WESTEND Advisors
A VICTORY CAPITAL® INVESTMENT FRANCHISE

Economic and Market Commentary

Q2 2026

Macro Drives Markets. WestEnd Knows Macro.

Continued Growth from Shifting Tailwinds

The economic cycle is mature but remains on track. We expect trend-like growth to continue with a modest cyclical pickup in some regions, increasingly supported by investment rather than the consumer. We are positioned for ongoing expansion, while adjusting exposures for risks and broadening opportunities we see ahead.

SUMMARY

- Second quarter 2026 saw continued inflationary pressures and some labor market stabilization in the U.S., along with a strong stock market rally as investors looked past the Iran conflict and refocused on AI and tech-related investment.
- We believe trend-like economic growth can continue as ongoing investment and a pickup in related cyclical activity help offset a softening of consumer activity in the U.S.
- Internationally, we see some economic tailwinds shifting from favoring tech-heavy Emerging Asia to favoring more cyclically diversified European markets.
- Despite lingering inflation, we see opportunity from elevated real yields in long-term Treasury bonds, while historically narrow credit spreads present risk for longer-term corporate bonds.
- We see return opportunities in diversified real asset exposures, which historically tend to do well in environments similar to today.

Q2 2026 REVIEW

Major U.S. stock indices posted some of their strongest quarterly returns in Q2 since the initial COVID market rebound in 2020 as investors looked toward a potential resolution of the Iran conflict. The gains were led by AI and tech-related shares, which rallied in April and May amid an AI-fueled memory chip shortage that tightened pricing across the supply chain. The rally cooled in June, however, as more investors seemed to question the near-term economics of massive AI capex spending, while firmer inflation and employment data revived concerns that the Fed's next move could be a hike rather than a cut.

The quarter's gains were supported by a relatively stable U.S. economic backdrop and an apparent broadening of cyclical and investment activity. Orders for non-defense capital goods ex-aircraft have accelerated sharply this year, exceeding 10% year-over-year growth in April and May. Meanwhile, the ISM Manufacturing PMI posted a sixth consecutive expansionary reading in June. Job growth stabilized somewhat in Q2, averaging roughly 111,000 payrolls per month—below long-term trends but a notable improvement from more volatile readings that averaged just 22,000 per month from the start of 2025 through Q1 2026.

As tech-related shares pulled back in June, large-cap U.S. sector leadership broadened out in a pattern reminiscent of early Q1, with Industrials, Financials, and Health Care all posting gains. Further illustrating the broadening of leadership, small-cap stocks as measured by the Russell 2000 outperformed every large-cap sector except Information Technology in Q2. Consumer-related sectors, by contrast, underperformed for the quarter amid concerns over elevated gas prices crowding out other categories of household spending and as income gains remained muted. Energy was the worst-performing sector in Q2 as oil prices plunged amid deescalation in the Iran conflict.

Shifting Market Leadership
AI and tech-related shares led in April and May but fell in June while a range of other sectors, both cyclical and defensive, continued to post gains.

International equities also rose across most regions. EM Asia led globally, despite a pullback in China, as Taiwan and South Korea benefited from AI-driven investment and the memory chip cycle. Developed Europe posted double-digit returns and, after lagging through April and May, outperformed more tech-heavy regions in June as its cyclical exposures came into favor.

In fixed income markets, the yield curve flattened during Q2 as shorter-dated securities began to price in the possibility of Fed rate hikes, but healthy yields offset the price impact of rising rates on Treasury bonds. Corporate credit outperformed the Treasury market as credit spreads continued to narrow toward multi-decade lows.

OUTLOOK

Overview: For much of the globe, we see mature but stable growth extending into 2027, though we perceive some evolution in the underlying drivers of growth. In the U.S., recession risk has normalized from elevated levels, in our view, with a stabilization in the

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labor market, reduced risk of price shocks from the Iran conflict, and a broadening of cyclical activity. In particular, we are seeing a shift from consumer-driven growth to investment-driven growth, which extends beyond the widely covered direct AI and tech capex. The earnings outlook also remains mostly positive into 2027, and with earnings growth more widely distributed among sectors than in 2026. We see earnings growth as a key driver of potential equity returns, given that valuations, though mixed, are generally elevated and could compress.

Outside the U.S., we see some regional shifts in growth drivers. Emerging Asia has become increasingly concentrated and reliant on the semiconductor cycle and tech investment, where growth may be peaking, while Europe is showing signs of an upturn in cyclical activity.

Health in Old Age

The U.S. economic cycle is mature, but we see shifting cyclical forces that could sustain late-cycle growth.

U.S.: The U.S. economic cycle is mature, but we have seen recession risk normalize from elevated levels in recent years, and we believe trend-like GDP growth can continue. This is partly due to a rotation of growth drivers within the cycle from consumption to investment and a broadening of investment beyond AI. With these shifting growth drivers, we see opportunities in select cyclical areas of the U.S. markets amid a broadening of earnings growth across sectors. Further, as recession risk has receded somewhat, in our view, we have reduced our precautionary overweight of defensive exposure in portfolios.

Technology investment remains a key economic driver, and we expect that the AI/tech investment cycle will continue over our investment horizon. This investment cycle has driven significant earnings growth for a variety of tech-related companies in recent quarters, and rising earnings growth expectations for Information Technology since the start of the year have actually pushed down the sector's forward P/E ratio. However, consensus estimates for tech and AI-related earnings and free cash flow growth going forward are now extremely elevated. We are cautious about AI and tech-related companies' ability to sustain expected high growth rates, as the need for continued investment could eat into cash flow, drive increased depreciation expense, and require potential capital raises that could dilute per-share metrics—all while the future path of AI adoption and monetization remains uncertain.

That said, we retain a significant allocation to Information Technology in U.S. large-cap allocations, given that it still has the strongest fundamental outlook among sectors. However, we are actively underweight the sector given the risks we see versus elevated expectations. We also retain U.S. Communication Services exposure at a roughly market weight in our ETF strategies, having eliminated a prior overweight tied to a modestly reduced outlook for the sector.

Along with the ongoing tech investment cycle, we have seen a broadening out of cyclical activity in the U.S. We maintain an overweight of the Financial sector in the U.S., which we believe should benefit from continued economic growth, improving loan growth, elevated capital markets activity, and the positively sloped yield curve. We see rising capital goods orders and production activity benefiting both the Transportation industry within the Industrials sector and the Materials sector, which is seeing secular tailwinds from investment in things like data center construction and the electric grid, as well as improved pricing dynamics and accelerating demand for packaging. In balanced and global portfolios, we also maintain a diversified U.S. small-cap allocation, which we expect to benefit from the general broadening out of ongoing economic activity as well as stabilizing manufacturing production and improving credit conditions.

In contrast to the capital investment backdrop, we see potential softening of the U.S. consumer. Consumers still have relatively healthy balance sheets and have remained resilient so far this cycle, but consumers have been outspending income growth over the past two years. The U.S. savings rate was down to just 3% in May, the lowest level on record except during the run-up to the 2008 Financial Crisis and, briefly, right after COVID stimulus. All this together suggests consumers have limited room to accelerate spending from here. Meanwhile, they continue to face elevated energy prices that can divert spending from other areas and above-target inflation that weighs on real consumption. Tax refunds likely dampened the initial impact of elevated energy costs from the Iran conflict, but the positive impulse of tax benefits is not likely to continue, while cost pressures could linger for an extended period, even with a resolution to conflict.

With this consumer backdrop, we expect many consumer-facing companies are likely to face margin pressures. Various Consumer Staples companies, for instance, face headwinds to volume growth following recent pricing increases, yet they are likely to see continued input cost pressures. Accordingly, we continue to underweight the Consumer Discretionary sector and recently eliminated exposure to the Consumer Staples sector in the large-cap U.S. allocations of our ETF portfolios, a move which reflected both the softening consumer outlook and our comfort in reducing defensive late-phase sector exposure in the U.S. Still, we retain an overweight of defensive sectors via Health Care and Utilities where we see secular earnings growth drivers and a more favorable risk/return profile.

Latitude for the Fed

While the Iran conflict has created pricing pressures, inflation still appears to be headed down over time, leaving a path to Fed easing absent an unlikely job boom.

Despite the current inflationary headwinds from energy price shocks and supply chain constraints for other commodities (including memory chips for tech companies), we still expect longer-term disinflationary trends, though at a slower pace than we expected prior to the Iran conflict. At this point, we believe core inflation is likely to remain elevated in the 2.5%-3.0% range through year-end before slowly moving back toward 2.0% by the end of 2027. This still leaves the Fed with a path to easing, in our view, despite recent concerns over possible rate *hikes*, but the bar is higher and timing is less certain given firmer inflation and labor market stabilization year-to-date. We believe the labor market trajectory will be the key input in the Fed's rate path. Encouragingly, labor market data has been one of the largest contributors to positive readings in economic surprise indices this year. Still, payroll growth remains below historical norms for an expansion, but it appears roughly balanced by reduced levels of layoffs and net immigration, which are also lower than is typical in an expansion.

International: We see shifting regional economic tailwinds for international equities. This includes signs of improving cyclical activity in Europe while risks have increased in Asia and emerging markets.

Tech-related shares—particularly semiconductor stocks—have been a key driver for international equities in 2026, but this has led to a recent concentration of outperformance. Emerging Asia's strong global outperformance in Q2 and year-to-date was largely a function of South Korean and Taiwanese equity markets, which saw triple-digit returns in the last year, fueled by a surge in memory and component prices. Those two countries now make up roughly 60% of the MSCI EM Asia Index. We believe this makes near-term emerging market equity performance heavily reliant on the global memory chip price cycle, which may be at risk of rolling over after global semi sales reached record growth of +94% year-over-year in April. Year-over-year growth comparisons are likely to become meaningfully tougher in the back half of 2026, in our view, while additional manufacturing capacity that is expected to come online in 2027 and 2028 could weigh on pricing going forward.

Tailwinds Shifting East to West
Emerging Asia's growing concentration in tech-driven sectors and countries presents risks if semi cycle turns, while we see potentially under-appreciated signs of a cyclical upturn in Western Europe's production-oriented economy.

Valuations could also be a headwind for Emerging Asia. While the region's forward P/E multiple is in line with its long-run average, other valuation measures, such as price-to-sales, are near record highs. As a result, our in-house valuation composite for Emerging Asia has reached elevated levels on par with late-2007 and mid-2021, which has historically been indicative of negative forward returns on a 1-to-2-year basis.

Europe, in contrast, is showing signs of cyclical improvement, which we believe is underappreciated by markets. Production-driven European economies have faced headwinds in recent years from restrictive rate policy and cautious consumer spending. Prospective resolution of the Iran conflict, however, reduces the risk of further price shocks, which could allow ECB to maintain a neutral policy stance and ease input costs for European manufacturers.

Additionally, we are seeing a global broadening out of activity beyond AI and semiconductors to "old economy" industrial goods, machinery, capital equipment and autos, which should benefit Europe. Earnings for European equities are expected to grow at a double-digit pace year-over-year into early 2027, driven by improvement in Financials, Consumer Discretionary, Industrials, and Materials. Meanwhile, despite improving fundamentals, Europe offers relatively attractive valuations at a larger-than-normal discount to global markets.

Given these ongoing and anticipated shifts in regional fundamental tailwinds, which appear underappreciated given valuation differentials, we have adjusted international regional exposure in global portfolios. We reduced Emerging Asia exposure (and, thus, overall EM exposure) and increased our recent overweight of Western Europe.

Fixed Income and Real Assets: In fixed income markets, yields have risen year-to-date, driven by a combination of higher inflation and a shift in the policy rate outlook. At the same time, real yields on long-term Treasury bonds have risen to one of the highest levels in decades, while we think the risk of runaway inflation has receded. At this point, we believe any increase in short-term rates by the Fed is likely to have more impact on the intermediate range of the yield curve than on longer-term bonds. Meanwhile, intermediate and longer-term corporate credit spreads have retraced toward historical lows. This supported corporate bond outperformance of Treasury bonds in Q2 and year-to-date, but we now see increased risk for corporate bonds from a potential widening of spreads going forward.

Within fixed income allocations, we have reduced corporate credit exposure, while retaining a focus on shorter maturities within corporate credit to limit spread duration risk. At the same time, we increased long-term Treasury exposure, which lengthened the overall duration of fixed income allocations.

For multi-asset portfolios, we believe the current environment favors maintaining a diversified allocation to real asset exposures. Since 1976, periods with economic characteristics similar to today's have seen commodities outperform fixed income about 60% of the time. With a range of inflation and growth paths possible, we diversified our real asset exposure earlier this year away from a focus on gold to include a broader set of global natural resources and energy infrastructure exposure.

CONCLUSION

Economic data this year has increased our confidence in the durability of this economic cycle as tailwinds for growth have shifted. With the evolution in our outlook, we have adjusted portfolios across applicable asset classes to take advantage of potential return opportunities while maintaining appropriate risk controls. As always, we stand ready to act as the macroeconomic and market backdrops warrant, and we look forward to maintaining active communication of our outlook and portfolio positioning.

WestEnd Advisors Investment Team | July 6, 2026

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