Q2 2026: Halftime

By Peak Trust Company's Chief Investment Officer, Lisa Russell, CFA. August | 2026

HIGHLIGHTS

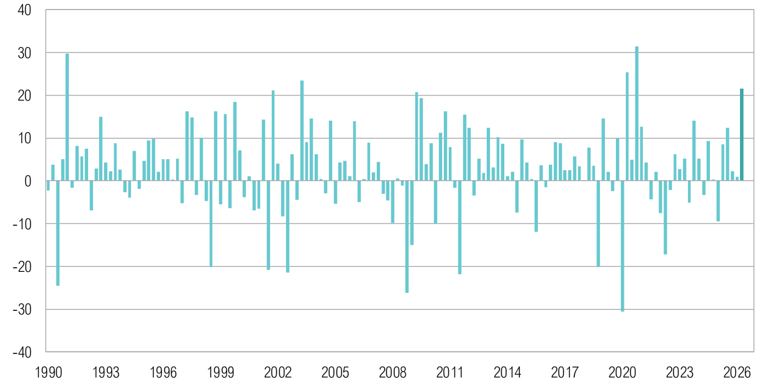
- U.S. large-cap stocks ended the quarter up 15%, while small-cap stocks gained 22%. Moreover, U.S. intermediate-term bonds had modest gains, ending the quarter up 0.7%.
- The U.S. economy remained resilient due to strong job growth, steady consumer spending, larger tax refunds, and improving lower-income household finances offsetting higher inflation.
- The U.S.–Iran conflict disrupted energy markets, pushing oil prices above $110 per barrel and driving gasoline prices sharply higher before conditions stabilized late in the quarter.
- The Federal Reserve entered a new era under Kevin Warsh, launching a review of its inflation framework, communications strategy, balance sheet policy, and approach to the role of AI-driven productivity.
- Artificial intelligence (AI) remained a dominant market theme, although investor focus shifted from AI spending to AI returns, thereby contributing to broader market leadership beyond mega-cap technology.

Overview

The whistle has now blown on a quarter defined by geopolitical tensions and a continued AI-related investment boom, and all against the backdrop of a domestically hosted FIFA World Cup and the 250th anniversary of U.S. independence. In particular, U.S. large-cap stocks, as measured by the S&P 500 Index, closed at a new all-time high on June 2 and finished the quarter up 15%. Moreover, U.S. small-cap stocks, represented by the Russell 2000 Index, performed even better, gaining a noteworthy 22%—that is, their strongest quarterly return since Q4 2020, when the index advanced 31%. In addition, U.S. intermediate-term bonds, as measured by the Bloomberg U.S. Aggregate Bond Index, posted a modest gain of 0.7%.

In Q2 2026, U.S. Small Cap Stocks Saw Their Best Returns Since Q4 2020

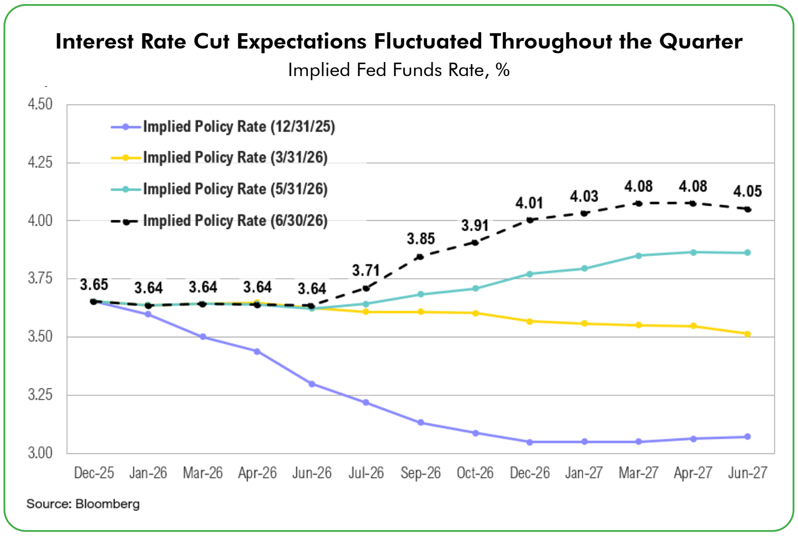
U.S. Small Cap Stocks Quarterly Return, %



Source: Bloomberg. U.S. small cap stocks proxied by the Russell 2000.

The labor market remained resilient throughout Q2. In fact, the U.S. economy added 365,000 new jobs over the three-month period despite the continued layoffs in certain sectors of the economy. The technology sector remained the center of job cuts during the first half of 2026. For the fourth consecutive month, AI was cited as the primary driver of layoffs, with 23% of all announced job cuts in the first half of the year being directly attributed to AI.

The U.S. consumer also remained surprisingly strong. Personal spending increased by 0.4% in April and



0.7% in May. Yet wage growth (3.5% year-over-year in June) has not kept pace with inflation (4.2% year-over-year in May according to the most recent reading). Larger-than-usual tax refunds following the passage of the One Big Beautiful Bill in July 2025 appear to have supported spending. These tax refunds were 18% higher than in 2025, with the average refund increasing approximately 12% to $3,280.

A defining development during Q2 was the beginning of new Federal Reserve Chair Kevin Warsh's tenure (more on this later). As expected, the Federal Reserve left interest rates unchanged throughout the first half of 2026. However, expectations regarding the path of interest rates shifted dramatically as energy prices pushed inflation higher amid the conflict in the Middle East. This rapid repricing reflected two key forces—namely, inflationary pressure stemming from the U.S.–Iran conflict and the continued resilience of the U.S. economy, underpinned by a resilient labor market and a strong consumer.

Halftime

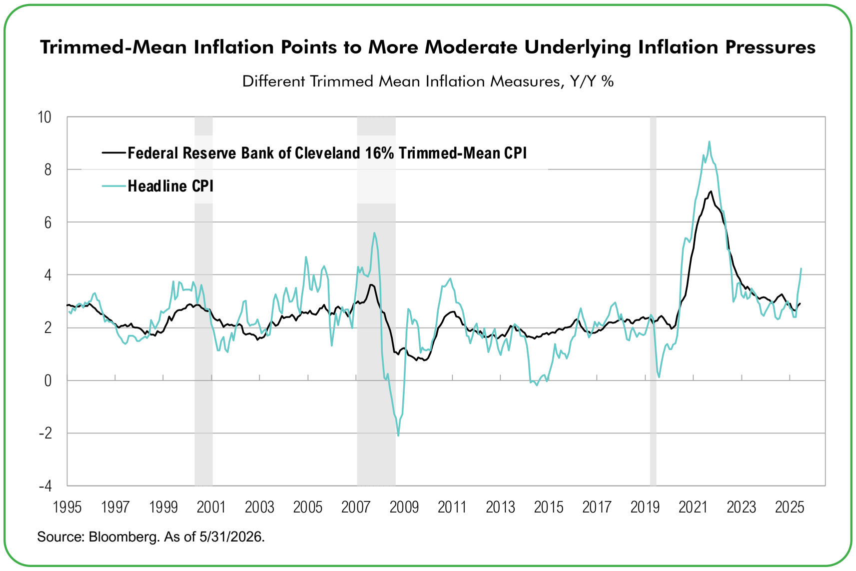
The U.S.–Iran conflict dominated headlines during Q2. Following the outbreak of hostilities on February 28, both countries significantly escalated their military campaigns throughout the first half of 2026. The conflict situated the Strait of Hormuz at the center of global attention, disrupting energy flows and contributing to fuel shortages worldwide. Tensions peaked in early April, with West Texas Intermediate crude oil rising to $113 per barrel and Brent crude reaching $118.

Diplomatic efforts gained traction when the U.S. and Iran agreed to a Pakistan-mediated ceasefire on April 7, although violations by both countries persisted and the U.S. later imposed a naval blockade on vessels bound for Iranian ports. Negotiations remained fragile throughout May before culminating in a 14-point memorandum of understanding being signed on June 17. This agreement established a framework for discussions covering navigation through the Strait of Hormuz, Iran's nuclear and missile programs, and sanctions relief. While military operations have formally ceased, many key issues remain unresolved and negotiations continue. The 60-day deadline specified in the June 17 memorandum of understanding expires in mid-August.

Domestic energy markets reflected the impact of the U.S.–Iran conflict. U.S. crude oil exports reached a record 6.4 million barrels per day in April and remained elevated through mid-June, which benefited domestic producers. Even so, gasoline inventories fell to multi-year lows during Q2, driving a sharp increase in fuel prices. The average pump prices for regular unleaded gasoline rose from $2.80 per gallon in early January to a peak of $4.60 on May 20 before ending June at $3.85.

May 15 marked the start of a new era at the Federal Reserve. Kevin Warsh was nominated as Federal Reserve Chair in January 2026, and his April confirmation hearing outlined a framework centered on trimmed-mean inflation measures, removal of forward guidance and the dot plot, and belief that AI-driven productivity gains will ultimately prove disinflationary. These themes remained front and center during his first Federal Open Market Committee meeting on June 16–17. At the post-meeting press conference, Warsh announced the establishment of five task forces focused on Federal Reserve communications, balance sheet policy, data sources, productivity and AI, and the inflation framework.

The newly established task forces suggest that a broad review will be conducted of how monetary policy is communicated, implemented, and evaluated. The most consequential changes will likely emerge from the inflation framework review. Here, Warsh appears focused on whether traditional headline inflation measures adequately capture the underlying price pressures,



Source: Bloomberg. As of 5/31/2026.

and he seems interested in placing greater emphasis on trimmed-mean measures that exclude extreme price movements.

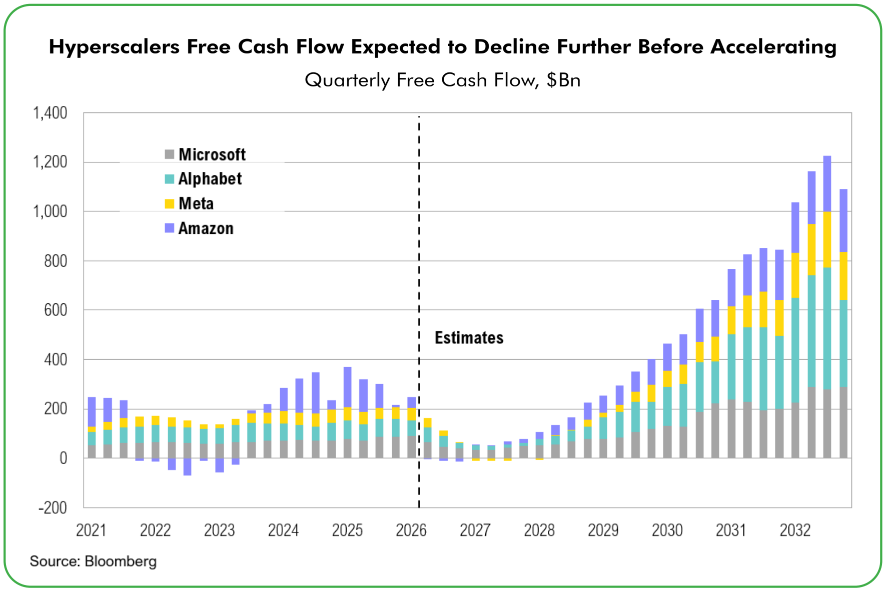
A shift toward gauges such as the Cleveland Fed Trimmed Mean Consumer Price Index (CPI) would place greater emphasis on inflation trends rather than short-term volatility, potentially influencing both policy decisions and how inflation risks are communicated to markets. The Cleveland Fed's 16% Trimmed-Mean CPI is derived from the Bureau of Labor Statistics' CPI data and calculated by excluding the most extreme price increases and decreases each month (approximately the highest 8% and lowest 8% of weighted price changes) and then averaging the remainder, thereby providing a clearer measure of the underlying inflation trends.

Despite the mixed political and economic backdrop, the U.S. consumer remained resilient throughout Q2 and the first half of 2026. Consumer fundamentals remained healthy, and both personal income and spending (at 0.7% month-over-month in May) stayed above the five-year averages of 0.4% and 0.5%, respectively. The Johnson Redbook Index (a higher-frequency datapoint that measures the weekly same-store sales of major U.S. retailers) rose to the highest non-pandemic-fueled level on record. Evidence emerged during Q2 that lower-income consumers may be recovering. Indeed, according to PNC Bank credit card data, the spending gap between upper- and lower-income households narrowed from 4.5% at the end of 2025 to approximately 1.5% by June 2026. The cash savings buffers of lower-income households also increased from 25 days to over 30 days. Similarly, Bank of America data showed that lower-income household spending reached its highest level in three years during June 2026.

Importantly, the 2026 FIFA World Cup was unlikely to have been the primary driver of this strength. Most World Cup-related spending occurs in relation to lodging, dining, transportation, and ticketing, categories that are not well captured by the Johnson Redbook Index. However, other data sources reflected strong activity. For instance, OpenTable (a measure of key restaurant performance metrics, guest spending behavior, and seated diner traffic) reported a 40% year-over-year increase in seated diners during the last week of June.

Consumers may experience relief in terms of certain goods' prices in the coming months. On February 20, the Supreme Court ruled that President Trump lacked authority to impose tariffs under the International Emergency Economic Powers Act (IEEPA), effectively invalidating the April 2025 "Liberation Day" tariffs. On March 4, the U.S. Court of International Trade ordered Customs and Border Protection to refund at least $165 billion in improperly collected tariffs, injecting liquidity back into both businesses and consumers. According to court filings, as of the end of June, $71 billion had effectively been refunded, while $100 billion was in the pipeline. For example, Walmart is expected to receive roughly $2.4 billion. As Walmart chief financial officer (CFO) John Rainey noted: "We think the single best return that we can have on a dollar of capital right now is to invest in the consumer and invest in price."

Since the launch of ChatGPT in November 2022, the five largest U.S. hyperscalers (Amazon, Microsoft, Meta, Alphabet, and Oracle) have driven the largest corporate investment cycle on record. Capital expenditure (CapEx) increased from $156 billion in 2023 to $443 billion in 2025, and it is expected to reach $700 billion in 2026 and over $900 billion in 2027. Some estimates suggest that AI-related CapEx accounted for around 50% of U.S. gross domestic product (GDP) growth in 2025. AI-related spending on data centers, chips, and networking equipment accounted for approximately 0.8% of U.S. GDP in Q1 2026, helping push the total computing infrastructure investment to 1.5% of GDP—that is, more than double its average



share between 2015 and 2022. Effectively, the AI hyperscalers have sponsored much of the strength of the U.S. economy and of equity markets for nearly four years. Yet this trend shifted in the first half of 2026. As AI CapEx accelerated, free cash flow came under pressure. For instance, Alphabet's Q1 free cash flow fell 47% year-over-year, while Amazon's declined 95% under the weight of AI infrastructure spending.

The market breadth (the percentage of stocks participating in a market advance or decline) improved steadily during Q2. More than 60% of S&P 500 constituents ended the period above their 200-day moving averages. Moreover, U.S. small-cap stocks outperformed their large-cap counterparts by 6%, while a broader mix of companies reached new highs. This suggests that market leadership may be expanding beyond the mega-cap technology companies that have dominated returns in recent years. In addition, earnings expectations for the remainder of 2026 support this view. Energy (66%), information technology (49%), and materials (39%) are expected to lead the S&P 500 earnings growth, while the overall index earnings are projected to increase by 24% on 11% revenue growth.

Markets

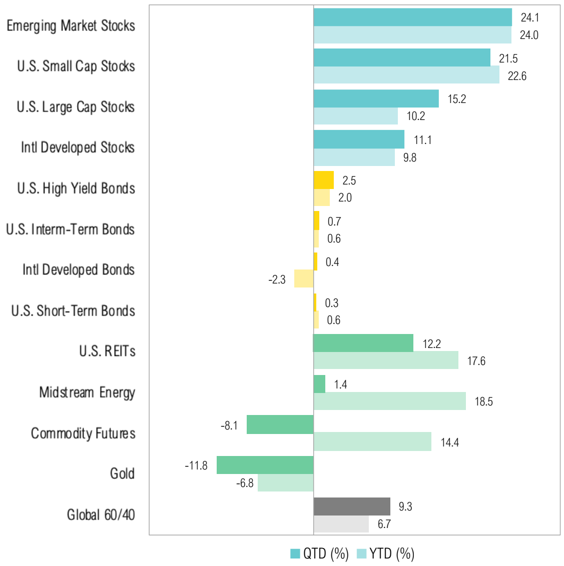
Emerging markets remained resilient, particularly given their disproportionate exposure to Middle Eastern oil, ending Q2 up a noteworthy 24%. Among the emerging markets, Taiwan (+49%) and Korea (+88%) stood out as top performers due to the outsized gains by a handful of semiconductor and AI-related names. In Korea, chip manufacturer SK Hynix rose by over 220% in Q2, while electronic giant Samsung gained nearly 100%. In Taiwan, the Taiwan Semiconductor Manufacturing Company (TSMC) gained 36% in Q2. The Morgan Stanley Capital International (MSCI) China Index ended Q2 down 7%, bringing Chinese equities down nearly 15% year-to-date. In contrast, the MSCI India Index gained 10% in Q2, bringing the year-to-date returns to -10% for the country.

Fixed-income markets remained relatively muted throughout Q2. U.S. intermediate-term bonds posted modest gains, ending the quarter up 0.7% despite an upward shift in the yield curve over the quarter. After increasing to 4.66% on May 19, the 10-year U.S. Treasury yield ended Q2 at 4.42%.

Looking Forward

We are focused on how the AI buildout will transition from a story of capacity expansion to one of monetization, profitability, and broader economic productivity. The key question is whether hyperscalers' AI spending will generate sufficient returns to support expectations concerning more than 20% S&P 500 earnings growth in 2026 and continued margin expansion across industries. In particular, Meta's decision to lease excess AI capacity highlights a growing debate about whether bottlenecks are easing and supply is catching up with demand. Ultimately, the next phase of AI development may be defined less by who builds the infrastructure and more by which companies successfully convert AI adoption into sustainable revenue growth, margin expansion, and free cash flow.

Q2 2026 Key Market Total Returns



Source: Bloomberg. See disclosures for index definitions.

We are monitoring the outcomes of Kevin Warsh's five Federal Reserve task forces, especially whether they result in changes to how inflation is measured and to Federal Reserve communications, including a potential shift toward trimmed-mean inflation measures. Beyond monetary policy, we are also watching the reopening of the initial public offering (IPO) market, an evolving supply backdrop for U.S. equities, and monitoring signs that market leadership is broadening beyond AI CapEx beneficiaries toward sectors such as healthcare, financials, energy, and real estate. The 30-year bond yields as of today (7/30/2026) are at a 19-year high and definitely warrant close monitoring.

About Lisa

Lisa Russell started with Peak Trust Company in 2003 and currently serves as Chief Investment Officer. Lisa brings over 25 years of investment experience to the Peak team. She specializes in designing unique investment programs for high-net-worth clients and trust accounts. She is highly attuned to the tax consequences of investment actions.

Lisa holds a Master of Business Administration in Finance from Emory University and a Bachelor of Science in Business Administration from the University of Southern California. Lisa holds the designation of Chartered Financial Analyst (CFA), and is a member of the CFA Institute and the CFA Society of Seattle.

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Chief Investment Officer

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