STRATOS
INVESTMENT MANAGEMENT

CONFLICTING DATA

COMMENTARY

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Last quarter we were discussing the difficulties in equity markets (and elsewhere) caused by the War with Iran. What a difference a few months make. Far from Sell in May and Go Away[1], US equity markets have recovered everything they gave up in the first quarter. While the S&P 500 finished the quarter marginally lower than it ended the month of May, S&P 500 equity prices are nearly 10% higher (on a price basis) than they ended 2025. While the market may be back on a roll, we have some concerns that could keep domestic equity returns from moving dramatically higher. Over the succeeding paragraphs, we will talk about what has happened so far this year and will lay out some of our concerns.

Did He Get What He Wanted?

The first question that comes to mind is did President Trump get what he wanted out of the conflict with Iran? There was regime change (sort of); Iran's nuclear ambitions were (depending on who you listen to) either set back decades or destroyed and the Strait of Hormuz was reopened and ships have resumed shipments. But did it really?

Yes, there was regime change in Iran, but the new "supreme leader" has not been seen since his taking power and those running the country have seemed to actually get more extreme. Their nuclear ambitions certainly took a hit, but it may end up simply being a pause (perhaps an extended one) – even with international investigators in country, Iran has shown themselves capable of evading international scrutiny before and will likely going forward. Even the re-opening of the Strait of Hurmuz has come with "strings attached" as the Iranian Revolutionary Guard has fired on ships transiting the rout cleared by the US military close to the coast of Oman.

In many ways, it seems as if the results of the Iranian conflict look like a continuation of a trend with this administration as they seem to want quick victories with limited incursions/input. This has come to be known as TACO or Trump Always Chickens Out, and it would seem to run (somewhat) counter to the Donroe Doctrine. From our perspective these shifts in what is viewed as a "win" actually makes some degree of sense. While President Trump has shown a willingness to militarily engage bad actors to show that he means business, he has also shown a dislike for what has come to be called "forever conflicts". Additionally, since he likes to use the markets as a barometer of how he is doing as President, he is willing to take small victories in order to get a "win" and allow markets to recover. Hence the deal with Iran which has seen oil prices drop back to near pre-war levels and equity markets hit new highs (see figures 1 and 2).

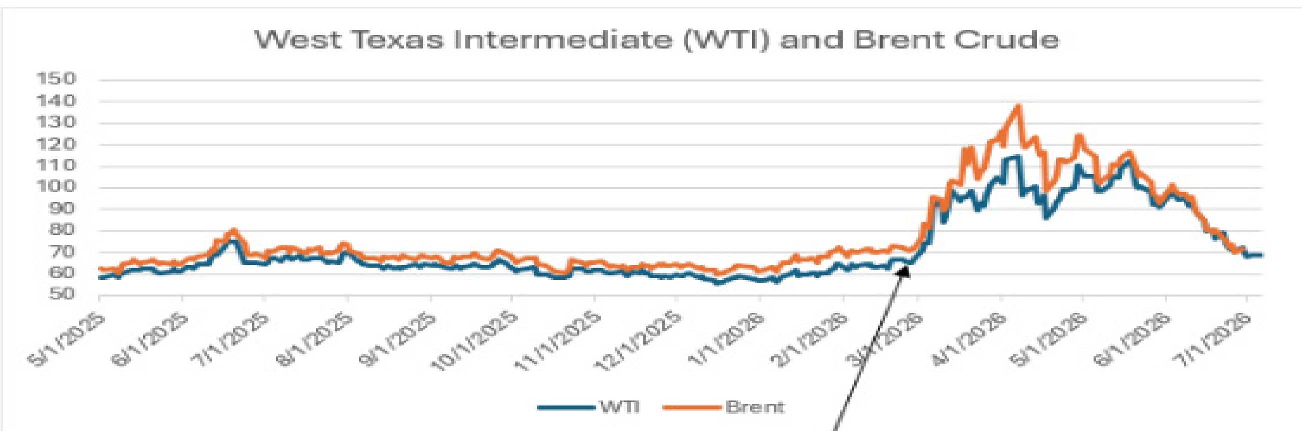

Figure 1 - Source: Macrotrends.com

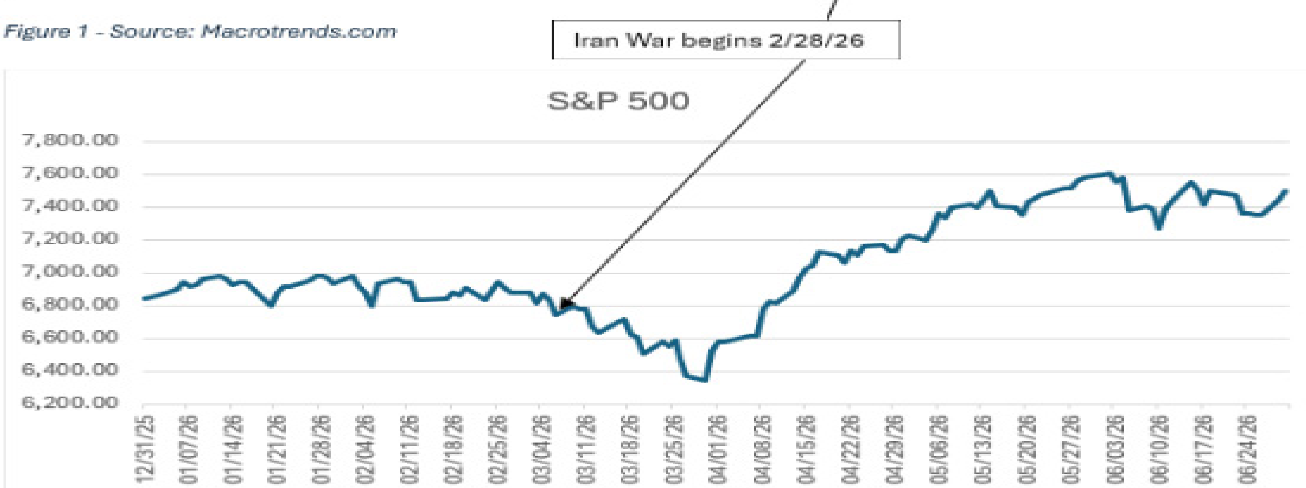

Figure 2 - Source: FactSet

But are current gains sustainable or will economic data and/or the Fed cause them to roll over?

The Economy

In somewhat of a surprise, given the conflict in Iran, the first quarter turned in a relatively strong performance - growing at an upwardly revised rate of 2.1% and half a percent higher than expected. As SIM has said in past commentary, the consumer is what drives economic growth and the first quarter was no exception as consumer spending has held up well since the onset of hostilities. It looks as if spending is showing signs of accelerating (see figure 3 below) with the monthly numbers running higher than the twelve-month moving average in four of the last six months.

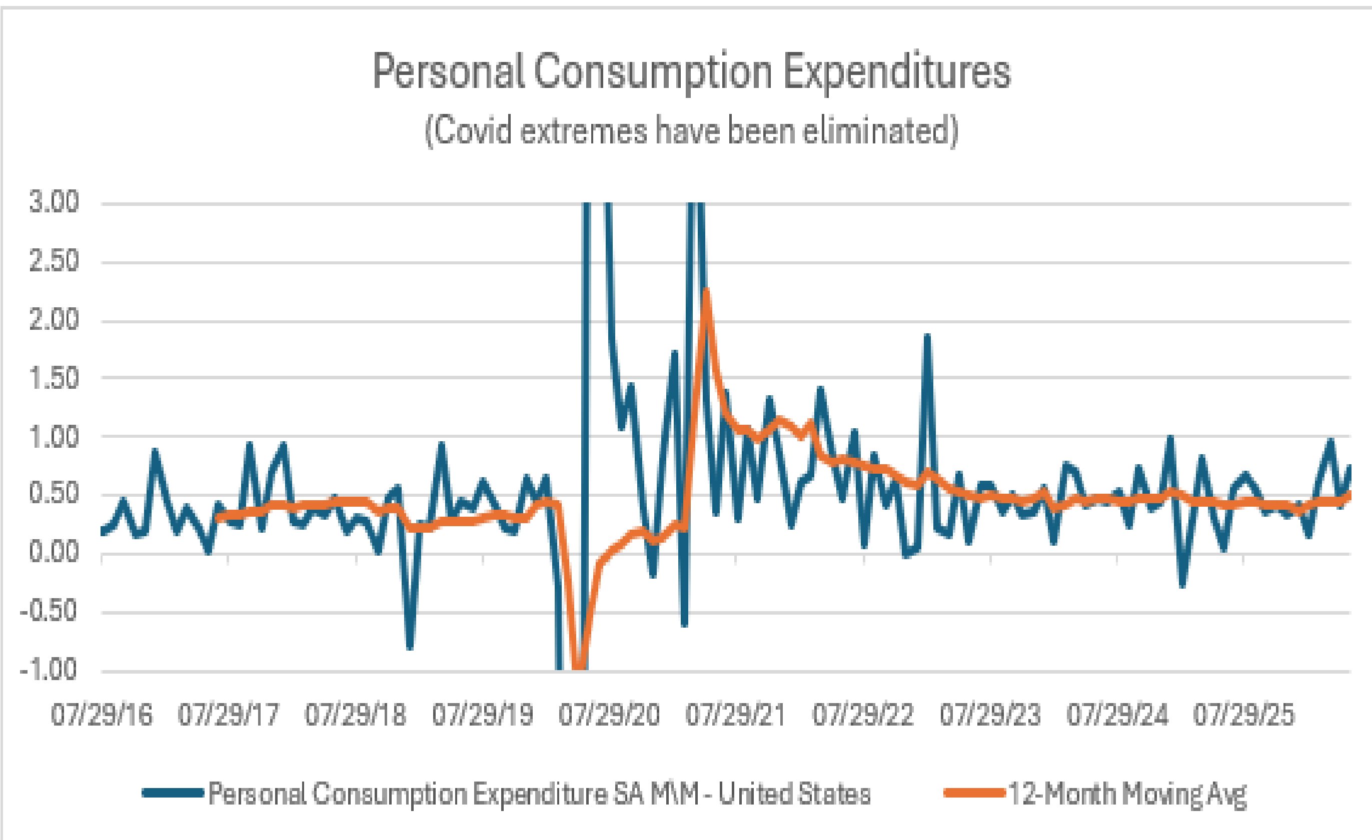

Figure 3 - Source: FactSet

But what is driving spending? In a word, inflation. As you should note in Figure 4 below, both the headline and core[2] inflation rates (as measured by PCE) are running above their twelve-month moving average and have been trending higher pretty much since the beginning of 2025. The gap between the Headline and Core PCE deflators can be largely attributed to one thing – higher fuel costs (Figure 5 below). Hopefully, with the price of oil now declining to near pre-war levels, we may see a similar rollback in energy inflation…or not. Quite a bit will be determined by how

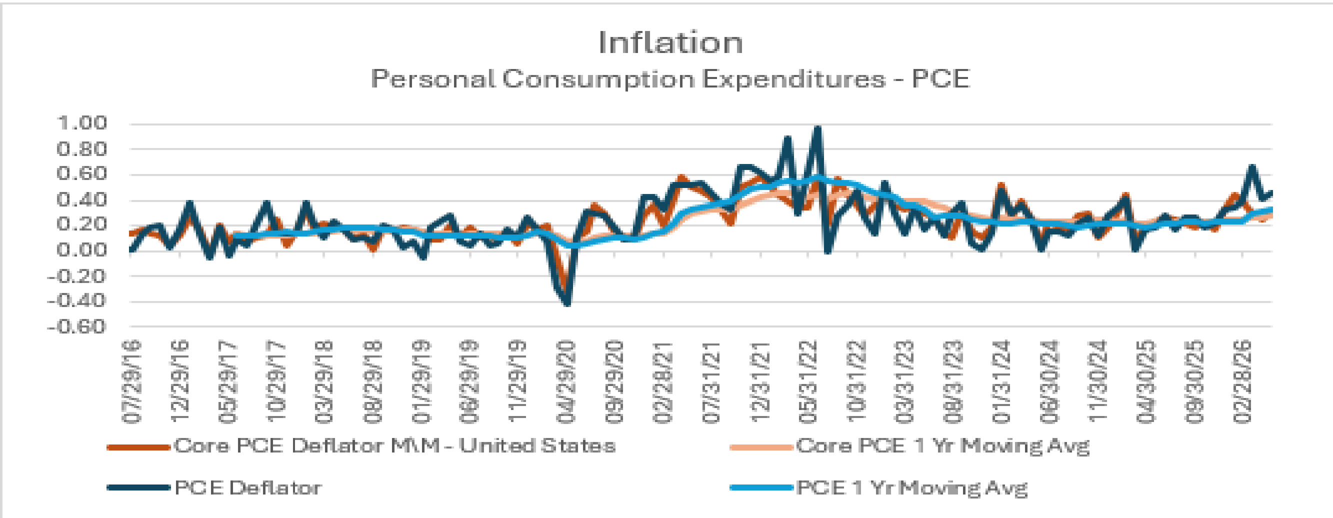

Figure 4 - Source: FactSet

much of the increase in energy costs result in higher product costs and whether (or not) businesses pass on lower costs to consumers. In one specific case, an industry that was particularly negatively impacted by higher energy prices seems reticent to roll back prices or restore routes cut during the surge in prices[3].

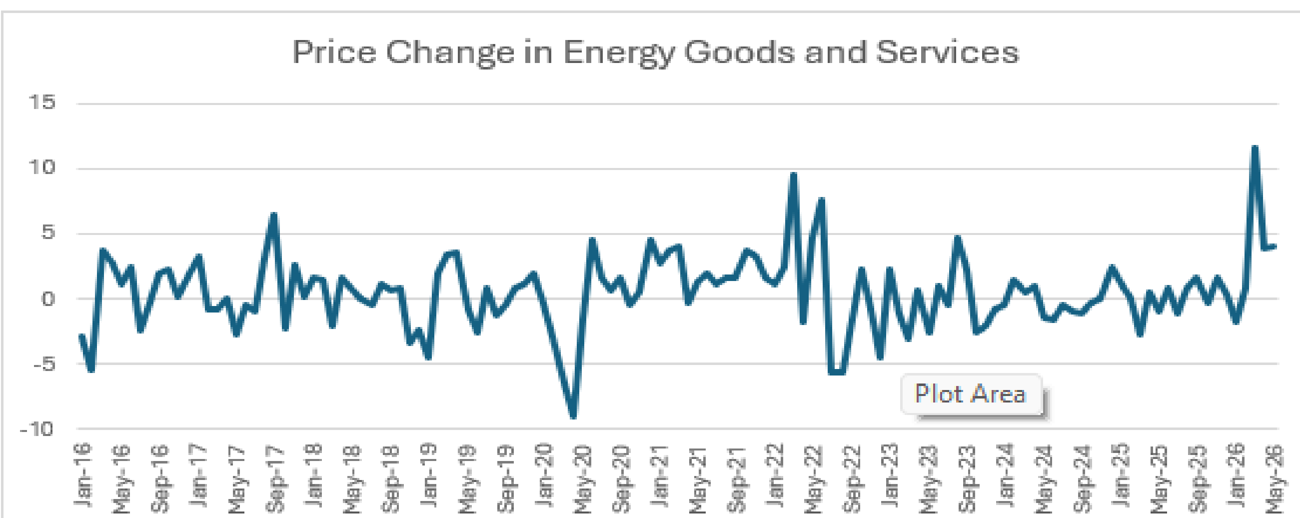

Figure 5 - Source: US Bureau of Economic Analysis

But enough of the gloom. Jobs, or lack thereof, which had been the primary issue the Fed used for its fall rate cut, seem to have bounced back with job openings seemingly having bottomed in December 2025 at 6.55 million. While February and March did again dip below 7 million, they trended higher across the first two months of the second quarter, nearing 7.6 million in May. (The Job Openings and Labor Turnover, JOLTS, data operates on a one-month lag.) Even though (job openings) could certainly trend downward again, they have also moved above the 12-month moving average. Hires have even seemingly bottomed at around 5 million.

If signs seem to be pointing in the right direction, then why the gloom from the market with the payroll data that was released before the fourth of July holiday? Though payrolls, both private and non-farm, did rise in June, the increase was less than expected as both were more than 40% lower than expected - a continuation of the steady decline since March.

The market is concerned (as is SIM) that we are nearing an inflection point that has typically accompanied a recession. If the decline continues and rolls into payroll contraction, then can a recession be too far behind? We are not expecting it to get that far, but there are several confusing statistics (of which this is one) that will need to resolve themselves in one way or another.

Payrolls, Leading Indicators and the Cost of Money

Have we just been in a pause in payrolls before a renewed decline or have we bottomed (see Figure 6 below)? SIM isn't sure, but this is just one of what we view as several troubling economic indicators that will need to resolve themselves in the not-too-distant future. The others are the Leading Indicators and Fed Funds, with the last of those facing an issue of administrative desires versus economic realities.

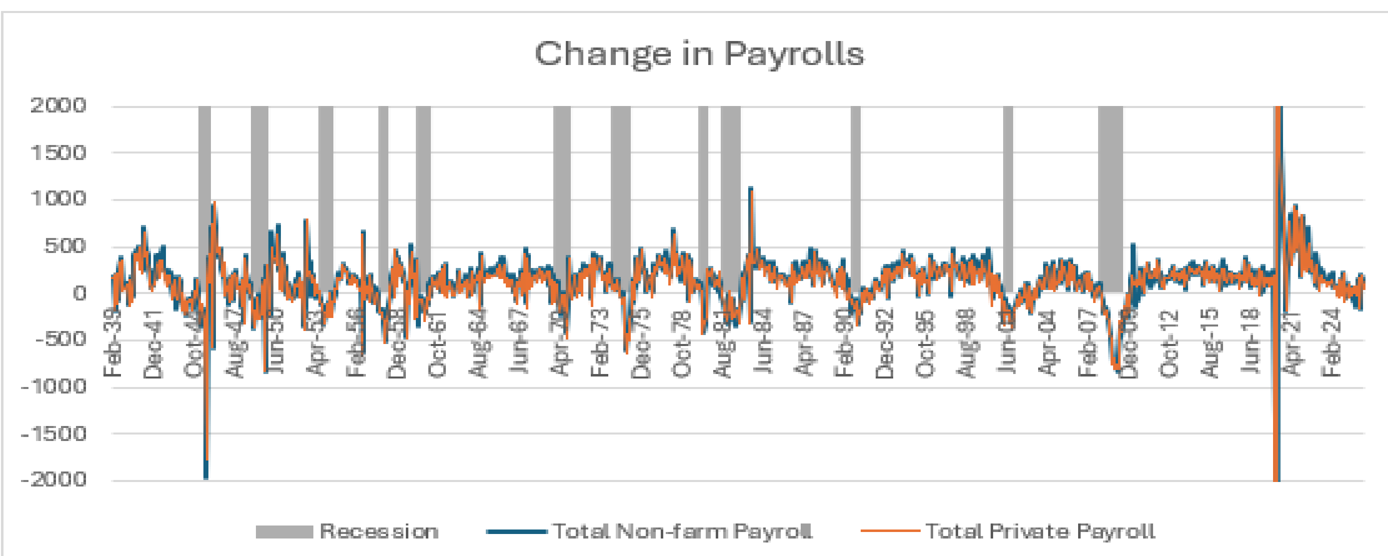

Figure 6 - Source: US Bureau of Labor Statistics

The Leading Economic Indicators (LEI) are a series of data points that the Conference Board has released that, in theory, point to either continued economic expansion or economic contraction. The Conference Board also releases their Coincident Economic Index (CEI) in conjunction with the LEI to help support the evidence found in the LEI. This is because, in most cases, the CEI tends to turn as recessions happen and shortly after the LEI has begun its decline. As you will note from Figure 7, the LEI turned negative in late 2021/early 2022 but has not yet been confirmed with a downturn in the CEI as has been the case since The Conference Board began reporting data in 1959[4].

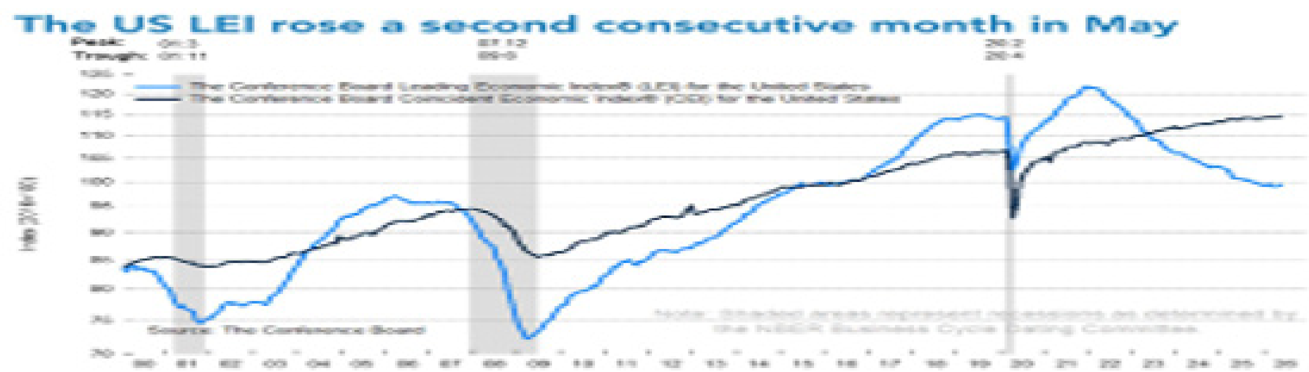

Figure 7 - Source: The Conference Board

What is causing this anomaly, particularly since all but two of the components of the Leading Indicators are either negative or barely above zero? In a word, the markets. The two components driving, even modest, improvements are the S&P 500 and the spread between Fed Funds and the 10-Year Treasury. In other words, as long as the markets are doing well, the LEI may hold up or even rise marginally. On the flipside, Consumer Expectations for Business Conditions are driving the decline and therein lies the conundrum. If consumer expectations for business conditions are poor, how much worse could they go if markets turn down? After all, the consumer still makes up more than two-thirds of economic activity and if the consumer isn't feeling good about their prospects might that not lead to an economic downturn? It hasn't so far, but we do have concerns.

Consumer confidence, as measured by the Conference Board and as measured by the University of Michigan, has been falling fairly consistently since the summer of 2021. The question that should be on the market's mind is, how much longer can confidence fall before the consumer stops (or slows) spending? For now, two things are keeping the spending going: 1) the K-shaped economy means that the bottom 30ish percent of consumer's spending doesn't really impact total consumer spending and, 2) rising home values has meant that there is plenty of untapped equity from which spending can be financed. However, as rates rise, then the borrowing spigot may get closed off as debt gets more expensive to service.

The Trump administration has been pretty vocal about its desire to see interest rates come down, and has tried to re-make the Fed to be more friendly to the administration's input. SIM believes that this is due to a realization that the President missed an opportunity to restructure federal debt during his first administration when rates were, effectively, zero. As the yield curve has normalized (long rates higher than short rates), Treasury has been forced to largely finance at the shorter end of the yield curve in order to keep debt service costs from rising too much. Unfortunately, financing at the short end of the curve means that debt service costs become far more volatile as refinancings happen with greater frequency and there is less control over ultimate costs.

While the Fed does set short term rates via the Fed Funds and Discount rates, the market often provides input through the shape of the yield curve (upward sloping generally means potentially faster growth and higher inflation) and by providing an indication of where it thinks monetary policy should move. We can see the market's input on monetary policy via the Chicago Mercantile Exchange's (CME) FedWatch tool.

The Fed Watch tool uses the 30-day Fed Funds futures prices to determine the likelihood of the Federal Reserve Open Market Committee's (FOMC) decision at each of its meetings over the next eighteen months. We can see the current results below:

	CME FEDWATCH TOOL - AGGREGATED MEETING PROBABILITIES		
MEETING DATE	350-375	375-400	400-425
7/29/2026	75.95 %	24.05 %	0.00 %
9/16/2026	24.09 %	75.91 %	0.00 %
10/28/2026	1.95 %	98.05 %	0.00 %
12/9/2026	0.00 %	62.02 %	37.98 %
1/27/2027	0.00 %	45.95 %	54.05 %
3/17/2027	0.00 %	25.23 %	74.77 %
4/28/2027	0.00 %	20.95 %	79.05 %
6/9/2027	0.00 %	27.09 %	72.91 %
7/28/2027	0.00 %	35.95 %	64.05 %
9/15/2027	0.00 %	48.76 %	51.24 %
10/27/2027	0.00 %	57.95 %	42.05 %
12/8/2027	0.00 %	67.38 %	32.62 %

The tool is currently showing that there is a very good chance that the FOMC increases its Fed Funds rate by a quarter of a percent (.25%) at one of its last three meetings of this year, and again sometime next year. Assuming the Fed Funds rate rises, then it is also very likely that consumer financing rates (revolving credit like credit cards and home equity lines of credit, HELOC) rise. This would put more pressure on an already stressed consumer. Could this be the straw that breaks the (consumer) camel's back?

The Markets So Far

While we said the first quarter was "interesting", the second quarter has been equally "interesting", but in a good way. All the major benchmarks closed higher for the year-to-date through June 30, with the S&P 500 and Russell 2000 setting new record highs (see Figure 8 below). Leading the way were emerging markets as described by the MSCI EAFE Emerging Markets index (up 25.75%) and the Small Cap Russell 2000 Index (up 22.57%). Next in line was the S&P MidCap 400 (+17.34%) and putting in strong numbers, though comparatively not strong enough, was the Large-Cap S&P 500 (up 10.21%) and the MSCI EAFE Index (+10.07%). Interestingly, if the S&P 500 just stays flat through year end, it will mark its fourth consecutive year with double-digit performance. This has only happened four times since 1926 (1942-1945, 1949-1952, 1995-1998 and 1996-1999), and in only one instance did the fifth-year return end in positive territory (1999).

On the bond front, returns have been barely positive with the Bloomberg Aggregate Bond Index returning just 0.62% for the first half, the Bloomberg US 1-5Yr Gov Credit Index returning 0.52%, and the ICE US Treasury 7-10Yr Bond Index essentially flat at just 0.03%.

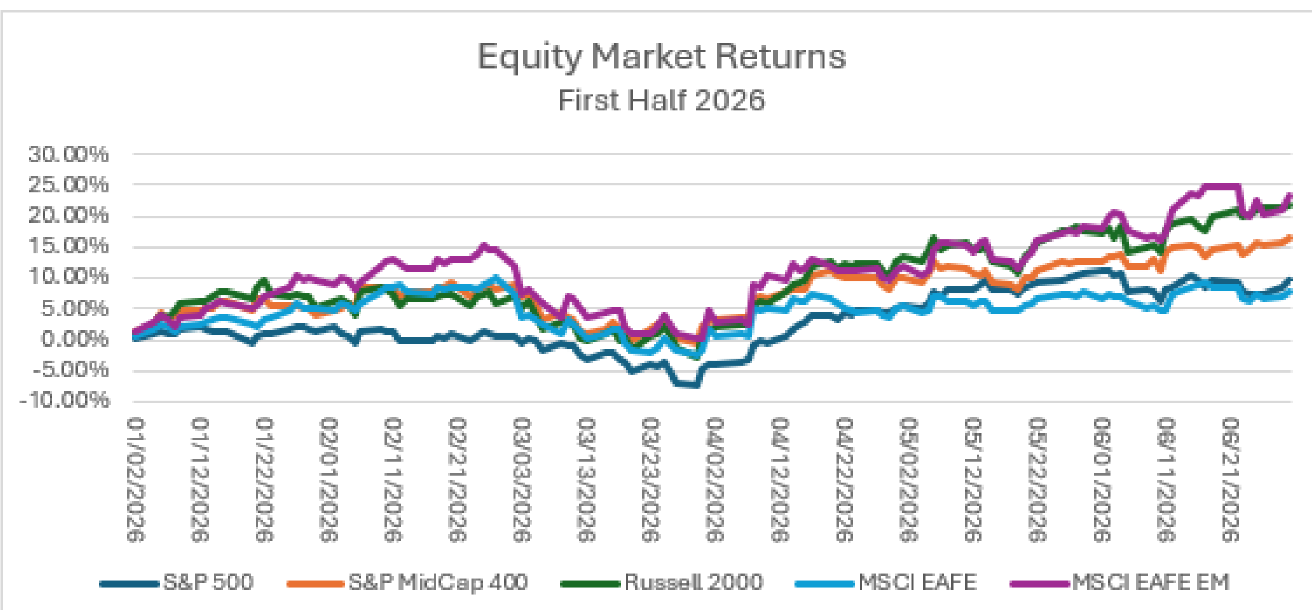

Figure 8 - Source: FactSet

Outlook

SIM is cautious about the rest of the year. As the markets have seemingly shaken off inflationary forces caused, in part, by the conflict with Iran, it is needing to make some assumptions that hang by the (in SIM's view) thinnest of support. As we indicated above, if the S&P 500 finishes flat for the balance of this year, 2026 will mark the fourth consecutive year of double-digit equity returns. The average return in year five is just 0.72%, and that is because the sole instance of a positive return after four consecutive double-digit return years was 1999. Absent that, the average return would have been down a bit over six percent.

What has to happen in order for markets to continue powering higher? Earnings need to show growth and so far, this has been coming through in pretty good shape. For the current calendar year, the S&P 500 is expected to show better than 25% earnings growth versus 2025, and while next year's growth rate is expecting a decline, it is still well into double digits (16.79%). However, we believe that in order for that to happen, we will need to see profit margins at least stay close to current levels. We have some concerns. For example, is it rational to think businesses can maintain margins in the face of higher input prices?

The issue about maintaining margins in the face of rising prices should not be taken lightly – particularly when current margins are near record highs (see figure 9 below). Businesses only have two options available to them regarding higher prices: pass the costs on to their customers or eat the cost increases. If they pass the costs on to their customers, the higher prices show up in inflation data which is likely to cause the central bank (Federal Reserve) to raise interest rates in an attempt to fight inflation. If business chooses to retain the higher costs, then those higher costs show up in lower profit margins. What is a company to do?

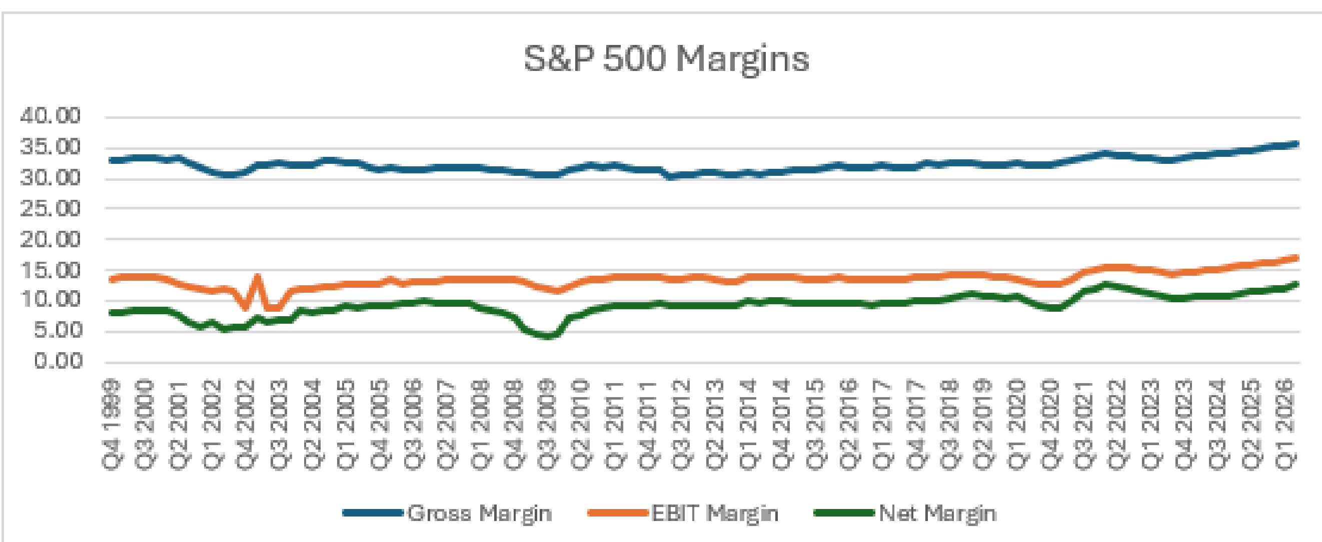

Figure 9 - Source: FactSet

SIM is being cautious. If you remember the inputs used to value a company (the discount rate, earnings and earnings growth), it is beginning to look increasingly likely that either earnings growth could fall, earnings could stagnate or the discount rate could rise, any one of which could push values down.

PE (Price to Earnings) ratios are also in danger territory, in SIM's view. We recently pulled down the constituent list of the S&P 500 and sorted it by sector and market capitalization and included the current forward PE (forward one year). What we found was that extended valuations exist pretty much across the S&P 500. The market PE (as calculated) was 32.21X expected earnings. (Our PE calculation had to make some adjustments for companies which did not show expected earnings over the next twelve months. We changed the earnings for those companies from N/A to 0. The PE ratio for the S&P 500 on expected 2026 earnings is 22.11X according to FactSet.) The sector with the highest forward PE was Consumer Discretionary at 66.09X and the lowest was Energy at 14.17X earnings.

The S&P 500 also remains quite concentrated in Information Technology at 35.89% of the index, and when combined with Communications Services (10.79% of the S&P 500), represent more than 46% of the total market capitalization of the index. In SIM's view, the risks associated with the market capitalization-weighted S&P 500 continue to point us away from it and to a less concentrated equal-weighted index.

We have said for some time that the 2% inflation target used by the Fed as an inflation goal was not grounded in historical reality and that a higher target would be a better goal. This had also meant that the Fed's decision to cut rates last year was not necessarily grounded in economic reality. While the administration would like to see lower short-term interest rates, we think it is far more likely that rates start ratcheting higher, and we are likely to get one hike in the Fed Funds rate this year. In our view, this will only result in a flattening of the yield curve if the market also sees a slowing in inflation.

Because SIM believes we are at the beginning stages of a secular (long-term) increase in interest rates, we believe it more likely that the entire curve shifts upward – at least marginally. This is likely to mean that bond returns remain similar to what we have seen through the first six months of the year – essentially flat.

SIM is also sticking to its beginning of the year thesis that equity returns will end the year on a positive note. Having said that, ending on a positive note could happen simply by prices remaining roughly equal to where they are now. There are a number of issues likely to impact market spirits – not the least of which are mid-term elections in November with both the House of Representatives and the Senate in play.

From our perspective the equity market horse-race is likely to end up very similar to what has happened thus far. Emerging markets and small(er)-cap stocks holding their lead with large-cap and developed international equities bringing up the rear.

It's been an interesting ride so far, and it's likely to remain interesting for a while. Stay vigilant. What SIM has learned from our more than 100 years of combined experience is that when risks are elevated, that you make sure that you are getting paid adequately for the risks taken. Where investors get disappointed is when they focus too much on the (expected) return and not enough on the risks inherent in each investment opportunity. It never hurts to take some profits, and it makes sense to reduce positions that have become too large.

Definitions and End Notes

1. Sell in May and Go Away: A saying in finance that is based on stocks' supposed underperformance during the six months from May to October. Popularized by the Stock Trader's Almanac, which discovered that the stocks in the Dow Jones Industrial Average from November to April would have produced reliable returns with reduced risk since 1950. Unfortunately if you switched to the S&P 500 summers (May to October) almost always outperformed winters (November to April).
2. Core inflation: The rate of inflation after removing the impact of food and energy prices.
3. "Jet-Fuel Prices Have Plunged but Aren't Resulting in Much Lower Fares," by Alison Sider, The Wall Street Journal, July 6, 2026.
4. "The Conference Board Leading Economic Index® (LEI) for the US Rose for the Second Consecutive Month in May", The Conference Board, June 18, 2026