2026 Q1 Economic Update and Outlook

After a solid start to the year, stocks swooned in March, with the Vanguard Total Stock Maret Index fund (a good proxy for the entire US stock market) going from a positive year-to-date return of 2.4% in late January to -6.7% in late March. While a 9% negative return is common historically, in recent years such things are not supposed to happen. Not to worry, investors quickly got used to $100 oil, or decided that it just didn't matter or wouldn't last, and stock prices rallied again. From the end of the quarter to the date of this writing (June 4), the S&P 500 has returned about 15%.

Damir Tokic calls the current market the "Mother of All Bubbles." This is due to what he describes as a "bubble in earnings", with a historically high 42x Shiller Price/Earnings (P/E) ratio applied to these peak earnings.[1] Two years ago, John Hussman wrote, "In general, if you want to make a lot of money, and you want to have a long bull market, you need high unemployment, depressed profit margins, and depressed P/Es. It's beautiful double-counting. Multiplying depressed earnings by a low P/E is really double counting. Multiplying peak earnings by a high P/E, which is what we're doing today, is also double jeopardy the other way. And the gap between peak P/E times peak profits all the way to trough P/E times trough profits, that's a big run. That's the kind of thing we saw ending up in 1974 and 1982, and to some extent in 2009. Yes, it was somewhat higher in 2009 than 1982, but the discount rate, interest rate, everything else had shifted, and it was down an awful lot from its peak."[2] In other words, your best performance follows the worst of times – when things have nowhere to go but up, and simply looking at the P/E is inadequate because the E is also cyclical.

Tokic argues that profits have been driven by globalization, fiscal and monetary expansion, and favorable demographics, all of which are now reversing. To wit, in 2000, government debt was only 56% of GDP, but is now 125%. The monetary base in 2000 was 4.2% of GDP, but is now 23%.[3] While it is impossible to know the exact peaks, government debt/GDP over 100% is consider high, and the Fed's balance sheet is a multiple of what it

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[1] (Tokic, 2026)
[2] (Hussman, 2024)
[3] (Tokic, 2026)

has historically been, making a continuation of the recent trends unlikely. The demographics in 2000 favored continued spending and investment, with the Baby Boomer cohort 35-55 years old. Today they are 60-80, which is an age when spending typically declines.

For a long time, I have been arguing that a major driver of increased corporate profits has been lower tax and interest rates. Michael Solyansky, from the Federal Reserve, quantified this in a 2023 paper, “End of an era: The coming long-run slowdown in corporate profit growth and stock returns”. He found that over 40% of the real growth in corporate profits from 1989-2019 was from lower interest expenses and lower taxes. The percentage of Earnings Before Interest and Taxes (EBIT) going to interest and taxes dropped from 54% to 27% over that time period, allowing profits to grow 3.8% per year (nearly double the 1962-1989 rate) while EBIT grew only 2.2%, after adjusting for inflation. In other words, much more of corporate earnings went to owners instead of creditors and Uncle Sam. That’s been a great thing for investors, but not drivers we should count on permanently boosting growth.[4]

One might ask, if market observers have been commenting on peak earnings since at least 2023, and earnings keep rising, should we pay attention? S&P 500 earnings continue to grow. Have their warnings been discredited? I do not believe so, for two reasons. First, we only know an actual peak in retrospect. We can observe that conditions correspond with those from prior peaks, and that drivers of increased profitability seem exhausted or reversing. We can identify catalysts that might cause earnings growth to revert to normal levels. But we cannot precisely predict when something as complex as the world economy will turn. I believe we were probably seeing the beginning of a downcycle in 2022, but late that year it was interrupted by ChatGPT, which reignited corporate spending and investor euphoria. The Federal Reserve estimates spending on software, data centers, information processing and Research & Development to have boosted GDP by almost a full percentage point or about 39% of GDP growth for the first three year quarters of 2025, significantly above its long-term average of 0.39% contribution, or 12% of growth .[5] This doesn’t capture the increase in capital spending on electricity production to power data centers. Ostensibly, as spending has continued to increase, so has the contribution to GDP growth. I’ve seen estimates of $600B in data center spending by hyperscalers in 2026, which is about four times Microsoft’s earnings. If there is a multiplier effect on this spending (i.e. contractors who earn good money building data centers likely spend more than they otherwise would have, and so on) the effect is even greater. While the effect on

[4] (Smolyansky, 2023)
[5] (Patro, 2026)

GDP and corporate revenue growth is significant, the effect on profits is even greater. This has to do with an accounting technicality. If a company spends on building out data centers, the spend is current revenue to the suppliers, but the expense to the hyperscaler is spread out over the useful life of the asset, and this doesn't start until the asset is placed in service. Most of the spending on building data centers in 2026 will not show up as an expense until 2027 and beyond. Another factor in recent impressive earning growth is an accounting standard (SAU 2016-01) which requires companies to mark their investments to fair market value each quarter, with gains or losses being recorded on the Income Statement. As private equity values rise (without necessarily having the support of actual transactions to verify the alleged value) the publicly traded companies book earnings for their paper profits on investments. Professor Baolian Wang found that for Q1 '26, these paper gains from just three companies (GOOG, AMZN, NVDA) added about 12% to the annualized growth of the S&P 500, boosting it to 28%. Even if these gains are real, they generally do not receive the same multiple as operating earnings, as they are not part of the core business and not likely to recur.[6]

During the tech bubble, Scott McNealy famously ridiculed his own stock trading at 10x revenue. A recent check on YCharts of global stocks worth $20 Billion and up shows 127 companies globally trading at over 10x revenue, for a total of $46.6T in market capitalization. The global value of all publicly traded stocks is about $127T, so a little over a third is in this formerly rare valuation strata. The ten largest US companies with price/revenue above 10x combine for over $29T in valuation. One could discount price/revenue as a relevant metric, as bottom line earnings or cash flow are more representative of what owners get to keep, but price/revenue neutralizes the profit margin, which makes sense if we believe it will revert to its mean.

Where do things go from here? My crystal ball is currently in the shop, and as the great sage Yoda said, "Hard to see, the future is." Things have already gone on much longer than I expected. Or as Keynes allegedly stated, "The market can remain irrational longer than you can remain solvent." Fortunately, we are not dependent on a market view to enjoy reasonable returns. That said, while things could continue, the longer you go without a fire, the worse the fire is when it finally comes. (As a Californian, this metaphors resonates with me.) Valuations on nearly any metric are in historical territory, even as uncertainty is very high. The upcoming IPOs of SpaceX, Anthropic, and OpenAI, among others, could boost investor enthusiasm, and lead the markets even higher, or could pull capital from the current shiny objects to fund the latest fad. I favor the second theory, but this will be interesting. The impact on index investors is likely to be negative. An article posted by

[6] (Wang, 2026)

MSCI in February showed that the top ten constituents of the MSCI All Country Venture Backed Private Company Index had a total valuation of about $3T. Companies are added to indices based on the amount of free float available (shares offered to the public). At just a 5% float, the largest four would be added to the MSCI index, while at 25% float, all ten would be added.[7] This article "only" had a $800B valuation for SpaceX, but more recent estimates are for $1.75T or even more. Furthermore, the NASDAQ is waiving its float requirement and using a 3x float multiplier for new stocks with less than 10% of outstanding share available.[8] This seems manipulative. For instance, if SPACE-X sells 5% of outstanding shares at a $2T valuation (raising $100B), indexers will need to buy shares as if 15% of the stock is available, even though only 5% truly is. This would push SpaceX to about 0.5% of the NASDAQ 100 index, but more importantly, would force NASDAQ indexers to buy even more of a stock that has very limited availability. Indexing already suffers from being a forced buyer of stocks being added to the index and a forced seller of stocks being removed. Avantis Investors notes that the Russell reconstitutions taking place in late June will already require Russell 1000 index funds to buy 212-541% of the average daily volume for companies being added and to sell 620-800% for companies being deleted. The Russell 2000 is even worse, with additions requiring 1000-1400% of average daily volume and deletions 2250-11140%. This means that for one stock in particular, the index funds will sell over 100x the average daily volume on the day of the reconstitution. These transactions will create a drag for index fund investors as they quietly do year after year. The cost of the newly public companies could be much larger. For instance, the largest company expected to be added to the Russell 1000 is Sunbelt Rentals Holdings (SUNB) with a market capitalization of $33.6B. SpaceX, at a $1.75T valuation would be well over double that size, with some indexers required to buy a multiple of the float. Many holders will be retail investors who are buying with high hopes of making a lot of money and will not easily be convinced to sell their shares right way even if the price jumps. In fact, that might encourage them to hold on even more tightly. A jump in the price from the IPO for SpaceX (or Open AI or Anthropic) will be good for those who bought on the IPO, as well as for those who owned shares pre-IPO, but it will be bad for index investors who will be forced sellers of other securities to make space (no pun intended) for the new IPOs, for which they are forced buyers. One could cynically conclude that the insiders are trying to boost the price as high as possible before their lock-ups expire so they can try to sell at inflated prices once trading history has been established.

A related question is whether investors should try to participate in the blockbuster IPOs. I can confidently say, "I don't know." History is not on your side. Avantis Investors

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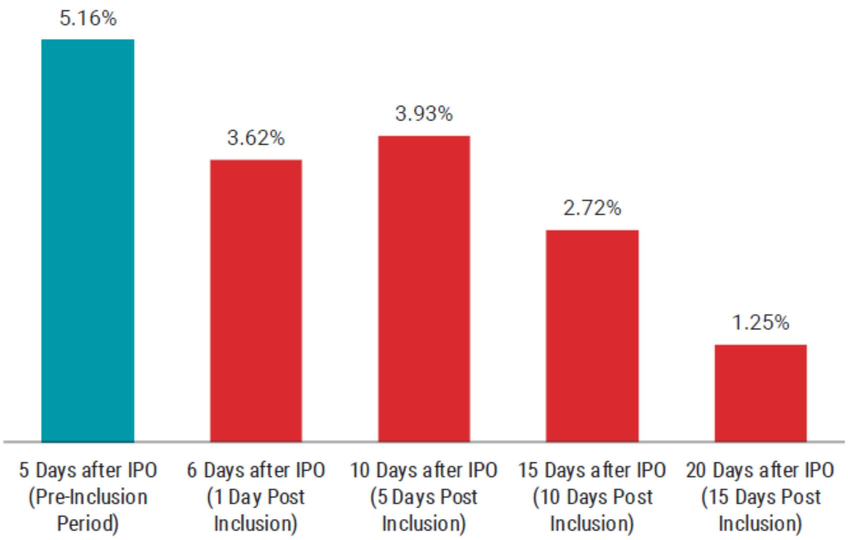
[7] (How Megacap IPOs in 2026 Could Reshape Global Benchmarks, 2026)
[8] (Friesen, 2026)

found that Fast-Tracked IPOs (in other words, those who had the obligatory waiting period reduced to 5 days as these new ones will have) averaged about -4% in the first 15 days post-index inclusion. The fast-track index inclusion in this case is designed to boost the stock price, so there could easily be a short-term buying frenzy a few days after the IPO. Intrepid investors may try to capitalize this by buying into the IPO to flip to the index funds a week later, but given that the IPOs are already at nosebleed valuations, this seems very risky.

Figure 4 | CRSP Index Fast-Tracked IPOs Have, on Average, Cost Index-Tracking Funds

Performance of IPOs Fast-Tracked into CRSP Indexes vs. Other IPOs Included by CRSP (Pre- and Post-Inclusion), 2017-2023



DAYS POST INDEX INCLUSION	1 DAY	5 DAYS	10 DAYS	15 DAYS
SHORT RUN PRICE IMPACT	**-1.54%**	**-1.24%**	**-2.45%**	**-3.92%**

Data from 2017 – 2023. Source: Chris Murray and Marco Sammon, "Primary Capital Market Transactions and Index Funds," July 2025. Available at SSRN. Short run price impact is the difference between the fast-track IPO return premium over the 5 days after IPO (pre-index inclusion) and the return premium from IPO through day 6/10/15/20 thereafter. The results show that the outperformance observed in the 5 days after IPO (prior to index inclusion) has on average dissipated materially in the weeks after index inclusion (after the first 5 days from IPO).

Source: Avantis Investors

Asset Class and Strategy Review[9]

[9] Because this newsletter is available to non-clients, we won't comment on specific funds. The funds being referenced are believed to do a good job capturing generic exposure to their strategy or asset class, and are not recommendations.

Finally, we take a look at recent performance of various asset classes and factors. The S&P 500 lost about 4.3% in the first quarter, but has subsequently rebounded to a +10.9% (as of 6/4) for the year on one of the strongest two-month [10]bounces in history. Small caps (IWM) briefly dipped negative in March, but finished the quarter slightly positive and now have returned 17% year to date. Value (VTV) has done a little better than the S&P 500 at 12.3%, and notably never dipped negative this year. It had a positive 3.3% return in the first quarter, but its 7.6% outperformance over the broader index has shrunk to just 1.4% year to date. Momentum (MTUM) lost 4.4% in the first quarter, but has been on an absolute tear since then and is now up 31.75% year to date. International developed markets returned about 2.7% in the first quarter and 14.9% year to date. Emerging markets (VWO) were roughly flat in the first quarter and are now up 12.2%. Bonds (AGG) were also breakeven in the first quarter, and have returned just 0.26% year to date, as interest rates have risen modestly, offsetting the yield earned. While we enjoy watching account balances rise as seeing our clients accumulate paper wealth, we expect that some part of the recent returns are borrowed from the future.

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investment indices and/or categories generally may not reflect the deduction of transaction and/or
custodial charges, nor the deduction of an investment management fee, the incurrence of which would have the effect of decreasing historical results.