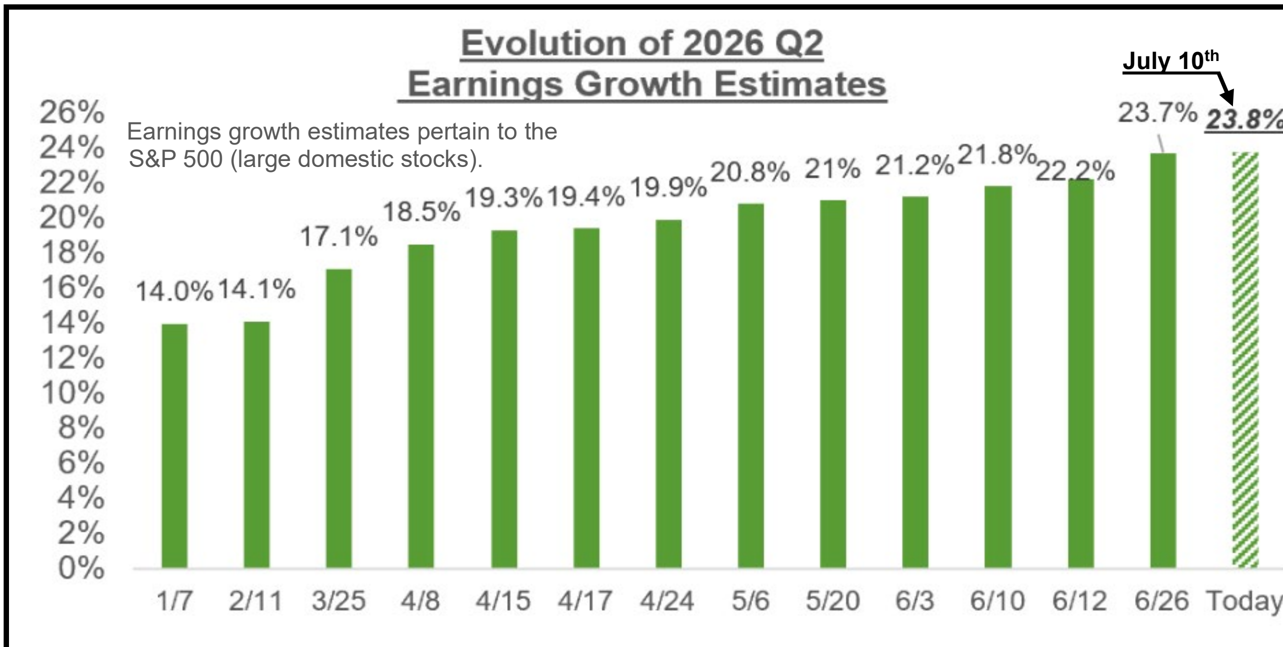
EARNINGS REMAIN STRONG / STOCKS A BIT UNDERVALUED

Year-to-date returns generated by domestic stocks have been generous through mid-July with the S&P 500 (large stocks) posting a return of 9.6%, the S&P 400 (mid-sized stocks) posting a return of 14.2%, and the Russell 2000 (small stocks) leading the domestic way with a return figure of 26.4%. Returns generated by foreign stocks have been similarly generous with stocks in developed economies in Europe, Asia, and the Far East, generating a return of 10%. Meanwhile, stocks associated with emerging economies have returned a bountiful 25.8% over this same period.

EARNINGS OUTLOOK FOR U.S. COMPANIES CONTINUES TO IMPROVE

Earnings growth is the primary ingredient for rising stock valuations, so it makes sense to track analysts' earnings expectations. Although the second quarter is now behind us, most publicly held companies have not released earnings figures yet. However, consensus **analyst estimates for year-over-year, 2Q-26 earnings growth have continued to rise since the beginning of the year, as shown here.**



Source: Zacks Investment Research Inc.

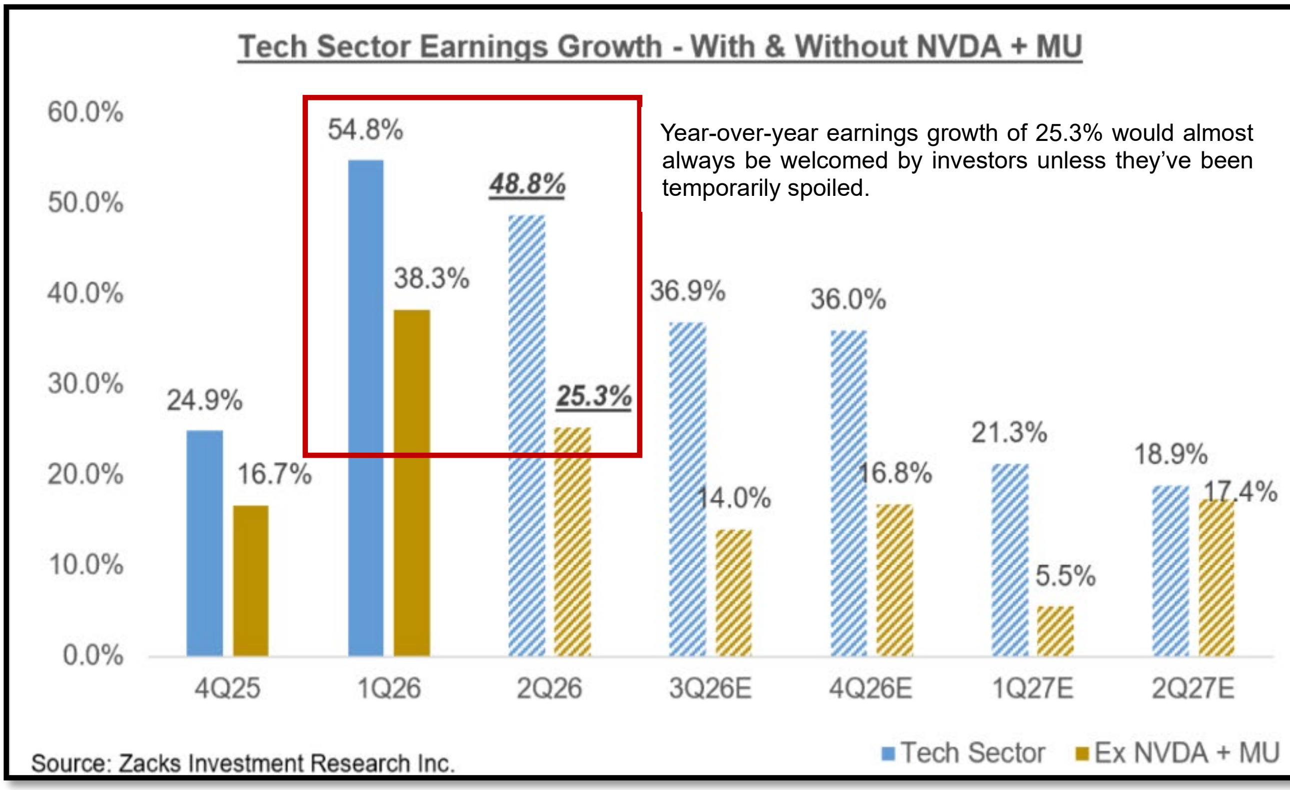
EARNINGS LOOK GOOD EVEN WITHOUT WINDFALL ENERGY PROFITS …

According to a July 17th research note from Zacks Investment Research, **"The picture emerging from early results is one of continued strength and solid momentum**. **An above-average proportion of companies are beating estimates, while management teams are offering reassuring commentary regarding their outlooks for the current and upcoming periods."** That research note further adds **"… the initial data gives us strong confidence that the broader corporate earnings landscape remains highly positive."** Zacks expects 11 of 16 economic sectors to report accelerated 2Q-26 earnings growth versus a year ago with tech sector earnings expected to be 48.8% higher and energy sector earnings expected to be 129.5% higher. **Even if windfall energy earnings were to be excluded, Zacks estimates that 2Q-26 earnings growth for the S&P 500 would still be 20.7% higher versus a year ago.**

… AND THEY LOOK GOOD EVEN WITHOUT TECH STOCK DISTORTIONS

The technology sector is unlike any of the other 15 sectors Zacks tracks, as it accounts for 41% of all S&P 500 earnings and for almost 46% of the index's total market value. Semiconductors as a whole, and two companies in that industry in particular, Micron Technology and Nvidia, are having an outsized impact on the technology sector's current growth profile. Nvidia's 2Q-26 earnings were 59% higher than they were a year earlier and Micron's earnings were up a breathtaking 1,350% on revenues that were 346% higher.

However, even if earnings contributions from Nvidia and Micron are excluded from the data, Q2-26 earnings for the rest of the technology sector would still be up 25.3% compared to a year ago, versus 48.8% otherwise (boxed, below).

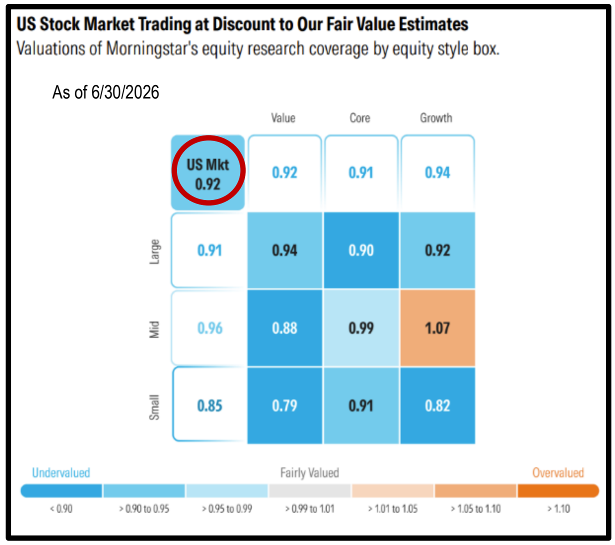


Overall, analysts expect year-over-year earnings growth for companies within the S&P 500 to remain robust through at least 2028, and I see no hint that this expectation would not apply to smaller companies, as well.

Analysts expect earnings and revenue growth to subside through 2028, but they expect that growth to remain solidly positive. **By the end of 2028, corporate earnings could be 66% higher than they now are.** All else being equal, this is a strong positive.

MORNINGSTAR SEES STOCKS AS SOMEWHAT UNDERVALUED

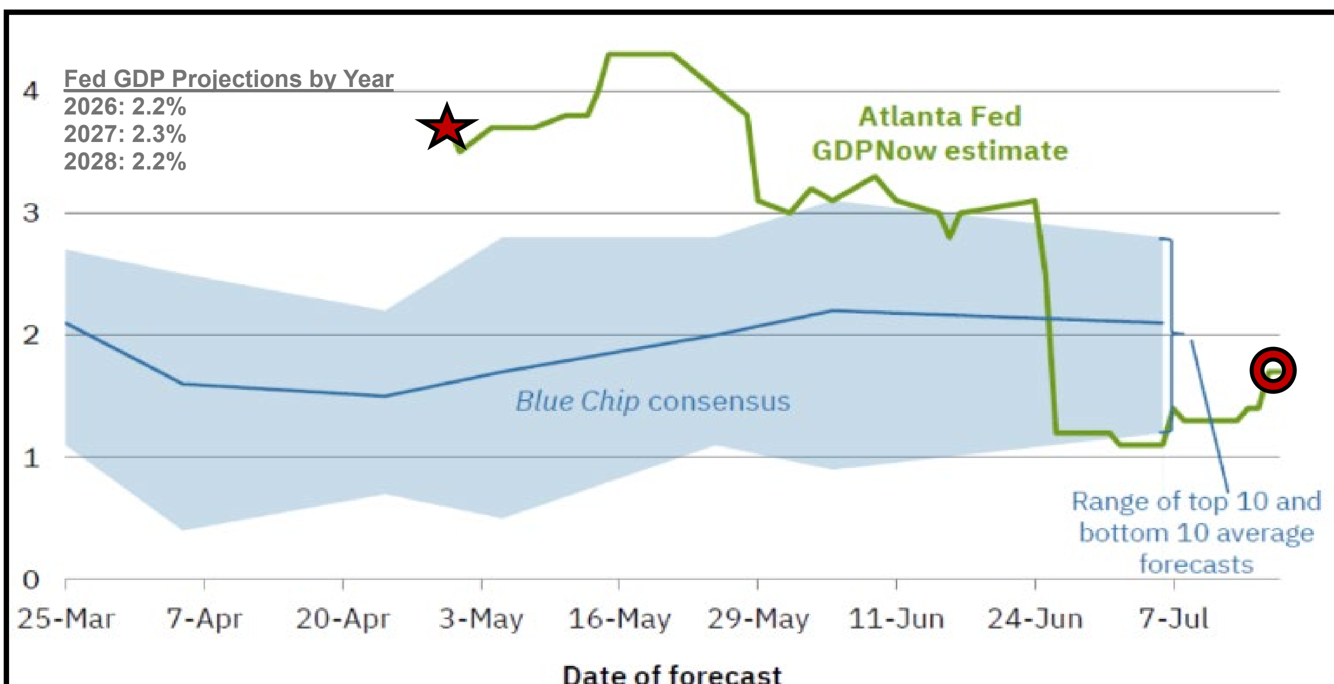
As of the close of 1Q-26, Morningstar estimated that on an overall basis, U.S. stocks were trading for about 88% of their actual intrinsic value. Despite the fact that they have posted a 15+% rise in value during the second quarter, Morningstar estimates that stock valuations still represented only 92% of their intrinsic value (8% discount) as of June 30th (circled). Such is the effect of rapidly advancing earnings. This slight discount, if real, provides some comfort and an extra margin of safety, but I do not regard it as a reason to invest more aggressively than one otherwise might or as a reason to overweight stock exposure.



FED PROJECTS GDP GROWTH TO TEMPORARILY SLOW

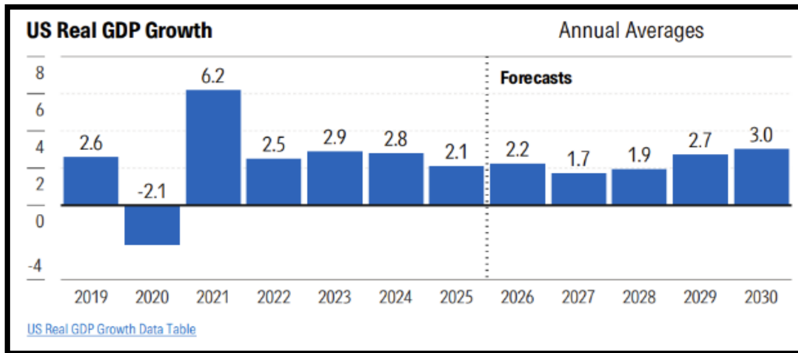
At the end of April, the Federal Reserve Bank of Atlanta's initial estimate of annualized 2Q-26 GDP/economic growth for the U.S. was 3.7% (star). As of July 17th, the Fed's estimate now stands at only 1.7% (bullseye). Morningstar notes that GDP growth within the U.S. has been trending lower since the 2022–2024 period when growth averaged about 2.8% per year and since 2025 which produced GDP growth of 2.1%.

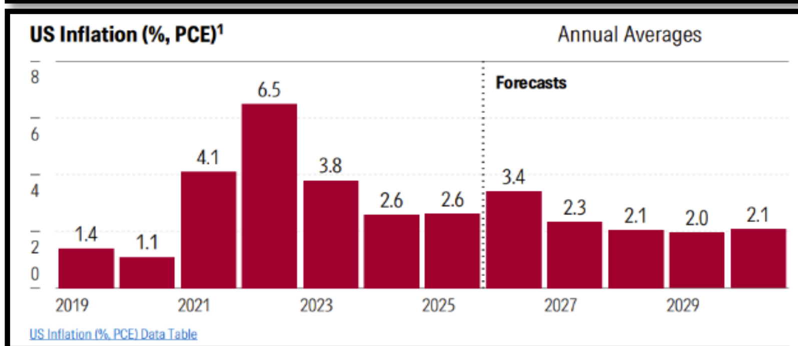
The Fed projects U.S. GDP growth to stabilize between 2.0% and 2.3% between now and the end of 2028 which is in line with the International Monetary Fund's projections (discussed later).



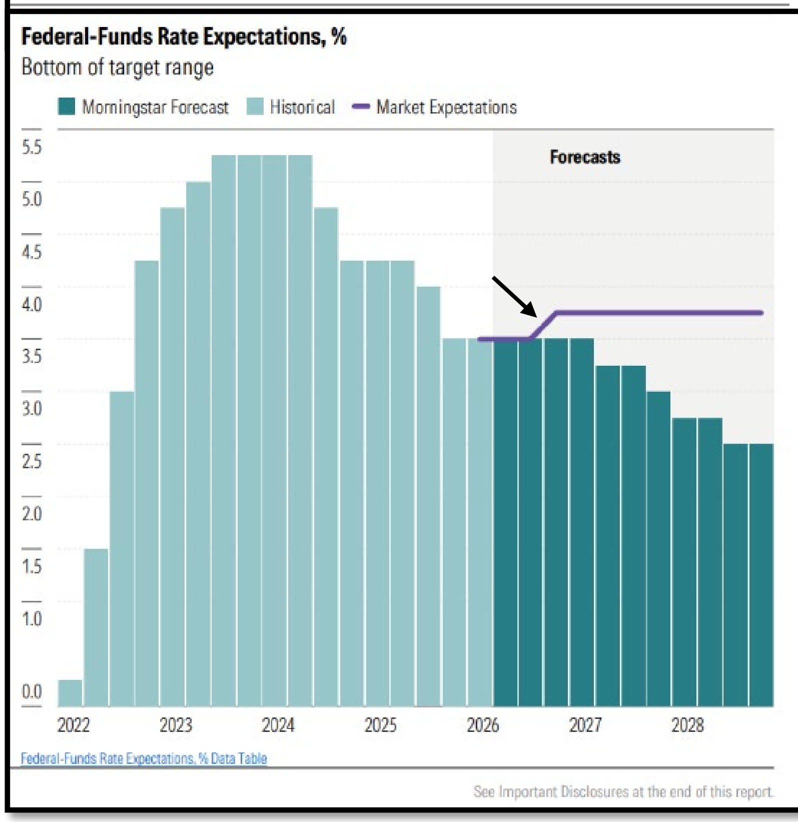
MORNINGSTAR EXPECTS GDP GROWTH TO DIP AFTER THIS YEAR …

… as a result of the impact of tariffs, lower population growth, the lingering effect of higher interest rates, and reduced AI spending growth. However, Morningstar expects U.S. economic growth to surpass current levels by 2029.





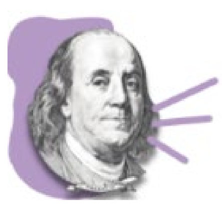
Morningstar also thinks inflation will subside after 2026 to more closely approximate the Fed's annual 2% target. If inflation does, in fact, subside after this year, that could allow the Fed more latitude to reduce interest rates which could then set the stage for the renewed GDP growth depicted in the upper panel.



Whereas there is a general expectation that the Fed may hike its benchmark short-term interest rate from its current level (arrow in panel to the right), Morningstar expects the Fed to begin reducing rates by the second quarter of next year. Those rate cuts could then set the stage for the renewed economic growth Morningstar projects to occur in 2029 (in the upper panel).

It's worth noting that the U.S. has a strong incentive to control its borrowing costs since it is among those countries that carry a high relative debt load in addition to it also carrying the highest absolute level of debt in the world.

It's better to have a rooting interest in lower interest rates when the world's largest debtor ostensibly shares that same interest, than when it doesn't.

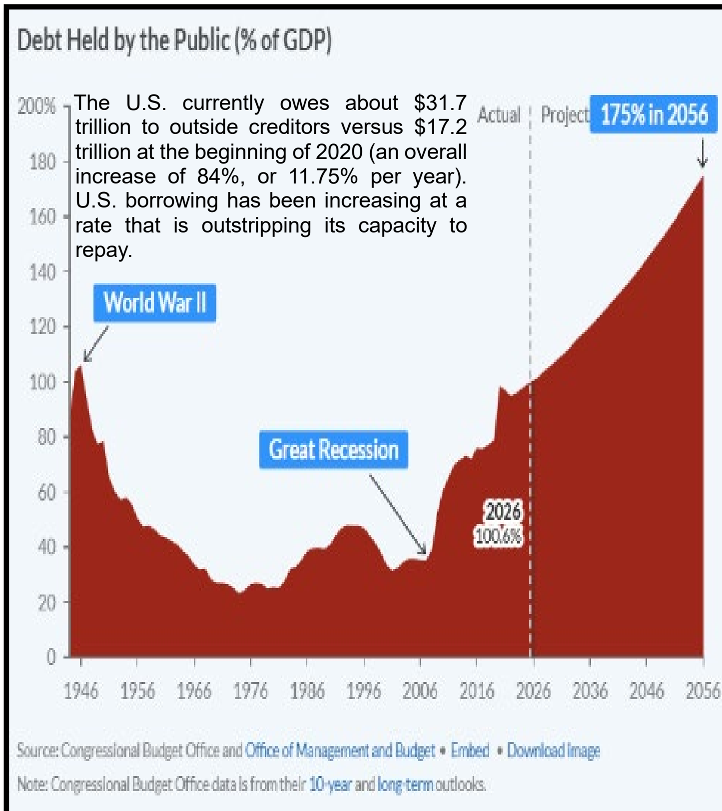


"Rather go to bed without dinner than to rise in debt."

Benjamin Franklin, statesman, civic leader, and diplomat

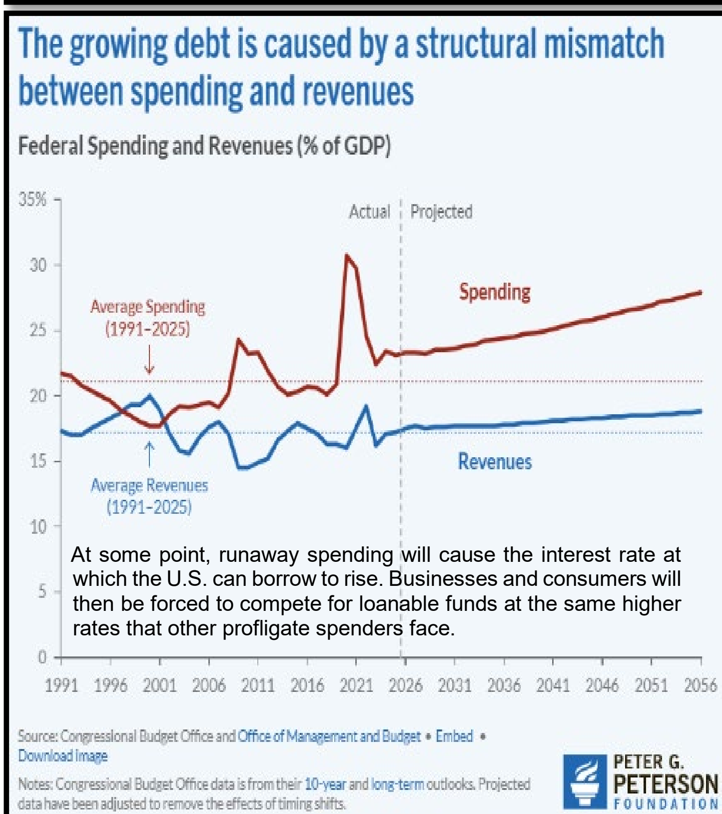
DEBT CONCERNS MOUNT …

As a nation's indebtedness increases, the associated increase in debt service that accompanies it reduces its capacity to borrow further, diverts resources from other endeavors, pressures governmental and household budgets, and crowds out future investment as investors are increasingly placed in the position of competing with their own federal government for loanable funds. Since the federal government holds the power to tax, it is the individual borrower, i.e., the citizenry, that gets pushed to the side or, in economic parlance, crowded out.



An individual's capacity to borrow is measured against his/her capacity to repay and the same holds true for nations. The U.S. borrowed heavily to finance its effort during World War II. As measured against one year's worth of its GDP (productive output), U.S. borrowing peaked in 1946 as shown to the right. In terms of capacity to repay, the U.S. is now about where it was in 1946, but without having been pushed there by a world war.

This next panel reveals that the problem is largely structural. That is, the U.S. simply spends more than it collects in fees and tax revenues, and it does so as a matter of routine practice. I point this out only because this is not the typical policy stew from which reliably low interest rates tend to spring forth. To the contrary, routine budget deficits create the backdrop against which borrowing capacity and creditworthiness are assessed ever more assiduously, and potential borrowers and investors become increasingly circumspect with respect to whether borrowing makes sense, whether they are likely to be able to repay those would-be loans, and whether it might be better to simply go to bed hungry.



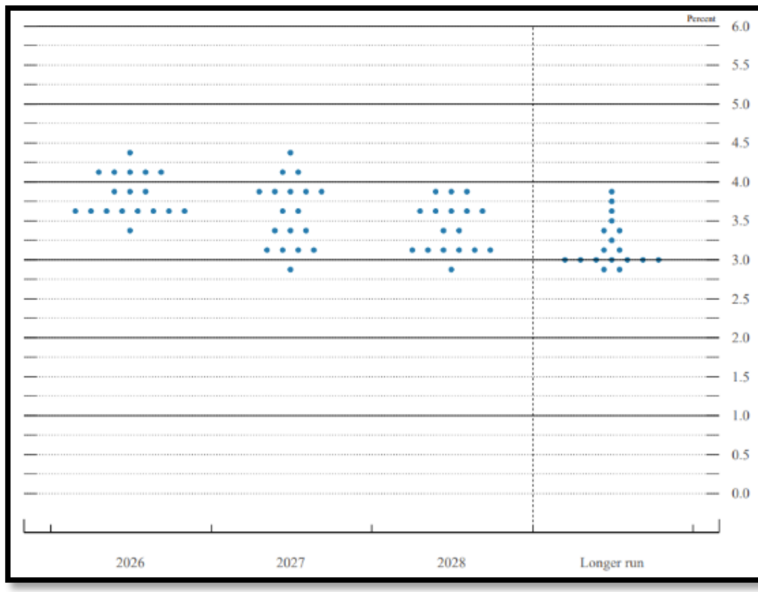
HOWEVER, FED MEMBERS REMAIN OPTIMISTIC

Interest rates that are *eventually* higher would pose an unambiguous headwind to the economy as a whole and to most every entity that is part of that economy. For now, however, the members that comprise the Fed's interest-rate-setting committee (i.e., the Federal Open Market Committee) remain encouragingly optimistic with respect to the probable course of interest rates and other important metrics of the U.S. economy over the next few years and beyond.

At each FOMC meeting, committee members are invited to project where they think certain economic metrics will stand at various future points in time as well as over the longer term. The most recent meeting was held on June 16th and 17th, but only 18 of the 19 committee members provided projections because newly confirmed Fed Chair Kevin Warsh withheld his projections to avoid the appearance of rigid forward guidance. Thus, there are only 18 dots/projections for the two economic metrics that follow.

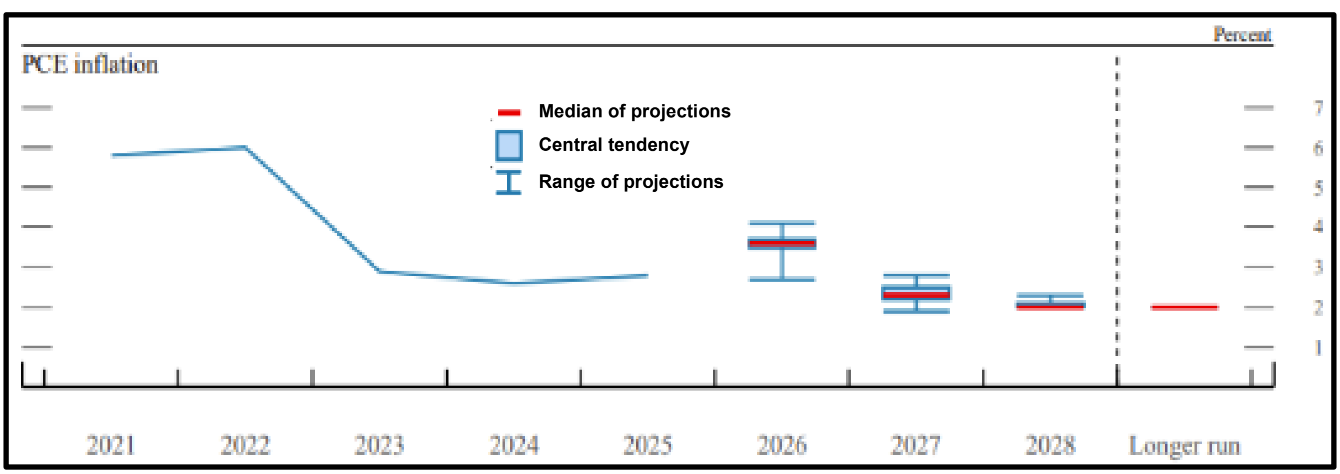
SHORT-TERM RATES

FOMC members generally expect the Fed's benchmark short-term interest rate to decline over the next two years and to then remain there. I cannot divine how this view comports with ongoing structural deficits that result in an ever-increasing mountain of debt, but I am grateful to know that optimism persists within the Fed because lower short-term interest rates would be an unambiguous positive for investors, borrowers and a profligate government.



INFLATION

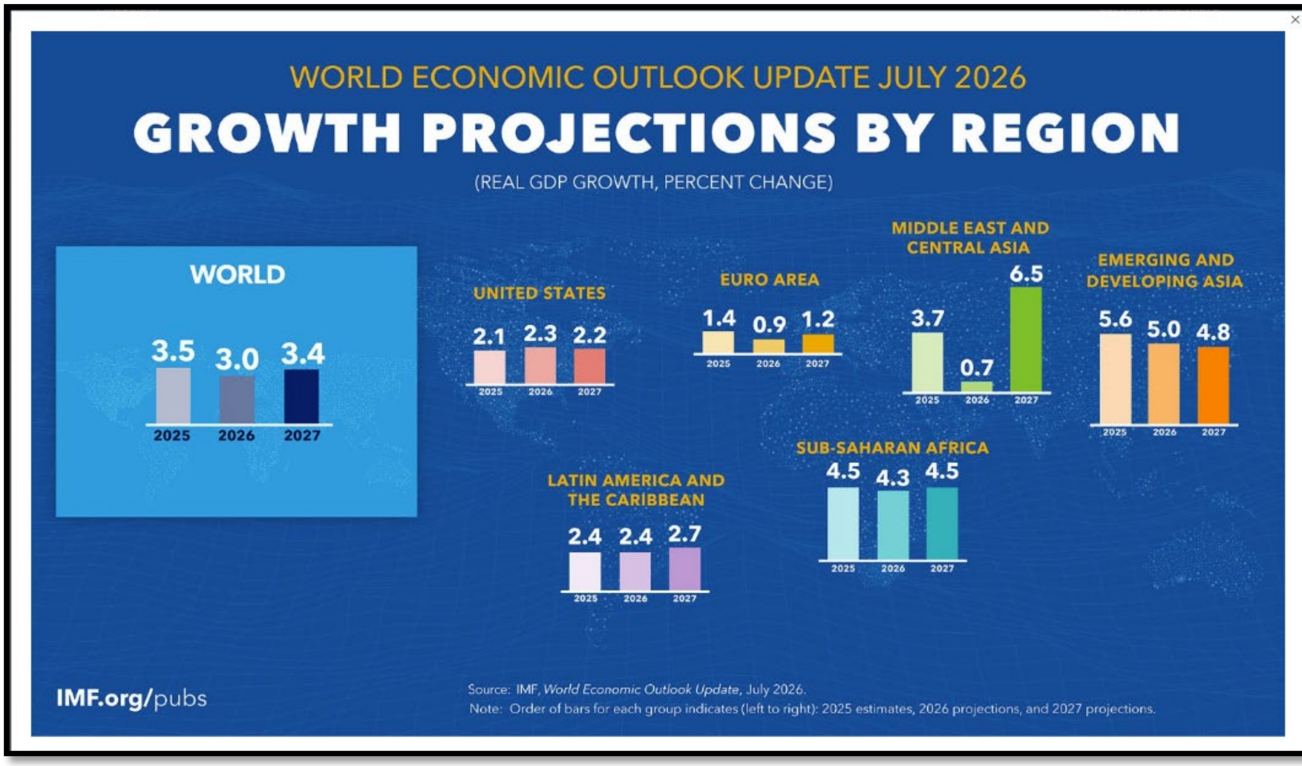
After a modest rise this year, FOMC members generally expect the Personal Consumption Expenditures Index, which is the Fed's preferred measure of inflation, to drift lower over the next couple of years and to remain subdued, thereafter. If this comes to fruition, consumers and investors will certainly appreciate it.



FROM THE INTERNATIONAL MONETARY FUND'S JULY OUTLOOK:

"Global growth is projected at 3.0 percent for 2026 and 3.4 percent for 2027, broadly unchanged cumulatively from the April 2026 World Economic Outlook. The outlook is uneven: The war shock is weighing on energy importers and vulnerable economies, while AI-driven demand is lifting countries integrated into the global technology value chain. Global disinflation has stalled."

"Risks are more balanced than in April, but downside risks from renewed conflict and financial market repricing persist."



IMF: FACTORS TO DETERMINE THE WORLD'S GROWTH PROSPECTS

As the effects of the war in the middle east continue to be felt, the IMF expects stronger investment in technology to partly offset those effects. The following statements are excerpts from the July update to the IMF's World Economic Outlook:

- "Energy exporters outside the conflict are benefitting and tech-led economies are seeing stronger activity, but low-income energy importers face a weaker outlook."
- "These uncertainties and factors will decide future economic growth:
    - The evolution of the conflict [in the Middle East],
    - Energy prices,
    - Supply chains, and
    - Technology-driven expectations and outcomes."

FROM THE WORLD BANK'S JUNE 2026 OUTLOOK

As shown above, the IMF sees world economic growth relaxing from 3.5% in 2025 to 3.0% this year before reaccelerating next year. The World Bank shares a similar view that is somewhat more muted for this year.

Global activity: weaker growth expectations

According to the June 2026 *Global Economic Prospects*, the global outlook has deteriorated, reflecting higher energy prices, disruptions to commodity markets, elevated uncertainty, and tighter monetary conditions. **Global growth is expected to soften to 2.5 percent this year**, **with nearly two-thirds of economies facing weaker prospects** (figure 1.A). Over 2027–28, global growth is projected to firm to 2.8 percent as energy prices decline, commodity markets normalize, financial conditions ease, and trade picks up. **The downgrade this year is driven largely by emerging market and developing economies** (EMDEs), especially commodity importers and those directly affected by the conflict (figure 1.B). **Nevertheless, several sources of resilience remain, including solid growth in the United States, strong AI-related investment, and positive trade developments."**

Global inflation: rising inflationary pressures

"Before the outbreak in the Middle East, global inflation had been broadly stable. Disruptions to the supply of oil and natural gas have resulted in rising energy and other input costs, pushing up global headline inflation (figure 1.C)." "**Global headline inflation is projected to reach 4 percent in 2026, then moderate to 3.1 percent in 2027 as crude oil prices decline. The outlook, however, remains highly uncertain.**" The World Bank also notes that **an improved trade policy environment and "buoyant" AI-related investment are offsetting some of the damage done by the Middle East conflict**.

If rates decline, inflation subsides, and corporate earnings remain solid, the investment environment could be quite accommodating for investors.

- Glenn Wessel

FIGURE 1.A Share of economies by 2026 forecast revision relative to January

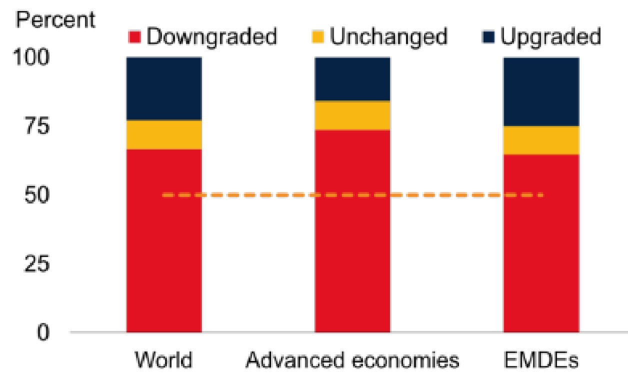


FIGURE 1.B Growth by country group relative to January

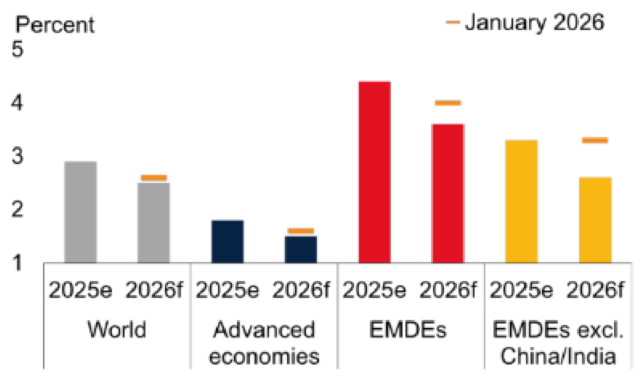
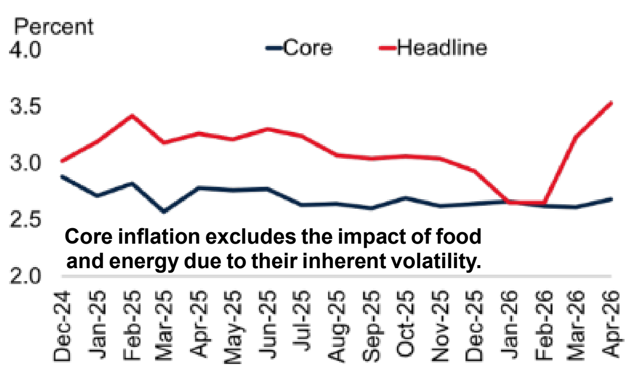


FIGURE 1.C Global headline and core CPI inflation



Sources: Haver Analytics; World Bank.
Note: EMDEs= emerging market and developing economies; excl. = excluding.
A. The share of economies by group and type of forecast revision in the current edition of the *Global Economic Prospects* report compared to the January 2026 report. The dashed line shows 50 percent.
B. Projected annual GDP growth by group from the current (bars) and January 2026 (yellow) editions of the *Global Economic Prospects* report.
C. Panel shows median year-on-year CPI inflation reading from a sample of up to 136 countries. Last observation is April 2026.