

Commentary

Rising Uncertainty Is Driving Volatility, Especially Beneath the Surface

- Equity markets entered the year facing elevated valuations, slowing growth concerns, and uncertainty around the path of interest rates.
- A crowded AI trade, shifting policy expectations, and mixed economic data have added to volatility.
- Beneath relatively stable index levels, investors are rotating defensively, signaling rising concerns about growth and inflation risks.

Coming into this week, and really all year, equity markets have been navigating an uncertain backdrop. Valuations have remained elevated, economic growth has shown signs of slowing, and expectations for Fed rate cuts have fluctuated amid a notable divide among policymakers and persistent optimism in financial markets for easier policy. These concerns intensified recently as several dynamics converged.

A Crowded AI Trade Meets Valuation Reality

Artificial intelligence remains a powerful long-term innovation theme, but investor focus has shifted from *possibility* to *price*. Expectations for the AI trade have become increasingly high, and even strong earnings results have not been enough to support stock prices, as seen in recent market reactions within the space.

Importantly, investors are not questioning the transformative potential of AI. Instead, they are reassessing valuations and the pace at which benefits will materialize. Adding to this uncertainty are growing concerns that AI may evolve from a productivity enhancer into a disruptor. Weakness in industries characterized by high margins and strong returns on invested capital, such as software, financial services, fintech, and digital advertising/media, suggests markets are beginning to price in that risk.

Policy Uncertainty Complicates the Outlook

At the same time, investors are recalibrating expectations around trade and interest rate policy.

On the trade front, the Trump Administration's move to raise tariffs under a different legal avenue introduces new uncertainty. While the authority is limited - capped at a maximum 15% tariff, restricted to 150 days, and required to be non-discriminatory - the implications are meaningful. Countries and regions that believed trade agreements were settled are now reassessing their positions, including key U.S. allies. Given the administration's history of using tariffs on a country-by-country basis to advance policy objectives, this shift adds another layer of unpredictability for markets.

On monetary policy, recent Federal Reserve commentary has leaned more hawkish than investors expected. Fed officials emphasized caution, signaling that rates may remain unchanged for some time. Recent inflation data, including today's Producer Price Index report, has reinforced that message and challenged hopes for more aggressive rate cuts in the near term.

Market Rotation Signals Growing Caution

Despite the fact that major equity indices have not moved dramatically at the surface, market action beneath the headline numbers tells a different story. A clear rotation is underway, with investors moving away from crowded trades and toward more defensive sectors. Mixed economic data and an increasingly uncertain AI narrative have contributed to this shift.

This rotation has increased market dispersion and overall volatility. Historically, these conditions tend to emerge when investors are reassessing growth expectations and risks.

Signals Point to Renewed Stagflation Concerns

Taken together, recent moves in financial markets suggest rising concern about the economic outlook. Treasury yields have pulled back while high-yield credit spreads have widened. These are clear signals that investors are becoming more cautious. Combined with weaker recent economic data, especially on the jobs front from both poor metrics and concerns that AI is reducing the labor footprint, and persistent inflation pressures, these trends indicate that stagflation risks are once again entering the conversation.

Looking Ahead

These developments align closely with one of our primary themes for 2026: equity returns are likely to be more volatile and below long-term averages. While markets can continue to make progress, we don't expect returns like we have seen the past few years. We expect modest returns with heightened volatility.

As uncertainty around policy, growth, and innovation persists, diversification and discipline remain critical. Volatility can be uncomfortable, but it can also create opportunities for long-term investors who stay focused on fundamentals and avoid reacting to short-term market noise.

This report is created by Cetera Investment Management LLC. [@CeteraIM](#)

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