Changing Lanes

"The road to success is always under construction."

– Lily Tomlin

If you're from the Greater Cincinnati area, you're likely aware of the $4.4 billion Brent Spence Bridge Corridor project. The project is expected to take eight years and will cover eight miles of the I-71/75 corridor, including highway expansion and construction of a companion bridge. For area residents, having to navigate new lanes and roads under construction is becoming a way of life. Similarly, June required investors to change lanes. As geopolitical risks eased and oil prices moderated, investors didn't appear to slam on the brakes. Instead, they began changing lanes — away from narrow leadership at the top of the market and toward a broader mix of opportunities.

<u>In our view, June represented an important transition in the market backdrop. The focus shifted from geopolitical headlines back toward fundamentals. The economy remained resilient, but the source of growth appears to be evolving. The Fed stayed focused on inflation, but investors increasingly needed to look beyond the policy-rate path alone. And within equities, leadership began to look more rotational than risk-off.</u>

The first lane change was macro. Early in the month, investors were focused on the US-Iran conflict, the Strait of Hormuz, and the risk that higher oil prices would further complicate inflation. By month-end, a 60-day MOU had helped reopen the Strait, oil had moved materially lower, and inflation expectations had moderated. That gave investors room to shift attention from geopolitical risk back toward the growth-resilient but inflation-sticky fundamental backdrop.

The second lane change was economic. The consumer remains important, but the incremental growth engine appears to be shifting toward CAPEX. Retail sales and spending have held up (likely helped by the World Cup effect), though confidence remains soft and the savings rate is historically depressed. By contrast, CAPEX indicators remain strong, helped by AI-related investment, durable goods strength, and pricing power without meaningful demand destruction.

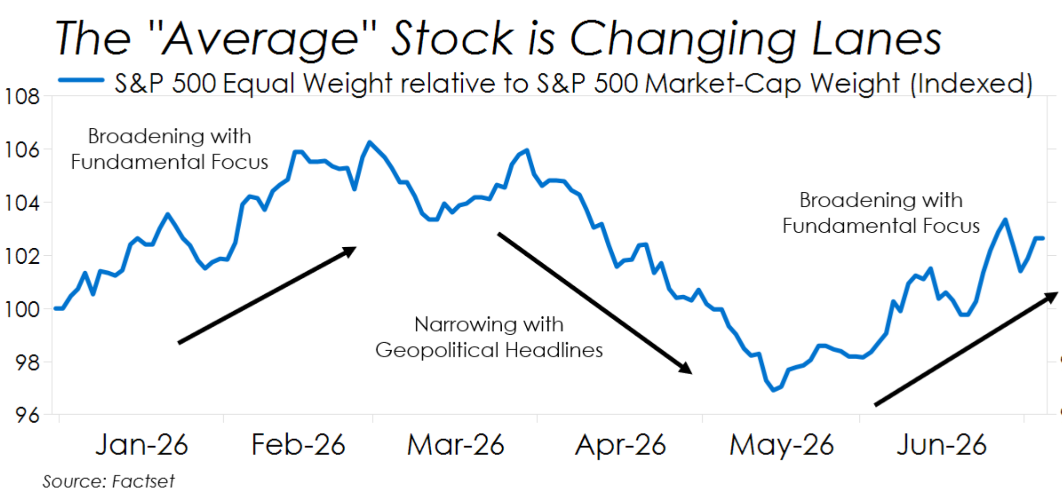
CHANGING LANES

	From	To
Macro	Geopolitical headlines	Fundamental focus
Economy	Consumer-led growth	CAPEX-led growth
Fed	Policy-rate driven	Balance sheet / liquidity driven
Market	Concentrated & Narrow	Rotational & Broadening

The Fed lane shifted as well. Investors have been focused heavily on the policy-rate path. However, the June Fed meeting – led by a new Fed Chair – delivered a hawkish hold and signaled less forward guidance under the new regime. In that backdrop, investors may need to pay closer attention to broader liquidity, bank deposits, credit creation, and Fed balance-sheet dynamics – beyond the direction of the rate policy alone.

The final lane change related to the market. For much of the spring, equity performance became increasingly dependent on a narrow group of large-cap Growth and AI-related winners. More recently, price action has looked less like investors abandoning risk and more like investors reassessing where they want to take it.

The chart below helps illustrate that point. From January through March, the "average" stock outperformed the market-cap weighted S&P 500 as investors focused on improving fundamentals and broader participation. That changed in April and May as geopolitical headlines intensified and oil uncertainty increased, pushing leadership back toward the largest index constituents. In June, as oil prices moderated and geopolitical pressure eased, the average stock began to recover relative to the index.



In our view, this is an important distinction. <u>A risk-off market is one where investors reduce exposure broadly. A rotational market is one where investors adjust their equity positioning without necessarily exiting the asset class. The recent improvement in the average stock suggests the latter may be taking place.</u>

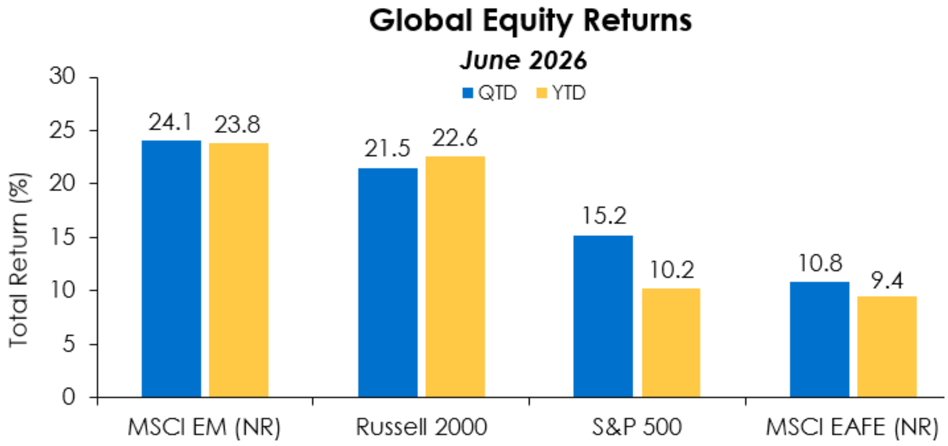
To be clear, the broadening process isn't complete. The average stock has improved but hasn't fully recovered its earlier-year relative highs. Still, the direction of travel is notable. Profit-taking in AI-related chip names has created volatility, but the broader tone looks more rotational than risk-off.

<u>For portfolios, that argues for balance. Earnings growth and CAPEX trends still support offense, but sticky inflation, a Fed on hold, and elevated valuations argue for defense as well.</u>

The bottom line is that the road remains under construction, but that doesn't mean investors need to stop moving. It means they need to pay attention to the changing lane dynamic.

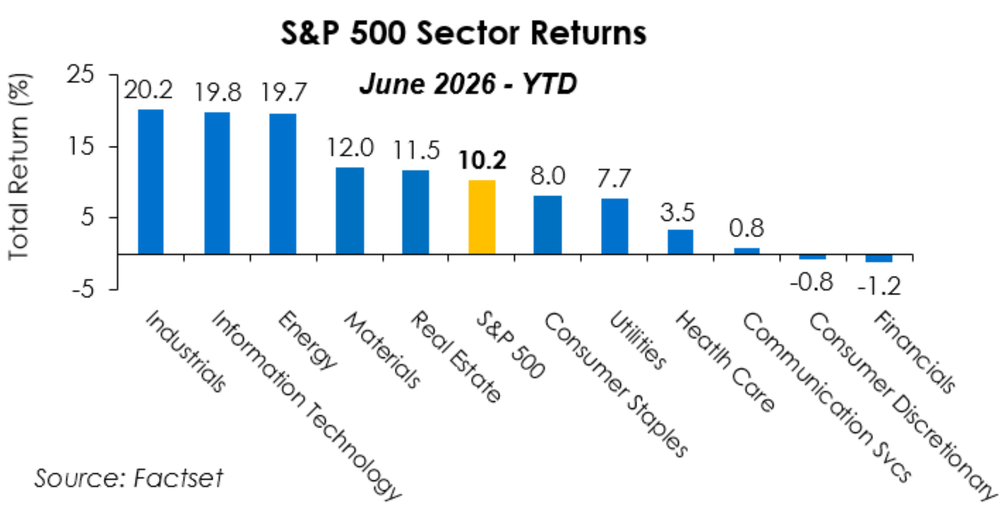
Most equity segments were down modestly in June after posting strong returns in April and May. Small caps were the exception as earnings growth expectations continued to improve. Bonds were up modestly with a bull steepener in play as investors expect policymakers to maintain a restrictive stance to curb inflation. Alternatives were mixed, with REITs advancing and commodities declining as energy prices moderated.

Stocks



Source: Factset

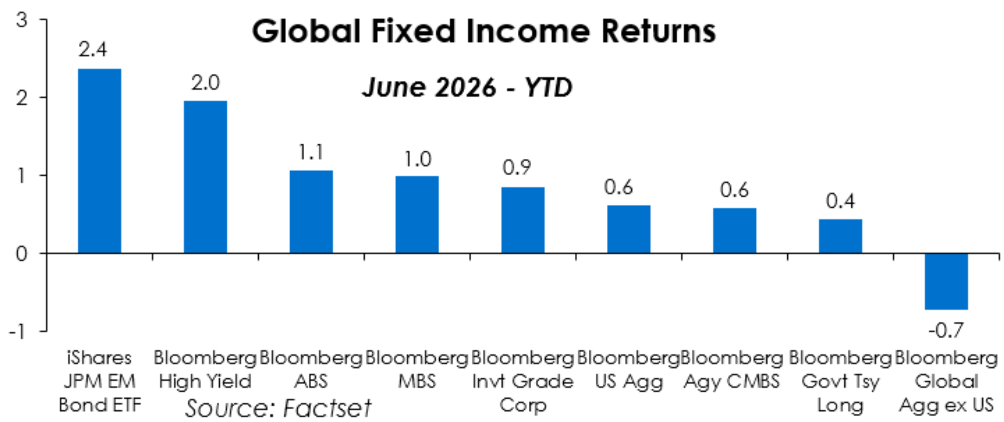
Emerging markets (MSCI EM) led equities higher both quarter-to-date and year-to-date, supported by strong earnings growth and continued demand for AI-related components such as CPUs/GPUs and memory chips. U.S. small caps (Russell 2000) also delivered very strong second-quarter returns, where earnings growth is expected to accelerate. U.S. large caps (S&P 500) posted their best quarter in six years, driven by the continued buildout of AI data centers and a surge in capital expenditures, which helped support strong second-quarter returns. While developed markets (MSCI EAFE) have lagged, as geopolitical tensions and greater dependence on Middle Eastern oil have been headwinds, year-to-date returns have still been very good. From a sector perspective, the market broadened in June, with seven sectors outperforming the S&P 500, while Technology and Communication Services paused after very strong results in April and May. Year-to-date, Industrials, Technology, Energy, Materials, and Real Estate outperformed, with most of these sectors directly benefiting from AI-related capital spending or disruptions tied to the conflict with Iran.



Source: Factset

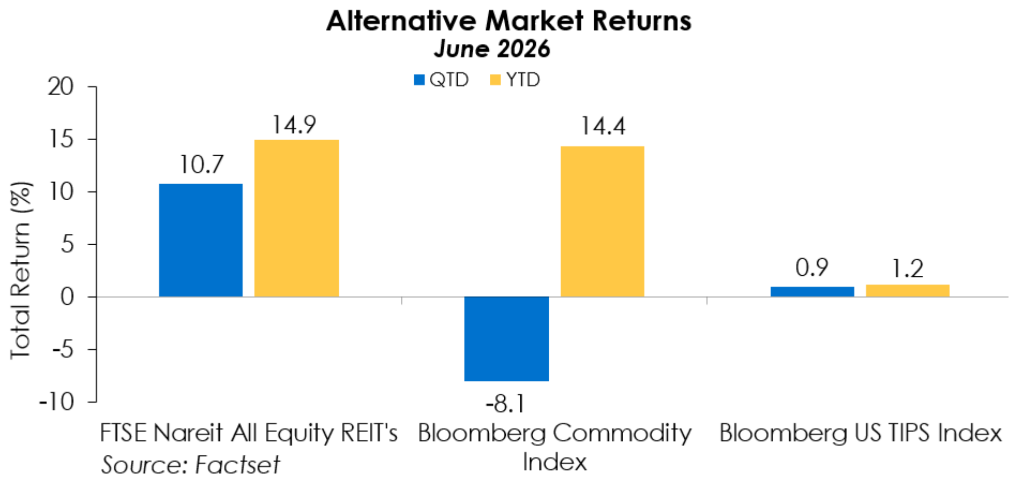
Bonds

Policymakers continued their cut-and-pause approach, with cuts in 2H24 and 2H25 followed by pauses in 1H25 and 1H26. Following the June meeting, the federal funds rate remained unchanged at 3.50%–3.75%, while the "dot plot" now implies one 25 bps rate hike by the end of 2026 followed by cuts in '27-28. This compares to a slightly more restrictive forward curve with a hike or two priced in. New Fed Chair Kevin Warsh emphasized price stability and the Fed's resolve to tame inflation, while indicating a preference for reduced forward guidance to increase policy flexibility. Bonds posted marginally positive returns in both June and year-to-date, as inflation concerns partly offset the benefit of tighter spreads and carry. Emerging market debt and high yield bonds have performed best due to their higher starting yields. Meanwhile, developed foreign market bonds have underperformed as the dollar strengthened, and long-dated U.S. Treasuries have lagged as well with the back up in rates (despite stabilization in June).



Alternatives

REITs were up in June and have delivered attractive returns year-to-date. Meanwhile, commodities declined as oil prices retreated following signs of US-Iran de-escalation and the reopening of the Strait. Commodities have still provided a useful inflation hedge year-to-date. Finally, Treasury Inflation-Protected Securities (TIPS) outperformed nominal Treasuries as inflation expectations rose earlier in the year amid the Middle East conflict before substantially moderating more recently.



Market Outlook

"There are two kinds of people in this world: those who believe there are two kinds of people in this world and those who are smart enough to know better."
– Tom Robbins (1980)

We came into 2026 with the tactical vantage point that this year would require the awareness of more nuanced views and the avoidance of oversimplification. Below is a framework for how we compared the generalized consensus view to the more nuanced views that investors were grappling with coming into this year. As we turn into the back half of 2026, we think it will continue to require more of a chess-than-checkers mentality. The backdrop remains full of crosscurrents:

2026 - The Year of the "Definitely, Maybe"

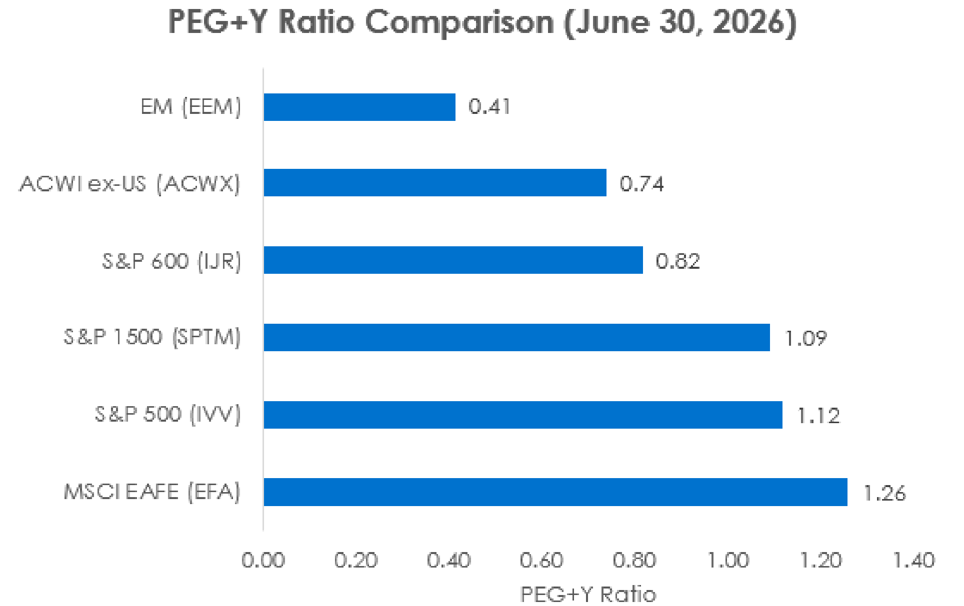
	Generalized View	Nuanced View	
Consumer	*"The consumer remains resilient."*	*High-income consumers maintain strong spending power from the wealth effect*	*Low and middle-income households struggle from affordability pressure*
Labor	*"It's a no-hire, no-fire labor market."*	*Structural tightening results from aging demographics and immigration policy*	*Structural loosening results from AI productivity initiatives*
Profits	*"Profits are solid."*	*Earnings growth is improving for the small and mid-caps*	*Earnings growth is leveling off in the larger cap companies*
Fed	*"The Fed is getting more accommodative."*	*Lowering interest rates loosens policy to improve affordability as inflation cools*	*A new Fed chair is often tested by the market resulting in a tightening of financial conditions.*
Policy	*"Fiscal stimulus will be a tailwind."*	*Midterm election years often coincide with accelerating economic growth resulting from policies of the incoming Administration*	*Midterm election years tend to usher in above average intra-year volality as markets "buy the rumor and sell the news"*
Markets	*"The AI story is early innings."*	*AI promises to be a transformative application*	*Leading edge AI stocks might be pricing in a lot of the good news*

- Growth has been resilient – helped by the wealth effect of the high income consumer – but is also shifting towards CAPEX-driven demand.
- The labor market remains stable with hiring gains low but firing impacts limited.
- Earnings are strong with the growth trajectory well above average and still expected to be superior down market cap.
- Fed direction is more uncertain as the new Fed Chair is less willing to provide guidance and policymakers are grappling with uneven inflation data (oil prices are down but realized inflation continues to trend above target).
- AI remains the dominant theme in the market but separating the economic story from the investment story should remain top of mind. As a result, market leadership appears to be broadening though uneven.

To this last point, if market leadership is broadening, investors might not be considering whether or not to own equities. Rather, they might be evaluating which equity lanes offer the best balance of valuation, growth and income. Strong earnings growth and AI-related CAPEX still support offense, but elevated valuations and concentration risk argue against simply chasing the most crowded parts of the market. One way to compare opportunities is through a PEG+Y framework, which adjusts valuation for expected earnings growth and dividend yield. Lower PEG+Y ratios suggest a more attractive combination of valuation, earnings

Comparing the Lanes

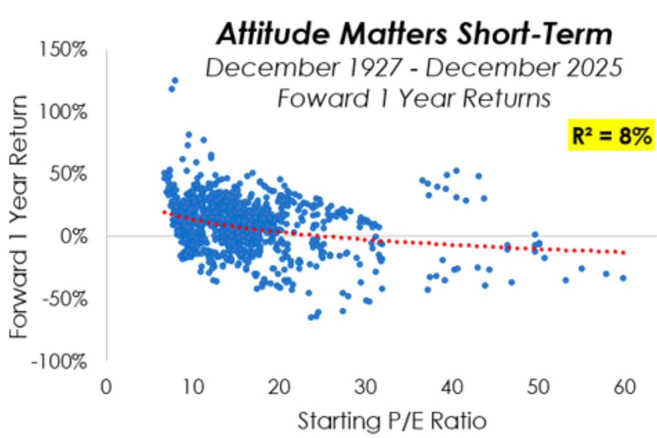
Market Segment	P/E Ratio	EPS Growth	Div Yield	PEG+Y
MSCI Emerging Mkts (EEM)	15.4	35%	2.26%	0.41
MSCI ACWI ex-US (ACWX)	16.7	20%	2.59%	0.74
S&P 600 Small Cap (IJR)	17.9	19%	2.77%	0.82
S&P 1500 Composite (SPTM)	23.0	20%	1.40%	1.09
S&P 500 (IVV)	23.5	20%	1.40%	1.12
MSCI EAFE (EFA)	17.4	11%	2.80%	1.26

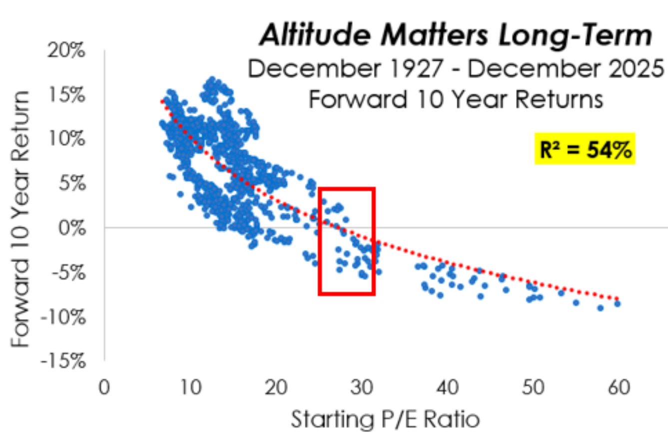


Source: FactSet; PEG+Y = P/E Ratio / (EPS Growth Rate + Dividend Yield) growth, and dividend yield. On this measure, Emerging Markets, ACWI ex-U.S., and Small Caps compare favorably to U.S. Large Caps. That doesn't mean U.S. Large Caps lack support — earnings growth remains strong — but it does suggest that better risk/reward may be available in areas where valuations are lower, yields are higher, and earnings growth is improving. In other words, changing lanes doesn't mean leaving the equity market; it may mean broadening exposure to areas where fundamentals are better priced. One caveat is that the PEG+Y statistic is not a great timing tool (valuations rarely are) and should be viewed alongside other considerations, including earnings quality, currency risk, policy risk, liquidity, and index composition. The bottom line is that the market seems to be changing lanes, and the PEG+Y ratio suggests investors may have reason to look beyond narrow U.S. large-cap leadership toward areas where growth, income, and valuation appear better aligned.

More broadly, June's lane changes reinforce why 2026 requires nuance. The decision is not simply risk-on or risk-off. It's about choosing the right lanes — balancing offense and defense, managing concentration risk, and looking for better risk/reward where fundamentals and valuation align.

This also folds nicely into our strategic frame which requires the discipline to "keep the main thing the main thing". As much as we opine on the factors that influence the shorter term setup, the fact remains that starting valuations tend to be the most influential factor for long-term returns. In short, what you see is what you get. In the past, we've described this as, "Attitude matters in the short run, but Altitude matters in the long run."





Source: PE ratios were calculated monthly based on the value of the S&P 500 and trailing 12-month S&P 500 Normalized Earnings. Normalized Earnings were calculated by determining the constant long-term growth rate that best fit actual S&P 500 earnings. This process is meant to smooth out short term fluctuations in earnings caused by the business cycle. Forward returns are price appreciation only and do not include dividends. Historical S&P 500 data was gathered from Robert Schiller's website (http://www.econ.yale.edu/~shiller/) and Factset.

Please see the charts above for context. In the short run (chart on the left), S&P 500 returns measured over a one year period have very little to no relationship with the starting price-to-earnings valuation multiple. Investor opinion – driven by a number of factors – can shape popularity for markets and drive short term results that can be both expected and unexpected. However, the chart on the right shows that the S&P 500 returns measured over a much longer ten-year period have a much more important relationship with the starting price to earnings valuation multiple. We think remembering this concept is an important step to maintaining discipline as a long-term investor.

<u>The combination of the above argues for flexibility in the short run and discipline in the long run.</u>

So what are the implications and key takeaways for portfolios?

- **Think chess, not checkers.** Nuanced markets can produce multiple paths to the same outcome, so short-term decisions require flexibility.
- **Balance offense and defense.** Earnings growth, CAPEX, and broadening leadership support offense, while sticky inflation, Fed uncertainty, and elevated valuations argue for defense.
- **Use diversification as a "twofer."** Diversification can provide both risk reduction and upside optionality if market leadership continues to broaden.
- **Be willing to look different.** Long-term discipline may require going against the grain, especially when concentration risk is high.
- **Mind the pendulum.** When leadership becomes crowded and risk/reward becomes less favorable, reducing exposure to the most concentrated areas can create room for better opportunities elsewhere.

<u>From a portfolio positioning perspective, we continue to emphasize the importance of diversification and balance.</u> We continue to look for opportunities to selectively rebalance – taking profits in equities a couple of times this past quarter and reallocating the proceeds to underweighted areas like bonds and alternatives (where applicable). See more specific detail below:

<u>Within equities</u>, our positioning incorporates balance geographically and within our US Large Cap exposure especially (away from the top of the market). Our bias has generally been to have more exposure to less expensive areas (down market cap). As such, we've maintained a larger OW in Cyclical Value and Defensive sectors, combined with a smaller sized cap bias along with a modest OW in Small Caps. We remain UW the most concentrated and expensive larger cap Cyclical Growth areas.

<u>Within fixed income,</u> we remain biased toward the higher quality US Core Fixed Income segment – where we're slightly longer in duration for diversification purposes. We've maintained an EW to International Fixed Income, where the end of negative interest rate conditions has led to more attractive opportunities. Maintaining a higher quality bias means that we still remain UW the most expensive part of the bond market – High Yield – where (still) tight spreads have made the risk/reward less attactive in our view.

Within alternatives, we remain fairly balanced though slightly overweight in Diversified Alternatives. Last year, we adjusted our mix in this area in order to provide greater insurance against market volatility by emphasizing income and short exposure – areas that can benefit from choppy market conditions like what we've experienced episodically this year.

Thanks for giving this a read.