



Q2 Outlook

The War Changed Everything

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The War Changed Everything

How the Iran Conflict Rewrote the Macro Regime in a Single Quarter
Q2 2026 Quarterly Commentary | GRIP Framework Analysis

A Regime Shift, Not a Data Point

Entering 2026, the macro environment was cooperating. Growth was decelerating but positive, inflation was falling, and the Federal Reserve was cutting rates. The GRIP framework confirmed what markets were pricing: a disinflationary growth scare that would be met with monetary accommodation. The playbook was familiar—slowing growth and falling inflation is the regime where the Fed eases, credit holds, and risk assets find support from policy. Markets were positioned for exactly that outcome, with rate cut expectations extending well into the second half of the year and equity valuations reflecting confidence in ongoing support.

Then the Iran conflict upended the calculus. In the span of a single quarter, the GRIP framework registered one of the most violent regime shifts in its history: Inflation reversed from its maximum negative reading (-1.00) in December to its maximum positive reading (+1.00) in March. The catalyst was unmistakable—gasoline prices nearly doubled over three months, surging 87% from \$1.71 to \$3.20 per gallon. What had been a cooperating inflation backdrop became a headwind virtually overnight.

The distinction between the regime we left and the regime we entered matters enormously for policy, positioning, and the trajectory of the real economy. In a growth-slowing, inflation-falling regime, the Fed eases and markets can look through weakness toward the stimulus on the other side. In a growth-slowing, inflation-accelerating regime—the quadrant we now occupy—the Fed's hands are tied. Cutting rates into an energy price shock risks entrenching inflation expectations. The central bank's primary tool shifts from action to communication, and investors lose the safety net of expected accommodation.



Where We Stand: The GRIP Dashboard

Pillar	Score	Signal	Regime
Growth	-0.33	Mixed	Slowing
Risk Appetite	+0.33	Risk-On	Deteriorating
Inflation	+1.00	Rising	Accelerating
Policy	-1.00*	Easing*	On Hold

**Policy easing driven by a spike in the 2-Year Treasury yield (war premium), not by Fed action. Likely to revert when the conflict ends.*

The GRIP framework currently reads: Growth mixed at -0.33 , Risk Appetite positive but deteriorating at $+0.33$, Inflation at its maximum reading of $+1.00$, and Policy registering a technically easing -1.00 . Each pillar tells part of the story, but it is the interaction between them that defines the regime.

Growth: The LEI Is Warning, But Demand Has Not Broken

The growth composite sits at -0.33 , reflecting a genuine divergence between forward-looking and coincident measures. The Leading Economic Index has been declining across all three lookback windows— 3, 6, and 12 months—since late 2025, and now sits 18.6% below its long-run trend at the 0.1st percentile of historical readings. This is a level that has historically been associated with the 1974 and 1982 recessions. The signal is unambiguous: the LEI is forecasting material economic deterioration.

Yet Real Final Sales to Domestic Purchasers—the measure that strips out inventories and net exports to isolate actual demand—remains positive at $+1.9%$ annualized. It has decelerated from $3.4%$ in mid-2024 and $2.9%$ in mid-2025, but it is not contraction. The economy is growing slowly, not shrinking. This distinction is critical because it determines whether we are late-cycle or in recession, and the policy and investment implications are materially different.

The labor market reinforces this late-cycle read. Employment conditions continue to trend lower, with leading indicators of labor market health deteriorating. The data is likely to get worse, particularly if the energy price shock persists and erodes consumer purchasing power. A negative Real Final Sales print in Q1 2026 would shift the growth composite from mixed to fully contracting—that release is the single most important data point for the growth outlook.



Inflation: The Price Shock That Changed the Regime

Inflation's reversal from -1.00 to $+1.00$ in a single quarter is the defining event of 2026 so far. The speed alone is significant—this is not a gradual drift, but an acute supply-side shock driven by the Iran conflict's disruption of energy markets. Gasoline is up 40% year-over-year, and the TIP/TLH breakeven ratio confirms that market-implied inflation expectations are rising across all three lookback windows. When both a spot commodity price and a market expectations measure agree at maximum intensity, the signal carries high conviction.

This is the pillar that changed the regime. Through December 2025, the GRIP framework showed slowing growth with falling inflation—the disinflationary quadrant where the Fed can ease and markets can find a floor. The moment inflation flipped to maximum positive; we moved to the stagflationary quadrant: growth slowing, inflation accelerating. The Fed's calculus changed immediately. Rather than cutting to support growth, the Fed has been forced to the sidelines, relying on communication rather than action as its primary policy tool. Rate cut expectations have been pushed out, and the market must now contend with a central bank that cannot deliver the accommodation it was counting on.

Policy: On Hold, Regardless of What the Dashboard Says

The policy composite reads -1.00 —maximum easing—but this number requires the most aggressive discounting of any reading in the current framework. The yield curve uninverted in March not because the Fed cut rates below the 2-Year Treasury yield, but because the 2-Year yield itself spiked 45 basis points in a single month, from 3.39% to 3.84%. The Fed Funds rate has been unchanged at 3.64% since January. This is a war premium, not a policy shift. The bond market is repricing conflict-driven inflation risk and fiscal uncertainty into the front end of the curve, and when the conflict resolves, the 2-Year yield is likely to retreat below Fed Funds, reinverting the curve and restoring a tight policy signal.

The real policy story is simpler and more concerning: the Fed is on hold. Under the incoming leadership of Kevin Warsh, the Fed faces the classic stagflationary bind. Cutting rates risks fueling inflation that is already at maximum readings. Holding rates risks allowing the growth deterioration signaled by the LEI to deepen into something more serious. For now, the choice has been to hold and communicate—a posture that may be prudent but offers no lifeline to an economy absorbing a significant energy tax. It is worth noting what this means for the market's prior pricing. Coming into 2026, futures were discounting meaningful rate cuts through the second half of the year. That expectation has been systematically unwound. The repricing of rate cut expectations is itself a tightening of financial conditions, even though the Fed has taken no action. The removal of anticipated easing is functionally equivalent to tightening from the market's perspective, and it hits hardest in the rate-sensitive and growth-dependent segments of the market that had been positioned for accommodation.



Risk Appetite: The Lagging Indicator

Risk Appetite at +0.33 is the most deceptive reading on the dashboard. The composite remains positive only because 6- and 12-month trends in ACWI, Copper, and HYG have not yet turned negative. But every single 3-month rate of change has already flipped: ACWI -2.2%, Copper -2.9%, HYG -0.3%, Bitcoin -22.4%. Beneath the headline, the cross-market signals are more revealing. Gold is decisively outperforming global equities, with the ACWI/Gold ratio down 16.5% over twelve months. BPSPX breadth collapsed from 57.6 to 33.6 in a single month. VWEHX/VFITX—the high-yield versus investment-grade credit spread proxy—has gone neutral after months of positive readings.

The positive risk appetite reading is a legacy of the trend that preceded the war, not a reflection of current market dynamics. If the 3-month weakness persists for another one to two months, the 6-month windows will flip, and the composite will move decisively into Risk-Off territory. The primary price trend remains intact for now—Dow Theory still shows a positive primary trend—but the deterioration in breadth, credit spreads, and intermarket relationships suggests the foundation is cracking. We are approaching oversold conditions in breadth, which may produce a tactical bounce, but the underlying regime deterioration is structural until the inflation shock resolves.

The Path Forward: Resolution Is the Variable

The outlook for the remainder of 2026 hinges almost entirely on the duration and resolution of the Iran conflict. If the war winds down by mid-year, the path forward is relatively constructive. Gasoline prices normalize, the inflation composite reverses as sharply as it spiked, the 2-Year war premium drains from the curve, and the Fed—under Warsh's leadership—regains the flexibility to ease into what will still be a decelerating economy with a softening labor market. In that scenario, the GRIP framework would likely transition back toward the disinflationary quadrant: slowing growth, falling inflation, easing policy. That is the environment where risk assets historically find a floor and credit conditions stabilize.

If the conflict persists or escalates, the trajectory is considerably darker. The energy tax continues to erode consumer purchasing power, Real Final Sales decelerates toward zero or negative, the labor market deterioration accelerates, and Risk Appetite flips to outright bearish as the 6-month trends finally roll over. The Fed remains trapped—unable to cut because inflation is elevated, unable to hold because growth is breaking down. That is the classic stagflationary trap, and it is the scenario where the S&P 500 faces a 15–25% drawdown from its January highs as markets price in recession risk without the cushion of policy support.



Hopefully, a swift resolution returns the macro landscape to the regime we left in December: slowing growth meeting falling inflation, with a Fed that can act. Under Warsh's leadership, the focus would appropriately shift back to the deterioration in leading indicators and the labor market—the growth side of the mandate. That is the setup where policy becomes a tailwind rather than a constraint. Until then, the war premium distorts the signals, the Fed sits on its hands, and investors must navigate a regime where the macro variables are all moving in the wrong direction at once.

Positioning Implications

The current regime favors defense. Fixed income over equities, short duration over long, high quality over speculative credit, international over domestic, value over growth, active over passive, and commodities and managed futures as diversifiers. Cash yields remain attractive relative to the risk-adjusted return on equities in a regime where the Fed cannot ease and growth is decelerating. The Mag 7, which led the prior regime, has become the lag 7—a rotation that is characteristic of late-cycle regime shifts where yesterday's winners are most vulnerable to the change in underlying conditions.

The key tactical signal to watch is the Risk Appetite composite. If the 6-month windows hold and the composite stabilizes above +0.20, the primary trend is intact and the equity drawdown is a correction within a bull market. If it breaks below zero, the regime shift is confirmed at the market level, and a more significant de-risking is warranted. We are one to two months from that decision point. The GRIP framework will tell us when it arrives.

The GRIP framework (Growth, Risk Appetite, Inflation, Policy) evaluates macro conditions using a 3/6/12-month rate-of-change signal with a 2-of-3 confirmation rule. Growth uses LEI (2/3 weight) and Real Final Sales level (1/3 weight). Risk Appetite uses price trends (2/3) and cross-market breadth (1/3). Inflation equally weights gasoline and TIP/TLH. Policy equally weights the yield curve (FF/2Y ratio) and Fed Funds direction. Scores range from -1.0 to +1.0.



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