AVITY Investment Management Inc.®

PERSPECTIVE

April 2026

Equity markets retreated in the first quarter as the sudden eruption of hostilities with Iran injected new geopolitical risk into the outlook. Fixed income investments faced volatility from rising interest rates as higher fuel prices reduced the expectations for monetary easing. Many major foreign nations are dependent on energy imports and will be vulnerable to disruption. The trajectory of the global economy began the year on solid footing but is now contingent upon the duration and intensity of the war in Iran.

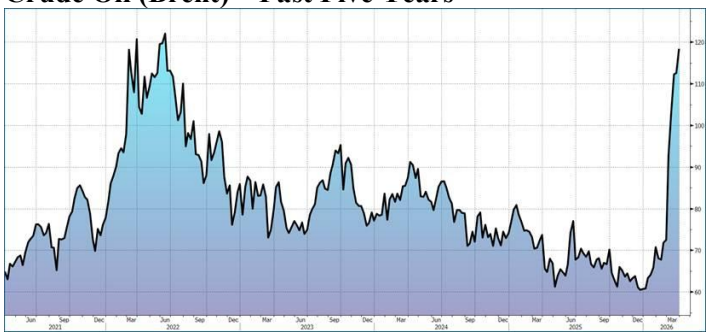
ECONOMIC BACKDROP

The U.S. economy entered the year with expectations for continued expansion driven by fiscal stimulus, deregulation and monetary easing, but the outbreak of war in Iran has clouded the forecast. Prior to the conflict, domestic consumption remained resilient but exhibited some bifurcation. Aggregate consumer spending was healthy in many areas such as services, travel and retail sales, but consumer confidence had been persistently weak, subdued primarily by lower income households who have been disproportionately impacted by higher prices since the pandemic. The Core Personal Consumption Expenditures price index, the Federal Reserve's preferred inflation barometer, increased slightly to 3.1% in January, remaining stubbornly north of the central bank's 2.0% mandate. While the Fed deemphasizes volatile food and energy components, surging fuel costs may prompt a slower pace of rate cuts, counterbalanced somewhat by the expectation for tariffs' inflationary effects to wane in the coming months. The Fed is unlikely to respond to higher energy prices with tighter policy unless price pressures permeate stickier categories, such as wages and services. The unemployment rate increased marginally over the past year to 4.3% in March but remains historically low as sluggish job growth has been offset by a dearth of firing and lower labor supply, in part due to reduced immigration flows. Deregulation and fiscal stimulus should serve to offset higher energy costs to some extent and the strength in corporate productivity, bolstered by new technologies, provides a critical buffer for profit margins against rising input costs. Overseas, fiscal measures remain intact for Europe and Asia but the spike in fossil fuel prices has compromised regional economic agendas and intensified stagflation concerns. The global outlook remains tethered to the regional turmoil, though the U.S. economy is better positioned than most international counterparts.

WAR IN IRAN

The destruction of energy infrastructure and the effective closure of the Strait of Hormuz, through which approximately one-fifth of the world's oil supply crosses, resulted in the largest oil supply disruption in history. Brent Crude prices surged to $118 per barrel, representing an increase of over 60% since the onset of confrontation. The shock extends beyond crude oil to critical byproducts such as helium, essential for semiconductor manufacturing, and fertilizer, intensifying agricultural pressures just ahead of planting season. The International Energy Agency sought to alleviate oil shortages by authorizing the release of up to 400 million barrels from emergency reserves, the largest intervention of its kind, though this is a temporary fix as restoring trustworthy passage of maritime corridors will not be immediate. Despite the current ceasefire, it will take time to restore commodity supply chains, and a geopolitical risk premium may keep energy prices elevated for an extended period.

Crude Oil (Brent) – Past Five Years



Source: Bloomberg

The economic and financial market impact has varied by region. Bolstered by decades of drilling innovation, the U.S. has become the world's top oil and gas producer, which grants it a degree of insulation from energy shocks. Europe and Asia, both net importers of energy, are much more vulnerable to higher prices. Though only a small share of Europe's fossil fuels come from the Middle East, the region's transition off Russian gas has left it increasingly exposed to the price volatility of the global spot market. Asia's exposure is more acute, with the region accounting for a staggering 85% of crude oil that transited the Strait last year. Taiwan and South Korea, semiconductor manufacturing hubs, import nearly all their oil and natural gas. The crisis has compelled governments

across Asia to put in place measures to ration fuel. Despite the U.S.'s favorable standing as a net exporter of energy, a protracted closure of vital shipping lanes could have cascading effect across the domestic economy. Gasoline prices, which have increased 35% over the last month, will reduce discretionary household budgets. Diesel, which is key for logistics, agriculture and construction, has risen 45% and businesses have begun to pass this rising input cost through their supply chain. Failure to achieve a timely cessation of hostilities increases the probability of entrenched inflation pinching consumer spending and profit margins. The White House is incentivized to broker a settlement as the rising cost of living will weigh on economic growth and voter sentiment heading into the midterm elections. However, the path to a diplomatic resolution remains contentious. The U.S. wants Iran to abandon its nuclear programs and allow free passage to return to the Strait, among other demands, while Tehran had insisted upon reparations for damage and the closure of regional U.S. military bases. Despite the impasse, the steepening cost of conflict incentivizes a shift towards de-escalation. The two-week ceasefire proposed April 7th is a promising step for future negotiations.

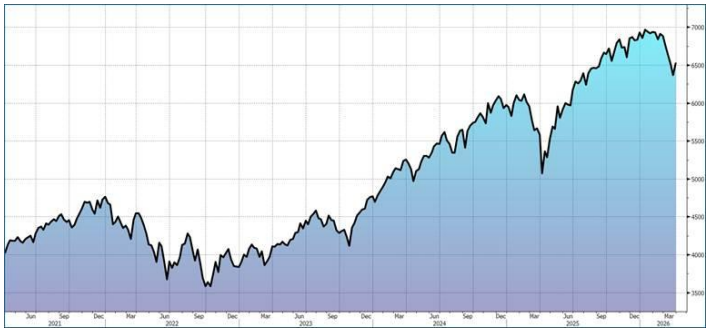
FIXED INCOME

U.S. fixed income investments produced muted returns in the first quarter as fears of inflation reduced expectations for Federal Reserve rate cuts. Government bonds, traditionally considered a refuge in times of geopolitical turmoil, faced lower prices and rising yields since the initial flashpoint. Fed leadership faces a transition in May, from Chair Jerome Powell to nominee Kevin Warsh, at a time when the central bank is tasked with balancing price stability with a cooling labor market. The challenges facing U.S. policymakers are amplified abroad with European sovereign debt markets experiencing more pronounced weakness, reflecting the region's heightened susceptibility to stagflation. Unlike the Federal Reserve's dual mandate, European central banks prioritization of price stability may necessitate restrictive policy to combat inflation even at the risk of exacerbating a slowdown. In the U.S. municipal bond market, state budgets are sound after several years of federal assistance and the demand for tax-free bonds remains steady. Credit spreads for corporate bonds have widened modestly, reflecting unease over the economic environment, but do not yet signal widespread stress. A more idiosyncratic pocket of stress emerged in the private credit market, particularly for asset managers with high exposure to software lending where the threat of AI disruption has triggered concerns of loan defaults. Mounting redemption requests have forced many of these managers to cap withdrawals. In client fixed income portfolios, we continue to prioritize liquidity and credit quality with an intermediate-term duration.

EQUITIES

The prevailing optimism for an extended economic expansion, which buoyed stocks at the beginning of the year, was disrupted by hostilities in the Middle East. The S&P 500 Index declined 4.4% in the first quarter as robust corporate earnings growth was eclipsed by a sharp contraction in valuation multiples. International markets, which led the global rally through February, experienced a more significant correction following the onset of war, reflecting their heightened sensitivity to energy-driven supply shocks. Beneath the surface of the U.S. indices, dispersion between sectors was significant. Energy stocks, near-term beneficiaries of higher oil prices, were the best performing group last quarter followed by the safe-haven areas of consumer staples and utilities. Laggards included financials, consumer discretionary and technology, with the latter pressured by a shifting artificial intelligence narrative

S&P 500 Index – Past Five Years



Source: Bloomberg

around software. Once viewed as primary conduits for AI revenue, software businesses are now confronting disintermediation fears as new agentic tools, from companies like Anthropic, threaten to erode seat-based subscriptions, lower barriers for new competitors, and empower enterprises to migrate software development in-house. Consequently, an industry once prized for its predictable and profitable revenue streams concluded the quarter trading at historically low valuations. While overall U.S. market multiples remain slightly elevated relative to historical norms, the retrenchment in valuations across various industries has surfaced attractive opportunities in high-quality franchises. Consistent with the historical tendency for geopolitical market volatility to be short-lived, the mere prospect of de-escalation, even if core disputes remain unresolved, should redirect investors' focus towards the supportive backdrop for long-term profit growth.