Post Oak Private Wealth Advisors

ADVISORY, CONSULTING & INVESTMENT MANAGEMENT

April 2026

Monthly Market Commentary

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The stock market's "goldfish brain" was on full display at the start of April, seeming to forget last month's anxieties over the Iran conflict as soon as the calendar page turned. The S&P 500 snapped back from its 5% drop in March to rise 10.5% in April—the best month for stocks since 2020—while the Nasdaq Composite Index recouped last month's losses with a 15% gain.

The market turned on a dime early in the month following news of negotiations between the U.S. and Iran and the possibility for a cease fire that would open the Strait of Hormuz. These initial signs of progress eased some of the pressure from high oil and fuel prices and lifted the S&P 500 into record territory. But a kind of "no war, no peace" stalemate has since settled in with little progress on the diplomatic front and competing blockades constraining the energy trade and sustaining higher energy prices.

The stock market can have a short attention span when it comes to certain external events, particularly military conflicts that don't have an immediate economic or financial impact. I shared in last month's report the stock market's track record following the start of previous military actions, showing that stocks have convulsed in the near term but eventually posted gains over the next 12 months and the longer term. Perhaps that's what we're seeing today. But with uncertainty still looming over the entire Middle East situation, the potential for more surprises and market downturns is out there. The better news is that a bigger story—one that's more fundamental to future stock returns—has captured the market's attention: earnings.

All about the earnings

We are in the midst of Q1 earnings season as I draft this month's report, and just over 60% of S&P 500 companies have announced results. The picture is not yet complete, but it's shaping up to be another stellar period for earnings growth. As of May 1, the blended Q1 earnings growth rate (which includes actual results of reporting firms and estimates for those yet to report) stood at an astonishing 27% year-over-year, which if sustained would mark the sixth-straight quarter of double-digit earnings growth. Revenues and margins are expanding too—net profit margin for S&P 500 firms is at 17-year highs—which speaks to the resilience of U.S. businesses given the threats from higher energy prices and uncertainty about the impacts on the economy. A remarkable 84% of S&P 500 firms that have reported Q1 earnings have beat expectations, which is above the 5- and 10-year averages. The size of those earnings beats has also been impressive and above long-term averages.

As investors, we pay more attention to earnings beats than the size and quality of company earnings because markets are forecasting mechanisms and consensus earnings estimates are

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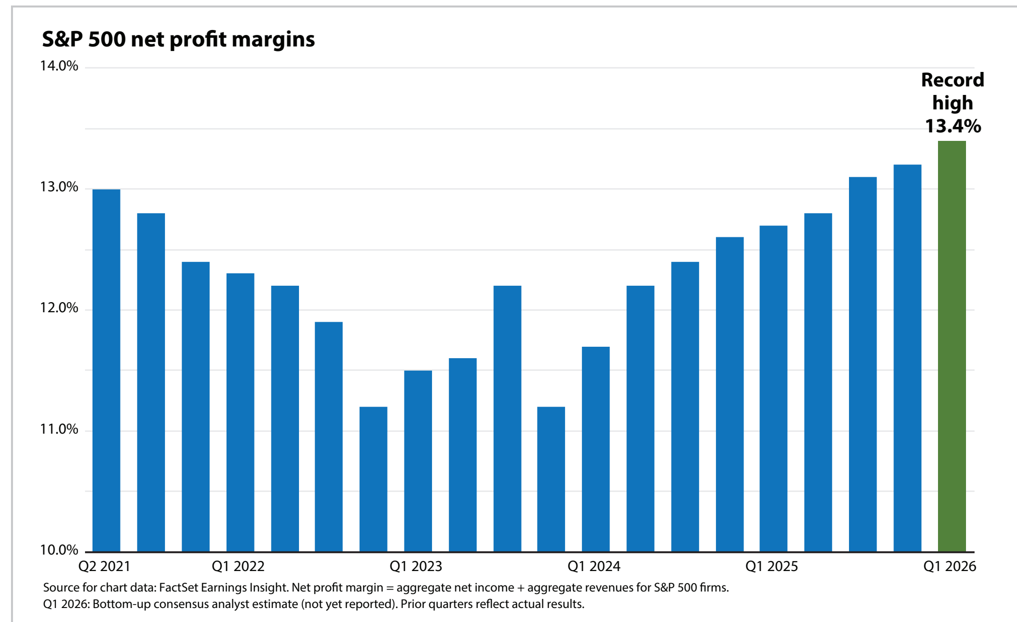

essentially "baked into" or reflected in current market prices. This is what happens when a company reports good news, such as a 10% increase in profits, but sees its stock price fall because a better result had been expected. The same dynamic works in reverse; a bad result—say, a 6% decline in quarterly earnings—could help the stock price rally if a worse result had been expected.

Something similar was at work during this recent earnings season. A host of big tech firms—Alphabet, Amazon, Meta Platforms and Microsoft—reported earnings on Wednesday, April 29. Taken together, the reports were solid; revenues and net income topped expectations. But investors zeroed in on capital expenditures; each firms announced big increases in spending going forward, on top of the large investments already committed. The market reaction was mixed with Alphabet (parent company of Google) rising 10% on the day while Meta (parent of Facebook) sank 8.5%.

So, we must be aware not only of the actual earnings number that's reported but also what the market expects the result to be. The loftier the earnings expectations, the harder they are to achieve, which also means a higher potential for a disappointment that could lead to a stock pulling back. By most valuation metrics, the broad US stock market is extremely expensive at present; only three times in history has the S&P 500's price/earnings ratio been higher. This doesn't necessarily mean stocks are heading for an imminent correction; typically, if earnings results are strong and exceed expectations, the market continues to rally regardless of valuations. Stocks tend to correct when expectations are not met.

Looking under the earnings hood

The strength of Q1 earnings provided the catalyst for the stock market's rally in April, but it's important to note that earnings and stock performance continues to be driven by a narrow range of companies and sectors. Technology remains the biggest sector in terms of earnings growth, but mostly because of chipmakers NVIDIA and Micron Technology were responsible for that half of that growth. Another example is GE Vernova, which helped the industrials sector deliver strong quarterly numbers by smashing expectations with Q1 earnings per share of $17.44 versus

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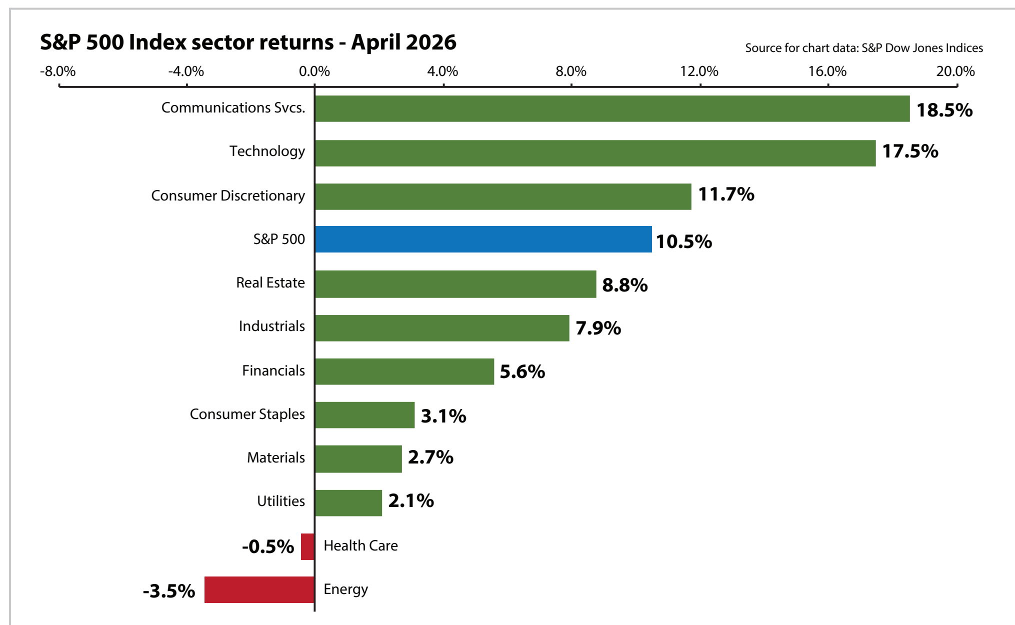
estimates of $1.95. These firms and others in the same industries are on the front lines of the AI investment boom and benefiting directly from the vast capital expenditure sums that the tech behemoths are spending to win the AI race.

As of April 24, eight of the 11 S&P 500 sectors have reported quarterly earnings growth, but earnings slipped in health care and energy. Even within these lagging sectors, the losses can be traced back to two key firms: ExxonMobil and Merck. The divide in earnings growth also translated to monthly performance, highlighting the attention and scrutiny that stock investors are bringing to company fundamentals. The lagging energy and health care sectors also were the worst performers and only decliners in April, while the growth-stock standard-bearers—technology, communications and consumer discretionary—outperformed. The tech sector as a whole contributed over half of the S&P 500's gain for the month.



The fog surrounding the Iran conflict

The numbers for Q1 earnings seasons have been impressive by themselves, but they may be more remarkable when considered in context with the opaque economic climate. Businesses had been operating in a fog of uncertainty for much of last year, due to tariffs threats and trade policy shifts, but the start of the Iran conflict this year added another layer of mystery that poses a potential threat to their revenue and margin growth. While other regions in the world are coping right now with the economic impacts of higher energy prices and constrained oil supplies related to the conflict, the ripple effects may be starting to hit U.S. shores.

The latest batch of economic data was a mixed bag, which may not be encouraging to businesses and investors who want clarity but shows there are positive signs for the U.S. economy to build on. To start with the good news, economic growth for Q1 was positive with 2.0% year-over-year GDP growth, an improvement over Q4 of last year. The end of the federal government shutdown last quarter helped this quarter's numbers, but unsurprisingly AI spending powered much of this growth with consumer spending slowing from the previous quarter. In fact, it's estimated that

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AI spending accounted for more than 50% of first-quarter GDP. The jobs market also had good news to share; the 178,000 new jobs added to nonfarm payrolls in March defied expectations and came as a relief following the big decline in February.

But if we're going to see adverse effects of higher oil prices, it's going to show up in the monthly inflation reports. The March CPI report showed consumer-price inflation rising 3.3% year over year, the hottest pace of growth in nearly two years. Gas prices fueled the inflation surge, jumping around 19% from the previous month. PCE inflation, which is the Federal Reserve's preferred inflation gauge, rose 3.5% from the same month one year ago, with an 80% monthly increase in consumer spending on gas and other energy products providing the catalyst for the inflation surge.

With evidence of higher energy prices beginning to appear, the Federal Reserve has little reason to consider cutting interest rates at this time. The April FOMC meeting passed with the central bank holding the line on monetary policy, which was not necessarily news as the decision to hold was widely expected. What was not expected after the Fed meeting was dissent among FOMC members, which is an indication of the divide on the future path of interest rates that awaits the incoming Fed Chair, Kevin Warsh. The likelihood of any move by the Fed for the rest of the year is low as the central bank waits for more signs to emerge from the fog to see how the U.S. economy weathers the storm from rising oil prices.

Prudent investing starts with timeless principles

Both earnings results and stock market performance continue to underscore the massive scale of the transformation in the U.S. economy due to the adoption of artificial intelligence and the buildout of the infrastructure needed for this revolution. While some companies are reaping rewards in the present day from this transformation, the reality is we are still in the early innings. It's difficult to know who the ultimate winners and losers from the transition will be or what the economy will look like in a few years.

But as my colleague David Marion, CFA says, "There are a few investment principles that are timeless: stock prices are driven by earnings; and the multiple that investors are willing to pay for those earnings." The results we have seen in the current earnings season so far are ahead of even the aggressive estimates analysts made at the start of the year. Should this trend of earnings beats continues and stock valuations adjust to those beats, it's reasonable to expect the stock market to climb to stay on a record-setting path, although not without some bumps and dips along the way.

Following such an excellent month for investors, we anticipate the remainder of earning season to be positive and are optimistic about the future. As has always been the case throughout history, there will continue to be situations like the situation in Iran that warrants concern, but U.S. financial markets have demonstrated and should continue to demonstrate resilience and quality companies will continue to innovate to reward shareholders over the long term.

From the entire Post Oak team, we wish you and your families a happy and safe May. We look forward to speaking with you soon.

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