MARKETS IN FOCUS

GEMMER ASSET MANAGEMENT LLC
LOCAL PARTNER | GLOBAL INVESTING

SECOND QUARTER 2026 JULY 14, 2026

Market Benchmarks

Market Indices	2Q26	YTD	3-Yr An
Global Equities	13.9%	11.9%	19.7%
S&P 500 Index	15.2%	10.1%	20.4%
Russell 2000	21.4%	22.6%	18.4%
Int'l Index (EAFE)	8.6%	9.9%	16.3%
Emerging Mkts	11.4%	11.1%	16.9%
Other Indicators	**6/30/26**	**3/31/26**	**12/31/25**
Fed Funds Rate	3.50%-3.75%	3.50%-3.75%	3.50%-3.75%%
2-Year Treasury	4.16%	3.79%	3.47%
10-Year Treasury	4.45%	4.32%	4.17%
30-Year Treasury	4.94%	4.91%	4.84%
S&P 500 P/E Ratio*	20.4	19.7	22.0
Crude Oil	$70.09	$101.38	$57.45
Core Inflation	3.4%	3.0%	2.8%

Forward 12-month operating earnings per S&P

Quarter-In-Review – It was a good quarter for global equities, with many of the major indexes posting their best three-month return since the spring of 2020. The advance was led by many of the companies supplying the 'picks and shovels' for the AI buildout, while money rotated out of commodities. Early in the quarter investors started to look past the war with Iran and focus on strong corporate earnings growth. Lower oil prices also helped alleviate concerns about the global economy and possible stagflation. Economically sensitive small-cap stocks stand out as the big winner in the second quarter, while international developed market equities lagged the S&P 500 modestly. Interestingly, the so-called Magnificent Seven stocks have underperformed the broad market in 2026, after years of outperformance. So far this year the group is down -2.5% as concerns grow about the massive sums they are spending on AI. More on this below.

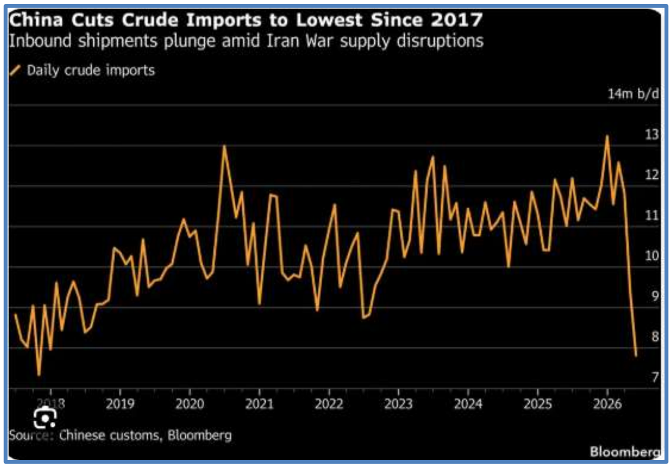
Bond yields increased noticeably during the quarter as the inflationary shock from the war with Iran filtered through the system and the market started to price in possible rate hikes later this year. The increase in 2-year yields is particularly notable as it indicates a better than even chance the Fed tightens at least once by the end of December. Government bond returns for the quarter were relatively flat, despite the increase in yields, as coupon payments largely offset price declines. Short-term Treasury bonds returned +0.3% in the second quarter while intermediate-term Treasury bonds added +0.1%. Corporate bonds were better performers with investment-grade bonds gaining +1.3% while lower quality bonds advanced +2.1%.

Over the last few weeks we've been getting a number of questions that can generally be lumped into four broad sections. Let's touch on each topic in turn.

I'm surprised the market shrugged off the war with Iran so easily – In retrospect, as soon as it became clear that the U.S. administration wasn't willing to put troops on the ground, the market essentially started to look past the Iran War as a significant macro risk. At first blush, this might seem short-sighted. After all, at the time the Gulf was still ostensibly closed to shipping traffic and there were periodic attacks on key infrastructure projects throughout the region. But investors interpreted the aversion against escalation as a sign that both Iran and the U.S. were operating with constraints on their actions, and these constraints were working against the 'worst-case' outcome. Both sides could clearly see the dire economic consequences from jeopardizing energy and civilian infrastructure and weren't willing to step over the line.

This isn't to downplay the oil shock. The chart at the bottom of the page shows the price for Brent crude oil from the beginning of 2021 to now. As you can see, prices spiked to almost $120 a barrel, but a couple things jump out from this chart. First, prices didn't surpass the highs seen in 2022 when Russia invaded Ukraine. Few would have expected this before events in the Gulf unfolded. Secondly, the price spike was relatively brief. In part this is because the belligerents in this war were constrained in their actions. Finally, China had built up massive reserves before the war started and was able to cut its imports during the war significantly. The chart at the top of the next page shows that imports fell to their lowest level since 2017 after the war started.

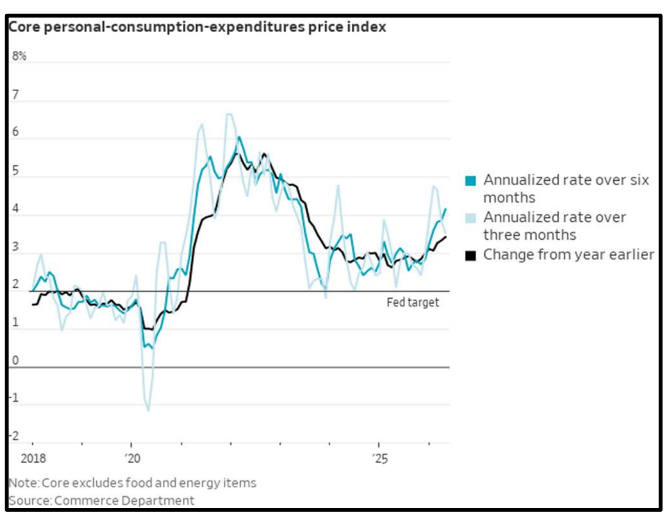
The other point that analysts realized only after the fact is that oil demand may be far more elastic than originally thought. Economists tend to think oil demand is rather inelastic - if prices go up 50%, the world will consume roughly the same amount because life has to go on. But over the last few months it has become apparent that governments, businesses, and consumers changed their consumption habits by far more than we originally thought in response to price spikes. We've seen numbers in the 5-to-8 million barrel range per day of demand that simply disappeared when Brent moved over $100.



Combine all these factors and the oil shock of 2026 is likely to be remembered as a relatively modest event. And if anything, the world may gradually come around to the idea that the Gulf is less important for the global economy than we would have thought only twelve months ago. Already Gulf states are plowing untold billions into pipelines and other export alternatives. Over time, this will only serve to diminish the importance of the Strait of Hormuz as a geopolitical flashpoint.

Will inflation come back down now that oil prices have normalized? – First, let's touch on what we know for sure. The inflation data that was released at the end of June points to continued price pressures (see the chart at the bottom of the page). And note that this chart is of the core PCE measure of inflation, so it excludes the impact of oil and food prices. In essence, ever since COVID, the world has seen inflation running above target (2% in the case of the Federal Reserve) due to a number of factors, not least of which include massive ongoing fiscal deficits, deglobalization, and rising tariffs.

But the big question is how quickly will inflationary pressure abate now that oil prices are back below pre-war levels? Economists, in their quiet moments, readily admit that their ability to model inflation isn't very good. They missed the inflationary spike after COVID, and few anticipated inflation running above the Fed's 2% target even after the significant rate hikes in 2022. But there's a case to be made that the inflationary picture is unlikely to improve much. Yes, lower oil prices will tip the scales towards deflation, but there are different pressures in the other direction. Critically, if economic growth accelerates in the second half of this year, price pressures may not come off the boil much at all. Some may be skeptical that growth could accelerate later this year, but with oil prices down and the trade war in the rear view mirror, it might not take much to see hiring reaccelerate and inflationary pressures start to percolate once more.



Is the new Fed Chairman going to change anything? - Kevin Warsh presided over his first meeting of the Fed on June 17th, and it quickly became clear from Warsh's press conference that he plans to run the Fed a little differently. First, he is likely to reduce, if not eliminate, so-called forward guidance. In the past, Fed governors have gone out of their way to communicate their intentions weeks, if not months, ahead of time. The idea was to avoid surprising investors and the markets. Warsh made it a point that this is going to end. Secondly, he made a big deal of his initiative to create five task forces to study the Fed's operations. Specifically, they are going to look into:

1. Fed communications – maybe fewer press conferences (please!!!)?

2. Fed's balance sheet – should they shrink the balance sheet, and if so, how?

3. Use and reliance on existing data sources – there is talk about more 'real-time' data.

4. Fed's inflation frameworks – possibly reassessing the Fed's 2% target.

5. Productivity and jobs in an era of transformation.

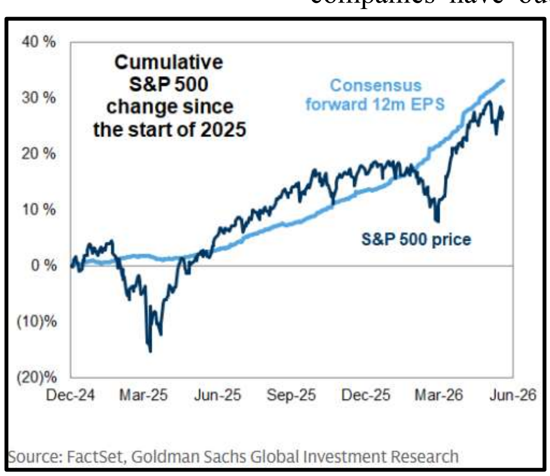
This last point is potentially a big deal and captured in the chart at the top of the next page. If all the AI investment is truly going to be revolutionary, one of the yardsticks that will be important to watch is what happens with productivity. The concept is simple – rising productivity means doing more with less. Alan Greenspan forcefully made this argument in the 1990's regarding the internet. He used this line of reasoning to successfully argue against rate hikes even though the labor market was tightening. Similarly, Chairman Warsh has talked about the impact AI may have on future productivity.

What will this all mean in practice? It's hard to say at this point. The heads of each task force are only now being put in place, and none of this stuff is likely to move quickly. Could the Fed change policy before the results are in? Almost certainly, but any major changes are likely to hinge on the findings.

In the short term, the market is pricing in one rate hike before the end of this year, and close to two more rate hikes in 2027. But the range of opinions on this differs remarkably. Some well-respected analysts are predicting cuts in 2027 as the Fed starts to incorporate the anticipated productivity gains coming from AI into their models. Other, equally respected economists, think the Fed will finally get serious about hitting their 2% target. For what it's worth, our view is that the path for rates is likely only to become relevant for the markets in 2027. We think the Fed could hike a couple times between now and, say, the first quarter of next year, without much impact on the broad equity and bond markets. But by then we think the confluence of a few issues could become significant.

1. By early next year we will have a much better sense as to how much of the recent inflation data has been driven by the oil shock, and how much is ingrained in the system.
2. Additionally, it's quite possible that growth rebounds in the second half of 2026, and, if so, renewed hiring could start to be viewed by the Fed as having inflationary consequences.
3. The results of the Fed's task forces are likely to be out by early next year. This could have important implications for the Fed's balance sheet, inflation targets, economic modeling, etc.
4. Finally, in another six to nine months we will have a better sense as to whether AI is really going to be a game changer from a productivity perspective.

Depending on how these questions are answered will determine the path for rates, and probably the broad markets, in 2027.

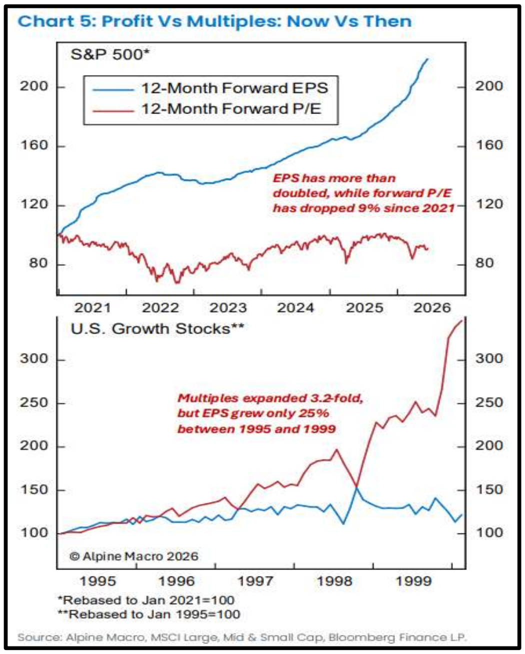


Source: FactSet, Goldman Sachs Global Investment Research

Are stock prices running ahead of the fundamentals? – This is probably the most common question we get. Surely the returns of the last few years have pushed stock prices well beyond what the fundamentals can support, the thinking goes, and shouldn't I raise cash to try to front-run the next downturn? Of course, the right answer will differ in part for everyone depending on their individual situation. Maybe you don't need to take much risk given your stage in life and financial situation? Or if you may need a chunk of cash for a down payment on a home, now might be a good time to start to scale things back. But from a big picture perspective, the market performance this year doesn't seem unusual given the earnings trends we've seen. The chart at the bottom of the page overlays a measure of earnings on the S&P 500 since the start of 2025. The market is certainly up over this time frame, but earnings are up even more. And as you can see from the statistics table on page 1, the price/earnings ratio for the S&P 500 has actually fallen this year from 22.0 to 20.4. This doesn't seem to raise much of a red flag for investors, particularly if you think interest rates hover around today's levels for the foreseeable future.

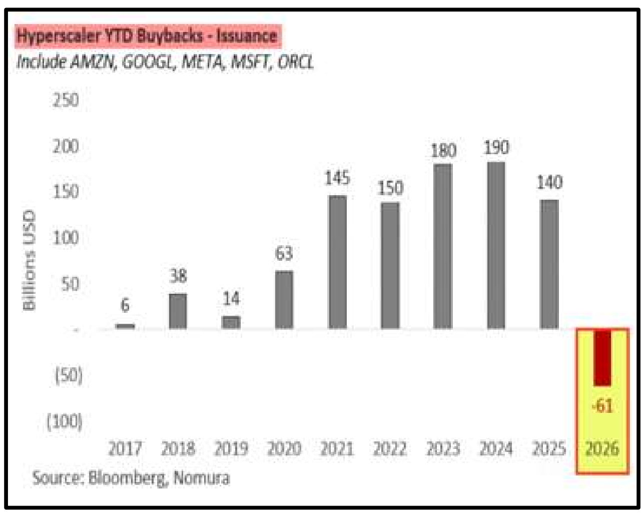
Much of the bearish commentary likens today's markets to the tech bubble in the late 1990s, and on one level this resonates. The massive investment taking place in AI is undoubtedly going to lead to pockets of malinvestment or even fraud, but we think it is too soon to make a broad market prediction just because investment in a new technology is booming. And it is easy to forget just how unhinged the tech bubble was almost thirty years ago. The chart at the top of the next page shows the current S&P valuations and earnings (top panel) versus similar measures for growth stocks from 1995 to 2000 (bottom panel). Prices completely lost touch with reality from late 1998 onwards as price-earnings multiples went parabolic. We can certainly debate the valuation metrics on some of the new IPO's this year, but from a broad market perspective, it's hard to argue that we are seeing a re-run of the 1998/1999 period just yet.

But underneath the surface there are some notable changes taking place. For a number of years now, the big tech companies have outperformed the broader market by a significant margin. The Magnificent Seven stocks were the only game in town for investors for much of the 2021 to 2025 period. However, as we noted earlier, the group has underperformed this year as investors start to worry about the massive amounts these firms are spending on the AI buildout. For example, the chart at the bottom of the next page shows the net stock buybacks on the part of the five hyperscalers (Amazon, Microsoft, Google, Meta, and Oracle). For a number of years, these companies bought back massive amounts of their own shares. But this year, not only have the buybacks ground to a halt due to massive capital spending tied to the buildout of the AI infrastructure, but we've started to see net stock issuance (as well as bond issuance that isn't reflected in this chart). And this goes a long way towards explaining why the Mag-7 group is lagging this year – what were once viewed as capital-lite firms that could generate massive amounts of free cash flow are now viewed as capital constrained!!



This isn't a bearish story from a macro perspective; after all, the hyperscale's' spending is revenue for other sectors of the market. But it does speak to the rotation between sectors that is likely to play out in the months and quarters to come. Sectors are likely to go in and out of favor even though the broad market may continue to advance. This is likely to frustrate someone trying to raise cash to time a broad-based bear market.

What's the biggest threat for the global equity market? By their nature, bear markets often materialize because something unexpected happens that isn't already embedded in prices. Obviously, COVID would be the latest example. But bear markets can also come about due to policy choices. A decision to pivot towards fiscal austerity triggered problems in Europe in the years after the financial crisis. Similarly, central banks around the globe have a history of killing bull markets as part of their commitment to fight inflation. Maybe Kevin Warsh's new Fed will channel their inner Paul Volker in 2027? We think it is too soon to position for such an outcome, but stay tuned!!



<u>Looking Ahead</u> – Investors were well rewarded for staying the course after the war with Iran started at the end of February. Probably even the most optimistic analysts were surprised by how quickly the markets shrugged off the closure of the Straits of Hormuz and the consequential hits to the global supply chains for numerous key commodities. But the global markets have shown a surprising ability to bounce back from shocks over the last few years. In retrospect, it was simply too hard for stock investors to ignore such a strong earnings backdrop for too long.

Going forward, much will hinge on the direction of inflation and how central banks react to what could be secular inflationary pressures. Our suspicion for a few years now has been that inflation was likely to run hot, or at least hotter than it did during the post-financial crisis period. But the question has always been how policy makers would respond. In 2022, it looked for a relatively brief period that they would force the markets to take the pain to get inflation back to target, but their commitment proved only to be half-hearted. Ultimately, market volatility forced them to capitulate. Will the new Fed under Chairman Warsh have a different view? It's too soon to say, and at a minimum we will have to wait for the results from the various task forces to have confidence in any view. But one thing we know for sure, the bureaucracy moves slowly. We suspect we will only have hints of an answer next year.

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