War & Warsh – What's Next?

Second Quarter Review

Markets staged an impressive rebound in the second quarter on a surge in tech-related earnings growth and rising hopes for a U.S./Iran ceasefire. In early April, President Trump announced a two-week ceasefire with Iran and that news pushed oil prices lower and set the stage for allowing stocks to recoup from their geopolitically driven March declines.

Annual earnings growth surged to over 25% for the S&P 500 following the first quarter results. While AI-linked infrastructure companies posted some of the strongest growth on booming data center demand, a broad swath of companies and industries posted impressive financial results. This is evident as more than 80% of the companies reporting during the earnings season beat Wall Street estimates. In our view, that AI-led growth, along with the U.S./Iran ceasefire, fueled the strong rebound in stocks in the second quarter.

While the tech sector again posted some of the strongest results, earnings overall were impressive with retail behemoth Walmart producing solid results and pushing back on fears that higher prices were hurting consumer spending. Meanwhile, surging demand for data center components such as flash memory and semiconductors led to massive gains in certain tech stocks through the end of May. The S&P 500 hit multi-new, all-time highs during the month.

While there was no official U.S./Iran ceasefire, markets suggested there would be no material military escalation. The rally continued in June on reported progress of a U.S./Iran ceasefire agreement, signed by President Trump and Iranian leaders in mid-June.

Turning to other domestic developments on June 17th, new Federal Reserve Chairman Kevin Warsh announced that the Fed would not change the fed funds rate as many expected. Despite being appointed by Trump, Warsh took a "hawkish" stance implying that the probability for a rate hike later this year had increased. The Fed's deviation from previous policy expectations caused renewed market volatility at the time. However, stocks generally proved resilient as falling oil prices dropped back to pre-war levels leading investors to believe the current inflation spike may be temporary.

Second quarter gains in the S&P 500 index were broad, but the impact of the AI boom was evident across and throughout markets. By capitalization, small caps outperformed large caps due to a combination of strong economic growth (which can disproportionately benefit smaller company earnings), falling oil prices, and the "trickle down" of AI optimism towards small-cap tech and AI infrastructure businesses.

US Equity Indexes	Total Return 2Q 2026	Total Return YTD 2026
S&P 500	15.20%	10.19%
S&P 500 Equal Weighted	11.39%	12.11%
DJ Industrial Average	13.38%	9.76%
NASDAQ Composite	21.60%	13.14%
S&P 500 Dividend Aristocrats	6.72%	9.31%
Russell 2000 (Small Cap)	21.57%	22.69%
MSCI EAFE (International Developed)	11.08%	9.90%
MSCI Emerging Markets	24.14%	24.00%

Source: Bloomberg Professional (6/30/2026)

Tech/AI also influenced international market performance. Emerging markets handily outperformed the S&P 500 in the second quarter due to an extreme rally in South Korean and Taiwan shares as both benefited from the boom in memory-chip demand. Foreign developed markets lagged modestly when compared to the S&P 500.

Commodities saw moderate declines in the second quarter, primarily to the drop in oil prices. Crude prices remained volatile but ended the quarter solidly lower on a combination of increased ship transit through the Strait of Hormuz and the U.S./Iran ceasefire agreement. Gold prices also fell during the quarter on the decline in geopolitical concerns and a stronger U.S. dollar. The U.S. dollar hit a one-year high in June on rising rate hike expectations.

Switching to fixed income markets, the leading benchmark for bonds (Bloomberg U.S. Aggregate Bond Index) realized a modest positive return for the second quarter as falling commodity prices reduced inflation concerns.

Looking deeper into fixed income, shorter-duration bonds again outperformed longer-duration fixed income as inflation statistics hit multi-year highs and ended the quarter far above the Fed's 2.0% target. For corporate bonds, both investment grade and lower quality fixed income posted solidly positive quarterly returns. High-yield and tax-free municipal bonds outperformed investment grade debt, as generally resilient economic growth supported current yields.

US Bond Indexes	Total Return 2Q 2026	Total Return YTD 2026
Bloomberg US Aggregate Bond	0.67%	0.62%
Bloomberg US T-Bill 1-3 Month	0.91%	1.80%
ICE US T-Bond 10-20 Year	0.81%	0.64%
ICE BofA US High Yield Index	2.45%	1.89%
S&P National AMT-Free Municipal Bond	2.31%	2.11%

Source: Bloomberg Professional (6/30/2026)

****(SMID SIDEBAR)****

Understanding SlateStone’s AlphaEdge SMID Strategy: Finding Growth in the Overlooked Middle

AlphaEdge SMID, SlateStone's small- and mid-cap equity strategy launched December 2, 2025, takes a different approach than most strategies in this segment. Rather than drawing purely from small- and micro-cap names the way a traditional benchmark like the Russell 2000 does, the strategy builds its investable universe from a composite of the Bloomberg US 400 MidCap and US 600 SmallCap indices — roughly 1,000 companies that skew toward more established, larger-market-cap businesses than typically found in that category. The goal is to identify companies still at an earlier stage in their business growth journey than the mega-cap names dominating the S&P 500, but mature enough to have the fundamental data, analyst coverage, and other metrics needed for proper evaluation. It is a deliberate approach: young and nimble enough to offer real growth potential, yet seasoned enough to support rigorous, data-driven analysis.

From that universe, AlphaEdge SMID applies a systematic, multi-factor screening process, evaluating each company on areas including capital efficiency, price momentum, Wall Street consensus sentiment, and institutional trends. This process narrows the universe to approximately fifty holdings, each roughly equally weighted, with the portfolio rebalanced every three months to refresh those signals and remove companies whose signals are deteriorating. The result is an actively managed, dedicated small- and mid-cap sleeve designed to complement portfolios — capturing potential mispricing in a part of the market that receives far less analyst attention than mega-cap names, while maintaining the discipline to move on from names as soon as the data signals a shift.

Current market data underscores why this segment is worth a closer look. As of June 30, 2026, both small- and mid-cap companies, based on our analysis, are expected to grow earnings faster than their large-cap counterparts over the next four quarters — yet they trade at meaningfully lower valuations (see below chart). In other words, valuations imply investors paying less for more growth in the small- and mid-cap space.

Equity Market Indexes	Forward NTM Price/Earnings Ratio	Expected NTM EPS Growth
S&P 500 Index	21.2X	20.6%
S&P 400 Index (MidCap)	17.7X	23.7%
S&P 600 Index (SmallCap)	16.9X	27.9%

Source: S&P Data as of 6/30/2026

An allocation to small and mid-cap names may be warranted at appropriate levels based on personal objectives and risk parameters, if you have interest in learning more about this strategy, please reach out to your SlateStone Wealth Advisor to determine the suitability for your portfolio.

****(END SMID SIDEBAR)****

<u>Second Half 2026 Outlook</u>

As in 2025, stocks proved resilient in the first half of 2026 despite several macro-economic surprises, as strong corporate earnings and underlying economic growth overcame doubts about AI profitability, war, and higher interest rates.

To that point, investors had to confront numerous market surprises over the first six months of 2026. But while those surprises each caused temporary bouts of market volatility (with the worst coming in March after the U.S./Iran war began), they were largely offset by foundational bull market metrics: strong earnings and solid economic growth.

However, while the market and economy were again impressively resilient in the first half of 2026, we must caution against allowing this resilient market to lull us into a false sense of security as we embark on the second half of the year, because risks to this bull market remain.

First, as we were going to print with this update, on July 8 President Trump abruptly declared an end to the three-week-old ceasefire when Iran renewed attacks on commercial cargo vessels in the strait. The U.S. retaliated swiftly with heavy military airstrikes as diplomatic negotiations deteriorated. With renewed hostility and supply lines threatened again, oil prices spiked initially but subsequently steadied. The financial outlook remains uncertain as investor sentiment deteriorated, signaling caution over the near term.

Second, expectations for Fed rate hikes have resurfaced. At the start of 2026, investors widely expected one or two rate cuts in 2026. Now, because of higher inflation expectations exacerbated by renewed disruption to the oil supply, and ongoing geopolitical tensions, the market is anticipating one or two rate hikes this year. While this is not automatically negative for markets, the reality is that the last time the Fed embarked on a rate hike campaign in 2022, stocks dropped sharply.

Third, the exposure of the entire economy and financial markets to continued AI capital investment remains is also a source of concern. Massive AI infrastructure investment is helping to power the economy. If the companies spending that money begin to doubt their ROI (Return on Investment), they could reduce spending. This would be a negative economic outcome impacting both equity and fixed income markets.

Despite these issues weighing on financial markets, the U.S. economy has proven resilient over the past several years, but it is fallible. The rebound in inflation, and the ongoing war with Iran, would further damage consumer confidence, threatening spending, the housing market, and putting further pressure on financial assets. We will be watching all developments closely. As markets maintain their elevated valuations, the concern is that the impact of ongoing war and the potential for a decline in economic momentum would result in an increase in market volatility as stocks price in these risks.

In sum, we start the second half of 2026 in a different place than where we ended. However, we point to above average earnings growth, resilient economic growth, and continued AI enthusiasm. Yet we remain cautious, as oil prices rise and hostilities escalate, risking higher inflation, potential interest rate hikes, and vulnerability to an AI infrastructure spending slowdown. We are diligently focused on seeking both opportunities and managing risks for you in our portfolio positioning. We thank you for your ongoing confidence and trust. Please rest assured that our entire team will remain dedicated to helping you successfully navigate this market environment.

Please do not hesitate to contact us with any questions, comments, or to schedule a portfolio review.

Sincerely,

The SlateStone Wealth Investment Committee

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