Pavlic Investment Advisors Inc.

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2nd Quarter 2026 Market Review & Outlook

Dear Client,

Following a volatile start to the year, the second quarter of 2026 brought about strength to the headline U.S. equity markets, driven by continued corporate earnings growth and ongoing advancements in productivity. While major indices are sitting near all-time highs, beneath the surface of the broad market shows a deeper transition unfolding as investors adjust their expectations for the years ahead. AI euphoria kicked into overdrive in the second quarter as gains were led by a handful of chip and semiconductor equipment names. We remain focused on keeping your portfolios diversified and positioned for the best future risk-reward opportunities—skating to where the puck is going, not where it has been.

For much of the last five years, the market has been defined by a remarkably narrow set of leaders. Larger companies have consistently outperformed smaller ones, and expensive stocks have become more expensive. While this large-cap dominance has been rewarding, we are increasingly looking at areas of the market that have been left behind, namely in areas that are not as strongly tied to the AI enthusiasm that has driven a handful of names up triple digits in the second quarter. In short, we believe some of the most compelling areas moving forward are those that are currently "out of favor, not out of opportunity." Over the long term, what drives stock prices is earnings and cash flow.

AI, AI, AI is All Anyone Wants to Talk About

The market has been trained for years to reflexively "buy the dip" on any weakness, but long-term growth must be supported by solid corporate fundamentals. The transition we are seeing—from an AI "buildout" phase to an "implementation" phase—is already helping companies across various sectors expand profit margins and drive productivity. If corporate earnings hold up, the market has a solid foundation, even if sentiment wavers. If corporate earnings look like they're losing steam, at current valuations the broader stock indices have ample room to consolidate. Interestingly, a recent report from Goldman Sachs highlighted that AI infrastructure stocks are expected to contribute 60% of the S&P 500's earnings per share (EPS) for 2026. To highlight the extreme concentration at the top, just two companies—NVIDIA and Micron—are estimated to drive 40% of the index's overall EPS growth on their own. We have been increasingly positioning portfolios for any hint of slowing in the capital expenditures of large hyperscalers (Microsoft, Google, Amazon, Meta).

Within the AI sector, the economy is continuing to transition from the "buildout" phase—dominated by semiconductor manufacturers and data center infrastructure—into the "implementation" phase. Companies across all sectors, from industrials to financials, are deploying AI tools to expand profit margins, reduce operational costs, and drive productivity gains. We are focused on screening for companies who will be the ultimate beneficiaries of AI driven by enhanced productivity metrics and improving free cash flows, not necessarily the major spenders on the build out of AI.

Between "Iran" and a Hard Place

The second quarter was marked by a belief in the market that cooler heads will prevail and a ceasefire agreement between the U.S. and Iran will be signed. Just in the early part of the third quarter, we have seen this is not necessarily a done deal. Ultimately what the U.S. market cares about is the price of oil and its impact on consumers. Higher oil prices will reignite inflation concerns which have already trended higher over the last few months. Rising inflation concerns boost expectations for rate hikes, which would be at least a partial negative for stocks. Finally, high inflation pressures Treasury yields higher which would also become a headwind on stocks.

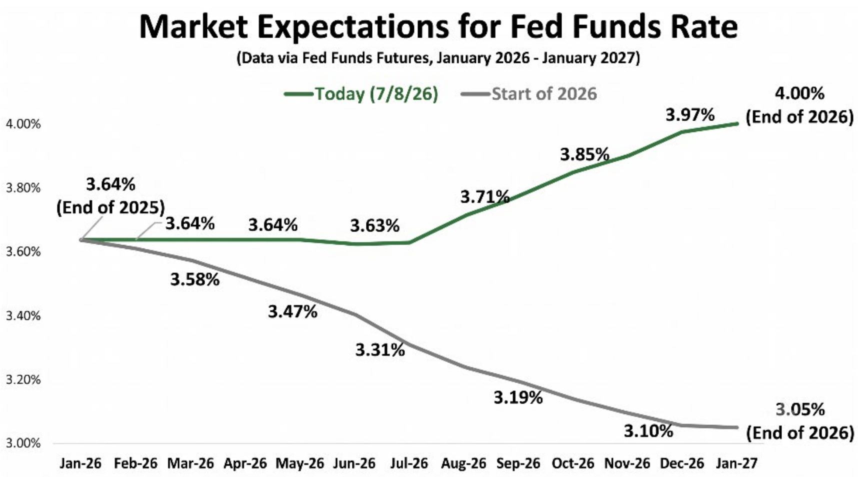
Ultimately, if the reciprocal strikes last for more than a few days it will incrementally add to headwinds on the market via higher inflation, boosted rate hike fears, and rising bond yields, 0so the sooner a "ceasefire" is agreed to once again, the better for markets. We are closely monitoring our oil and gas exposure which trade largely correlated to the price of oil.

Balancing Consumer Sentiment vs. Corporate Earnings

Another key theme we are monitoring is the divergence between consumer sentiment and actual consumer behavior. The University of Michigan's Consumer Sentiment Index has recently hit record lows (dropping to 44.8 in May 2026), while S&P 500 forward earnings expectations are surging—projected to grow over 23% year-over-year in Q2 2026. While consumer sentiment data has looked bleak influenced by headlines regarding government deficits, sticky inflation, and geopolitical issues, the overall consumer has remained remarkably resilient in terms of spending, particularly in the upper income cohort. In fact, the top 10% of households account for roughly half of all U.S. consumer spending. While lower- and middle-income households are feeling the compounding pressures of inflation and high interest rates (driving the overall sentiment index down), wealthier households are insulated by rising asset prices and continue to spend.

Bond Market Review: Navigating the Yield Curve

In the fixed-income markets, the narrative continues to be driven by the Federal Reserve's delicate balancing act. Under the leadership of the new Fed Chairman, Kevin Warsh, the central bank struck a surprisingly hawkish tone at the June FOMC meeting. With the Fed's preferred inflation gauge—Core PCE—ticking up to 3.4% in May, the narrative has quickly shifted from anticipating rate cuts to bracing for the possibility of additional rate hikes by year-end (chart below).



With inflation moving higher and employment remaining close to full capacity, the Fed has maintained a cautious approach to interest rate adjustments. The government's need to finance a growing deficit also puts persistent pressure on the long end of the yield curve. Consequently, we believe short-term yields remain attractive, while longer-term rates continue to reflect a complex economic backdrop.

We view the bond market as a stabilizing force in a portfolio. By extending duration strategically and locking in yields where appropriate, we can secure steady income streams that buffer against the potential volatility inherent in equity market rotations. All that said, we expect an all-stock portfolio to outperform a bond portfolio over the long term. This is where we utilize our financial planning software to determine each client's unique risk tolerance levels in setting appropriate target asset allocations.

Looking Ahead: Strategic Considerations

As we look toward the second half of 2026, we are well equipped to balance risk and reward for clients as the market transitions present ideal opportunities to review and optimize your financial plan. In the second half of the year, we will continue to work closely with clients to evaluate tax and retirement planning strategies. Depending on your individual circumstances, this may involve analyzing the long-term benefits of Roth conversions, maximizing contributions to Health Savings Accounts (HSAs) to capture their unique tax advantages, and ensuring 529 education funds are optimally positioned. Thank you for your continued trust and partnership. We look forward to connecting with you soon to review your portfolio and ensure your financial plan remains fully aligned with your long-term goals.

"The individual investor should act consistently as an investor and not as a speculator." — Benjamin Graham