Second Quarter 2026 Letter

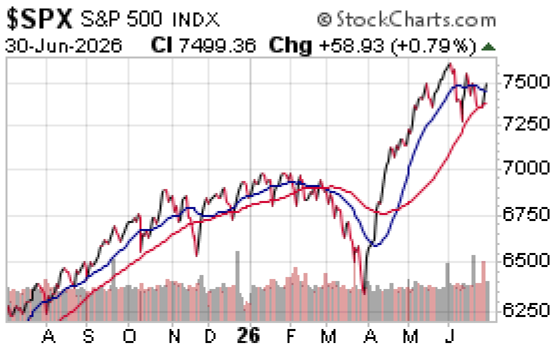

Figure 1 – S&P 500

Figure 2 – U.S. 10-Year Treasury Yield

Market Recap

The second quarter of 2026 began with markets still reeling from the oil shock and geopolitical tension of Q1, but sentiment shifted quickly as diplomatic signals pointed toward a ceasefire between the U.S. and Iran. Oil prices, which had peaked near $115 a barrel in early April when the conflict closed the Strait of Hormuz, fell back to around $70 by quarter's end as the strait's reopening came into view. Stocks staged a sharp recovery as energy costs eased, with equities recovering their Q1 losses by the end of April and continuing to climb. By quarter's end, easing energy costs and strong corporate earnings had pushed markets to record highs, though a new Federal Reserve chair's hawkish tone on inflation introduced fresh uncertainty for the months ahead.

Stock returns were strong across the board. The S&P 500 index of large cap U.S. stocks rose 15.2%. The small-cap Russell 2000 rose 21.5% and the S&P 400 Mid Cap added roughly 14.5%. Growth stocks (+21.9%) outperformed value (+8.0%), led by technology, particularly AI-related semiconductor manufacturers. International stocks also advanced strongly, with emerging markets up 24.1% and MSCI's Europe, Australia and Far East Index rising 10.2%. Fixed income index returns were modestly positive. Bond yields were volatile but roughly flat over the quarter (climbing as high as 4.6% at mid-quarter before settling back near 4.4%), as inflation concerns and a hawkish shift at the Federal Reserve offset renewed confidence in economic growth. The Bloomberg U.S. Aggregate bond index posted a total return of 0.7%.

S&P 500 earnings grew 25.5% in the first quarter on 10.4% revenue growth, a sharp acceleration from the fourth quarter's 14.1% growth. According to research service FactSet, 84% of companies topped analyst expectations, well above the 5-year average of 78%. Technology, energy and utilities continue to post the strongest earnings growth. For the second quarter, technology earnings are expected to grow nearly 45%, while energy earnings, sharply boosted by the Iran conflict and the resulting oil price spike, are expected to more than double, up 120.4%. S&P 500 Q2 earnings are expected to grow 22.3%, up from the 18% growth rate estimated at the start of April, though still shy of the first quarter's actual 25.5% pace. As companies report, analysts will be evaluating whether the earnings boost from elevated energy prices sustains as oil prices retreat on hopes for a lasting ceasefire, along with guidance for the third quarter.

Economic Perspective

U.S. Gross Domestic Product (GDP) grew 2.1% in the 1st quarter, a solid improvement from the 4th quarter's weak 0.5% result. Business investment and government spending were strong, while consumer spending rose only 0.5%, the slowest pace since 2022. Consumers appeared to be squeezed by higher prices, especially at the gas pump. Forecasts for the 2nd quarter GDP reading call for slowing to 1.3% growth, while the expectation for the full year is expansion of 2.0% to 2.2%. Purchasing manager surveys indicated expansion, building on the first quarter's strength. Both the manufacturing and services sectors logged three more months of growth, with particular strength in new orders. These readings were reinforced by Federal Reserve regional surveys, which suggested accelerating manufacturing activity.

Employment grew steadily in the 2nd quarter, as the U.S. economy added jobs in each month. The average add of 111,000 jobs was an improvement over the 1st quarter's very modest 68,000 per month. The unemployment rate ticked down slightly to 4.2% in June apparently driven by some potential workers leaving the workforce. Job openings surged in the quarter to 7.6 million, the highest level since May 2024. Average hourly earnings increased 3.5% in June, roughly the same pace as the last 4 months, as workers struggled to catch up with recent price increases.

Inflation followed a volatile path through the second quarter before easing meaningfully in June, though wage growth continued to trail price gains for much of the period. The headline consumer price index (CPI) climbed to 4.2% in May, the highest reading since April 2023, as the war with Iran and the closure of the Strait of Hormuz continued pushing energy costs higher. That reversed sharply in June, when a ceasefire helped bring oil and gasoline prices down and drove the CPI to 3.5% year-over-year, its first decline in five months and the largest single-month drop since 2020. Core inflation, which strips out food and energy, followed a similar arc, rising to 2.9% in May before cooling to 2.6% in June, suggesting the energy shock's spillover into the broader economy has remained limited.

Consumer sentiment improved marginally: the University of Michigan's Consumer Sentiment index rebounded from May's all-time low to 49.5 in June, while year-ahead inflation expectations eased to 4.6% from 4.8%. Still, both readings remain well below pre-conflict levels, and renewed hostilities between the U.S. and Iran in early July have already pushed oil prices back up, leaving the durability of June's improvement in question. 30-year mortgage rates reached 6.55%, the highest in over a year, adding to the pressures felt by U.S. consumers.

Looking Ahead

The current bull market is almost four years old, and investors may be wondering whether stocks can keep climbing. Many valuation measures are high by historical standards, adding to potential concerns. We continue to focus on corporate earnings growth, which has been robust and improving. Markets may respond to headline news but it is ultimately earnings that will determine stock prices.

The technology sector (**Fig. 3 – iShares Technology**) has had the strongest earnings growth and consequently has led for most of this bull market. Spending on AI has lifted semiconductor manufacturers and related companies and that growth seems likely to continue. AI has changed technology use in many ways. Network security companies, for example, are busier than ever responding to new threats. We continue to emphasize the technology sector in our portfolios.

Industrials (**Fig. 4 – iShares Industrials**) have seen improving earnings this year, benefitting from AI-related construction, energy infrastructure building and defense and aerospace spending. Earnings guidance from these companies has been very compelling, leading to analyst upgrades and increased price targets. We'll look for opportunities to add to this sector.

Figure 3 – Technology

Figure 4 – Industrials

Index returns taken from Morningstar.com

In the last two years, investors faced the shocks of tariffs in 2025 and the war with Iran earlier this year. Both events led to sharp stock declines which were fortunately followed by rapid recoveries. We note and caution that the next painful market drop could be just around the corner. It's important for investors to understand how their asset allocation helps them weather those stormy periods and stay invested. We will always be happy to discuss your portfolio composition and help address your concerns.

Best regards,

Kenneth M. Bernard, CFA

Index returns taken from Morningstar.com