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Q2 2026 MARKET UPDATE
THE AI ECONOMY, SECTORS SEESAW, AND THE RETURN OF SMALL CAPS AND EMERGING MARKETS

Equity markets rebounded off their March lows in Q2 as earnings growth continued to exceed expectations, the economy remained resilient despite higher inflation, and oil prices fell on hopes of the Iran conflict ending. Massive investments in AI capacity is a key driver of economic growth this year. These investments in the "AI economy"—including chips, storage, data centers, power, foundational models/LLMs, and agentic AI—are also responsible for most of the elevated earnings growth among large-cap companies, accounting for an estimated 60% of S&P 500 earnings growth in 2026*. This, in turn, has helped maintain high stock valuations as investors are willing to pay a premium price for growth. This AI premium was evident in SpaceX's much anticipated June IPO. Although only part of its business is AI-related—xAI and data centers in space—the stock debuted at a $1.7 trillion valuation and quickly rose above $2 trillion, making it the sixth most valuable U.S. company and Elon Musk the first trillionaire. As long as investment capital remains available, there seems to be an insatiable demand for new AI capacity, supporting continued momentum in the AI economy.

Sectors expected to be disrupted by AI—such as software, consulting, and call centers—have continued to sell off in 2026, but we have recently seen a seesaw effect between perceived AI winners and losers. On some days, AI winners rally while AI losers decline; on others, the pattern reverses. We view this as a healthy development because it suggests the market remains constructive on AI stocks while also showing some skepticism about whether their long-term growth projections and valuations are sustainable. At the same time, valuations for perceived AI losers may have fallen far enough for investors to step in, based on the view that disruption could be slower or less severe than current prices imply. The market has broadened beyond AI and technology stocks. The Dow Jones Industrial Average continues to reach new highs, while the technology-heavy Nasdaq 100 peaked in early June and has moved lower since. Yet, the best-performing asset classes in 2026 have been small-cap and emerging market stocks. Emerging markets are benefiting from the AI trade because semiconductors are the largest sector in the index, while small-cap stocks have little direct AI exposure. We have highlighted the relative value opportunity in small-cap stocks versus large-cap stocks for several quarters, and investors are finally taking notice. We continue to see the best relative value opportunities in small- and mid-cap stocks.

Here's What Happened in Q2:

- Inflation readings increased in the quarter with the latest year-over-year readings on core CPI and core PCE (fed's preferred gauge) of 2.9% and 3.4% respectively*, well above the Fed's stated target of 2%. The Fed kept rates unchanged in Q2, but future projections have shifted from a downward bias to flat or higher rates due to renewed inflation pressure. The current Fed Funds rate is 3.75% with a median forecast of no additional cuts in 2026, down from 2 expected cuts just three months ago*.

- Yields on the 10-year Treasury bond were up slightly in the quarter, from 4.3% to 4.4% as the spike in oil prices raised inflation concerns.

- The S&P 500 gained 15.2% in Q2*, supported by stronger-than-expected Q1 earnings, up 29%, and projected full-year EPS growth of 18%, largely driven by AI spending*.

- Growth stocks slightly outperformed value stocks in the quarter, up 16.7% and 13.9% respectively. Year-to-date, value (+17.5%) is still well ahead of growth (+3.2%)

Index Total Returns (indices listed in footnotes)

	US large-cap	US mid-cap	US small-cap	Developed International	Emerging Mkts.	Agg Bonds
Q2 2026	15.2%	14.5%	19.7%	10.8%	24.1%	0.7%
2026 YTD	10.2%	17.3%	24.0%	9.4%	23.9%	0.6%

How the Markets Look Now & What's Ahead:

- **Valuation**: The S&P 500 continues to trade at a higher valuation than historical averages. Based on trailing 12 month estimates of $274* in earnings per share for the index through Q2, the trailing price/earnings (P/E) ratio would be 27.5 (higher P/E= stocks are more expensive). This compares to a 34-year median of 18.8*. Based on the consensus 2026 estimate of $324 per share, the market's forward P/E of 23.3 compares to a 34-year median of 17.9*. The S&P 500, a benchmark for large-cap stocks, is clearly expensive. Yet, the S&P indices for mid and small cap stocks are trading in-line with historical valuations and appear to be a much better relative value when compared to large-caps, hence our recommendation for asset class diversification.

- **Liquidity**: There continues to be a record $3.1T in retail money market funds *. This represents a lot of liquidity that could eventually flow into stocks, even if a significant portion is likely earmarked as a fixed income alternative. One-year flows into US equity Exchange Traded Funds (ETFs) are still very positive at $803 billion, including $111 billion in the last month, another sign of favorable liquidity for stocks.

- **Sentiment**: Momentum indicators on the S&P 500 are positive (as of 7/9), while investor sentiment from the American Institute of Individual Investors (AIII) is mildly bearish. This sentiment indicator is most informative at times of extreme bullishness (likely near a short-term top) and extreme bearishness (likely near a short-term bottom).

- **Stock Volatility:** Stock volatility as measured by the VIX index (currently 15) trended lower in Q2 coming off a elevated level of 25 at the end of Q1. The VIX is referred to as the "fear index" as it tends to spike higher when stocks selloff. Readings above 30 demonstrate elevated investor fear and usually coincide with a near-term bottom. Whereas readings below 20 usually indicate investor complacency. The current level of 15 is bullish for stocks.

- We still expect the yield on the 10-year Treasury to remain at or above 4.0% (currently 4.5%) unless there is increased fear of an economic slowdown.

Investment Considerations:

- Since elevated stock valuations=higher risk of below average long-term (5 year+) returns.*** , we believe a more defensive allocation is still warranted. Within one's risk allocation (stocks), we suggest some tech exposure, but also exposure to unloved value stocks, small and mid-cap stocks.

- There are still good values outside mega-cap tech, particularly in healthcare and energy stocks. Within tech, certain enterprise software names look very attractive.

- In fixed income, we would avoid long-term bonds due to the risk of long rates moving higher and stick to short-term and intermediate term (3-7 years) bonds.

- Other major risks beyond elevated valuations and an uncertain jobs market include: selling in the bond markets sends the 10- year Treasury yield above 5%; corporate earnings growth disappointing; oil prices remaining high and dragging the economy into recession; a deteriorating situation in Iran and the Middle East and other global and domestic geopolitical risks. The biggest long-term risk is out of control government debt and spending.