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In Brief

July was characterized by a period of consolidation in U.S. equity markets following a strong first half of the year. The S&P-500 declined a modest 0.06% during the month. Beneath the surface, market participation broadened. Semiconductor stocks recovered from their earlier correction following Microsoft's strong earnings, which provided the first meaningful evidence that substantial investments in artificial intelligence are beginning to translate into higher revenues and profitability. At the same time, Industrials, Financials, and Health Care outperformed as investors increasingly favored companies benefiting from infrastructure spending, manufacturing reshoring, and continued economic resilience. Fixed income markets remained under pressure as Treasury yields continued to move higher, tightening financial conditions without additional action by the Federal Reserve. During July, the 2-year Treasury yield rose to approximately 4.23%, the 10-year Treasury yield increased to around 4.68%, and the 30-year Treasury yield climbed to roughly 5.21%, with the long end of the curve reaching its highest levels in years.

Economy

The U.S. economy continues to demonstrate remarkable resilience despite a higher interest-rate environment. Consensus forecasts call for GDP growth of approximately 2.0% in 2026, supported by healthy consumer spending, continued business investment, and strong corporate balance sheets. Unlike previous economic cycles, several important growth drivers including artificial intelligence investment, manufacturing reshoring, infrastructure spending, and recently enacted fiscal stimulus are relatively insensitive to interest rates and continue to support economic activity. At the same time, the economy remains increasingly uneven. Higher-income households continue to benefit from rising asset values and healthy savings, while lower-income consumers are facing slower wage growth, rising credit card balances, increasing student loan repayments, and higher delinquency rates. Overall, we continue to view the U.S. economy as fundamentally healthy. While growth is expected to moderate over time, structural investment, innovation, and continued productivity gains provide a constructive backdrop for long-term economic expansion.

Labor Market

The U.S. labor market continues to normalize, although recent data suggest that hiring momentum is slowing. Nonfarm payrolls increased by only 57,000 in June, well below expectations, while the unemployment rate remained low at 4.2%. At the same time, labor force participation declined, indicating that labor market conditions are gradually cooling rather than weakening abruptly. Employment trends also continue to shift across sectors. Strong investment in artificial intelligence infrastructure and data center construction is supporting hiring in manufacturing and construction, while employment in information services and other white-collar industries has softened. Although it is too early to attribute these changes solely to artificial intelligence, businesses are becoming more selective in their hiring decisions. Overall, the labor market remains supportive of continued economic growth. We view the current environment as one of a "low-hire, low-fire" labor market, where hiring has moderated but layoffs remain historically low. Such conditions are consistent with a gradual economic slowdown.

Monetary Policy

Monetary policy entered a new phase under Federal Reserve Chairman Kevin Warsh. While inflation expectations have continued to moderate, inflation remains above the Fed's long-term target, supporting Warsh's view that price stability must remain the central bank's primary objective. Recent labor market data have reduced the likelihood of further interest-rate increases for now. While inflation expectations have moderated, inflation remains above the Federal Reserve's long-term target, particularly as food and energy prices continue to exert upward pressure. Therefore, rising long-term Treasury yields have tightened financial conditions independently of Federal Reserve action. Warsh has also signaled a meaningful shift in the Federal Reserve's communication strategy. He has questioned whether excessive forward guidance, including the Summary of Economic Projections and the "dot plot", has reduced the effectiveness of monetary policy by encouraging markets to focus on future guidance rather than incoming economic data. His preference for a more disciplined, data-dependent approach could result in fewer policy signals and greater emphasis on the Federal Reserve's commitment to maintaining price stability.

Corporate Earnings

Corporate earnings remain the strongest fundamental support for equity markets. S&P-500 earnings are forecast to grow approximately 24.5% in 2026, followed by a still strong 18.1% in 2027, representing a moderation from exceptionally high levels rather than a deterioration in profitability. Technology continues to lead, with earnings expected to grow nearly 50% in 2026, driven primarily by semiconductors and AI-related investment. Importantly, recent results from Microsoft provided some of the first clear evidence that substantial AI capital expenditures are translating into higher revenues and profits. Health Care is also expected to accelerate meaningfully, with earnings growth forecast at approximately 19% in 2027, supported by biotechnology, pharmaceuticals, new drug development, and increased acquisition activity. Overall, the earnings outlook remains constructive. While valuations in parts of the market are elevated, continued earnings growth provides fundamental support for equities and remains central to our investment outlook.

Food for Thought

For much of the past year, concerns over rising U.S. government debt, fiscal deficits, and de-dollarization led many investors to expect a sustained weakening of the U.S. dollar. Instead, the dollar has strengthened as global capital continues to flow toward the United States. While monetary policy plays an important role, currencies ultimately reflect relative economic strength, productivity, and investor confidence. The U.S. continues to attract capital through resilient economic growth, strong corporate earnings, and its leadership in artificial intelligence and other productivity-enhancing technologies. Expectations that these investments will translate into higher productivity, and future earnings further reinforce the attractiveness of U.S. assets. For our European clients, the direction of the dollar can materially influence investment returns measured in euros. While currencies remain difficult to predict over shorter periods, the structural case for the dollar remains constructive as long as the United States maintains its relative advantage in innovation, productivity, and corporate profitability.

Market Outlook

We expect market volatility to remain elevated as investors balance strong corporate earnings and economic resilience against higher interest rates, inflation, and elevated valuations. In this environment, portfolio rebalancing becomes increasingly challenging, as significant market shifts can quickly reverse and create unnecessary trading risk. Rather than making major changes to portfolios, we believe a more disciplined approach is warranted: taking partial profits where valuations have become extended and selectively increasing positions where fundamentals and valuations justify doing so. We remain invested and focused on earnings, valuations, and individual company fundamentals, making incremental adjustments as opportunities arise while avoiding major portfolio shifts in response to short-term market volatility.

Your Terra Nova Team