

2026: A Tale of Two Quarters!

Economic Perspective

The first half of 2026 has shown a U.S. economy defined by a structural divergence: resilient headline consumer spending and booming artificial intelligence (AI) investment are contrasting with a cooling labor market and persistent energy cost pressures. Despite downbeat consumer surveys, actual discretionary spending has come in better-than-expected due to stimulus tailwinds and record tax refunds. With that said, a k-shaped bifurcation remains with higher-income consumers leading the way whereas lower-income consumers face greater headwinds due to sticky core services and energy costs. Thankfully, the AI Super-Cycle is alive and well and remains the key engine for our economy. While hyperscalers and data centers dominate the capex headlines, we are encouraged that corporate investment has broadened across many sectors as a result of fiscal stimulus initiatives and lower tariffs. On the other hand, our economy is a ways away from an all-clear! The second quarter estimate for economic growth estimate (from the Atlanta Fed GDPNow forecast) has fallen from a high of 4.3% to a current reading of 1.4%! The most recent nonfarm payroll report came in well below expectations at + 57,000 jobs for the month with revisions for the prior two months at - 74,000 jobs. This is likely to concern the Fed if this persists. Also, sticky headline inflation (heavily impacted by the high price of oil) remains a stubborn growth headwind - even though geopolitical tensions improved late in the quarter from a rolling boil to a simmer. We will continue to monitor the energy markets closely as they can have an outsized impact on the American consumer and discretionary spending.

Market Perspective

With yo-yo economic activity the norm of late, no wonder the stock market has been so volatile! After a challenging first quarter of the year, equities rebounded significantly during the second quarter - posting its 12th strongest second quarter showing since 1950. Market fundamentals drove the advance. Earnings growth, after climbing 29% in Q1, rose 24% during Q2. Importantly, corporate profit margins hit an all-time high of 20.7%! With the technology sector currently in its euphoria stage, one has to question the sustainability of outsized returns into the future? Also, the churning of money movement among market sectors has been at historic highs. Some will argue that the recent surge in technology-related IPOs coming to market (SpaceX, Anthropic, OpenAI, etc.) is a clear signal that froth is upon us. While chasing these high-growth names can be tempting, we caution that many recent large IPOs over the last few years have experienced drawdowns of at least 50% during their first years as a public company. Our investment team's valuation discipline and constant quest for margin-of-safety opportunities have us on the sideline for now. However, this could change if a company's margin-of-safety and/or risk/reward ratio improves.

Looking Ahead

Our investment team would like to note that the stellar second quarter market advance (while certainly appreciated) is actually quite atypical during a midterm election year. As Strategas Research has previously published, the opposite is typical. At some point during a midterm election year, a market decline of high-teens is common. Interestingly, the economy is strongest and the stock market the weakest during year two of a presidential cycle. This year, it seems the opposite is true with current economic growth projections on the decline but stock returns at all-time highs. The wild card during the second half of the year is tied to the Fed and its new leader Kevin Warsh. Will current hawkish commentary (potential rate hikes) be replaced by dovish commentary (rate cuts) by Fed officials? Or will all this economic uncertainty, combined with stretched valuations, eventually lead to risk-off sentiment going into midterm election in November? Time will tell but you can be sure that our investment team will be proactive and position your portfolio accordingly.