2026 Midyear Update

Resilience, Rotation, and Opportunity

The first half of 2026 reinforced an important lesson: investment themes evolve, but investment discipline should not. We entered the year expecting AI to remain the primary engine of growth, and that view has largely been confirmed. What changed was the breadth of its influence, the resilience of the broader economy, and the geopolitical backdrop.

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Key Points

- **Resilience:** The economy and corporate earnings proved stronger than expected despite geopolitical shocks.
- **Rotation:** Market leadership continues to evolve as AI spending moves through the economy and portfolio positioning adapts.
- **Opportunity:** AI remains the largest source of both opportunity and risk, making diversification and active management increasingly important.

First Half Review

When we entered 2026, we described the economy as increasingly K-shaped. On one side were companies benefiting from artificial intelligence and higher-income consumers supported by strong balance sheets and rising asset values. On the other were businesses and households facing tighter financial conditions and slower growth.

Six months later, that framework still applies, but it has evolved. What began as a relatively narrow group of AI beneficiaries has expanded well beyond technology, with spending now supporting semiconductors, power generation, electrical equipment, construction, and data center infrastructure. While the circle of beneficiaries has widened, it remains fundamentally tied to AI investment rather than broad-based economic acceleration.

The consumer story has also become somewhat less bifurcated. Higher-income households continue to lead spending, but lower-income consumers have shown modest improvement, helped in part by larger tax refunds. Higher fuel prices offset some of those gains, but the gap between the strongest and weakest parts of the economy narrowed somewhat during the first half.

The year's biggest surprise was the conflict involving Iran and the resulting disruption to global energy markets. Despite that shock, the economy and financial markets proved considerably more resilient than we expected.

Corporate America also demonstrated greater confidence than headlines often suggested. Through May, announced M&A volume increased 37% over the same period in 2025, reaching levels last seen during the dealmaking surge of 2021.

Perhaps the strongest evidence of resilience came from corporate earnings. We entered the year expecting S&P 500 earnings to grow approximately 13% in 2026. Rather than being revised lower, which typically occurs, consensus earnings estimates have increased roughly 10% since January. AI spending remains the primary catalyst, but we were encouraged that earnings estimates for the equal-weighted S&P 500 also increased approximately 9%, suggesting improving participation beyond the market's largest companies.

Fixed income followed a different path than we anticipated. We expected the Federal Reserve to continue lowering interest rates and believed elevated starting yields positioned bonds for another year of attractive returns.

Instead, inflation reaccelerated as higher energy prices due to the war in Iran and supply constraints associated with AI infrastructure spending pushed markets from expecting additional rate cuts to debating the possibility of future rate hikes.

International positioning also generally played out as expected. Developed international equities performed roughly in line with the S&P 500, while our slight overweight to emerging markets added value as the asset class materially outperformed U.S. equities during the first half. In March, however, we reduced that overweight and reallocated capital toward U.S. large-cap growth stocks, reestablishing a domestic bias as it became increasingly apparent that the Strait of Hormuz could remain closed for an extended period. While both positions subsequently performed well, leaving the adjustment largely neutral from a performance standpoint, we believe it appropriately reflected the changing geopolitical backdrop.

Following that adjustment, economic data continued to improve. Employment reports surprised to the upside, retail spending remained resilient, earnings estimates continued moving higher, and merger activity accelerated. Rather than relying solely on continued AI spending, we looked for confirmation that economic strength was broadening. Those developments ultimately gave us sufficient confidence to modestly increase our equity allocation.

Looking Ahead

We continue to believe AI remains the single most important driver of economic growth and corporate earnings. It also represents the market's largest source of concentration risk. While the visibility surrounding AI-related capital spending remains unusually high, investors increasingly face the challenge of balancing that confidence against growing dependence on a single investment theme.

We believe the AI story is beginning to enter a new phase driven by those companies that can successfully translate ongoing investments into productivity gains, higher margins, and stronger earnings growth. Early evidence remains largely anecdotal, but companies increasingly appear to be moving beyond AI experimentation toward redesigning business processes around AI. And, as we are seeing with software companies, AI deployment is also likely to disrupt some business models.

While we remain constructive on equities, we expect returns may be more modest, following such a strong first half. Mid-cap companies continue to offer attractive opportunities, and we are evaluating whether improving earnings revisions, broader participation among AI-related industries, and continuing resilient consumer spending warrant increasing exposure to small-cap equities following second-quarter earnings.

Internationally, we remain neutral on developed markets. Europe continues to show encouraging signs despite higher energy costs and increasing competition from China. A full reopening of the Strait of Hormuz and progress toward ending the war in Ukraine would improve our outlook further. Within emerging markets, performance has become increasingly concentrated among a handful of semiconductor companies. While we remain constructive on the longer-term opportunity, we believe investors should recognize that recent returns have been driven by relatively few stocks.

Within fixed income, higher yields continue to improve the long-term opportunity set. While markets have shifted toward pricing the possibility of another Fed rate hike, we believe the Federal Reserve is more likely to remain on hold than begin a sustained tightening cycle. Today's nominal and real yields provide attractive income while also offering meaningful diversification should economic conditions weaken.

Finally, as attention turns toward the November midterm elections, political uncertainty will likely receive increasing attention. Although markets have historically experienced elevated volatility ahead of midterm elections, we place relatively little weight on election-cycle patterns given the limited sample size and the dominant influence of economic fundamentals. More important, in our view, will be whether policy initiatives support consumer confidence and business investment during the second half.

Concluding Thoughts

The first half of 2026 reinforced an important lesson: investment themes evolve, but investment discipline should not. We entered the year expecting AI to remain the primary engine of growth, and that view has largely been confirmed. What changed was the breadth of its influence, the resilience of the broader economy, and the geopolitical backdrop.

Rather than allowing any single theme to drive portfolio decisions, we continue to look for confirmation across employment, consumer spending, corporate earnings, business investment, and financial markets. Those signals led us to make only modest adjustments to portfolios during the first half, reflecting increased confidence without abandoning diversification.

We expect volatility to remain elevated during the second half as investors navigate evolving Fed policy, geopolitics, and the next phase of the AI investment cycle. While leadership may continue to shift, we believe active management and disciplined asset allocation remain the best tools for identifying opportunity while managing an increasingly concentrated market.

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Word About Risk

Investing in Equities is subject to market volatility and loss. International and Emerging Markets equities also carry the associated risks of economic and political instability, market liquidity, currency volatility and differences in accounting standards. The risks associated with investing in international markets are magnified in Emerging Markets. Fixed Income/ Debt securities can lose their value as interest rates rise and are subject to credit risk which is the risk of deterioration in the financial condition of an issuer and/ or general economic conditions that can cause the issuer to not make timely payments of principal and interest also causing the securities to decline in value and an investor can lose principal.