2Q26 Market Overview: The Cost of Credibility

Easing tensions in the Middle East prompted a strong rally in risk markets during the second quarter.

With a fragile peace reached between the US and Iran, equity markets more than recovered from their first quarter challenges. The S&P 500 Index advanced 15.2% in the second quarter, while the MSCI EAFE Index gained 10.8%. Growth names came roaring back during the period, with the MSCI World Growth Index more than doubling the return of its value counterpart.[2]

While this exuberance is cause for concern, it is not without support from earnings expectations and easy financial conditions. Risk perception has remained limited as evidenced by tight credit spreads and generally high equity valuations.[3] Although markets have maintained their credibility in the eyes of investors, we are mindful of ongoing inflationary impulses to the economy and the policy constraints caused by the ballooning government debt.

KEY TAKEAWAYS

- During the second quarter, easing tensions in the Middle East prompted a strong rally in risk assets, supported by strong earnings and artificial intelligence (AI) investment spending.
- The perceived hawkish bias of new Federal Reserve Chair Warsh has helped push two-year Treasury yields and the dollar higher and prompted a de-rating in gold.[1]
- Market risk perception has remained limited, as evidenced by tight credit spreads and generally high equity valuations.
- The Fed's ability to increase interest rates meaningfully in the face of inflationary pressures is likely constrained by the government's need to continually roll over its existing debt obligation and to finance large primary deficit at prevailing higher interest rates.

1. Source: Bloomberg; data as of June 30, 2026.
2. Source: FactSet; data as of June 30, 2026.
3. Source: Bloomberg, Federal Reserve, Goldman Sachs; data as of June 30, 2026.

Celebrating Credibility

To us, the most notable development during the second quarter was the pronounced shift higher in US interest rate expectations even as those for other major economies generally moderated. One reason for this has been the appointment of Kevin Warsh as chair of the Federal Open Market Committee, replacing Jerome Powell. While Warsh's nomination for the role in March initially had some observers questioning his ability to lead the central bank independent of President Trump's rate-cutting influence, sentiment regarding his credibility has since shifted markedly. While it remains to be seen if Warsh's credibility is merely enjoying a honeymoon period to begin his term, his consistently hawkish tone has helped push two-year Treasury yields and the dollar higher and gold lower.[4]

While we view rate hikes as possible based on Warsh's rhetoric, the deliberate lack of formal Fed guidance under the new regime makes policy trajectory difficult to assess. Further, as credible as Warsh may be, he doesn't have the same degree of policy flexibility that many of his predecessors had given today's fiscal situation. The ability to increase interest rates meaningfully in the face of inflationary pressures is likely constrained by the government's need to continually roll over its existing debt obligation and to finance large primary deficit at prevailing higher interest rates.

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Markets, too, have maintained their credibility in the eyes of investors. Excepting the Covid-19 period, financial conditions in the US are pretty much the easiest they've been in the last couple of decades, as risk perception has remained limited as evidenced by tight credit spreads and generally high equity valuations .[5] The strong demand for financial assets can be seen in the percentage of household wealth invested in equities versus real estate. Currently, more US wealth is held in equities relative to real estate at any point in the post-World War II period. Moreover, the only other times this ratio approached current levels was at two equity market peaks in the late 1960s and late 1990s.[6] The natural response to this demand has been increased equity issuance, which turned positive for the first time since the post-Covid days.[7]

Earnings expectations have helped support the rebound in financial assets. S&P 500 estimate revisions, for example, have been biased higher, primarily driven by the artificial intelligence (AI) infrastructure buildout.[8] Easing oil prices as a fragile peace was reached between the US and Iran have helped. After peaking near $140/bbl on the spot market in early April, Brent crude ended the period around $70/bbl—more or less consistent with pre-war levels.[9] However, the fragility of the deal—which was declared null by Trump in early July following renewed Iranian attacks—combined with operational constraints suggest traffic in the Strait of Hormuz is likely to remain well below normal levels for some time.

Perhaps more impactful to earnings has been households' absorption of tariff- and energy-related price increases. The US personal savings rate declined to 3% in its latest reading, half the long-term average of 6%.[10] Given the very high savings rate of the highest-earning Americans, this trend implies that lower-income households are spending more than they earn and are relying on debt to bridge the gap. This is something to keep an eye on; consumers will need to rebuild their savings buffer at some point, to the detriment of corporate profit margins.

The magnitude of capital expenditures by hyperscalers—companies like Amazon, Apple, Meta, Microsoft and Oracle that operate massive data centers supporting cloud computing—has been another source of support for investor sentiment. Spending on data-center software and information processing equipment relative to GDP

4. Source: FactSet; data as of June 30, 2026.
5. Source: Bloomberg, Federal Reserve, Goldman Sachs; data as of June 30, 2026.
6. Source: Federal Reserve; data as of March 31, 2026.
7. Source: Federal Reserve, Haver Analytics; data as of March 31, 2026.
8. Source: Bloomberg; data as of June 30, 2026.
9. Source: yCharts; data as of June 30, 2026.
10. Source: Bureau of Economic Analysis; data as of May 31, 2026.

now exceeds the dot-com peak, funded primarily out of operating cash flow and, increasingly, debt issuance.[11] While spending on data centers and other AI infrastructure is forecast to continue, its current rate of growth to us seems difficult to sustain. Meanwhile, this spending has produced frictions in the real economy, pushing up prices on inputs ranging from copper to dynamic random access memory (DRAM) chips and serving as an inflationary impulse to the economy as a whole.

Gold Price Continues to Wane

Expectations of less accommodative monetary policy was an anchor for gold during the quarter, dragging the metal's price down by around 14%. At current levels, gold is near its 50-year geometric average relative to the amount of Treasury debt outstanding. We would argue, however, that the quality of Treasuries is not at its 50-year average given the country's massive primary deficit and what may be a structural shift higher in interest rates.[12]

The deterioration of assets like Treasuries is likely among the reasons central banks have continued to be a source of gold demand as they diversify their reserves in an effort to hedge financial and geopolitical risks. Central banks have bought an average of 1,000 tonnes of gold per year since 2022, and gold now exceeds US Treasuries as a percentage of total international reserves. Further, 89% of central bankers polled in a recent survey by the World Gold Council expect global gold reserves to increase in the next 12 months.[13]

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The price of gold had more than doubled over the preceding two years in response to rising geopolitical risk, and a correction upon the realization of a priced-in risk is not surprising and consistent with the pattern observed during similar supply shocks in the Middle East in the 1970s.[14] While the prospect of higher nominal interest rates in an inflationary environment may weigh on gold in the near term, we remain confident in the benefits of a strategic long-term allocation to gold as a potential hedge in diversified portfolios.

Finding Value Beneath the Surface

After struggling during the first quarter, growth stocks surged in the second, and, in our view, value stocks remain cheap relative to growth despite occasional blips of outperformance. That said, there may be more to this story than index-level analysis suggests. Comparing an equal-weighted version of the S&P 500 Index to the traditional market-cap weighted index, for example, reveals that the former is more rationally valued. In fact, the gap between these two indexes is the widest it has been in the last 15 years or so, suggesting potential opportunity outside of the mega cap stocks that dominate benchmark performance. Notably, international stocks have also remained cheap relative to US stocks by historical standards.[15]

11. Source: Reuters; data as of March 17, 2026.
12. Source: Bloomberg; data as of June 30, 2026.
13. Source: World Gold Council; data as of June 16, 2026.
14. Source: Bloomberg; data as of June 30, 2026.
15. Source: FactSet; data as of June 30, 2026.

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All investments involve the risk of loss of principal.

The principal risk of investing in value stocks is that the price of the security may not approach its anticipated value or may decline in value. "Value" investments, as a category, or entire industries or sectors associated with such investments, may lose favor with investors as compared to those that are more "growth" oriented.

Investment in gold and gold-related investments present certain risks, including political and economic risks affecting the price of gold and other precious metals like changes in US or foreign tax, currency or mining laws, increased environmental costs, international monetary and political policies, economic conditions within an individual country, trade imbalances and trade or currency restrictions between countries. The price of gold, in turn, is likely to affect the market prices of securities of companies mining or processing gold and, accordingly, the value of investments in such securities may also be affected. Gold related investments as a group have not performed as well as the stock market in general during periods when the US dollar is strong, inflation is low and general economic conditions are stable. In addition, returns on gold related investments have traditionally been more volatile than investments in broader equity or debt markets. Investment in gold and gold related investments may be speculative and may be subject to greater price volatility than investments in other assets and types of companies.

There are risks associated with investing in foreign investments (including depositary receipts). Foreign investments, which can be denominated in foreign currencies, are susceptible to less politically, economically and socially stable environments, fluctuations in the value of foreign currency and exchange rates, and adverse changes to government regulations.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

Past performance does not guarantee future results, which may vary. The value of investments and the income derived from investments will fluctuate and can go down as well as up. A loss of principal may occur.

Gross domestic product (GDP) measures the total value of all economic output in goods and services for an economy.

Two-year Treasury yield is the interest rate paid on a US Treasury note with a maturity of two years upon issuance.

MSCI EAFE Index (Net) measures the performance of large and midcap equities across developed markets countries around the world excluding the US and Canada. A net-return index tracks price changes and reinvestment of distribution income net of withholding taxes.

MSCI EAFE Growth Index (Net) measures the performance of large and midcap equities exhibiting overall growth style characteristics across developed markets, excluding the US and Canada. Growth investment style characteristics are defined using long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate, long-term historical EPS growth trend, and long-term historical sales per share growth trend. A net-return index tracks price changes and reinvestment of distribution income net of withholding taxes.

MSCI EAFE Value Index (Net) measures the performance of large and midcap equities exhibiting overall value style characteristics across developed markets excluding the US and Canada. Value investment style characteristics for index construction are defined using book value to price, 12-month forward earnings to price and dividend yield. A net-return index tracks price changes and reinvestment of distribution income net of withholding taxes.

MSCI World Growth Index (Net) measures the performance of large and midcap equities exhibiting overall growth style characteristics across developed markets. Growth investment style characteristics are defined using long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate, long-term historical EPS growth trend, and long-term historical sales per share growth trend. A net-return index tracks price changes and reinvestment of distribution income net of withholding taxes.

S&P 500 Equal Weight Index (Gross/Total) measures the performance of the equal-weight version of the S&P 500 Index. The index includes the same constituents as the capitalization weighted index but each company is allocated a fixed weight of 0.2% of the index total at each quarterly rebalance. A total-return index tracks price changes and reinvestment of distribution income.

S&P 500 Index (Gross/Total) measures the performance of 500 of the top companies in the leading industries of the US economy and is widely recognized as a proxy for the US market as a whole. A total-return index tracks price changes and reinvestment of distribution income.

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