CHEAP STOCKS & STRONG EARNINGS AMID WAR WORRIES

Last quarter, I surveyed some of the thoughts and sentiments from prominent forecasting entities such as the International Monetary Fund and The Conference Board, and from large investment institutions such as Schwab, Fidelity, and Vanguard. A few of the more notable sentiments were as follows:

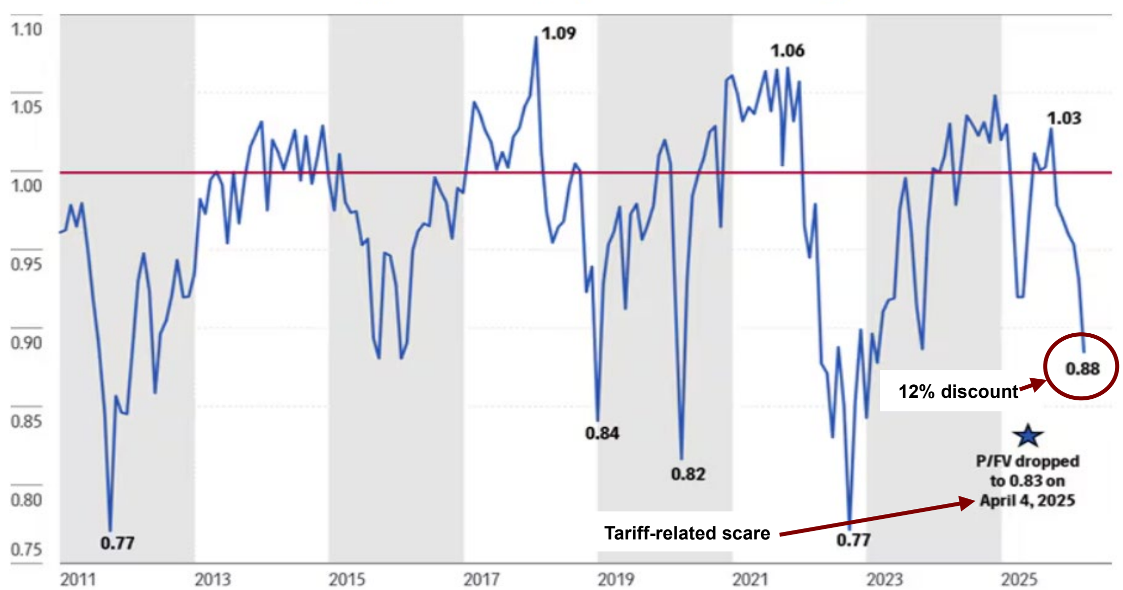
- **Stocks were richly valued**, but analysts expected continued earnings growth to justify those premium valuations.
- **Inflation was not expected to worsen** in the U.S. or abroad.
- **Bonds were expected to continue to provide returns in excess of inflation** and to remain a good diversifier.
- **The U.S. had moved beyond the typical environment of uncertainty into a realm of instability**, but AI-related advancements were inducing investors to look past some of that increased risk.

Let's examine those views in the context of the current environment.

STOCKS ARE NO LONGER RICHLY VALUED

According to Morningstar's Q2 2026 Stock Market Outlook, U.S. stocks as a whole currently sell for about 88% of Morningstar's estimate of fair value. Bargains come in the form of discounts, but so do warnings.

Price/Fair Value of Morningstar's US Equity Research Coverage at Month-End

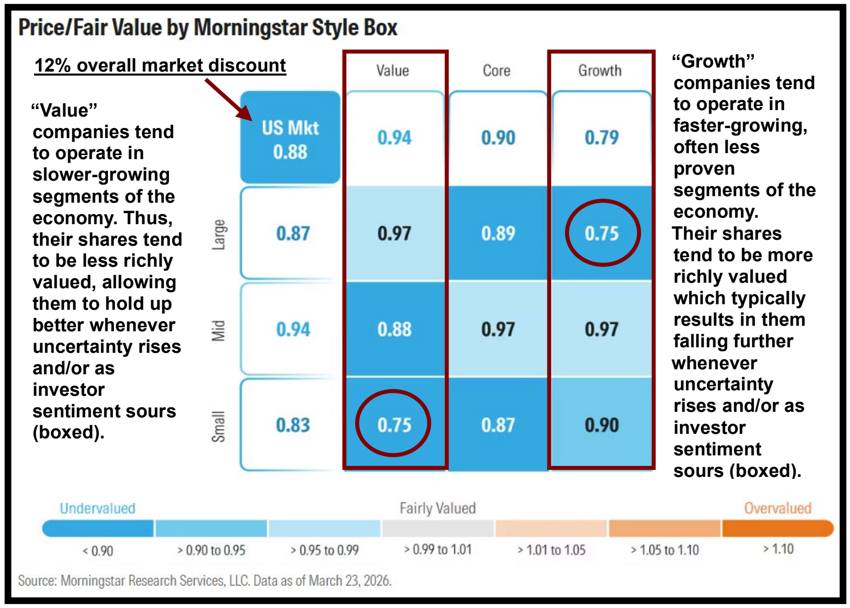


Source: Morningstar Research Services, LLC. Data as of March 23, 2026.

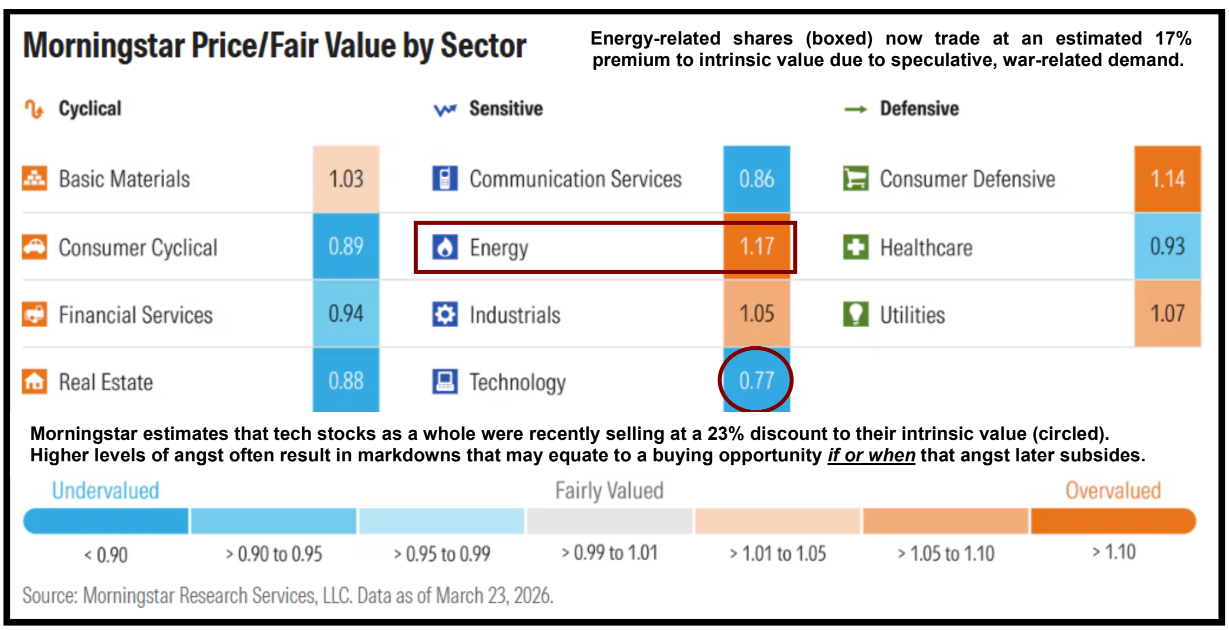
A portion of this 12% discount is a result of U.S. stock prices having declined around 4.5% during the first quarter. The balance of this discount is the result of strong, continued corporate earnings growth. Earnings growth typically pushes stock prices higher. Morningstar reasons that this 12% discount is the result of a "cloudy" future and "weakening macro dynamics." U.S. stocks show signs of wanting to move higher whenever steps are taken toward a moderation in the conflict with Iran. However, until there is a public signal from Iran that it is open to negotiations, Morningstar believes any stock-related rallies will be limited.

The following image provides a more granular view of the 12% discount Morningstar ascribes to the overall U.S. stock market. According to Morningstar's calculations of fair value, large, growth-oriented companies and small, value-oriented companies were recently trading at discounts of 25% (circled).

Shares of large, growth companies include the "Magnificent 7" (Amazon, Alphabet, Apple, Meta, Microsoft, Nvidia, and Tesla) along with other companies that exhibit dynamic growth profiles. Because these companies typically sell for rich valuation premiums, they are subject to pronounced markdowns anytime uncertainty swells. Shares of comparatively small, "value" companies typically sell for more reasonable valuations.



Despite their more reasonable valuations, these companies often operate in more cyclical areas of the economy such banking, insurance, real estate, and energy exploration. This cyclicality has likely contributed to the 25% discount to estimated fair value. The following image disaggregates Morningstar's overall, 12% valuation discount by sector. For example, Morningstar estimates energy-related stocks were recently valued 17% above their estimated intrinsic value (boxed).



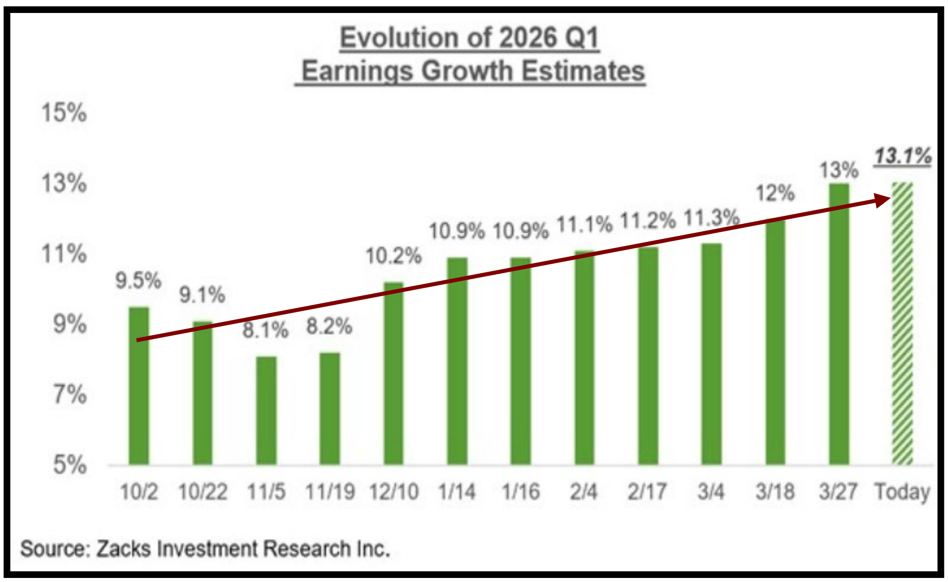
HOWEVER, ANALYSTS *STILL* EXPECT GENEROUS EARNINGS GROWTH

I mentioned in my last note that while stocks were richly valued, analysts expected continued corporate earnings growth to allow stocks to grow into their large valuation shoes. They apparently have grown into those shoes, so further earnings growth could create an environment for stocks to appreciate further.

Zacks Investment Research expects earnings for the 500 largest domestic companies to be 13.1% higher during Q1 2026 than they were a year ago (circled), and analysts expect year-over-year earnings growth for the remainder of 2026 to be even stronger (boxed). **The recent downdraft in stock prices coupled with continued, robust earnings growth could result in stocks offering compelling value, as long as those expected earnings *actually* materialize.**

S&P Capital IQ, a leading research database from S&P Global, also tracks earnings estimates issued by analysts. Its database shows that it expects earnings from member companies of the S&P 500 to show a year-over-year earnings increase of 11.4% for the first quarter of 2026 and a 16.8% increase for 2026 as a whole.

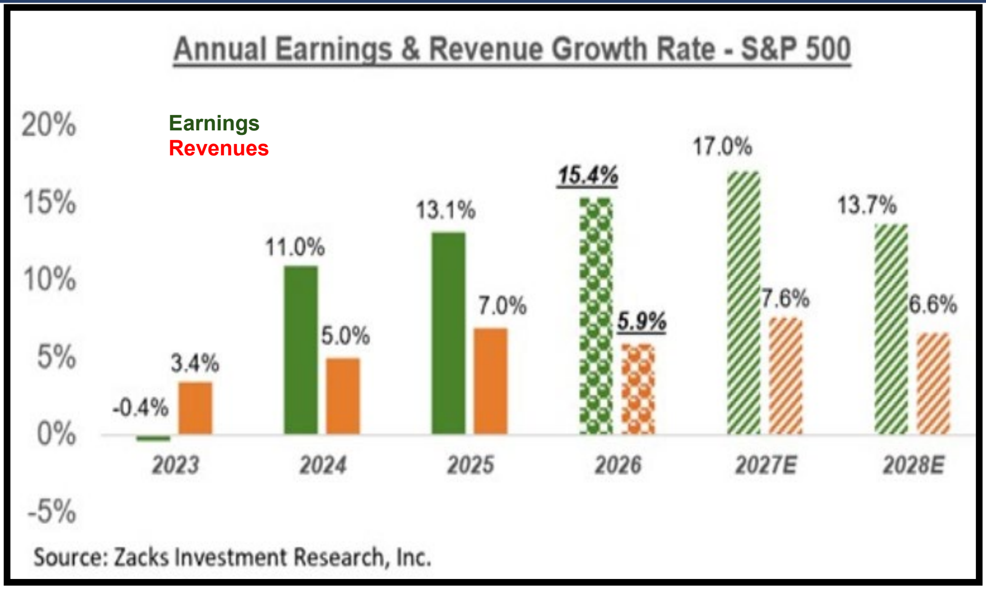
The image to the right shows that Zacks' expected earnings increase of 13.1% is actually a culmination of increasing earnings momentum that has been evident since last fall (arrow). Earnings estimates can be slashed with little more than the stroke of an analyst's pen but, for now, analysts as a whole expect corporate earnings and revenue growth to accelerate further during 2027 and to continue growing at a healthy pace through at least 2028 (image on next page).



EARNINGS EXPECTATIONS FROM FIDELITY AND SCHWAB

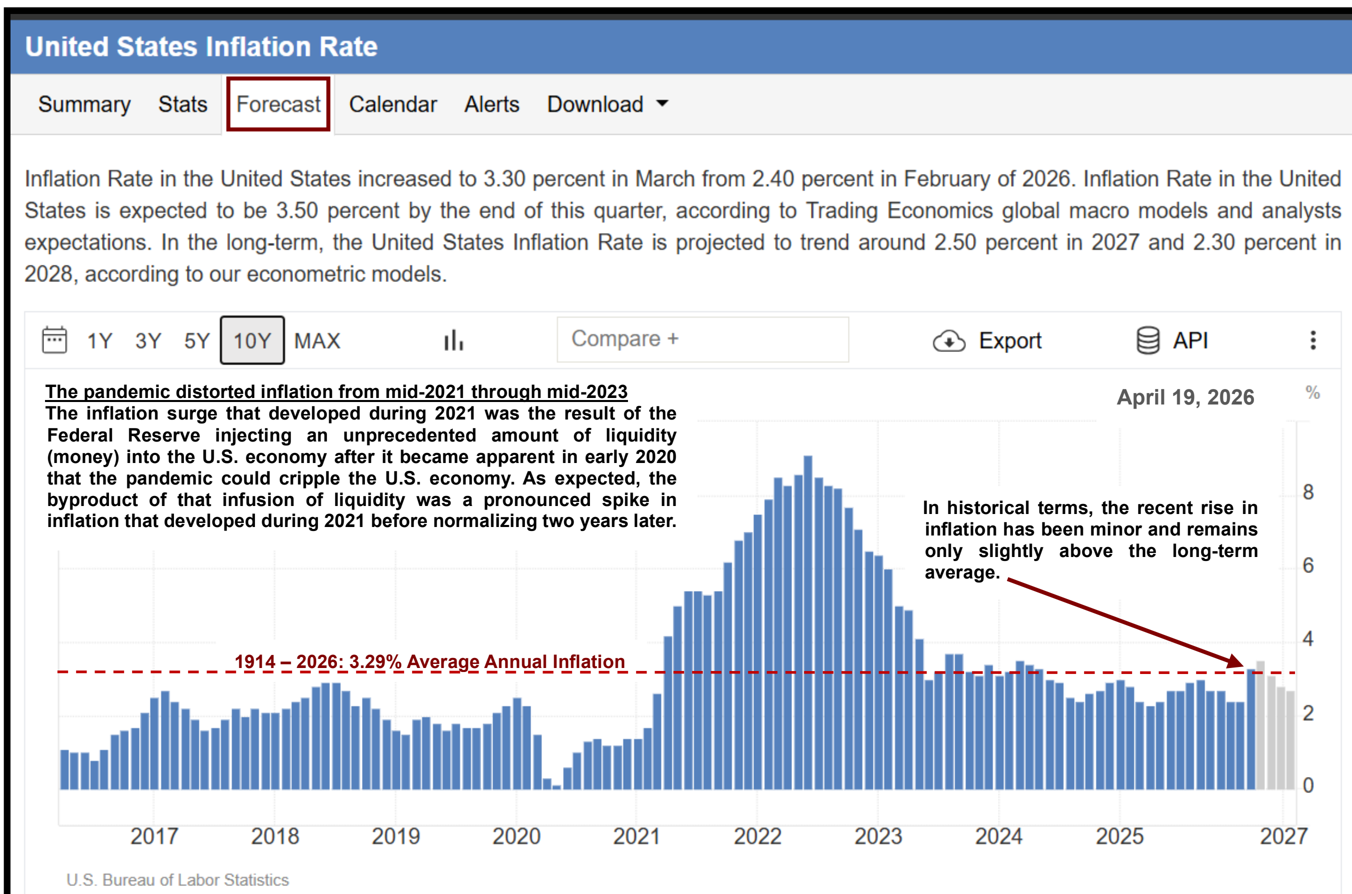
As of April, Fidelity suggests that firms in the S&P 500 face a transition toward slower, long-term growth, with 2026 expected to show solid earnings growth on the order of 14%–15%. While specific 2027-2028 figures are not finalized, broader forecasts suggest a moderation from recent peaks, with high single-digit to low double-digit growth anticipated. Schwab expects earnings growth of 17.4% from S&P 500 companies during 2026 with annual earnings growth approximating 15% per year through 2028. **Again, analysts can slash their earnings estimates with a stroke of the pen but for now, the outlook is positive.**

Political turmoil is always apt to drive stock prices lower, but over longer time frames, rising corporate earnings have tended to push stock prices higher. The image to the right shows that Zacks' earnings estimates are broadly aligned with those of S&P Capital IQ, Fidelity, and Schwab through 2028.



INFLATION HAS WORSENED

In March, the annual rate of inflation in the U.S. jumped from 2.4% in January and February to 3.3%, marking its highest level since May of 2024. The increase was driven primarily by higher prices for gasoline (up 18.9%) and fuel oil (up 44.2%), and for energy overall (up 12.5%), mostly due to the war with Iran. As inflation increases, investors demand higher returns on their capital as compensation which drives capital market values *lower*. (Future investment returns rise as the acquisition cost of a given investment declines.)



BONDS REMAIN ATTRACTIVE

The outlook for bonds and other fixed-income instruments is characterized by tension between sticky war-related inflation and a slowing, but resilient, global economy. While the recent jump in inflation has pushed bond yields higher and bond prices lower, **the consensus, forward-looking view is for bonds and other fixed income instruments to continue to generate solid returns during 2026**.

If inflation were to rise further, returns from bonds could face a bit of a headwind as bond prices adjust lower, but the inflation forecast on the previous page suggests that, if anything, inflation is expected to *subside* over the next few quarters. **If inflation were to subside, bond prices are apt to *drift higher*, thereby augmenting the returns bondholders already receive from interest income**. Additionally, if the economy were to show signs of stagnation, or if recession worries began to develop, bond prices would, once again, be apt to *rise* as the Federal Reserve works to stimulate the economy through lower interest rates. Even though these lower rates could occur as a response to fend off a recession, bond prices would be apt to rise anyhow. The notion that "bonds love bad news" remains true and is one of several reasons bonds and other fixed income instruments have earned a reputation as being good diversifiers.

IMF: CONFLICT IN MIDDLE EAST HAS UPENDED THE WORLD ECONOMY

On April 13th, the International Monetary Fund released a statement regarding the conflict. The most salient parts of that statement follow:

> "As we noted earlier this month, the impact of the war is substantial, global, and highly asymmetric, disproportionately affecting energy importers, in particular low-income countries. The shock has led to higher oil, gas, and fertilizer prices, triggering concerns about food security and job losses as well. Some oil and gas producers in the Middle East have also seen a dramatic loss of export revenue.
>
> The situation remains very uncertain, and shipping through the Strait of Hormuz is [sic] yet to normalize. Even after a resumption of regular shipping flows through the Strait, it will take time for global supplies of key commodities to move back towards their pre-conflict levels—and fuel and fertilizer prices may remain high for a prolonged period given the damage to infrastructure. Due to supply disruptions, shortages of key inputs are likely to have implications for energy, food, and other industries. The war has also forcibly displaced people, impacted jobs, and reduced travel and tourism, which may take time to reverse."

IMF DOWNGRADES WORLD OUTLOOK TO REFLECT CONFLICT

The IMF's April release warned, "After withstanding higher trade barriers and elevated uncertainty last year, global activity now faces a major test from the outbreak of war in the Middle East." The report concludes that "**downside risks dominate the outlook**." In a scenario where the conflict is *limited*, growth in world output is expected to slow modestly during 2026 and to then rebound a bit during 2027 (boxed). **Interestingly, the IMF expects growth within the U.S. to *increase* during 2026** (also boxed).

The **scenario of a "limited" conflict is premised on the assumption that the conflict will last through the end of April or so, after which a recovery will gradually develop**. During that recovery, the IMF expects disruptions to fade while production and exports from the warring regions normalize by mid-year. Notably, **the IMF expects a conflict of limited duration to have a greater impact on emerging and developing economies than it will on more advanced economies such as the U.S.**

The Commodity Prices graph that appears further below allows you to compare the costs of some basic commodities as they had been projected to be in the IMF's 2025 World Economic Outlook (dotted lines) to how the IMF now projects them to be in its 2026 World Economic Outlook (solid lines) which now incorporates the impact of the conflict. As you can see, **the spike in energy prices (blue line) is expected to begin relaxing by mid-year** but may remain elevated through at least the end of 2027. To a lesser extent, **food prices are also expected to remain elevated**.

Therefore, and as already discussed, **the conflict with Iran has upended the notion that inflation will not worsen.**

With respect to interest rates, the IMF believes that the conflict may induce the U.S. central bank (our Fed) to implement a rate reduction sooner this year than it otherwise would have (solid blue line), ostensibly to stimulate economic growth to help offset war-related growth losses. **Longer term, however, the IMF projects that our Fed will need to keep interest rates a bit higher than they otherwise would have been to help offset some persistent inflation** that may manifest as a result of the supply chain shocks that are already developing. Lower rates in the near term may create a welcome tailwind for bond values. Longer term, yields might be slightly higher than they otherwise would be.

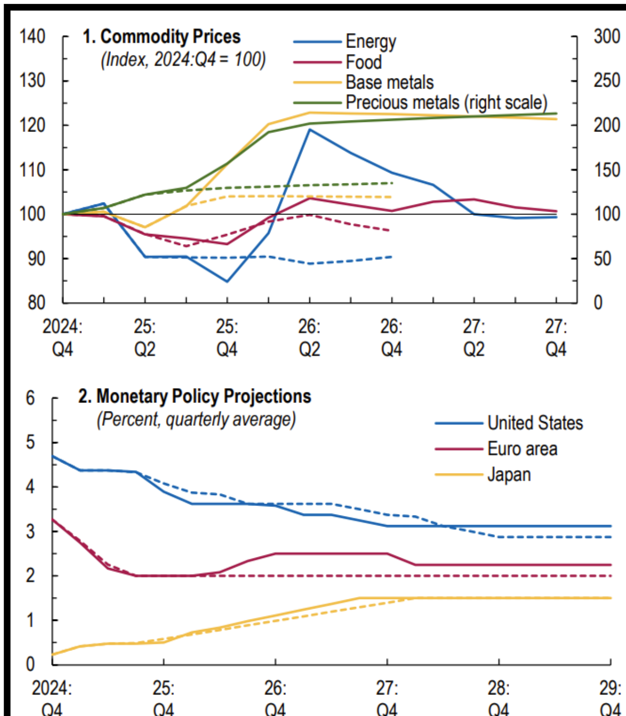
World Economic Outlook Growth Projections

(Based on a Conflict of "Limited" Duration)

(Real GDP, annual percent change)	2025	PROJECTIONS 2026	2027
World Output	3.4	3.1	3.2
Advanced Economies	1.9	1.8	1.7
United States	2.1	2.3	2.1
Euro Area	1.4	1.1	1.2
Germany	0.2	0.8	1.2
France	0.9	0.9	0.9
Italy	0.5	0.5	0.5
Spain	2.8	2.1	1.8
Japan	1.2	0.7	0.6
United Kingdom	1.3	0.8	1.3
Canada	1.7	1.5	1.9
Other Advanced Economies	3.0	2.6	2.2
Emerging Market and Developing Economies	4.4	3.9	4.2
Emerging and Developing Asia	5.5	4.9	4.8
China	5.0	4.4	4.0
India	7.6	6.5	6.5
Emerging and Developing Europe	2.0	2.0	2.1
Russia	1.0	1.1	1.1
Latin America and the Caribbean	2.4	2.3	2.7
Brazil	2.3	1.9	2.0
Mexico	0.6	1.6	2.2
Middle East and Central Asia	3.6	1.9	4.6
Saudi Arabia	4.5	3.1	4.5
Sub-Saharan Africa	4.5	4.3	4.4
Nigeria	4.0	4.1	4.3
South Africa	1.1	1.0	1.3
Memorandum			
Emerging Market and Middle-Income Economies	4.4	3.8	4.1
Low-Income Developing Countries	4.8	4.8	4.9

Source: IMF, *World Economic Outlook*, April 2026

Note: For India, data and projections are presented on a fiscal year (FY) basis, with FY 2025/26 (starting in April 2025) shown in the 2025 column. India's growth projections are 6.6 percent for 2026 and 6.7 percent for 2027 based on calendar year.



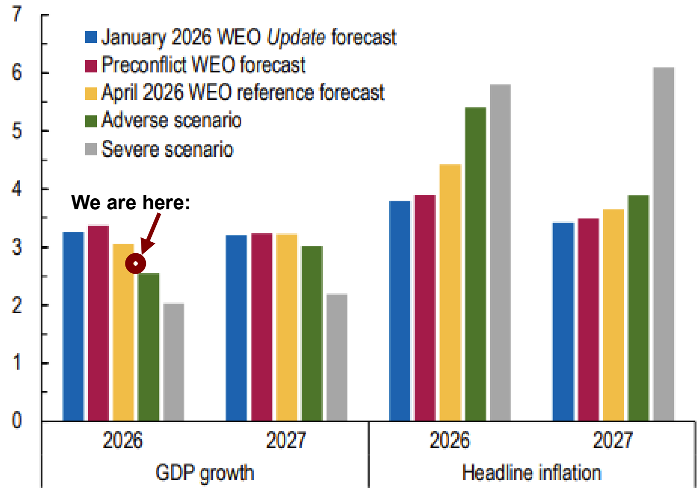
ADVERSE SCENARIO MORE LIKELY

The image to the right summarizes the impact the Iran conflict is having on the IMF's projections for world economic growth and inflation. The negative revision discussed on the previous page is captured by the yellow bars in this image which, again, is premised on a conflict of only limited duration. On April 14th however, **the IMF's chief economist warned that because disruptions in the Strait of Hormuz were continuing, the world had already moved past the IMF's "reference forecast" (yellow bars) and was drifting closer to the IMF's more "adverse" scenario (green bars)** as energy disruptions continue.

The footnote to the right is a bit of a challenge to digest, but I've included it because it shows that the IMF's "adverse" scenario is premised on oil prices increasing 80% during the second quarter of this year and natural gas prices increasing by 160%.

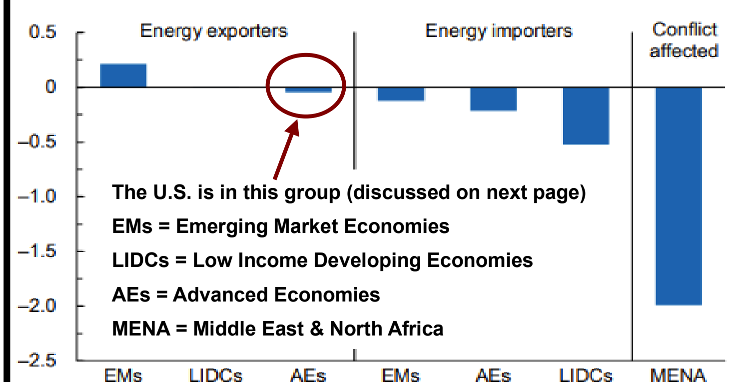
In the IMF's "severe" scenario, the price of oil is assumed to double during the current quarter and natural gas is expected to triple. Lurking near the bottom of that footnote is the IMF's assumption the corporate risk premiums increase by 100 basis points (1%) in a "severe" scenario. This is a technical way of implying that asset prices would get marked down. Risk premiums are beyond the scope of this note, but **rough math suggest that if the IMF is correct that risk premiums were to increase by 1% (underlined), stocks might decline somewhere around 10% and longer-term bonds could decline enough to offset about a year's worth of interest. For what it's worth, this practice holds mostly short-term bonds to mitigate this risk.**

Figure 1.8. Global Growth and Inflation Forecasts
(Percent)



Source: IMF staff estimates.
Note: The three WEO forecasts are constructed bottom-up from individual country projections before and after the outbreak of the Middle East conflict. The two scenarios are model-based top-down estimates. The adverse scenario assumes that oil (gas) prices increase by 80 (160) percent starting in 2026:Q2, relative to the January 2026 WEO *Update*, with the increase mostly unwinding in 2027, one-year-ahead inflation expectations increase by 50 (90) basis points in advanced economies (emerging markets excluding China), and corporate premiums rise by 50 (100) basis points in advanced economies plus China (emerging markets excluding China), while sovereign spreads in emerging markets excluding China increase by 50 basis points, with the tightening in financial conditions fading in 2027. The severe scenario is calibrated to larger and more persistent shocks. First, oil (gas) prices are assumed to be 100 (200) percent higher than the January 2026 WEO *Update*, starting in 2026:Q2 and staying at that level in 2027, while food commodity prices increase by 5 (10) percent in 2026 (2027). Second, one-year-ahead inflation expectations increase by 100 (130) basis points in advanced economies (emerging markets excluding China) by 2027. Third, corporate risk premiums rise by 100 (200) basis points in advanced economies plus China (emerging markets excluding China) in 2026–27, while sovereign spreads increase by 100 basis points in emerging markets excluding China over the same period. WEO = *World Economic Outlook*.

Figure 1.9. GDP Growth Revisions in the Reference Forecast
(Percentage points)

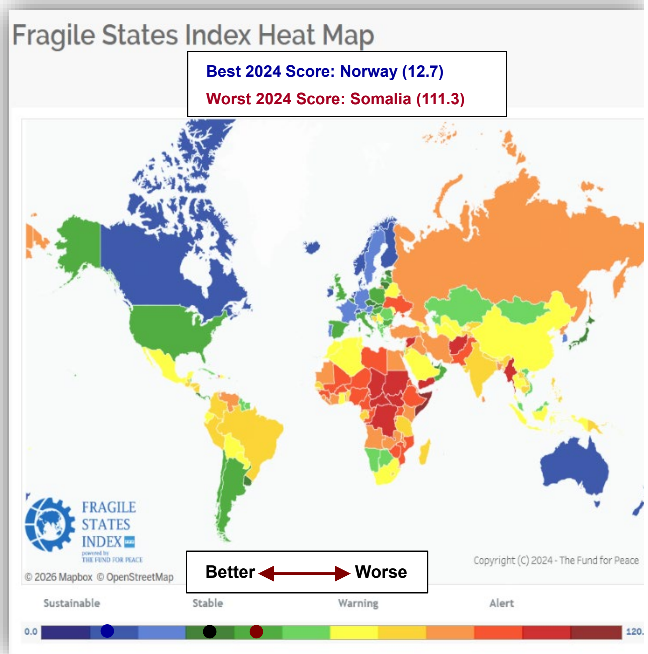


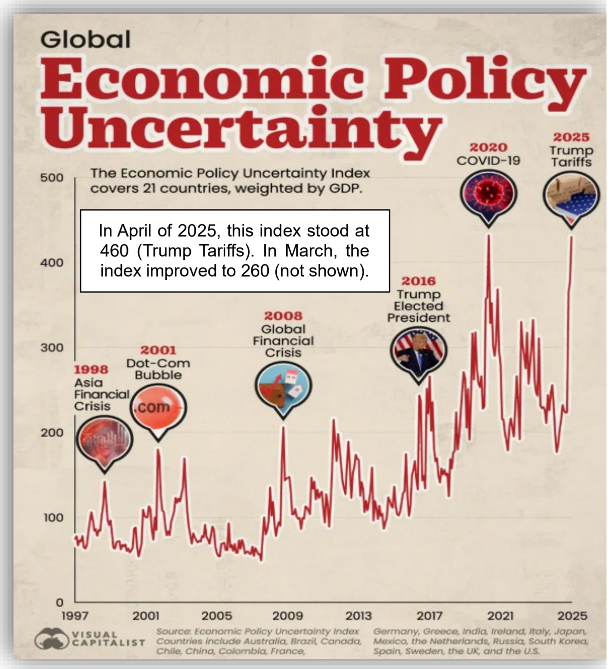
Sources: World Bank, World Development Indicators; and IMF staff calculations.
Note: The figure presents cumulative GDP growth revisions for 2026–27 relative to January 2026 *World Economic Outlook Update*. Energy exporters and importers are defined using 2022 net energy imports as a share of energy use. Groups are aggregated using purchasing-power-parity weights. EMs and LIDCs exclude MENA. AEs = advanced economies; EMs = emerging markets; LIDCs = low-income developing countries; MENA = Middle East and North Africa.

Referring back to the image on the bottom of page 6, the IMF projects that a conflict with Iran of limited duration would still allow economic growth within the U.S. to increase slightly during 2026 (from 2.1% to 2.3%). As noted, however, the conflict is already headed to the IMF's more "adverse" scenario.

The IMF has not provided an estimate of the economic damage that may be sustained in the U.S. or in other specific regions in cases where the conflict is more prolonged, but the image on the bottom of the previous page is instructive because it indicates that in terms of economic output, **energy exporting countries with advanced economies are apt to be *<u>less</u>* impacted by this conflict** than are energy importing countries. **Even though the U.S. is directly embroiled in the conflict, the IMF classifies the U.S. to be an advanced, energy exporting economy rather than to be in a conflict-affected region.**

INSTABILITY CONTINUES





The Fragile States Index Heat Map scores countries according to the degree to which they are impacted by factionalized elites, grievance, uneven economic development or decline, human flight, inadequate services, the perception of declining political legitimacy, disregard for laws, rights, and protections, demographic pressures, and external intervention. Countries with more sustainable systems have lower numerical scores and they appear bluer on the map.

This heat map was last updated is 2024, however the data is still instructive. At that time, Norway was the "bluest" country with a score of 12.7 (blue dot; *sustainable*) which means no country fell into the most sustainable category. In 2015, the U.S. scored 35.4 (black dot; *very stable*), but by 2024 that score deteriorated to 44.5 (red dot; *somewhat less stable*). This study hasn't been updated since 2024, but I suspect conditions in the U.S. have deteriorated further since then despite the recent improvement in the Economic Policy Uncertainty Index. – Glenn Wessel