July 2026

Quarterly Market Review

Second Quarter of 2026

Growth Absorbs the Shock; Inflation Gives Fed Pause

Ed Goard, CFA
Chief Investment Officer

The second quarter of 2026 marked a sharp rebound in equity markets and a meaningful shift in the macro debate. At the end of the first quarter, investors were focused on the economic impact of the Middle East conflict, the energy supply shock, and renewed concerns around private credit. By quarter-end, those risks had not disappeared, but markets had largely moved past the most acute phase of the stress. The S&P 500 returned 15.2% in Q2 and 10.2% year to date[1], while the Bloomberg U.S. Aggregate Bond Index returned a very modest 0.7% for the quarter and 0.6% year to date.[2]

The more important development, however, was the resilience of the U.S. economy. Growth continued to run faster than many expected given the energy shock. Manufacturing improved, the labor market remained firm, consumer spending held up, and AI-related capital spending provided a powerful offset to geopolitical and inflation headwinds. The result was a market environment defined by three related forces: resilient growth, sticky and accelerating inflation, and a Federal Reserve that no longer appears close to easing and may in fact hike.

Inflation has re-emerged as the dominant macro risk. Headline CPI and PCE have both moved back above 4% year over year, core measures of inflation remain near or above 3%, and pipeline measures such as PPI, import prices, and export prices suggest price pressures remain elevated and may accelerate.[3] What began as an oil shock has shown signs of broader pass-through into goods and services. That matters because the longer inflation stays above target or accelerates, the more difficult it becomes for the Fed to look through the shock.

Economic and Policy Backdrop

The economy entered the quarter with a high degree of uncertainty, but incoming data continued to point to resilient activity. Payroll growth remained supportive through most of the quarter, unemployment drifted lower, and job growth remained sufficient to support income and spending. Manufacturing indicators also improved, with ISM manufacturing signaling expansion for six consecutive months, while capital spending and industrial activity continued to benefit from reshoring, infrastructure investment, and AI-related demand.

The consumer also continued to spend. Retail sales remained solid despite weak sentiment surveys, reinforcing the gap between what consumers say and what they do. Job growth and income remain the primary drivers of household spending behavior, and for now those supports remain intact. Fiscal tailwinds, including tax refunds and capital spending incentives, have also helped cushion the economy from higher energy prices and broader affordability pressures.

The Federal Reserve is now facing a more complicated policy mix. Earlier in the cycle, the dominant question was when the Fed would begin cutting rates. That has shifted to whether the Fed may ultimately need to hike again. Warsh's arrival as Fed Chair has made the policy outlook less predictable. Although he was expected by some to favor easier policy, his early messaging has emphasized the Fed's inflation target and a less forward-guidance-driven approach. With growth resilient and inflation no longer simply elevated but showing signs of reacceleration, markets are beginning to consider the possibility that hikes may be necessary.

Treasury yields reflected this shift. Yields rose across most of the curve during the quarter, with the largest moves concentrated in the front and belly of the curve. The 2-year Treasury yield rose nearly 38 basis points, while the 10-year rose roughly 15 basis points, ending the quarter near 4.47%.[2]. We believe the move reflected a market repricing for reaccelerating inflation and a Fed that can't easily justify lowering rates.

Equities

Equity performance was exceptional in Q2. The S&P 500 gained 15.2%, the S&P 500 Pure Growth Index rose 36.8%, and the S&P Small Cap 600 advanced 19.7%. Technology led the S&P 500, with the sector up 31.8%, but the rally was broader than the headline leadership suggests. Industrials gained 14.9%, while mid cap rose 14.5%.[1]

This broadening remains one of the most important market developments of 2026. Market leadership is no longer exclusively dependent on the Magnificent 7. The S&P 500 Equal Weight Index and Russell 2000 reached new highs in mid-June, while only one Magnificent 7 stock made a new June high.[2] Fundamentally weighted strategies, mid-caps, small caps, REITs, and other non-mega-cap segments all showed strong year-to-date performance. AI remains a powerful theme, but its benefits are spreading beyond the largest platform companies into semiconductors, infrastructure, utilities, industrials, and suppliers.

Earnings have also improved meaningfully. 2026 S&P 500 earnings growth expectations rose from 12.2% at the start of the year to 23.9% by the end of June, while sales growth expectations increased from 6.5% to 10.6%. Importantly, all but two sectors saw both earnings and sales estimates revised higher, which indicates the rally has not been purely multiple-driven.[4]

Still, valuation discipline matters. The market is expensive on most historical measures and estimated next-12-month S&P 500 operating margins are at a record 20.7%.[4] High margins support earnings, but they also raise the bar. A market priced for strong growth and high profitability has less tolerance for disappointment, especially if inflation pressures keep rates elevated.

Fixed Income and Credit

Fixed income returns were limited by higher Treasury yields. The Bloomberg U.S. Aggregate Bond Index finished modestly positive, but the quarter was challenging for duration as markets priced in Fed cuts as early as October 2026 as well as greater policy uncertainty. The rate move was concentrated in shorter and intermediate maturities, consistent with a Fed that is likely to remain on hold and may eventually face renewed pressure to tighten if inflation fails to moderate.

Credit markets told a more constructive story. Intermediate BAA corporate spreads ended the quarter near 80 basis points, down from the March peak of roughly 104 basis points. Lower-quality high yield spreads also tightened materially, with BA/B spreads ending near 202 basis points after reaching nearly 270 basis points in late March.[2] In other words, Q2 fixed income weakness was primarily a rates story, not a credit deterioration story.

This distinction is important. Public credit markets appear to be treating the first quarter widening as a growth scare rather than the start of a broader default cycle. Spreads remain tight by historical standards, so we don't view credit as inexpensive, but the absence of persistent stress supports the broader view that the economy remains resilient.

Private credit remains worth monitoring. Redemption pressure and valuation questions haven't gone away, but public markets aren't currently signaling systemic risk. For now, the issue appears more likely to affect specific managers and vehicles than the broader financial system.

Strategic Outlook

Our outlook remains constructive, but the balance of risks has changed. The economy continues to benefit from solid labor markets, resilient consumer spending, fiscal policy support, and a powerful capital spending cycle tied to AI, infrastructure, and reshoring. These forces have allowed growth to absorb the energy shock better than expected. At the same time, the key risk is now inflation persistence. If the energy shock continues to pass through into broader goods and services prices, the Fed may have little choice but to remain restrictive for longer. Rate cuts are no longer the base case for the near term, and renewed hike discussions are no longer unthinkable. A higher-for-longer environment is our expectation, with 1-2 hikes by late spring 2027.

The second quarter reinforced several key themes. First, growth remains surprisingly resilient. Second, inflation has re-emerged as the dominant macro risk. Third, the Fed has shifted from when to cut, to could they hike. Fourth, the consumer is not rolling over, even if sentiment remains weak. Finally, market leadership continues to broaden beyond the mega-cap technology complex.

In equities, we continue to favor diversified exposure beyond the S&P 500 as well as fundamental strategies that reduce excessive concentration risk. AI remains an important growth driver, and its benefits are spreading across a wider set of industries, which supports broader participation. At the same time, equity valuations are elevated, and strong earnings expectations leave less room for disappointment. That argues for maintaining equity exposure, but with greater attention to valuation, quality, and diversification.

In fixed income, we favor a moderate tilt toward credit and away from duration. Yields remain attractive, and credit fundamentals continue to look reasonably healthy, but spread valuations are tight after the second-quarter rally. That limits the margin of safety and argues for maintaining flexibility should better entry points emerge. Q2 was a reminder that markets can recover quickly when growth holds, but it was also a reminder that sticky or accelerating inflation can keep the Fed on hold, with a possibility of hiking, denying investors the lower rates they had been expecting.

July 2026

Quarterly Market Review

Second Quarter of 2026

Disclosures

[1] Source: Standard & Poors as of 6/30/2026
[2] Source: Bloomberg as of 6/30/2026
[3] Source: Bloomberg/Bureau of Economic Analysis as of 7/2/2026
[4] Source: Strategas Research Partners and Factset

This commentary is provided for informational purposes only and should not be construed as investment advice or a recommendation to buy or sell any security. The views expressed are those of YCM as of the date of publication and are subject to change without notice. Information contained herein has been obtained from sources believed to be reliable; however, YCM does not guarantee its accuracy, completeness, or timeliness. Opinions expressed are subject to change without notice as market and economic conditions evolve. Past performance of investment strategies discussed is no guarantee of future results or returns. Index performance is shown for illustrative purposes only. Indexes are unmanaged and are not available for direct investment. It contains statements of opinion and forward-looking statements that reflect YCM's current views, expectations, estimates, and assumptions as of the date of publication. Forward-looking statements are inherently uncertain and actual economic, market, or other conditions may differ materially from those anticipated. There is no assurance that any forecasts, projections, or opinions will be realized. Yousif Capital Management, LLC, YCM, is a registered investment advisor based in Bloomfield Hills, MI. A more detailed description of YCM, its management team and practices can be found in the firm's brochure, Form ADV Part 2A, which can be requested by contacting the company or at adviserinfo.sec.gov.