

Quarterly Outlook

At-A-Glance

First-quarter GDP came in at 1.6%, below expectations, but second-quarter estimates point to acceleration, with the Atlanta Fed's GDPNow model tracking near 3%.

Headline CPI rose 4.2% year-over-year in May, the highest reading in over three years, driven largely by energy prices stemming from the Iran war.

Core PCE, the Fed's preferred inflation measure, rose 0.2% in April — softer than expected — suggesting the worst of the inflation spike is energy-driven rather than broadly embedded.

The unemployment rate remained at 4.3% in May, and the prime-age employment-to-population ratio is near its highest level since 2001, with 81% of adults aged 25–54 employed.

The new orders components of both the ISM Manufacturing and Services PMI indexes are above 55, firmly in expansionary territory.

Full-year 2026 S&P 500 earnings growth estimates revised from 16.3% in March to 23.3%, driven by strong results and optimistic forward guidance.

The 10-year Treasury yield peaked at 4.66% in May before settling near 4.5%, while the 2-year yield jumped 16 basis points on the day of the June Fed meeting alone.

Steady Ground, Rising Stakes

The first half of 2026 has been defined by resilience in the face of disruption. The outbreak of the Iran war introduced a lot of uncertainty, driving energy prices higher, pushing inflation higher, and forcing a reassessment of the Federal Reserve's policy path. Yet through it all, the U.S. economy has held its footing. Growth has remained positive, the labor market has stabilized, and consumer spending has stayed solid. The conflict that many feared would derail the expansion instead revealed its underlying durability.

The most significant development of the period, however, was not geopolitical, it was the strength of corporate earnings. S&P 500 companies delivered nearly 28% blended earnings growth in the first quarter, with over 84% of companies surpassing estimates. Artificial intelligence capital spending was the primary engine, with the technology sector posting nearly 46% earnings expansion. Full-year 2026 earnings estimates have since revised sharply higher, from 16.3% to 23.3%. That is an extraordinary reset in a short period of time, and it carries its own risks. Expectations have moved well ahead of the economy, and as the second half approaches, results that simply meet a rising bar may no longer be enough to sustain momentum.

In fixed income, the rate cutting cycle that began in late 2024 appears to be on indefinite pause. At its June meeting, the first under new Fed Chair Kevin Warsh, the Fed held rates steady for the fourth consecutive time, while nine of eighteen officials penciled in at least one rate hike before year-end. Inflation, running at 4.2% over the past twelve months, remains the central concern. The 10-year Treasury yield has settled near 4.5%, and we expect it to remain rangebound absent a material shift in the geopolitical backdrop. We continue to favor intermediate maturities and higher-quality credit in this environment.

Looking ahead to the second half, the path forward hinges on two interdependent questions: whether a durable ceasefire in the Middle East takes hold and relieves pressure on energy prices, and whether the Fed can thread the needle between containing inflation and avoiding a policy mistake. A sustained resolution to the war would provide meaningful relief to consumers and reduce the probability of a rate hike.

The overall outlook remains constructive but more nuanced than it appeared entering the year. The economy is on solid ground, earnings have surprised to the upside, and credit markets remain calm. But the margin for error is narrowing. Diversification may matter more in the second half than it did in the first.

For a quicker look at our views on the economy and markets, please see the [Summary Version of our Q3 2026 Market Outlook](#).

Economy

Despite the war in Iran, the U.S. economy has remained resilient. Part of that strength reflects tailwinds we highlighted in prior outlooks: carryover growth following the fourth-quarter government shutdown, stabilization in tariff rates, a durable labor market, and support from increased IRS tax refunds. These forces helped offset uncertainty and higher energy prices stemming from the conflict. While below expectations, first-quarter real GDP still registered a modest 1.6%. Consensus estimates for second-quarter GDP are around 2%, although the Atlanta Fed's GDPNow model is more optimistic at roughly 3%, indicating momentum may be picking up ahead of the third quarter.

Although U.S.-Iran ceasefire agreements appear to be gaining traction, their durability remains uncertain. Still, both sides face meaningful pressure to maintain an agreement to end hostilities and open up the Strait of Hormuz. In the United States, midterm elections are approaching, and the war has proven politically unpopular. In Iran, the economic situation is far more acute, with the economy contracting and inflation, already elevated prior to the conflict, accelerating sharply, particularly in food prices. Iran's central bank estimates CPI rose over 77% year-over-year in May.

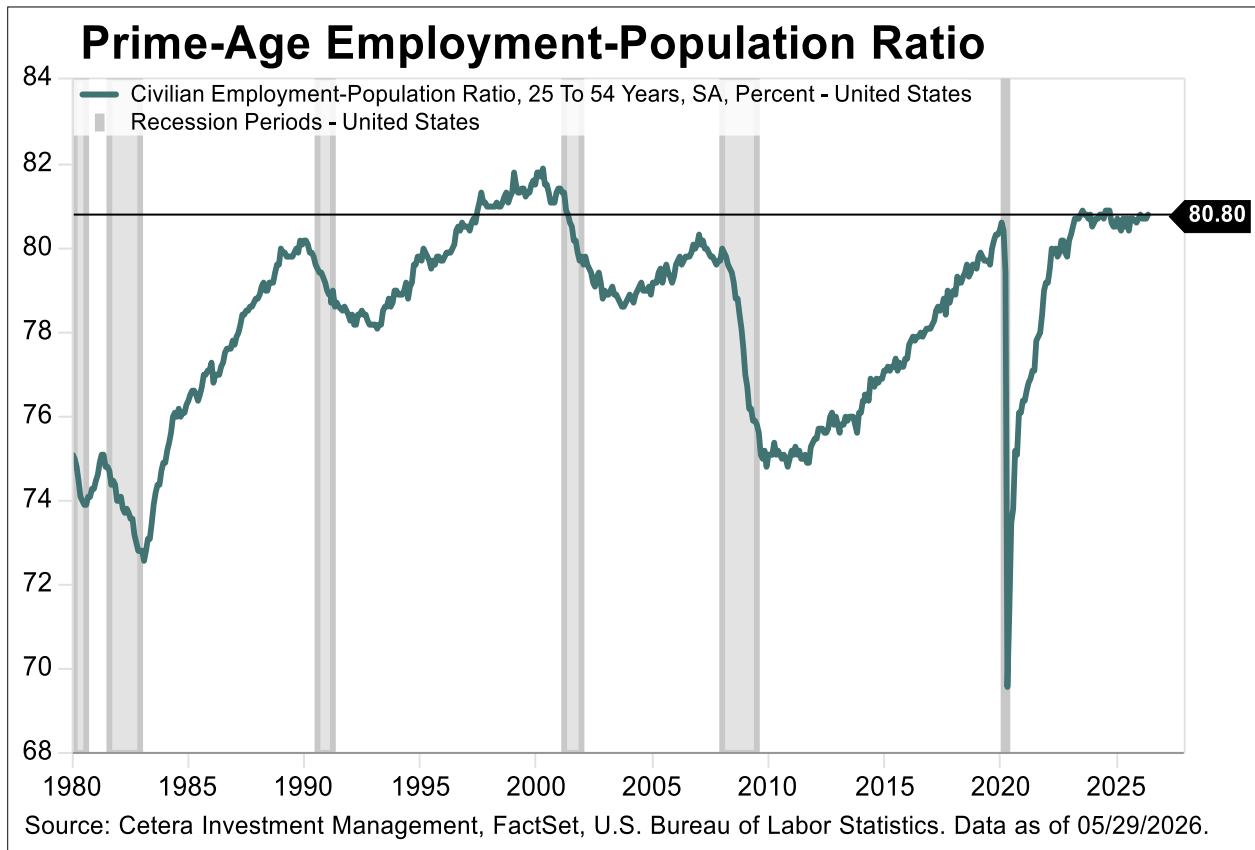
Inflation is also ticking higher in the United States, with headline CPI up 4.2% over the past 12 months. This increase comes on top of the already elevated price levels left in the wake of pandemic-era inflation. As the midterms approach, inflation will remain a central political and economic issue.

Assuming a durable agreement is reached, the outlook for the remainder of the year appears constructive. A decline in energy prices would provide meaningful relief to consumers heading into the summer months. Consumer spending has remained strong, and forward-looking indicators suggest continued momentum. Notably, the new orders components of both the ISM Manufacturing and Services PMI indexes are above 55, firmly in expansionary territory.

Before the year began, the labor market appeared to be the primary risk for 2026. The Fed was on a path toward rate cuts to cushion potential employment weakness. However, labor market data has stabilized. The unemployment rate, which bottomed at 3.4% in April 2023, gradually rose to a cycle high of 4.5% in November 2025, before easing slightly to 4.3% as of May.

While there is ongoing concern that artificial intelligence could disrupt labor markets, evidence of broad-based displacement remains limited. Hiring has picked up in recent months, and layoffs remain low. One of the most important measures of labor market health is the prime-age employment-to-population ratio, which remains strong. Currently, 81% of the population aged 25 to 54 is employed, near its highest level since 2001 (see **Figure 1**).

Figure 1: The Backbone of the Workforce

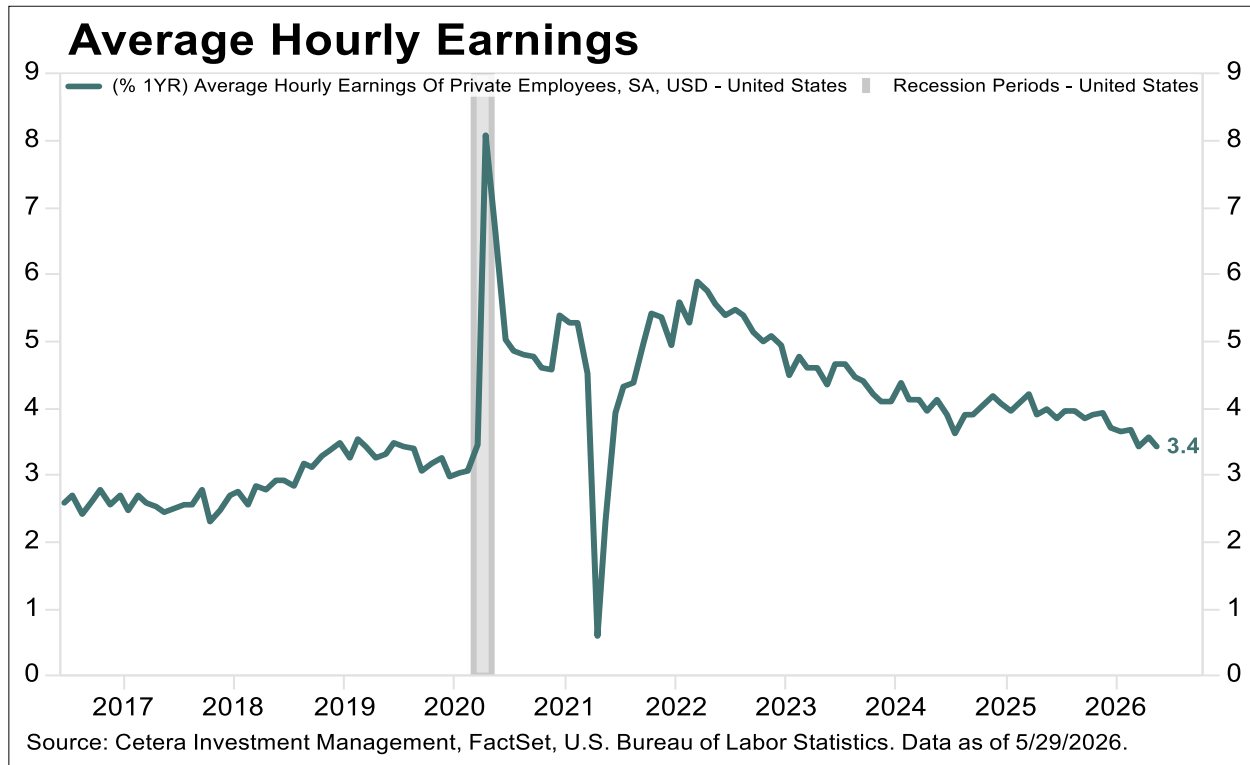


With labor market resilience intact, the Fed has less urgency to cut interest rates. Instead, rising inflation has shifted attention toward the possibility of rate hikes. Fed Funds futures and short-term bond markets suggest the Fed could raise rates once this year. That said, much of the recent inflation pressure appears tied to higher energy prices resulting from the war.

Importantly, raising interest rates will not resolve supply disruptions such as those affecting the Strait of Hormuz. Absent broader second-round effects, particularly sustained wage inflation, the Fed may remain cautious about tightening policy further. Although wage growth is currently moderating (see **Figure 2**), and CORE PCE inflation, the Fed's preferred measure, never made it back down to pre-pandemic levels and is ticking up. How the Fed interprets this will be important, as a premature rate hike could introduce another risk: a policy mistake driven by over-tightening.

Historical comparisons to the 1970s are instructive but often oversimplified. While energy shocks contributed to inflation during that period, underlying pressures, particularly wage inflation, were already significant beforehand. In fact, President Nixon implemented wage and price controls in 1971, two years before the 1973 oil embargo. The inflationary episode of the 1970s was not solely the result of rising energy prices, but rather a combination of entrenched inflation dynamics and policy responses.

Figure 2: Slowing Wage Growth



Globally, the economic backdrop remains uneven and more fragile than in the United States. Europe continues to face headwinds from higher energy costs and weak industrial activity, while many emerging markets are grappling with currency pressures, elevated borrowing costs, and sensitivity to commodity price swings. China's recovery remains subdued and inconsistent, constrained by structural challenges in its property sector and softer external demand. At the same time, ongoing geopolitical tensions, particularly in the Middle East, add uncertainty to energy markets and global trade flows, creating an added layer of risk for the global economy heading into the second half of 2026.

Against this backdrop, the U.S. stands out as a relative bright spot. Despite geopolitical uncertainty and modestly higher inflation, the domestic economy remains supported by a resilient labor market, steady consumer spending, and still-contained underlying inflation pressures. While risks remain, particularly around energy prices and potential Fed policy missteps, the expansion appears intact, leaving the U.S. in a position of relative strength compared to a more challenged global economy.

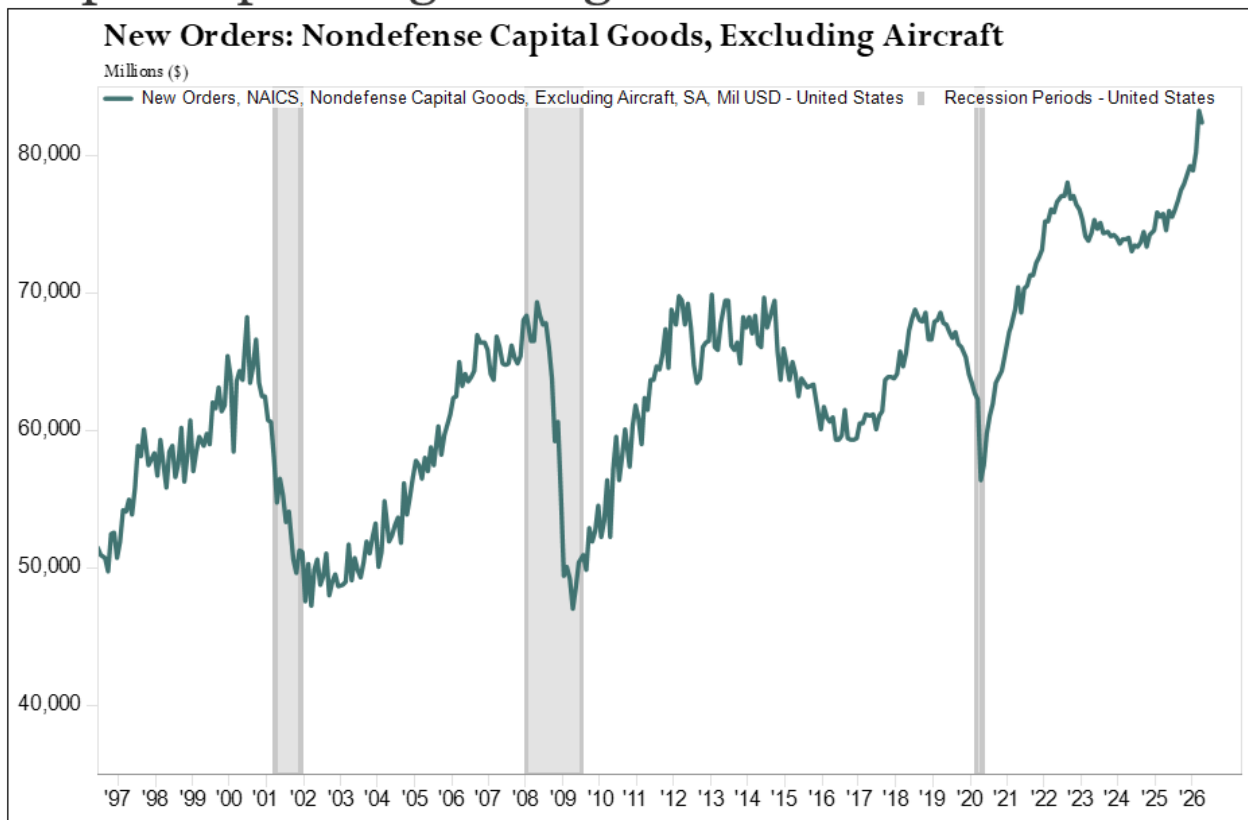
Equity Markets

Investors largely dismissed supply-side disruptions caused by the war as temporary, a dynamic we highlighted in last quarter's outlook. While geopolitical conflicts dominate headlines, their impact on financial markets is often limited and short-lived. In the second quarter, investor attention shifted decisively to corporate earnings, which were exceptionally strong. S&P 500 companies reported first quarter earnings at a blended growth rate of nearly 28%, with approximately 84% of companies surpassing estimates, the highest beat rate since Q2 2021.

Artificial intelligence capital expenditures were the single biggest driver, with the Information Technology sector posting nearly 46% earnings expansion. The "Magnificent 7" stocks grew earnings at roughly 30%, continuing to outpace the broader index.

Business investment demand is also trending higher independent of AI, with core capital goods orders (nondefense ex-aircraft) up 11% over the past year. While recent gains have been supported by AI and technology investment, the broader uptrend suggests strengthening underlying demand across the economy, an important and often overlooked pillar of the current growth story (see **Figure 3**).

Figure 3: Capital Spending Strength



The strong first quarter results may not even be the most significant development of the period. Full-year 2026 S&P 500 earnings growth estimates revised sharply higher, from 16.3% in March to 23.3% today, driven by better-than-expected results and unusually optimistic forward guidance from management teams.

Two important caveats are worth flagging. First, the earnings story remains heavily concentrated; AI beneficiaries account for a disproportionate share of both current results and forward estimates, and some portion of that growth reflects hyperscalers spending on each other rather than on genuine end-demand.

The roughly \$600 to \$700 billion in planned AI infrastructure spending for 2026 also introduces a meaningful, and still underappreciated, earnings headwind via the coming depreciation wave. As that capital is deployed, shorter-lived assets like GPUs and accelerated compute assets will drive faster expense recognition, pressuring margins in a way that does not yet appear fully reflected in consensus estimates.

At the same time, expectations for AI-exposed companies have reset materially higher. That creates a more asymmetric setup: it likely doesn't take a true demand shortfall to drive volatility, just results that fail to clear a rapidly rising bar. As we move into the second half, when both comparisons and scrutiny intensify, that gap between expectations and realized earnings could become a more meaningful source of market instability.

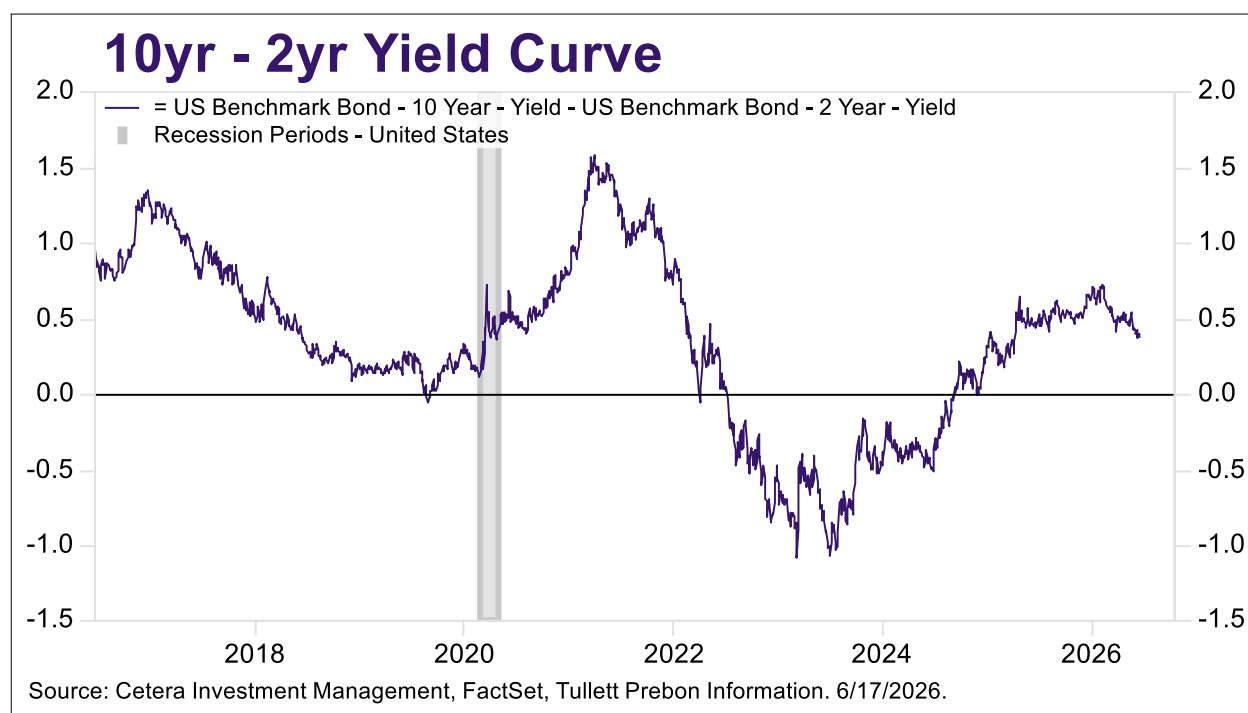
Another thing to watch will be inflation pressures if the agreement in the Middle East isn't durable. Input costs have been rising faster than consumer costs, which could mean margins come under pressure if inflation is not passed on to the consumer.

Fixed Income

The bond market has been relatively volatile as growth and inflation expectations were factored into bond yields. Bond yields had been falling prior to the war. After the war bond yields jumped and seemed to stabilize to start the quarter. In May that changed when hot inflation data drove the 10-year treasury yield up to 4.66%, before stabilizing again and settling closer to 4.5% with hopes of a ceasefire agreement.

The 2-year Treasury yield moved sharply higher as markets repriced the Fed's policy path away from cuts and toward a potential hike, while the 10-year reflected a combination of inflation risk premiums and geopolitical uncertainty. The result has been a flatter curve (see **Figure 4**).

Figure 4: Flattening Yields



That uncertainty crystallized with the Federal Reserve's June FOMC meeting, the first chaired by Kevin Warsh. The Fed held rates steady at 3.5%–3.75%, as widely expected, marking the fourth consecutive hold following the last rate cut in December 2025. The more consequential signal came from the dot plot: nine of eighteen officials projected the federal funds rate would end 2026 above its current range, effectively pointing to a higher probability of at least one rate hike before year-end.

The rate cutting cycle that began in late 2024 now appears to be on indefinite pause, with the next move more likely to be a hike than a cut, depending on how the Iran war and broader inflationary trends evolve. The 10-year yield is likely to remain rangebound in the 4.25%–4.75% area absent a material change in the geopolitical backdrop. In this environment, we continue to favor intermediate maturities and higher-quality credit, where income remains attractive without taking undue duration risk at a time when the terminal rate is genuinely uncertain.

The Bottom Line

The U.S. economy has proven resilient despite the Iran conflict, with growth positive, a stable labor market, and strong consumer spending. The second quarter's defining story was corporate earnings with S&P 500 companies delivering nearly 28% blended earnings growth, well above expectations, driven largely by AI investment. Forward estimates revised sharply higher, though concentration in AI beneficiaries and rising expectations remain important risks heading into the second half.

In fixed income, yields moved higher on persistent inflation and a hawkish turn from the Fed's June meeting, the first under new Chair Kevin Warsh, where nine officials penciled in at least one rate hike before year-end. The rate cutting cycle that began in late 2024 now appears on pause, with the potential for a rate hike in the second half of the year. Diversification and a disciplined approach to duration and credit risk remain prudent. Your Cetera financial professional can help align your portfolio to your goals as these dynamics continue to unfold.

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