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Quarterly Review and Outlook

Despite market volatility associated with the war in Iran and the inflationary impact of a rise in oil prices and other commodities, the S&P 500 index rose 15.4% in the second quarter and 10.4% year to date through June. Supporting the market's advance has been strong corporate earnings with earnings strength broadening beyond mega cap technology. Earnings growth across the other 493 companies in the S&P 500 has improved meaningfully, signaling strong prospects for additional upside for the remainder of the year. In aggregate, S&P 500 earnings were originally projected to be up 18% this year and are now expected up 24%. After a robust first quarter, earnings are projected to be up 22% in the second quarter. This will mark the second quarter in a row of growth over 20% and the seventh consecutive quarter of double-digit EPS growth for the S&P 500. Strong gains in corporate productivity have buttressed company earnings and profit margins. Higher output per worker is helping to keep unit labor costs down and corporate profits up. AI investments and the deployment of agentic application tools currently being used across a variety of industries should improve corporate productivity and help boost company operating margins. The robustness in corporate profits, bolstered by gains in productivity and increased capital spending, are key supportive factors for the economy and the stock market.

Investors also welcomed the easing of geopolitical tensions with the signing in mid-June of a 60-day peace framework between the US and Iran aimed at permanently ending the Iran war. The agreement calls for the immediate reopening of the Strait of Hormuz, through which ~20% of the world's oil passes, in conjunction with the lifting of the US naval blockade on Iran. During the 60-day moratorium, both parties will continue negotiating on Iran's stockpiles of highly enriched uranium. The US is calling for its elimination and for independent verification, in return for which the administration has stated it would be willing to lift economic sanctions against the Iranian regime and restore the country's frozen financial assets. Oil tanker traffic has resumed through the Strait of Hormuz, but at a significantly lower rate than pre-war levels, which is certainly positive and hopefully will result in lower oil prices. Peace negotiations with Iran have been fraught with escalating tensions and retaliatory attacks from both sides, so there is no guarantee that a peace agreement will be reached in 60 days, but there is a sense that both sides want an end to the hostilities, so investors are hopeful that an actual peace agreement will be finalized soon.

The biggest story in the equity market this year has been the enormous amount of capital spending on the build out of AI capabilities across industries which has helped bolster economic growth. The hyperscales– Google, Amazon, Meta, Oracle and Microsoft – are expected to spend roughly $765 billion in AI-related infrastructure in 2026. This is an enormous figure equivalent to nearly 2% of U.S. GDP. What makes this particularly notable is that the expectations for capex spending are continually being revised higher. Hyperscaler spending in 2026 is now projected to be roughly 30% higher than estimates at the beginning of the year. Those upward revisions are already increasing sales and earnings for companies providing products and services required for AI's expansion. The large increase in capital spending for AI may prove to be a potential boon for the entire economy. The big questions are how long will this capex spending cycle continue and when will the hyperscalers begin to see a return on their investments?

The second quarter also saw a changing of the guard at the Federal Reserve with the installation of Kevin Warsh as the new chairman replacing Jerome Powell. Warsh has emphasized a strong commitment to price stability. The FOMC policy committee at its meeting on June 17 voted to keep interest rates unchanged. Of note, the committee changed its monetary policy bias to neutral from a previous easing posture reflecting the pickup in inflation and improved labor market conditions since their last meeting. Looking ahead, the Fed's summary of economic projections showed a split among FOMC members with nine calling for no change in the Fed funds rate and nine calling for at least one rate increase by year end. The higher number of officials calling for a rate increase vs. the last Fed meeting reflects increased concern about inflation at a time when conditions in the job market have improved. With oil prices having declined following the signing of the US-Iran preliminary peace agreement, inflation could be expected to moderate going forward. However, this process could take a while given the depleted state of oil inventories and time needed to replenish energy supply chains.

Given the positive conditions in place in the U.S. economy, accommodating financial conditions, accelerating earnings growth and the expansion of AI related cap ex, we have maintained our focus on companies with sustainable earnings growth prospects - i.e. those with strong secular underpinnings to their businesses. With the conclusion of the Iran war hopefully in sight, investors can return their focus to economic conditions and company fundamentals. We believe it is earnings growth over time that drives long-term capital appreciation, and the outlook for corporate earnings is strong. We look to invest in companies with defensible business moats which have favorable economic tailwinds. We are also looking for companies with conservative balance sheets and strong management teams. Stocks are purchased at what we deem to be attractive valuation levels and attractive return prospects. Our investments are focused in technology, communications, industrials, healthcare, specialty finance, select consumer areas and companies that are providing products and services required for AI expansion.

In the fixed income sector, we primarily invest in corporate, government or municipal bonds tailored to each client's tax status. We prefer to use a laddered investment approach which provides flexibility to our client's individual goals. We have been targeting the intermediate part of the bond curve – i.e. in the two-to-ten-year maturity range. The Federal Reserve is pivoting to a more hawkish posture, however with less urgency now that oil prices have been stabilizing. This should ultimately help the inflation figures to moderate into year-end. We remain constructive on credit conditions and municipal finances as credit spreads and default risk remain at historically low levels. With oil prices recently heading lower and in our view inflation ultimately doing the same, we are constructive on the bond market.

As always, we value your trust and would welcome hearing from you should you wish to discuss your investments or portfolio positioning.