

ECONOMIC OUTLOOK

Summary

The U.S. economy entered 2026 carrying meaningful momentum. ISM manufacturing registered its second consecutive month of expansion in February, after snapping a nearly yearlong streak of contraction. January payrolls surprised to the upside at 130,000 jobs added, doubling the consensus estimate of 65,000. This helped push the three-month average back into positive territory at 73,000, while the unemployment rate ticked down to 4.3%. At the same time employment data was improving, headline Consumer Price Index (CPI) continued its downward trajectory, falling to 2.4% year-over-year. While fourth-quarter GDP was nearly half of the expected value at 1.4% annualized, much of the deceleration can be attributed to the lingering effects of the government shutdown, which distorted data collection and economic activity. Looking ahead, consumer spending should receive a material boost from provisions in the One, Big, Beautiful Bill Act as larger tax refunds begin injecting real dollars into household wallets.

That constructive backdrop quickly moved to the back of the mind on February 28 as investors weighed the economic implications of the coordinated U.S. and Israeli military strikes against Iran. The Strait of Hormuz, through which roughly 20% of global seaborne oil passes daily, has effectively shut down as major shipping companies suspended transit and insurers withdrew war-risk coverage. Brent crude surged by nearly 15% to trade in the low \$80s in the days following the first strike, while European natural gas futures spiked more than 50% after Iranian strikes damaged Qatar's liquefied natural gas (LNG) facilities. While the United States is better positioned than in past oil shocks as a net energy exporter, global supply disruptions of this magnitude have a way of filtering through to domestic prices and sentiment.

The implications for the economy and the Federal Reserve are significant. Markets now price virtually no chance of a March cut and odds of more than one reduction this year have

modestly declined. Core PCE, the Fed's preferred measure of inflation, has ticked back up to 3.0% year-over-year, evidence that inflation was proving sticky well before the conflict began. Now, surging energy prices threaten to push headline measures further from the Fed's 2% target while gradually flowing into broader costs. The range of outcomes from here is wide. If the conflict proves short-lived, the economy's underlying momentum and approaching fiscal tailwinds should reassert themselves. If it extends and oil pushes toward \$100, the inflation progress of recent months risks unwinding and higher energy costs could dampen the consumer momentum that has been a pillar of this expansion. The duration of this conflict, in particular, the Strait of Hormuz disruption, will be a defining variable.

Positives

January nonfarm payrolls significantly exceeded expectations (130k vs. 65k est.)

Headline CPI continues to decline, falling to 2.4% year-over-year

ISM manufacturing remains in expansion for the second consecutive month (52.4)

Negatives

Increasing energy prices due to geopolitical conflicts

ISM Manufacturing Prices Paid surged 11.5 points to 70.5, the largest monthly increase since '22

Diminished Federal Reserve rate cut expectations

EQUITY OUTLOOK

Summary

February was a generally choppy month for equity markets that concluded with a more nervous tone. The S&P 500 Index was lower by 0.8%, though the S&P 500 Equal Weight Index (EWI) was up 3.5%. The rotation out of growth stocks into value stocks continued during the month. The Russell 1000 Growth Index lost 3.4% while the Russell 1000 Value Index gained 2.6%. The Russell Midcap Index climbed 3.8% and the small-cap Russell 2000 Index added 0.8%.

With earnings season almost in the books, results and guidance have been mostly positive, but the market's reaction has not always translated as expected this quarter. As the month progressed, it seemed as though the street was looking for any reason to punish the smallest negative details. While the fundamentals still look solid and aggregate earnings growth trending at 14% to 15% year-over-year, equity markets appear fatigued in the near term.

The artificial intelligence (AI) bubble talk continues to echo and this month discussions reached a crescendo over what business models will and will not survive the pending AI metamorphosis. Software companies were ground zero incurring a valuation reset due to AI disruption, but it quickly spread to real estate, insurance, travel and other industries. The equity markets seem to be wrestling with the question whether these selloffs are justifiable or overblown. There are solid arguments to be made either way.

On the final day of February, U.S. and Israeli forces launched significant military strikes on Iran. This may result in a difficult and prolonged operation. The stock market's immediate response has been mostly muted but the longer the fighting continues, the more impactful the repercussions are likely to be on economic and market stability.

The outlook for equity markets appears to be mixed at the present time. The economic conditions and fundamentals are mostly favorable but stretch valuations and geopolitical tensions are likely to create near-term headwinds.

Positives

Corporate earnings growth

Tax refunds, World Cup and America 250

Improving market breadth

Negatives

Historically stretched valuations

Elevated geopolitical tensions

FIXED INCOME OUTLOOK

Summary

Bonds finally experienced an average month of volatility in closing yields. Following nine months of muted intra-month changes, the market saw a 33-basis point (bp) swing from a high of 4.28% on February 1 to a low of 3.94% on the last day of the month — the lowest close since October 2024. The 2-year yield dropped 15 bps to close at 3.38%, its lowest level since August 2022. The sharp decline in longer yields drove Treasury bonds to their largest gain in 12 months.

The broader economic outlook remains largely unchanged, supported by retail sales and capital expenditure data. The expectation of slow job growth with sticky inflation is consistent with prior forecasts. A few new developments fueled the yield decline. First, advancements in artificial intelligence (AI) raised concerns many software providers could become obsolete, pressuring equity prices and the loans of smaller companies. There are also increasing fears AI will further weaken an already slow labor market. Additionally, credit stress continued in syndicated and private loan markets, with several additional borrowers restructuring or defaulting. Finally, and likely more impactful, was the buildup of military assets in the Middle East as negotiations with Iran stalled. Despite these risks, the rate cut outlook has not materially shifted.

New issuance of investment-grade corporate bonds remained robust, with \$193 billion priced in February — 31% above the prior four-year February average per JP Morgan research. Investors absorbed the supply but demanded wider spreads, which increased 11 bps from record tight levels to an average of 84 bps per Bloomberg. As a result, intermediate investment-grade corporate bond returns (0.98%) trailed same-maturity range Treasury returns (1.20%) for the month.

A flight to safety is the typical playbook during military escalation or credit stress. Asian markets followed this pattern after the Iranian strikes on Saturday, but the dynamic quickly reversed when U.S. markets opened Monday. Yields moved 20 bps higher over four days as a 20% spike in oil prices reignited inflationary concerns.

Given the difficulty of assessing the duration or outcome of the Iranian conflict, speculating on its long-term impact on oil prices remains unproductive. Even if prices stay elevated, we question whether higher borrowing rates would meaningfully reduce that inflationary pressure without triggering a significant economic contraction. As such, we do not view a Fed rate increase as likely but can understand delaying cuts until there is greater clarity. We are maintaining a neutral duration policy and will continue using yield spikes as opportunities to add duration as portfolios age. We have been selectively increasing exposure to certain corporate bonds and sectors as spreads widened and remaining modestly overweight in aggregate.

Positives

Yields moved sharply higher following attacks on Iran

Potential for a “flight to safety” from U.S. and global investors

Tariff and housing impact on inflation should be waning

Negatives

Future rate cuts may be on hold given the increase in oil prices

Labor market remains resilient even with slow rate of hiring

Corporate bond issuance continues to be heavy due to technology cap expenditures

Unknowns

Outcome/resolution to military conflict with Iran

Oil prices and their impact on inflation

AI's ability to upend traditional software providers and developers