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Market Overview

All major U.S. indices staged a powerful second-quarter reversal, reaching record highs in mid-June as geopolitical tensions eased and AI investment accelerated, before a modest tech-led pullback into quarter-end. The Nasdaq led, surging 21.60% as growth stocks regained their footing; the S&P 500 gained 15.20% to close at 7,499, the Dow rose 13.38%, and the Russell 2000 recovered from its earlier volatility to finish up 21.49%.

The market narrative refocused on the physical infrastructure required to sustain the expanding AI ecosystem. Semiconductors and mega-cap technology reclaimed leadership, driving significant concentration at the top of the indices, while financials showed notable strength on robust capital markets activity and stable consumer credit. Software continued to face headwinds, widening the valuation gap between the companies building AI infrastructure and the vendors adopting it.

Inflation moved from background concern to center stage: headline PCE accelerated to 4.1% year over year in May — its highest since April 2023 — with core firming to 3.4% as the energy shock fed through the price level. The Federal Reserve held the funds rate at 3.50%–3.75% at Chair Kevin Warsh's first meeting in June, but its projections turned decisively hawkish, with the median dot now implying at least one hike this year. Resilient earnings nonetheless cushioned equities, fixed income was notably calmer — the 10-year Treasury settled at 4.44% and the 30-year closed June at 4.91% — and the Fed's hawkish shift kept the U.S. Dollar Index well supported, up 2.16%.

Global equities diverged sharply. Emerging markets led, surging 21.08% behind the AI memory and semiconductor complex in Korea and Taiwan, while developed international markets finished up 8.64%. In commodities, the war premium in energy dissolved as Middle East tensions quieted and Strait of Hormuz traffic resumed, with Brent crude falling over 40% to roughly $72. Gold retraced its conflict-driven spike, declining over 14% for the quarter as the stronger dollar and rising rate expectations weighed on the metal..

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U.S. Equity Returns Table Source: Tamarac			**U.S. Treasury Yield Table** Source: Treasury				**Other Indices Table** Source: Morningstar		
Index	**Q2 2026 Returns**	**2026 Returns**		**06/2026**	**06/2025**	**06/2024**		**Q2 2026 Returns**	**2026 Returns**
Dow Jones	**13.38%**	**9.76%**	3 month	3.87%	4.41%	5.48%	Gold (GLD)	-14.39%	-7.05%
S&P 500	**15.20%**	**10.21%**	2 year	4.14%	3.72%	4.71%	Brent Oil (BNO)	-21.77%	43.68%
NASDAQ	21.60%	13.13%	5 year	4.19%	3.79%	4.33%	U.S. Dollar Index (UUP)	2.27%	5.11%
Russell 2000	21.49%	22.57%	10 year	4.44%	4.24%	4.36%	Int'l Equity Markets (EFA)	8.64%	9.89%
MSCI World	13.32%	8.92%	30 year	4.91%	4.78%	4.51%	Emerging Equity Markets (EEM)	21.08%	25.68%

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The Energy Shock Recedes—But the Inflation It Unleased May Linger

When we last wrote in early April, the question was whether the U.S. economy could absorb the energy shock from the Iran conflict and the closure of the Strait of Hormuz without tipping into stagflation. Three months later, the answer is encouraging—but incomplete. The April 8 ceasefire and the 60-day memorandum of understanding reached in late May have allowed tanker traffic to gradually resume, oil prices have round-tripped from a peak above $120 per barrel to roughly $72 at quarter-end, and the S&P 500 posted its best quarterly performance since 2020. **Yet the inflation left behind by the shock is now the dominant risk to economic expansion. With headline inflation above 4% and the physical oil market still fragile, we believe inflation may prove more persistent than markets currently expect—and the central question for the second half is how the consumer and labor market hold up if energy prices firm anew and inflation lingers at or near 4% over the coming months.**

The economy carried more momentum into the conflict than initially reported. Real GDP increased at a 2.1% annualized rate in the first quarter, according to the third estimate released June 25—revised up from 1.6%—with investment, exports, government spending, and consumer spending all contributing.[1] The expansion appears to have continued through the second quarter: real consumer spending rose 0.3% in May, inflation-adjusted incomes rose for the first time in four months, and AI-related business investment remains a powerful tailwind. **The private-sector core of the economy expanded through the energy shock, vindicating our view last quarter that the underlying foundation was firmer than the headline volatility implied.**

The labor market has settled into the “low hire, low fire” equilibrium the St. Louis Fed described earlier this year—and on balance it remains a source of stability. The June employment report showed nonfarm payrolls rising 57,000, a step down from May’s strong 172,000 gain, with much of the swing attributable to seasonal payback in leisure and hospitality following May’s outsized increase.[2] The unemployment rate edged down to 4.2%, layoffs remain contained, and weekly jobless claims are low. To be sure, hiring remains concentrated in a narrow set of sectors and labor force participation slipped to 61.5%, so the report warrants monitoring rather than alarm. **We view the labor market as moderating, not weakening—but its resilience is precisely what will be tested if inflation proves as persistent as we suspect, since household purchasing power is the channel through which an energy-driven price shock ultimately bites.**

That shock is now fully visible in the price data. Headline PCE inflation reached 4.1% year over year in May—the highest reading since April 2023, up from 3.8% in April—while core PCE firmed to 3.4%, its highest since October 2023.[3] Our first-quarter letter projected that headline PCE could reaccelerate into the 3.2%–3.8% range by midyear; the actual outcome overshot even that range, a reminder of how quickly energy shocks propagate through the broader price level.

The consensus view holds that May marked the peak, with oil’s retreat—WTI closed below $70 in late June for the first time since February—set to pull headline inflation steadily lower through base effects. We are less sanguine, because the physical oil market will likely take longer to heal than the futures curve implies. Tanker traffic through the Strait of Hormuz remains well below pre-war levels, and Iran briefly re-closed the waterway as recently as June 20—the ceasefire is an armistice, not a peace. Shut-in Gulf production takes time to restore; strategic reserves drawn down heavily during the conflict must eventually be refilled, adding a new source of demand; war-risk insurance premiums surged to multiples of pre-conflict levels; and OPEC cohesion has frayed, with the UAE exiting the cartel in May and Iraq threatening to follow. Europe, meanwhile, enters the second half with depleted gas storage and will compete aggressively for LNG cargoes. With supply buffers this thin, even modest disruptions could send prices sharply higher again. **We believe inflation may prove more persistent than expected, with headline PCE at risk of holding at or near 4% over the next several months rather than decelerating on schedule—making inflation, not growth, the biggest threat facing the economy and markets in the second half.**

The Federal Reserve appears to share that concern. At the June 17 FOMC meeting—Chair Kevin Warsh’s first—the Committee held the federal funds rate at 3.50%–3.75% in a unanimous vote, but the accompanying projections turned decisively hawkish: the median 2026 projection rose to 3.8%, implying at least one rate hike this year versus the cut projected in March; 17 of 18 participants judged inflation risks to be tilted to the upside; and the Committee raised its 2026 inflation forecast to 3.6% while committing flatly to “deliver price stability.”[4] **The Fed’s reaction function has inverted since our last letter: the debate is no longer when the Fed will cut, but whether it will need to hike—and if inflation lingers near 4% as we fear, the Committee’s patience will be tested well before the labor market gives it a reason to ease.**

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Against this backdrop, equity markets delivered a stunning second quarter. The S&P 500 returned 15.2% on a toral return basis—its best showing since 2020—closing June 30 at 7,499, up 10.2% year to date after briefly surpassing 7,600 in early-June, while the VIX[5] settled just north of 16 from its late-March spike above 30. The rally has been earnings-driven rather than multiple-driven: first-quarter S&P 500 earnings grew 28.8% year over year on 11.9% revenue growth, and consensus expects 23.1% earnings growth for the second quarter and 24.0% for the full year, led by the AI infrastructure buildout.[6] A tech-led pullback of roughly 3% into quarter-end, however, was a useful reminder of how much of the index's return rests on a narrow, richly valued cohort. **With the index near record highs and estimates already embedding substantial AI-driven growth, the margin of safety is thinner than it was in April—and an upside inflation surprise is the most obvious catalyst that could test it.**

Our second-half scenario framework accordingly centers on the persistence of inflation and its interaction with the consumer:

Sticky Inflation, Sturdy Consumer (Extended but Choppy Expansion):

Scenario: Oil supply normalization proceeds slowly and prices firm modestly as reserve refilling, insurance costs, and constrained Gulf flows keep the market tight. Headline PCE holds in the high-3% to 4% area through the fall before decelerating late in the year. Real income growth and contained layoffs keep the consumer spending, the Fed delivers one insurance hike, and growth slows but remains positive.

Market Impact: Equities chop sideways to modestly higher with elevated volatility. The S&P 500 ends the year in the 7,300–7,800 range, as leadership rotates toward energy, value, and pricing-power names and away from the most richly valued growth cohort.

Likelihood: Moderate—this is our base case.

Implications: Favor pricing power, energy infrastructure, and inflation hedges; keep fixed income duration short and deploy into yield spikes opportunistically.

Faster Healing and Resumed Disinflation (Bull Case):

Scenario: Strait traffic normalizes faster than expected, Gulf production recovers, and oil settles into a $65–$80 band. Energy base effects pull headline PCE toward 3% by year-end, core resumes its descent, and the Fed holds rates steady—delivering neither the cuts hoped for in January nor the hikes feared in June.

Market Impact: The S&P 500 grinds toward the 7,800–8,100 range by year-end, consistent with the Street's median target near 7,850, with leadership broadening beyond the mega-cap AI cohort.

Likelihood: Moderate, but it requires a physical normalization of the oil market faster than the current evidence suggests.

Implications: Constructive for quality growth at reasonable valuations and lagging cyclicals; 10-year Treasury yields near 4.5% offer an attractive entry point to extend duration modestly.

Renewed Energy Spike Cracks the Consumer (Stagflation Redux):

Scenario: Re-escalation or a supply disappointment sends oil back above $100, and headline PCE holds at or above 4% into 2027. Real purchasing power compresses, the consumer retrenches, hiring stalls, and the Fed is forced to tighten into a slowing economy.

Market Impact: The S&P 500 corrects 10%–20% from record highs as earnings estimates are revised lower, with long-duration growth most exposed; energy equities, defensives, and inflation-protected securities outperform.

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Likelihood: Lower, but this is the tail risk we are most focused on hedging—and every week of constrained Strait traffic keeps it live.

Implications: Emphasize balance-sheet strength, essential services, energy and commodity exposure, and cash equivalents; avoid leveraged cyclicals and speculative growth.

The first half delivered both the shock and, improbably, the recovery: the economy absorbed the largest supply disruption in the history of the global oil market with growth intact and equity markets at record highs. But the bill is still being paid. Inflation sits at three-year highs, the Federal Reserve has pivoted to a tightening bias under new leadership, and valuations presume continued earnings excellence. Whether the second half extends the recovery depends, in our view, less on geopolitics than on prices: how long inflation lingers near 4%, and how gracefully the consumer carries it.

Our growth at a reasonable price ("GARP") strategy is well suited to this environment, emphasizing companies with pricing power, robust balance sheets, and secular demand tailwinds—particularly in domestic energy infrastructure, AI and data center buildout, defense and aerospace, and essential services. We are maintaining the energy and commodity-linked exposure we added last quarter, which now serves as a hedge against inflation persistence rather than acute conflict risk, alongside core positions in quality growth names that we believe can compound earnings across a range of macro outcomes. For fixed income allocations, we continue to favor a shorter-duration posture while using yield spikes to tactically extend duration where appropriate. **In our view, this balanced approach—participation in durable structural growth themes combined with deliberate inflation defenses—positions us well for a second half in which inflation, not growth, is likely to set the market's direction.**

Brent J. Miller, CFA® – Senior Portfolio Manager

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[1] https://www.bea.gov/news/2026/gdp-second-estimate-4th-quarter-and-year-2025

[2] https://www.bls.gov/news.release/pdf/empsit.pdf

[3] https://www.bea.gov/news/2026/personal-income-and-outlays-may-2026

[4] https://www.federalreserve.gov/newsevents/pressreleases/monetary20260617a.htm

[5] VIX is the ticker symbol and popular name for the Chicago Board Options Exchange's CBOE Volatility Index, a popular measure of the stock market's expectation of volatility based on S&P 500 index options.

[6] https://www.factset.com/earningsinsight

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