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Market Outlook

Q2 2026: Back to the Future

It started with a podcast in October 2025

The rotation didn't start with Iran – it began with a shift in the AI narrative

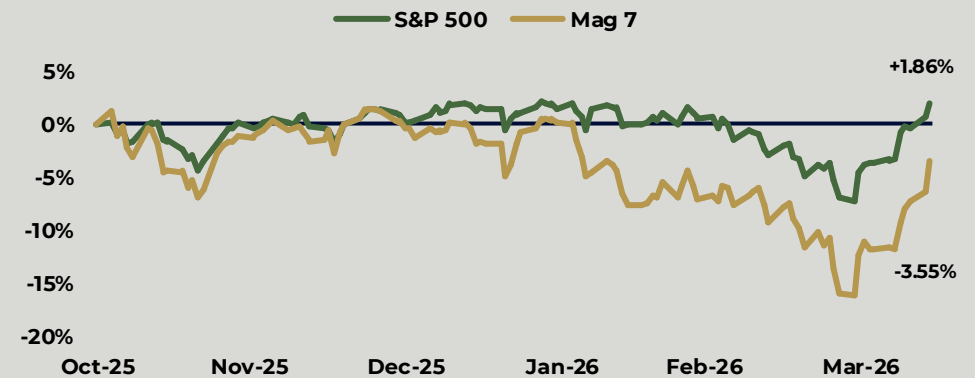
What happened

In October 2025, AI leaders – most notably Sam Altman – signaled that massive AI capex spending might not deliver returns as quickly as hoped. That single shift started a chain reaction still playing out today.

What it triggered

Capital rotated hard out of big tech and into the physical economy: energy, infrastructure, defense, materials. Microsoft was the first mega-cap to break key long-term support, and the 'growth at any price' trade started coming apart.

S&P 500 vs. Mag 7 since Oct '25



This rotation was underway before the first Iranian missile launched. The war accelerated it – but didn't create it.

The S&P is basically flat on the year after a massive relief rally, but the biggest tech stocks are still down over -3% YTD. Most of the market is doing great. The underperformance is concentrated in the names that dominated the last two years.

The S&P 500 is flat, but underneath, this market is thriving

The 7 biggest stocks are down ~3.1%. The other 493 are up ~4.0%. The index splits the difference and says “nothing happened.”

+1.78%

S&P 500 YTD

-3.14%

MAG 7 YTD

+4.05%

S&P 493 YTD

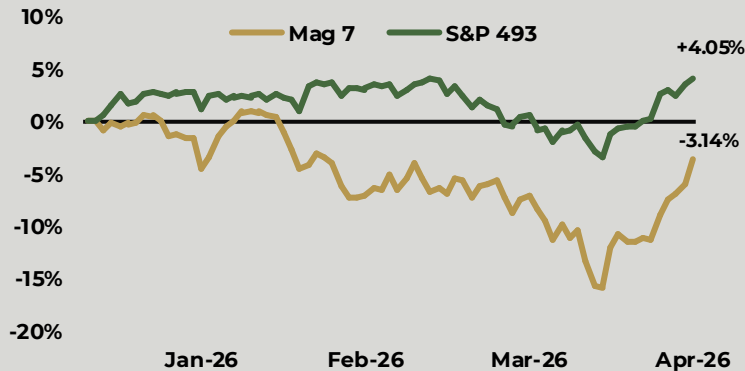
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DISPERSION %ILE

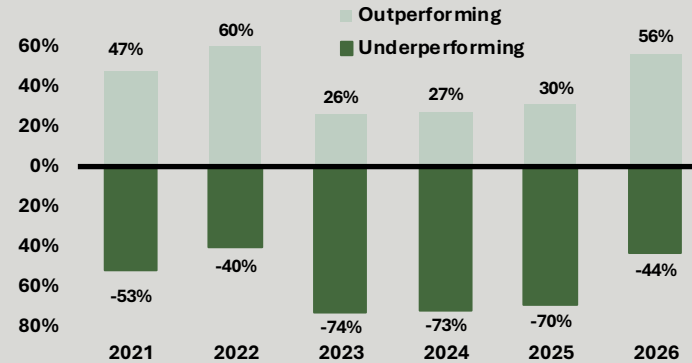
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SECTORS POSITIVE

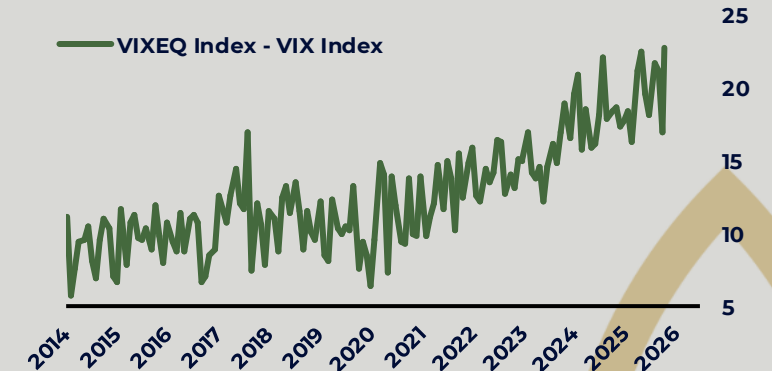
Mag 7 vs S&P 493 YTD performance



% of constituents outperforming the S&P 500



Single stock-level volatility premium near cyclical high

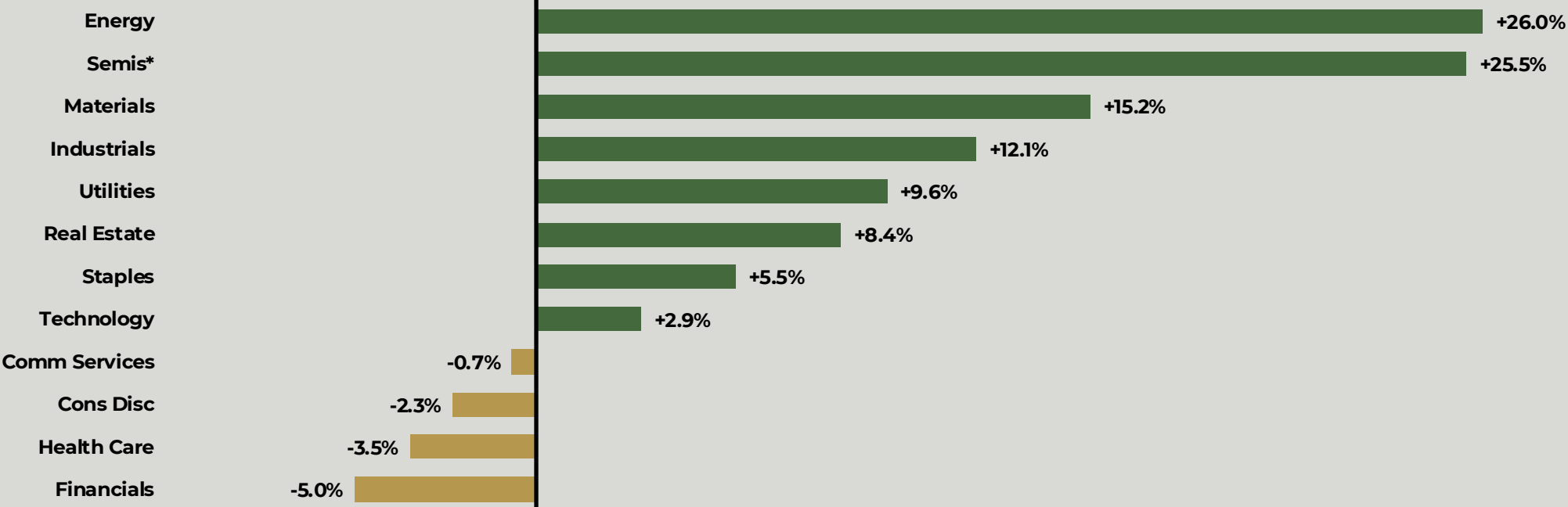


Equal weight S&P up +4.7%. Small caps +9.4%. The average stock is doing great – the index just doesn’t show it.

The S&P 500 was flat because a handful of mega-cap tech stocks were dragging the cap-weighted index. Microsoft alone was down over -20% at points. But 7 of 11 sectors are positive, and more stocks are outperforming the S&P 500 than at any point since 2022. Stock selection matters right now.

The market is rewarding the builders

Energy, materials, and industrials are leading. Semis are up +25.5% on AI infrastructure spending



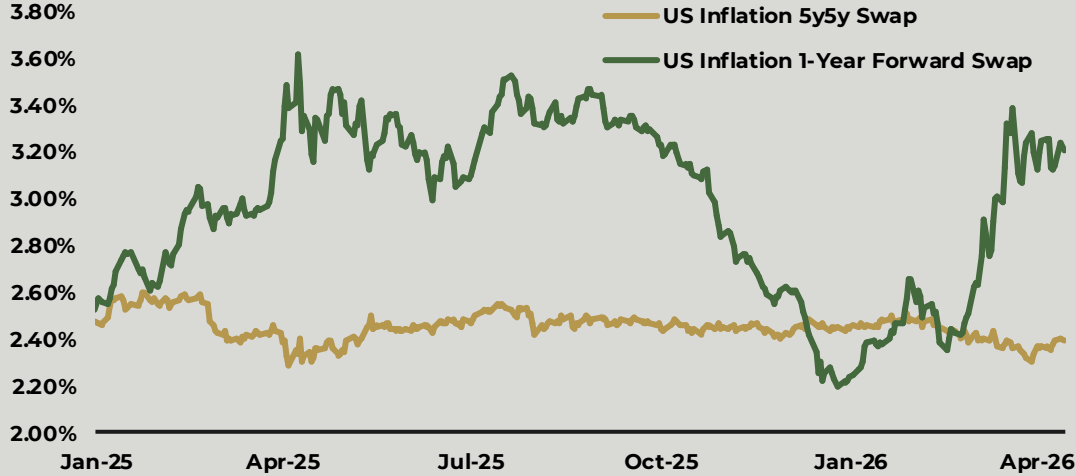
*Semis is a sub-sector within Technology

Oil +79%. Energy +26.0%. Semis +25.5%. Industrials +12.1%. The physical economy is winning.

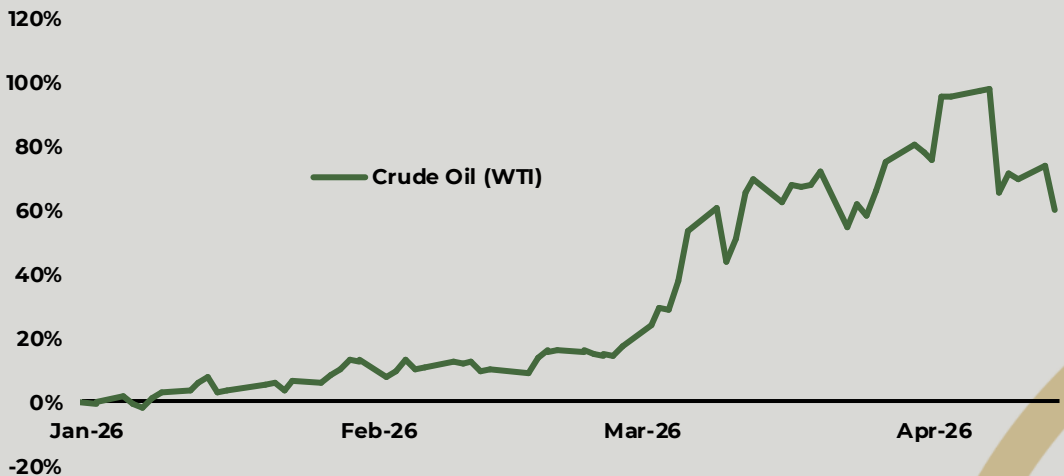
AI is the catalyst, but the beneficiaries are physical: power generation, transformers, copper, steel, and datacenter buildouts. Semis (+25.5%) are the clearest AI infrastructure play, while Energy (+26.0%) and Materials (+15.2%) have also seen benefits. These structural tailwinds predated the Iran conflict and remain intact post-ceasefire.

Inflation fears spiked with Iran, but the market sees this as temporary, not permanent

Long-term inflation expectations remaining stable



Oil is up +60% YTD but pulling back on ceasefire



Long-term inflation expectations are holding near 2%. The market is treating this as a temporary supply shock, not a repeat of 2022.

When oil spiked, short-term inflation fears spiked with it. But longer-term expectations barely moved. The market is pricing this as a conflict-driven supply shock, not a structural inflation problem. Trump's 2-week ceasefire and Iran's agreement to reopen the Strait have pulled oil below \$100. If that holds, the Fed can stop worrying about inflation and start watching jobs.

The Fed is back to being a tailwind

Dec '26 Fed Funds Futures: from 4-5 cuts (Sep '25) to hikes (Mar '26) to a partial cut (today)

December 2026 Market Implied Fed Funds Target



THE ARC SINCE SEPTEMBER 2025

- Sep '25:** 2.510. 4-5 cuts priced.
- Year-end:** ~3.08. ~2.3 cuts priced.
- Mar 26:** 3.791. Above target. Hikes priced.
- Today:** 3.543. Hikes gone. ~40% odds one cut.

<p>0</p> <p>HIKES '26</p>	<p>0</p> <p>HIKES '27</p>	<p>↑</p> <p>CUT ODDS</p>
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After the round trip, accommodation is back on the table

With inflation expectations anchored, the Fed can look through this supply shock. Outside of energy, most contributors to inflation are showing signs of stabilization. As we approach the May chair transition, we expect the narrative to shift toward accommodation, especially if the labor market breaks down.

The earnings picture doesn't support a recession narrative

Q1 2026 EPS growth estimated at +13.2% YoY, which would mark 6 consecutive quarters of double-digit growth.

+13.2%

Q1 EPS GROWTH EST

+9.7%

Q1 REVENUE GROWTH EST

19.8x

FWD P/E

59

CO'S ISSUING POSITIVE GUIDANCE

Revenue growth at +9.7% would be the highest since Q3 2022. Positive EPS guidance came in at 59 companies, well above the 5-year average of 44 and the 10-year average of 40. Forward P/E has compressed to 19.8x, close to the 5-year average, and well off the 22.0x we saw at Q4 end. Earnings are the strongest argument against the recession narrative right now, and the reason we're staying positioned for a risk-on market.

Valuations fair, earnings growing, forward guidance well above average. This is not a recession setup.

We still like the U.S. but International has been hard to ignore

International has outperformed since October, but the U.S. structural advantages are real

Value vs. Growth

+6.7%

VALUE

-2.7%

GROWTH

+4.2%

EQUAL WEIGHT

U.S. vs. International YTD Performance

+7.9%

EAFE

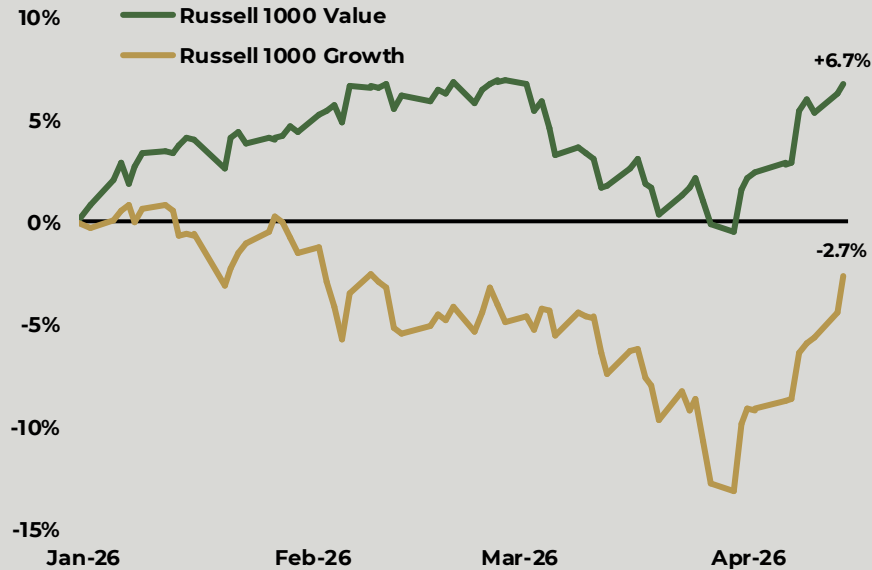
+13.7%

EM

+1.8%

S&P 500

Growth gives way to value



Why we remain U.S. overweight

Energy independence The U.S. is a net energy exporter. Europe and Japan import 90%+ of their energy. When oil spiked, EAFE dropped -7.8% in March alone.

Earnings superiority U.S. EPS growth +13.2%. Revenue +9.7%. Record positive guidance. Structurally higher margins and more buyback capacity.

AI and productivity The U.S. is where AI capex is deployed. Productivity +2.1% with only 5% of AI being used at scale. The productivity dividend accrues here.

March exposed the vulnerability International went from +10.9% YTD to +2.9% in one month on the oil shock. It recovered – but the fragility was clear.

We added international exposure selectively, but the U.S. structural advantages are real, and the risks of going further are asymmetric.

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