extend duration. Credit spreads, meanwhile, remain near all-time lows **(Slide 28)**: high-yield spreads are roughly half their long-term average, which normally argues for caution. That said, yields on higher-quality "junk" (BB-rated) bonds, around the low-6% range, still appear attractive on a risk-adjusted basis relative to the earnings and free-cash-flow yields available on U.S. stock indexes at today's multiples **(Slide 29)**. Because corporate bond income is tax-**in**efficient, the incremental yield is generally not compelling enough for taxable accounts, but we like this asset class inside tax-advantaged retirement accounts and HSAs.

Putting It Together: Why Diversification Matters More, Not Less. Where does this leave us? As we said, US valuations are elevated. A large share of the earnings growth supporting those valuations depends on both realized productivity (aka profitability) gains from AI adoption coupled with the continuation of AI-driven distortions, including the revenue/depreciation timing mismatch described above. Short-term and recession indicators are genuinely mixed: improving LEIs and contrarian-bullish sentiment on one hand; a midterm-year calendar, razor-thin credit spreads, and

4%+ inflation on the other. In that environment, continued focus on diversification, through defensive sectors, investment-grade bonds, commodities, and real estate, is incredibly important.

The correlation data makes the defensive-sector case concrete. With technology now nearly 38% of the S&P 500, one of the most powerful diversifiers available is simply owning what technology is not. Over the trailing 15 years, the utilities and energy sectors have exhibited correlations to the technology sector of just 0.16, with consumer staples at 0.44 and health care at 0.50 **(Slide 35)**. Compare that to what investors get from more conventional forms of equity diversification: U.S. small caps carry a 0.74 correlation to technology, international stocks 0.70, and even large-cap value 0.68 **(Slide 36)**. In other words, defensive sector ETFs have provided meaningfully stronger diversification against the market's dominant risk than diversifying by size, style, or geography, and they have not been dead money, with utilities returning over +11% across that same window. At the asset-class level, commodities (0.11 correlation to technology) and aggregate bonds (0.25) round out the toolkit **(Slide 37)**.

History offers a sobering benchmark: After the 2007 peak, it took roughly five years for an S&P 500 index fund to durably make new highs **(Slide 38)**, and U.S. valuations today are significantly more stretched than they were then **(Slide 39)**. Commodities trade at multi-decade lows relative to the S&P 500 and have historically provided their strongest diversification benefits precisely during prolonged inflationary periods that coincide with poor stock returns. And bond starting yields, historically the dominant driver of forward bond returns, sit near the top of their 15-year range. Being diversified and holding sufficient reserves to ride out a potentially prolonged bear market in U.S. stocks has arguably never been more important.

As always, if you would like to discuss how any of this applies to your situation, please reach out.

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END NOTES

Data referenced above and not sited below is pulled from our supplementary Chart Deck. References are attached therein.

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[i] Figures calculated looking at Taiwan + South Korea region exposure on ETF ticker "EEM" benchmarked to MSCI EM Index.
[ii] King, C., & Savi, R. (2026, July 2). *Equity market outlook: Seeking opportunity beyond AI*. iShares by BlackRock. https://www.ishares.com/us/insights/portfolio-insights/equity-outlook-2026-q3-free-cash-flow