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Equity Market Update



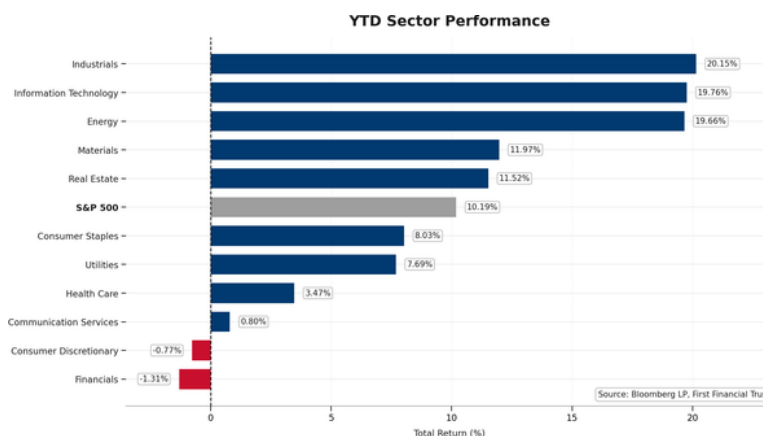
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In June, the U.S. stock market was shaped by a pronounced rotation away from mega-cap technology "hyperscalers" towards cyclical, value-oriented stocks, resulting in a modest 0.95% decline for the market-cap-weighted S&P 500 alongside a 2.37% gain for its equal-weighted counterpart. While robust chip demand continued to push the semiconductor index up 11%, the broader market grappled with elevated capital demands (massive equity raises from mega-cap tech giants and SpaceX's historic initial public offering). On the macroeconomic front, resilient business activity and firm manufacturing data clashed with an uncomfortably hot Consumer Price Index (CPI) reading of 4.2% year-over-year, which stoked stagflationary fears. These sticky pricing pressures, combined with a leadership transition at the Federal Reserve under new Chair Kevin Warsh, prompted a hawkish repricing of interest rate expectations in the bond market. Traders priced out near-term cuts and aggressively integrated the likelihood of a rate hike before the end of the year.

Performance

The U.S. equity markets experienced a dramatic, size-driven performance divergence in June. There was a pronounced rotation out of large-cap growth names that weighed on the market-cap-weighted S&P 500 Index and the tech-heavy Nasdaq Composite, which posted monthly total returns of -0.95% and -2.75%, respectively. Conversely, investors aggressively rotated into blue-chip cyclical, mid-caps, and small-caps, driving a monthly total return of 2.71%

for the Dow Jones Industrial Average, while the S&P MidCap 400 and S&P SmallCap 600 rose 3.59% and 7.29%, respectively. Year-to-date, small-cap equities lead the marketplace with a staggering cumulative total return of 23.98%, followed by mid-caps at 17.33% and the Nasdaq at 13.14%. The S&P 500 and Dow Jones Industrial Average concluded the six-month period on highly constructive ground, delivering strong double-digit and near-double-digit total returns of 10.19% and 9.76%, respectively.



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On a sector level, June's performance was heavily bifurcated as investors locked in profits from previous winners and sought shelter in value and defensive groups. S&P 500 Industrials led the charge in June with a stellar 7.29% monthly return, closely mirrored by Health Care (+6.62%) and Financials (+4.37%). Meanwhile, previously dominant sectors suffered sharp pullbacks, led by Communication Services (-7.78%), Energy (-5.06%), and Information Technology (-3.28%). This monthly positioning shifted the longer-term YTD sector hierarchy; while Industrials (+20.15%) claimed the top spot for the first half of the year, Information Technology and Energy remain powerful anchors of the broader market expansion, boasting massive YTD returns of 19.76% and 19.66%, respectively. Conversely, Financials (-1.31%) and Consumer Discretionary (-0.77%) stand out as the only two sectors trapped in negative territory, illustrating a jagged recovery across cyclical consumer and financial lines.

The underlying dynamics within the S&P 500 reveal that a handful of mega-cap technology laggards acted as a severe drag on the market-cap-weighted index in June, even as secondary semiconductor players rallied. Applied Materials and Micron Technology spearheaded the monthly leaders, accounting for 31.29% and 29.82% of the index's positive moves, flanked by significant gains from Lam Research and KLA Corporation. However, these gains were thoroughly overwhelmed by steep pullbacks in mega-cap heavyweights with Microsoft leading the laggards followed by Apple, Broadcom, Amazon, and Nvidia. For the first half of 2026, the semiconductor theme remains the undisputed driver of performance, with Micron commanding the top spot as the largest contributor to index results, followed by Advanced Micro Devices, Intel, and Applied Materials. In contrast, Microsoft was the main drag on S&P 500 returns the last six months.

Economic Data Summary

The U.S. consumer and labor sectors are displaying a complex narrative of resilient nominal demand layered over a cooling employment backdrop. Retail sales growth accelerated to 0.7% month-over-month in May, building on a 0.5% gain in April. This steady spending environment helped pull personal savings up slightly to 3.0% of disposable income, recovering from a cyclical low of 2.6% in April, though remaining well below historical norms. However, cracks are increasingly visible in the labor market; non-farm payroll gains rebounded to 172,000 in May before decelerating sharply to just 57,000 additions in June. The headline unemployment rate moved from 4.3% in May down slightly to 4.2% in June, while the underemployment rate followed a similar track, easing from 8.1% to 7.9%. Despite nominal wage growth holding firm at 3.5% year-over-year in June, inflation continues to erode consumer purchasing power, as evidenced by real average hourly earnings dropping further into negative territory at -0.8% from one year ago.

In contrast to the cooling labor market, corporate and industrial operations maintained steady expansionary momentum through the close of the second quarter. The ISM Manufacturing Index registered a solid 53.3 in June, marking its fourth consecutive month above the contraction threshold despite easing slightly from May's reading of 54.0. Forward-looking demand remains healthy, with manufacturing new orders coming in at a firm 56.0 in June following a 56.8 clip in May. The service sector also exhibited stable health, with the ISM Services Index settling at 54.0 in June while its corresponding employment component climbed back into expansion territory at 51.2. Crucially for corporate profit margins, severe supply-side inflation pressures have begun to moderate significantly from their spring peaks; the manufacturing prices paid index fell from a staggering 82.1 in May to 73.0 in June, while services prices paid edged lower from 71.3 to 67.7.

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While upstream input costs began to offer relief in June, trailing consumer-facing inflation metrics for May revealed an alarming and comprehensive re-acceleration of price pressures. Headline CPI spiked to 4.2% YOY in May, climbing significantly from 3.8% in April and 3.3% in March, while Core CPI reached 2.9%. Compounding this concern, the Federal Reserve's preferred inflation gauge, the Personal Consumption Expenditures (PCE) price index, jumped to 4.1%, with Core PCE accelerating to a stubborn 3.4%. This multi-month upward break confirms that consumer inflation is no longer merely "sticky" but is actively trending away from the central bank's comfort zone. The widening delta between nominal wage growth and headline consumer inflation underscores why real wages remain negative, forcing households to lean heavily on credit and cash flow to support their consumption habits.

This troubling cocktail of resurgent headline inflation and sharp June labor deceleration has forced a deeply complicated, hawkish policy posture from the Federal Reserve. At their recent monetary policy meeting and subsequent press conference, central bank officials acknowledged that progress toward their 2% price stability mandate has completely stalled, removing any immediate possibility of monetary easing. The Fed reiterated its commitment to a restrictive "higher-for-longer" interest rate environment, signaling that while the cooling payroll numbers in June warrant close monitoring, the re-acceleration of core consumer prices remains the primary threat to macroeconomic stability. During the press conference, Chairman Warsh emphasized that because structural business activity and new orders remain resilient, the economy can withstand a prolonged period of tight credit conditions. Consequently, forward guidance has been recalibrated to project an indefinite delay in rate cuts, with some policymakers leaving the door open for additional quantitative tightening or rate hikes if trailing inflation metrics fail to cool alongside wholesale prices.

Valuation & Earnings

The valuation of the S&P 500 currently stands at 20.3x forward earnings estimates, below last year's reading of 22.3x. It is slightly above the 5-year (20.0x) and 10-year (19.2x) averages. However, the equity risk premium that compensates investors for the excess risks associated with stocks compared to bonds remains thin due to the higher interest rate environment.

We are on the brink of another earnings season. Analysts are modeling year-over-year profit growth of 23.3%. That is a significant upward revision to their 18.8% view just three months ago. If the expected earnings growth should come to fruition, it would mark the second straight quarter of bottom line growth above 20%!



The primary catalyst for the upward revision to earnings expectations is a surge in profit growth from energy companies. Analysts have also raised their expectations for technology and materials. Collectively, ten of the eleven sectors are projected to report higher profits than one year ago. When zeroing in on specific companies, Micron is responsible for the bulk of the growth for technology given shortages in memory chips. For the full year of 2026, the consensus growth rate for earnings is predicted to be 24.1%.

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Conclusion

Stocks remain vulnerable to headline risk from major economic reports, the Fed, and geopolitical events; however, recent earnings reports have shown the economy remains on a growth trajectory. Unfortunately, business activity is widely uneven. Big tech companies are fueling most of the growth via their spending on artificial intelligence infrastructure. According to the most recent GDP report, AI spending accounts for over 50% of economic growth. This lopsided environment is causing investors to pile into companies affiliated with the build-out of AI.

This activity can be seen in market data. As we mentioned previously, the S&P 500 currently trades at 21.1x forward earnings estimates. If you equal-weight the names inside the index, which dilutes the influence of big tech companies, the forward PE ratio drops to 17.3x. That spread of 3.8 turns is lower than one month ago, but it is far less than the 6.1 turns seen last autumn. More importantly, the difference in earnings growth between the S&P 500 market-cap and equal-weight indexes is almost 8% today, up from only 4% last October. This tells us the premium valuation being assigned to AI-related names is warranted, given the increased divergence in growth between the AI names and everyone else.

Finally, we remain bullish on technology and AI-related names; however, we would not be surprised to see this theme take a breather given the massive upside move in many of these names over the past few months. Part of the trade appears crowded, but fundamentals do not warrant fading the structural theme. We also favor financials. The higher-interest-rate environment is conducive to asset repricing, and the underlying economy is still growing, albeit unbalanced. Credit quality, especially among banks, is strong. For larger banks with capital markets divisions, market volatility has boosted trading activity. These factors, along with lower capital requirements from the Fed, should lead to strong profit growth. Concerns surrounding private credit appear to be limited to a small segment of loans and product structures, while banks' exposure to non-bank financial institutions (NBFIs) remains low. Relative valuation of banks versus the market has collapsed over the last three months as concerns about the likelihood of the Fed cutting rates have increased. Lastly, we see several bargains across the healthcare sector. Succinctly put, we prefer quality balance sheets, secular demand, and pricing power during this turbulent and uneven economic environment.

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