



JAMES
INVESTMENT RESEARCH, INC.

ECONOMIC
OUTLOOK

2026

3rd Quarter Outlook

An Indepth Forecast
of the Year 2026

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Executive Summary

Oil is the variable that defines the second half of 2026. The energy shock that followed the Iran conflict pushed headline inflation to its highest level in four years and forced the Federal Reserve (Fed) into a hawkish hold, even as earnings, manufacturing activity, and consumer spending held up. The U.S.-Iran memorandum signed on June 18, 2026 has pulled Brent crude from its April peak near \$120 per barrel back to the low \$70s, opening a conditional path toward lower inflation.

The underlying economy is not broken, but it is under strain. The business cycle reads as a mid-to-late transition: financial conditions and the consumer remain supportive, while industrial production and housing are contracting and the labor market is decelerating without collapsing. The composite picture argues for below-average growth rather than recession.

Markets sit atop solid fundamentals yet remain nervous. Beneath an unremarkable headline equity return, leadership has rotated hard, with the Magnificent Seven (Nvidia, Apple, Microsoft, Alphabet, Amazon, Meta Platforms, and Tesla) down on the year while small caps, value, and semiconductors have surged. In fixed income, yields are the most attractive in years, but credit spreads are historically tight and the composition of Treasury demand is shifting in ways that point to higher borrowing costs and greater volatility.

Overlaying everything is the arrival of Chairman Kevin Warsh and a deliberate move away from the post-2008 framework of Fed transparency. The second half is therefore a market that must price a credible inflation path, a less legible central bank, and a concentration risk without modern precedent, all at once. The defining tension across asset classes is not the level of the fundamentals but the durability of the conditions that produced them.

The Economy: Business Cycle Outlook

The JIR Business Cycle Composite gathers signals across financial conditions, consumer spending, industrial production, the labor market, and housing. Over the last several months the composite has improved, though the

strength is uneven across its components, which argues for measured optimism rather than a new expansion. The most positive signal originates in the Retail Composite, now at its strongest reading in over a year. Financial conditions remain positive, while industrial production has continued to erode, housing remains under pressure from elevated mortgage rates, and the labor market has decelerated. The data is consistent with a mid-to-late cycle transition marked by below-average growth that avoids a significant downturn.

Financial Conditions

The Financial Composite posted its strongest reading since late 2025, a clear cyclical turn. Loan growth accelerated into early 2026, short-term rates remain anchored, and the yield curve has re-steepened, consistent with credit expansion rather than the late-cycle flattening that has historically preceded contraction.

The 10-year to 2-year Treasury spread has narrowed modestly in recent months, yet the curve remains in positive territory, and commercial and industrial loan growth continues to project expansion. Taken together, these two variables have historically been reliable leading indicators, and current readings do not suggest a bearish forecast. The primary risk is that geopolitical tension and inflationary pressure force the Fed into hiking by year-end. Such a pivot could reverse the curve, reduce credit availability, and threaten financial conditions.

Industrial Production

The Industrial Production Composite has deteriorated steadily over the past twelve months across output, new orders, and capacity utilization. Of the five composites, only housing has weakened more over the period. The number of individual indicators in expansion territory has contracted from nine earlier in the year to four as of the most recent reading. The deterioration warrants attention even though the aggregate index has not turned negative.

Tariffs, elevated input costs, and softening global demand have combined to restrain capital spending intentions outside AI and compress manufacturing margins. The trends are comparable to prior episodes that offer useful context, including the 2000-2001 technology recession and the 2018-2019 trade war. Both produced manufacturing drawdowns concentrated in goods-producing industries, with below-average output for a period before stabilizing. The current trajectory does not rule out further deterioration, but present levels do not signal an imminent recession.

Labor Market

The labor market composite entered 2026 near a multi-year high but has shown some weakness as the year progressed. The practical implication is reduced momentum without contraction. Services employment, civilian employment headcount, full-time employment, and total nonfarm payrolls have all turned neutral to mildly negative.

The divergence between reported openings and actual hiring is one of the more telling signals. Employers appear to want workers but are choosing not to hire them, a pattern consistent with policy uncertainty, geopolitical risk, and disruption from artificial intelligence. Even so, goods production, manufacturing hours, temporary help services, and job openings remain in expansion territory, suggesting that demand for labor has not vanished. The decline in momentum has not produced the persistent job losses that have historically preceded more severe downturns.

Consumer Spending

Consumer spending has rebounded sharply and now sits in expansion territory, a welcome development after pronounced weakness at the start of the year. Through the first half of 2026, the JIR Consumer Spending Indicator has delivered the strongest gain of any composite. Two explanations deserve equal weight before drawing conclusions about underlying consumer health. The first is the growth in household wealth and its effect on sentiment and spending, with higher-income households translating significant wealth gains into sustained consumption. The second is a steady labor market and an unemployment rate that has not signaled deterioration in consumer health.

Several areas warrant concern. Disposable personal income growth has slowed in 2026, and the personal saving rate has declined as households draw down accumulated savings to maintain consumption. Consumer credit conditions remain split, with prime borrowers retaining access at manageable rates while subprime borrowers are under stress. The composite expansion warrants monitoring through the second half, though tailwinds from lower oil prices and record equity prices could carry spending through year-end.

Housing

Housing has posted the most dramatic deterioration in our composite array over the last twelve months. Elevated mortgage rates and affordability constraints remain primary headwinds for the sector, and neither is likely to be resolved anytime soon.

Over the last three months, the U.S. housing market has shown modest improvement in activity, but conditions remain constrained by affordability. Existing-home sales rose 3.2% in May to a 4.17 million annualized rate, while inventory improved to 4.5 months of supply, giving buyers a bit more choice than earlier in the year. Home prices have continued to rise, though at a slower pace than in prior years.

Two main headwinds continue to pressure the market. First, mortgage rates remain elevated at roughly 6.4%, which keeps monthly payments high and limits affordability for many buyers. Second, price growth and high home values are keeping buyers on the sideline, even as inventory improves.

There are also a couple of tailwinds which could help the industry's turnaround. Inventory has been gradually rising, which is helping reduce some of the competition seen in prior quarters and giving buyers more negotiating room. In addition, sales momentum has improved as buyers adjust to the current rate environment and strong pent-up demand is still in the housing market.

Congress has also passed the 21st Century ROAD to Housing Act, now awaiting the president's signature, which would streamline rules for factory-built housing, press localities to remove zoning and construction barriers, and curb large institutional investors from buying single-family homes, all measures aimed at expanding supply over time.

Overall, the sector remains a drag on aggregate activity, with the Fed's rate path uncertain amid inflation concerns. Conditions are still challenging for affordability, but improving supply and steady demand are creating a more balanced environment. That means reasonably priced homes should continue to move, while overpriced listings may need price reductions or additional time to close.

Business Cycle Summary

The aggregate picture is not broken but under obvious strain. Financial conditions provide a positive backdrop, and a robust consumer has continued spending despite geopolitical tension and elevated gasoline prices. In

contrast, the industrial and housing composites are contracting while the labor market decelerates without collapsing. Similar patterns in prior cycles, such as the 2015-2016 mid-cycle slowdown and the 1995 soft landing, produced gradual, below-average growth rather than recession. A Fed that holds steady or eases modestly would be a welcome sign. If inflationary pressure forces additional tightening, the risk to the broader economy rises.

Inflation & Energy

Inflation has re-accelerated sharply after a brief disinflationary window. Headline Consumer Price Index (CPI) reached 4.2% year over year in May, the highest since mid-2023 and up from a January trough of 2.4%, marking the third consecutive monthly increase, while core CPI drifted to 2.9%. On the Fed's preferred gauge, headline Personal Consumption Expenditures (PCE) stood at 4.1% in May and core PCE at 3.4%, both well above target, according to Bloomberg.

The primary driver is energy, a direct consequence of the oil spike that began with the conflict in late February and fed through to transportation, manufacturing, and consumer costs. Core measures tell a more stubborn story. Service-sector inflation, housing-related costs, and food prices have all proven more persistent than policymakers expected, and that persistence carries greater weight in policy decisions than volatile energy prints. In the baseline forecast, headline CPI peaks just above 4% in the second quarter before trending lower, with the war's inflationary impulse fading by the second quarter of 2027. The scenario that matters for risk is re-escalation, which could re-spike crude and carry headline CPI toward 5%.

The Oil Channel

Oil is the single most important variable connecting growth, inflation, and policy, and its trajectory hinges on a fragile truce. Brent began 2026 in the mid-\$60s before the conflict drove it to a peak near \$120 in April, and the June 18 memorandum has reversed roughly 40% of that move, returning prices to the low \$80s, according to Bloomberg. Concern centers on the Strait of Hormuz, through which roughly one-fifth of global petroleum shipments pass.

The structural case beyond the conflict is soft. Pre-war consensus had non-OPEC supply expanding by 2.8 million barrels per day by 2027, U.S. output above 13.5 million barrels per day, and the Energy Information Administration (EIA) projecting a global supply surplus in 2027. Inventories will take time to rebuild, portions of damaged infrastructure may require three to six months to return to full operation, and a residual risk premium is likely to remain embedded until a permanent agreement is reached.

The investment-relevant point is the asymmetry of the scenarios. A durable ceasefire with a full Hormuz reopening would walk Brent from the \$80s toward the \$60s and deliver the inflation relief that lets the Fed hold or cut. A ceasefire breakdown could push crude back toward \$100 to \$120, carry CPI toward 5%, and force the Fed to hike, raising the risk of a stagflationary environment. The base case is inflation relief deferred rather than denied, with the tail risk skewed to the upside on price.



Gold

Over the past few months, gold has given back some of its earlier gains after a powerful rally, with prices becoming more volatile as markets shifted between safe assets and higher interest rate expectations. After gold hit record highs earlier in the year, investors took profits, central banks reduced holdings, and thin liquidity amplified the selloff. The move lower in price has been driven by changing macro conditions that made holding non-yielding assets like gold less attractive. Recent economic data have supported the case for firmer rates, which tend to lift the dollar and weigh on gold prices.

Even with the recent pullback, the long-term backdrop remains supportive if central bank buying returns or inflation concerns ease. For now, gold looks like it is in a consolidation phase with rates and the dollar to remain key drivers.

Federal Reserve Policy

The June 17, 2026 meeting of the Federal Open Market Committee may ultimately be remembered as a turning point for U.S. monetary policy. The Fed left rates unchanged, but the more notable story was the change in tone and approach under new Chairman Kevin Warsh, who succeeded Jerome Powell in May. Markets had speculated that new leadership might bring a more accommodative stance. Warsh's first meeting suggested the opposite, with the emphasis squarely on inflation, credibility, and a willingness to keep policy restrictive for as long as necessary.

Monetary Policy & The June Meeting

The Committee voted unanimously to leave the federal funds target range at 3.50% to 3.75%. Although rates were unchanged, the message was hawkish. Updated projections showed nine of eighteen participants expecting at least one additional increase before the end of 2026, and the Committee raised its core PCE projection to 3.3% from the 2.7% expected in March, according to Bloomberg. Markets now fully price a 25 basis point increase by September. Taken together, the projections suggest policymakers view current rates as sufficiently restrictive for now but are not yet convinced inflation is on a path back to target. Warsh made clear that the Fed

is not considering raising its 2% inflation target, even as policymakers acknowledged that the path back may take longer than previously expected.

A Different Approach To Communication

The most consequential developments had little to do with the level of rates and much to do with how the Fed intends to communicate. The shift represents a deliberate move away from the post-2008 transparency framework in pursuit of policy agility. Warsh inherits a difficult position, with sticky inflation driven by tariffs and the energy shock, an AI capital-spending boom pushing up the neutral real rate, and explicit political demand for lower rates.

Several changes stand out. The post-meeting statement was cut by more than 60% to roughly 130 words, reducing the opportunity for markets to overanalyze minor wording changes. Traditional forward guidance was largely removed. Warsh declined to submit his own projection in the quarterly dot plot, an unusual departure from recent practice. He also signaled a shift away from core PCE toward trimmed-mean inflation metrics that remove outliers from monthly price changes, and announced internal task forces, reporting by year-end, to review communications, inflation targeting, balance-sheet management, and economic measurement. Alongside this, Warsh and Treasury Secretary Bessent aim to drain the \$6.7 trillion balance sheet and return the banking system toward a pre-2008 regime of scarcer reserves, restoring the policy rate as the primary lever of monetary policy.

The central market implication is a higher baseline of volatility. Removing the dot plot strips out the anchoring mechanism that has contained rate volatility since 2012. Without a roadmap, markets will front-run a quieter committee, and every inflation and employment release becomes a repricing event. The operative assumption for the second half is a Fed that is hawkish in bias, opaque in communication, and more willing to surprise than at any point in the post-2008 era.

The Next 90 Days

The Fed appears likely to remain in wait-and-see mode through the summer. Futures markets continue to favor no change at the July meeting, but expectations for September have become more divided, and several major institutions now believe another increase is possible if

inflation data fails to improve. The removal of explicit guidance makes forecasting policy more difficult than it has been in years, which could contribute to greater volatility as investors react more directly to each release. For now, the burden of proof remains on inflation. Until policymakers see clearer evidence that price pressures are moving sustainably lower, the Fed is unlikely to signal a meaningful shift toward easier policy.

Equities

Market Leadership & Rotation

The S&P 500 has gained 10.18% year to date, but the headline return masks a significant shift beneath the surface. The Magnificent Seven, which led for much of the past three years, is down 8.81% on the year. In contrast, the Russell 2000 Index has advanced 22.85%, reflecting renewed interest in smaller companies and parts of the market that had previously lagged. International markets have kept pace without the same concentration, with MSCI Emerging Markets up 22.85% year to date, MSCI Europe up 10.29%, and MSCI World ex-U.S. up 8.92%. Breadth, rather than concentration, is carrying the market.

Technology remains the strongest-performing sector, though leadership within it has evolved. The Technology Select Sector Index is up 32.65% year to date even as the Magnificent Seven declined over the

same stretch. Performance has become increasingly concentrated in semiconductors and AI infrastructure rather than the large platform companies. Recent positioning data shows mega-cap exposure near a one-year low while semiconductor allocations sit at record highs, according to Bloomberg.

Outside technology, the tape divides along the oil and rate axis. Energy is up 20.41% year to date despite a 4.98% decline in June following the memorandum, while Industrials (up 20.04%) and Materials (up 13.00%) round out the cyclical leadership. The laggards tell the rate-sensitivity story in reverse: Communication Services down 8.47%, Consumer Discretionary off 1.39%, and Financials marginally negative at 1.28%. Gold has been volatile, up 7.60% year to date but down 23.95% since the conflict began as the wartime haven bid unwound.

The rotation is most pronounced across style and size. The Russell 3000 Value Index has advanced 16.50% against 5.89% for its growth counterpart, while the Russell Top 50 is up less than 2%. This is a near-inversion of 2025, when small caps lagged and growth reclaimed leadership. The market is now positioning for broader participation and a normalization of the rate backdrop.



Earnings & Valuation

Corporate earnings remain one of the strongest supports for the current environment. Following the challenges of much of 2025, profit growth has broadened across sectors and industries, and the primary question is no longer whether earnings are growing but whether the pace of upward revisions can be sustained.

Analyst expectations for 2026 remain robust. Bloomberg data shows S&P 500 earnings-per-share growth tracking near 32.7% for the year, and even excluding the Magnificent Seven, earnings are projected to increase by approximately 13.3%. All eleven sectors and 21 of 25 industry groups are expected to report earnings growth in 2026, up from nine sectors and 19 industry groups in 2025. First-quarter results reinforced the trend, with an earnings beat rate of 87.1%, the highest since the second quarter of 2021.

The revision cycle has been unusually strong. Consensus 2026 estimates have risen to roughly \$337 per share, an increase of more than 9% year to date and nearly two standard deviations above the typical late-May pace. Semiconductors, internet companies, and energy producers led the upgrades, while pharmaceuticals and biotechnology were notable areas of weakness. That pace is difficult to sustain, and early signs of moderation are emerging. Net upgrades for 2027 have become more broadly distributed, with mega-cap technology no longer dominating the revision cycle.

Margins, Valuation & Concentration

The earnings strength rests on structural margin expansion rather than a one-off. S&P 500 operating margins reached 15.1% in the fourth quarter of 2025, exceeding the 14% ceiling that characterized much of the previous decade, according to Bloomberg, and are expected to widen further through 2026, led by technology and materials. This is the mechanism that converts elevated valuations into supportable ones, since further upside now depends on earnings delivery rather than additional multiple expansion.

The S&P 500 trades near 20.8 times forward earnings, above its ten-year average of roughly 19 times, a premium the earnings profile can support so long as delivery continues. The structural risk is concentration. The ten

largest companies now account for approximately 41% of market capitalization, roughly 14 percentage points above the dot-com peak, and the effective breadth of the index has narrowed to about 48 companies, against 81 at the height of the internet bubble. The critical distinction from 1999 is the profit anchor, since AI-linked companies contribute a larger share of index earnings today than the technology, media, and telecom complex did then. Concentration at this level is not a standalone sell signal, but it leaves the index acutely exposed to any idiosyncratic shock at the top.

Sector Divergence & Key Risks

While earnings growth remains broadly positive, the drivers are becoming increasingly concentrated. Technology is expected to deliver the strongest growth through 2026, accelerating to 66.9% in 2026 from 31.0% in 2025 before moderating to 27.2% in 2027, according to Bloomberg, with AI-linked companies projected to account for more than 70% of total S&P 500 earnings growth. Energy continues to generate earnings disproportionate to its index weight, while Industrials carry the most clearly quantified second-half acceleration. Beyond 2026, consensus shows S&P 500 growth decelerating to 17.0% in 2027 and 11.6% in 2028, consistent with a maturing cycle.

The risks run through the macro variables in this outlook. Rising bond yields would compress valuations, a prolonged conflict that keeps oil elevated would lift inflation and erode margins at once, and any slowdown in hyperscalers (large cloud computing and data center providers) spending would ripple through the AI supply chain. The base effect is a headwind in its own right: global earnings growth reached 14.8% in the fourth quarter of 2025, its highest in three and a half years, and consensus global growth for 2026 has already been trimmed to 13.8% from 14.5%, according to Bloomberg. The earnings story is strong, but 2026 is more likely to mark the peak rate of change than a launchpad for further acceleration.

Why Markets Remain Cautious

Strong earnings, resilient data, and falling oil should produce a calm market, yet they have not. The anxiety is not about the level of the fundamentals but about the durability of the conditions that produced them.

The first pressure is the removal of the central bank backstop. Morgan Stanley has warned that the Fed will not rescue investors this time, according to Bloomberg. With markets pricing a September hike and CPI at 4.2%, the traditional Fed put is no longer operative. The second is the earnings revision peak: with AI-linked companies accounting for more than 70% of index earnings growth, the July reporting season becomes the first real validation test, and performance will depend more on delivery than on improving sentiment. The third is stretched market structure. The high-volatility factor returned 13.9% over the past month while low-volatility lost 2.7%, a crowding-unwind signature, according to Bloomberg, and the VIX has oscillated between 15 and 22. The fourth is geopolitical resolution that is priced but not delivered, since any breakdown in the truce would reverse the oil decline quickly and remove the inflation relief already banked.

Taken together, these concerns explain why markets remain cautious despite favorable data. A less predictable Fed, moderating earnings momentum, elevated concentration, and lingering geopolitical risk all contribute to an environment that remains constructive but increasingly sensitive to disappointment.

Investment Implications & Sector Analysis

The second half of 2026 favors a balanced rather than directional approach to equity markets. Business investment remains strong, while household spending is increasingly constrained by higher prices and slower income growth. As a result, the most attractive positioning combines sectors benefiting from elevated capital investment with more defensive areas of the market.

Oil prices remain the key swing factor. A sustained easing in geopolitical tensions would likely support further rotation into Consumer Discretionary, Health Care, and Communication Services while reinforcing Technology and Industrials through lower input costs and an improved policy backdrop. Conversely, renewed disruptions in energy markets would likely extend Energy leadership while placing renewed pressure on inflation-sensitive sectors and reducing the Federal Reserve's flexibility.

AI Infrastructure: From Investment Cycle to Earnings Growth

Technology remains the market's leadership sector, but the second half represents the first meaningful test of whether the artificial intelligence investment cycle can translate into sustained earnings growth. First-quarter results provided encouraging evidence that major cloud providers are beginning to monetize years of heavy infrastructure spending.

Microsoft, Amazon, Alphabet, and Meta all reported accelerating AI-related revenue alongside stronger-than-expected financial results. AI services have become meaningful contributors to revenue growth across cloud computing, advertising, and enterprise software, while industry estimates suggest AI revenue could exceed \$200 billion in 2026 after expanding rapidly over the past two years. The investment thesis has therefore shifted from expectations of future monetization toward evidence that commercialization is already underway.

The principal uncertainty is not revenue growth but capital intensity. Consensus forecasts continue to show capital expenditures rising through at least 2027, with the largest technology companies committing an increasing share of revenue to data centers, custom silicon, and supporting infrastructure. While these investments reinforce long-term competitive advantages, they also place pressure on margins and leave valuations increasingly sensitive to financing costs.

That makes monetary policy an important variable for the sector. Companies investing at this scale remain highly sensitive to interest rates, and the success of the current investment cycle will depend on whether earnings growth can outpace rising capital expenditures. Any meaningful slowdown in AI monetization would likely have an outsized effect on broader equity markets given the concentration of index performance within a handful of large-cap technology companies.

The investment bottleneck has also shifted. The primary constraint is no longer semiconductor availability but access to electric power and data-center capacity. Utilities, industrial equipment manufacturers, and infrastructure providers have therefore become increasingly important participants in the AI investment cycle as spending expands beyond technology companies themselves.

The longer-term risks remain difficult to quantify. Geopolitical disruptions, cybersecurity threats, and uncertainty surrounding the pace of future AI capability improvements all represent potential challenges to continued investment. While none appears likely to derail the current cycle, each has become increasingly relevant as AI infrastructure grows into one of the largest capital investment programs in modern corporate history.

The Mega-IPO Pipeline

One of the most significant developments of the second half is a wave of AI-related public offerings that function less as liquidity events than as compute-financing vehicles. Together, SpaceX, Anthropic, and OpenAI represent an estimated \$3.6 trillion of prospective market value according to Bloomberg. SpaceX completed the largest initial public offering (IPO) on record with a valuation of \$1.8 trillion. Anthropic and OpenAI filed for IPOs at \$965 billion and \$852 billion valuations, respectively.

The second-order effects are larger than the listings themselves. S&P Dow Jones, FTSE Russell, and MSCI are evaluating rule changes to incorporate the new entrants into their indices, raising the prospect

of significant passive rebalancing. The first week of SpaceX trading already generated substantial ETF flows, according to Bloomberg. The risks are specific. Three mega-listings in quick succession could exhaust investor appetite and pressure later valuations. SpaceX disclosed a \$4.28 billion quarterly loss in its filing, underscoring how capital-consumptive the buildout remains, and Bank of America's Michael Hartnett notes that the ten largest IPOs in history have typically underperformed in their first year.

Cyclicals: Industrials, Financials, & Materials

Cyclical sectors enter the second half with some of the strongest earnings expectations in the market. Industrials are expected to lead, supported by continued strength in capital investment, defense spending, and a manufacturing sector that has expanded for five consecutive months. Aerospace, transportation, and capital goods remain the primary beneficiaries, although the sustainability of recent gains will depend on whether inventory rebuilding gives way to stronger final demand.

Financials also appear positioned for continued earnings growth. Investment banks stand to benefit from a more active capital markets environment, particularly if AI-related public offerings accelerate, while insurance companies continue to receive favorable earnings revisions. The principal risks remain higher interest rates and potential credit deterioration should energy prices weaken sharply.



Materials continue to benefit from many of the same structural forces supporting technology. Demand for copper, electrical equipment, and other critical materials remains closely tied to data-center construction, electrification, and infrastructure investment, providing a favorable longer-term backdrop despite the sector's strong performance over the past year.

Defensives & Recovery Opportunities

Health Care remains one of the more attractive recovery opportunities following a period of relative underperformance. The sector generally benefits from lower energy costs through reduced operating expenses, particularly across hospitals, distributors, and medical manufacturers. While regulatory uncertainty remains an ongoing consideration, earnings expectations appear increasingly supported by improving cost conditions.

Consumer Discretionary and Communication Services also have the potential to benefit if energy prices continue to moderate. Lower gasoline prices effectively increase household purchasing power, providing support for discretionary spending and advertising activity. However, earnings expectations within Consumer Discretionary remain mixed, suggesting investors should emphasize industry selection rather than broad sector exposure.

Energy and the Oil Outlook

Energy remains the market's most direct expression of the oil outlook. If geopolitical tensions continue to ease and crude prices move lower, earnings growth within the sector is likely to moderate even as most other sectors benefit from lower input costs. Conversely, any renewed disruption to global oil supplies would reinforce Energy leadership while increasing inflationary pressures across the broader economy.

Lower oil prices would support equity markets through three primary channels. First, declining energy costs would improve profit margins for energy-intensive industries such as airlines, transportation, chemicals, and manufacturing. Second, lower gasoline prices would increase disposable income and support consumer spending. Third, easing energy-driven inflation would provide the Federal Reserve with greater policy flexibility, improving valuation support for longer-duration assets, particularly within technology and other growth sectors.

This relationship reinforces the central theme of the

outlook. Energy is both a beneficiary of higher oil prices and the principal headwind to broader market participation. A sustained normalization in crude prices would likely broaden leadership beyond the sectors that have dominated during the first half of the year.

Small-Capitalization Stocks

The most striking reversal from 2025 is the leadership of small caps. The Russell 2000 has advanced 22.64% in 2026 after a prior year weighed down by elevated borrowing costs and a large cohort of zombie borrowers, firms barely generating enough cash to service their debt. The durability of the move depends on the macro thesis at the center of this outlook, since small caps need lower oil, contained inflation, and a Fed not forced to tighten further.

Fixed Income

The energy shock has left a lasting mark on fixed-income markets. Even as oil retreated from its highs, investors are demanding greater compensation for inflation risk, contributing to higher Treasury yields and reinforcing the expectation that rates could remain elevated for an extended period. Against that backdrop, yields are the most attractive in years, but valuation, credit selection, and inflation expectations matter more than they have in some time.

Demand for U.S. Treasuries

One of the more important questions in fixed income today is who will absorb the growing supply of Treasury securities. Demand remains substantial, but its composition is changing in ways that could matter for rates. Foreign ownership reached a record \$9.49 trillion as of February 2026, supported largely by private investors, financial institutions, and global bond funds. Japan remains the largest foreign holder, followed by the United Kingdom and China, yet both Japan and China face circumstances that may limit future purchases. Rising domestic yields in Japan are making local investments more attractive for banks, pension funds, and insurers that have historically bought Treasuries, while China has continued a multi-year reduction of its holdings.

The result is a market that may become increasingly dependent on private, more price-sensitive buyers. Recent auctions provide evidence of the transition, with uneven demand and investors requiring higher yields to absorb longer-dated issuance. The Treasury's recent sale of 30-year bonds at yields not seen since 2007 highlights how dramatically financing conditions have changed. Treasury debt remains one of the world's most important safe-haven assets, but as traditional sovereign buyers become less dominant, the market may experience greater volatility and higher borrowing costs than investors have grown accustomed to. Given the size of ongoing federal deficits and the need for continued issuance, the evolution of Treasury demand is likely to remain a major theme through the remainder of 2026.

Credit Spreads

Despite higher rates and persistent inflation concerns, corporate credit continues to show resilience. Investment-grade spreads, the yield premium corporate bonds pay over comparable Treasuries, remain near historically tight

levels, and high-yield spreads, though somewhat wider, also remain compressed by long-term standards. The result is an unusual dynamic: yields are attractive, but the additional compensation for taking credit risk is not generous. Investors are being paid well to own bonds because Treasury yields are high, not because corporate spreads are unusually attractive.

The Iran conflict briefly tested this environment earlier in the year, widening spreads as energy prices surged, with high-yield affected more than investment-grade. Much of that widening reversed as tensions eased and risk appetite returned. Looking ahead, supply may prove more important than credit fundamentals. Corporate issuance is set to rise sharply in 2026, led by AI-related borrowing, with forecasts pointing to one of the busiest years for high-grade supply on record. For several years, strong demand has outpaced new supply and kept spreads compressed; that balance may finally be shifting. If issuance grows faster than demand, spreads could widen even without economic deterioration. This argues for selectivity, with many institutional managers continuing to favor higher-quality investment-grade bonds over lower-rated credits.



TIPS & Real Yields

Treasury Inflation-Protected Securities (TIPS) have become increasingly relevant as investors weigh the possibility that inflation remains above target longer than expected. Current readings remain well above the 2% target, yet the inflation expectations embedded in TIPS pricing suggest investors still expect inflation to moderate meaningfully over the coming decade. That disconnect raises an important question: whether markets are underestimating the persistence of inflation. The gap is notable, since inflation has averaged above many long-term expectations in recent years and the Fed itself now projects a slower return to target.

At the same time, real yields remain attractive by historical standards, offering positive real returns that were largely unavailable during much of the post-financial-crisis period. For investors who believe inflation may settle above 2% for an extended period, TIPS offer a way to protect purchasing power without sacrificing income. The intermediate portion of the curve, particularly the five- to ten-year range, continues to attract attention because it balances inflation protection against less interest-rate sensitivity than longer-dated securities. While no single asset class is a perfect inflation hedge, TIPS appear better positioned today than they have been for much of the past decade.

Conclusion

The common thread across the economy, equities, and fixed income is the durability of conditions rather than their current level. The business cycle is intact but strained, with supportive financial conditions and a resilient consumer offset by contracting industrial and housing activity and a decelerating labor market. The most probable path is soft growth rather than contraction, provided the Fed is not forced into further tightening. Oil is the hinge. A managed truce that walks crude lower would deliver the inflation relief that restores policy flexibility and broadens market leadership; a breakdown would reverse that relief and raise the risk of a stagflationary mix of slower growth and renewed inflation.

For equities, the setup is constructive but worth monitoring. Earnings are strong and broadening, yet the revision pace is peaking, concentration sits at historic extremes, and the AI capital-spending cycle must now prove it can convert into delivered profits. Holding both spending-driven growth stocks and defensive names, with the balance shifting as oil prices move, is the appropriate



posture. For fixed income, higher yields have improved prospective returns, but tight credit spreads, heavy supply, shifting Treasury demand, and unresolved inflation risk leave less room for error than at other points in the cycle, which favors quality and selectivity, with TIPS warranting a closer look.

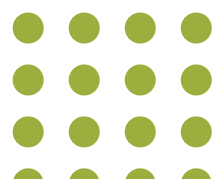
Geopolitical developments continue to drive commodity prices and sentiment, and the Federal Reserve has signaled a willingness to keep policy restrictive for as long as necessary.

Across asset classes, the second half rewards discipline: careful position sizing, attention to the oil and inflation path, and a clear view that the conditions supporting today's markets, not their level, are what must hold.

For Investors:

Equities

- Favor a balanced posture over a directional one, pairing sectors that benefit from elevated capital investment with more defensive holdings, since business investment remains strong while household spending is increasingly constrained by higher prices and slower income growth.
- Maintain selective Technology exposure as leadership rotates from the large platform companies toward semiconductors and AI infrastructure, even with the sector up 32.65% year-to-date and megacap positioning near a one-year low.
- Treat the July reporting season as the first real test of AI monetization, weighting delivered results over sentiment given that AI-linked companies are projected to account for more than 70% of S&P 500 earnings growth.
- Emphasize Industrials, supported by capital investment, defense spending, and a manufacturing sector that has expanded for five consecutive months, with aerospace, transportation, and capital goods the primary beneficiaries.
- Hold Materials for exposure to copper, electrical equipment, and other inputs tied to data-center construction, electrification, and infrastructure investment.
- Use Energy as a geopolitical hedge, since the sector has gained 20.41% year-to-date and benefits from any renewed oil disruption even as easing crude would moderate its earnings.
- Add Health Care as a recovery candidate following relative underperformance, with lower energy costs supporting margins across hospitals, distributors, and medical manufacturers.
- Approach small caps opportunistically rather than as a core conviction, since the Russell 2000 has advanced 21.64% but depends on lower oil, contained inflation, and a Fed that is not forced to tighten further.
- Remain mindful of concentration, since the ten largest companies account for roughly 41% of market capitalization, about 14 percentage points above the dot-com peak.



For Investors:

Fixed Income

- Take advantage of the most attractive yields in years while letting valuation, credit selection, and inflation expectations drive positioning rather than reaching for yield indiscriminately.
- Favor higher-quality investment-grade corporates over lower-rated credit, since tight spreads mean investors are paid well to own bonds because Treasury yields are high, not because credit risk is generously compensated.
- Watch supply rather than fundamentals in credit, since corporate issuance is set to rise sharply in 2026 on AI-related borrowing and spreads could widen even without economic deterioration if issuance outpaces demand.
- Hold intermediate-term duration and limit long-dated Treasury exposure given shifting Treasury demand, heavy issuance, and rising borrowing costs that recently cleared a 30-year sale at yields not seen since 2007.
- Give TIPS a closer look, since attractive real yields and the five- to ten-year portion of the curve balance inflation protection against lower rate sensitivity if inflation settles above 2% for an extended period.

International Diversification

- Use international exposure to diversify away from U.S. concentration, since global markets have kept pace this year without the same reliance on a handful of mega-cap names.
- Look to emerging markets, where MSCI Emerging Markets has gained 28.85% year-to-date, the strongest among major regional benchmarks.
- Maintain developed-market exposure as a complement, with MSCI Europe up 10.29% and MSCI World ex-U.S. up 8.92% year-to-date.
- Treat breadth as the prevailing theme, since broader participation across regions and styles rather than narrow concentration is carrying global equity returns.

Potential Risks to our Outlook

- A breakdown of the U.S.-Iran truce could push Brent back toward 100 to 120 dollars, carry headline CPI toward 5%, and force the Federal Reserve to hike, raising the risk of stagflation given that roughly one-fifth of global petroleum shipments transit the Strait of Hormuz.
- A less legible Federal Reserve under Chairman Warsh has removed the dot plot and forward guidance that anchored rate volatility since 2012, turning every

inflation and employment release into a repricing event.

- An earnings revision cycle at its peak leaves the market vulnerable, since AI-linked companies represent more than 70% of index earnings growth and any disappointment in the July reporting season would weigh heavily on the broader tape.
- Concentration without modern precedent leaves the market acutely exposed to a shock at the top, with the ten largest companies making up about 41% of market capitalization and effective index breadth narrowed to roughly 48 names.
- Indigestion from the mega-IPO pipeline is a live risk, since SpaceX, Anthropic, and OpenAI represent an estimated \$3.6 trillion of prospective market value and three listings in quick succession could exhaust investor appetite and pressure later valuations.
- A shifting Treasury buyer base, with Japan and China facing circumstances that may limit future purchases, leaves the market more dependent on price-sensitive private buyers and points to higher borrowing costs and greater volatility.
- Deepening contraction in industrial production and housing, paired with a labor market that slips from its current low-hiring, low-firing equilibrium toward outright layoffs.

Disclosure

This information is of a general nature and does not constitute financial advice. It does not take into account your individual financial situation, objectives or needs, and should not be relied upon as a substitute for financial or other professional advice to assess, among other things, whether any such information is appropriate for you and/or applicable to your particular circumstances. In addition, this does not constitute an offer to sell, or the solicitation of an offer to buy, any financial product, service or program. The information contained herein is based on public information we believe to be reliable, but its accuracy is not guaranteed.

Investing involves risks, including loss of principal. Past performance is no guarantee of future results.

Definitions

*Basis Point: one hundredth of one percent, used chiefly in expressing differences of interest rates.

*Consumer Price Index (CPI): An index of the variation in prices paid by typical consumers for retail goods and other items.

*Growth: A company stock that tends to increase in capital value rather than yield high income.

*Russell 2000 Index: a stock market index that measures the performance of the 2,000 smaller companies included in the Russell 3000 Index.

*S&P 500 Index: S&P (Standard & Poor's) 500 Index: is a market-capitalization-weighted index of the 500 largest US publicly traded companies.

*Stagflation: an economic condition characterized by simultaneous high inflation, high unemployment, and slow economic growth.

*U.S. Aggregate Bond Index: Designed to measure the performance of publicly issued US dollar denominated investment-grade debt.

*Indexes are not managed. One cannot invest directly in an index.



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