AVITY Investment Management Inc.®

PERSPECTIVE

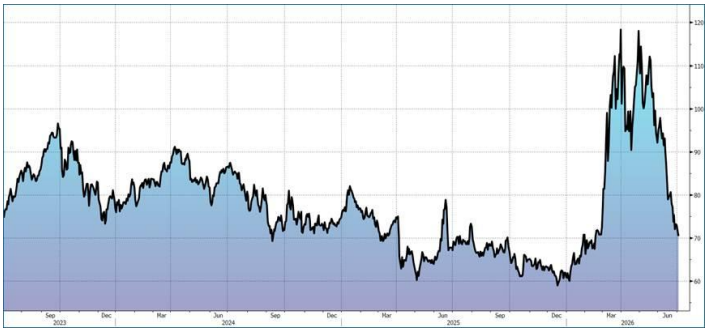
July 2026

During the second quarter, equity markets rebounded sharply from the selloff earlier in the year and recorded significant gains for the first half of 2026. Fixed income investments registered positive results for the year-to-date, tempered somewhat by inflation concerns and rising interest rates. The economic underpinnings in the U.S. remain favorable despite notable headwinds, while overseas economies appear more fragile. In the period ahead we expect domestic conditions to remain supportive for further profit growth, driven by capital expenditures, productivity gains and consumer spending.

ECONOMIC BACKDROP

The U.S. economy remained remarkably resilient last quarter, buoyed by enormous capital expenditures in artificial intelligence infrastructure and robust consumer spending from higher-income households. The labor market, while softening from its highs, maintained a solid equilibrium. The unemployment rate of 4.2% remains relatively low and job growth has improved in recent months. Tax cuts and deregulation have bolstered household budgets and business confidence. Capital investment in AI has reached a scale with little precedent in economic history and is boosting profits of businesses across multiple industries ranging from semiconductors to utilities. In addition, the rise in equity markets elicits a meaningful increase in consumer spending, known as the wealth effect. A noteworthy challenge in recent months has been the resurgence of inflationary pressures. The spike in oil prices related to conflict in the Middle East, coupled with the lingering effects of tariffs and spillover from the surge in AI spending have pushed inflation further from the Federal Reserve's target.

Crude Oil (Brent) – Past Three Years



Source: Bloomberg

Consequently, the central bank has been forced to pause any anticipated easing. An extended period of elevated borrowing costs has squeezed the housing market and strained middle-to-lower-income consumers who struggle with housing affordability on top of challenges with daily living expenses. Economic growth overseas slowed in the first half of 2026, weighed down by a jump in inflation. Europe, highly exposed to disrupted energy flows and inflated natural gas prices, is currently grappling with stalled output growth. Meanwhile, developing nations face their own unique hurdles, as elevated global borrowing costs and a strong U.S. dollar exacerbate sovereign debt vulnerabilities and limit regional infrastructure investments. Looking ahead, we expect inflation to moderate as tensions in the Middle East ease, while consumer spending and momentum in the technology buildout should continue to provide a favorable backdrop for U.S. economic growth.

THE PROMISE OF PRODUCTIVITY

Labor productivity, the amount of output produced by the average worker, is a key measure of economic vitality. Periods in which economy-wide productivity growth quickens, often through labor-saving innovations, tend to be marked by greater prosperity and rising living standards. Since 2022, the U.S. has experienced a notable acceleration in productivity. Following the economic plunge from the pandemic, output regained its prior peak well before employment fully recovered, signaling an adaptation to the adversity by learning to produce more with less labor. The U.S. experience was relatively unique, as most other major economies failed to adapt as effectively to pandemic restrictions and did not register similar improvements. Another contributing factor to the trend in the U.S. is the jump in new business formations after the pandemic, a dynamic that often contributes to rising productivity. In recent years, the commercial emergence of AI appears to have reinforced the trend. The benefits from AI have been uneven across industries and can be hard to measure in the aggregate economic data as implementation is in its initial stages. However, early adopters in areas like digital advertising and software development suggest adoption of AI is likely to amplify the current productivity improvements as firms transition from capital investment to full operational integration.

The benefits to the economy from faster productivity

growth can be profound. Nobel economist Paul Krugman once remarked that "productivity isn't everything, but in the long run it is almost everything." The pick-up in U.S. productivity over the past four years has coincided with resilient economic activity, above-average corporate profit growth and wage gains that exceeded elevated levels of inflation. Historically reliable economic indicators signaled that the U.S. economy was heading for a recession in 2023 after the Fed raised interest rates from near 0% to 5% to combat inflation, yet underlying vigor, including productivity improvements, kept the expansion intact. More recently, the domestic economy withstood the doubling in oil prices without meaningful disruption to the growth trajectory, further evidence of a structural advantage likely supported by improving productivity. The new chairman of the Fed, Kevin Warsh, has argued that sustained productivity growth from the AI boom will increase economic output without triggering long run inflation, granting the central bank the flexibility to lower interest rates in the periods ahead. If he is right, conditions will be fertile for above-average economic growth, rapidly rising corporate profits and further gains in equities.

FIXED INCOME

Changing monetary policy expectations and resurgent inflation pushed interest rates higher, particularly for shorter maturities. In spite of rising yields, client bond holdings generated positive returns in the first half of the year and fulfilled their role in providing stability to portfolios. The yield on the ten-year U.S. Treasury Note finished the quarter at 4.5%, up from a February low of 3.9% before hostilities in Iran. Inflation accelerated during the quarter, with the U.S. Consumer Price Index climbing to a 4.2% annual rate in May, largely driven by energy prices. In response to persistent inflationary pressures, the Fed maintained its federal funds target at 3.75% at Warsh's inaugural meeting last month. Notably, the Fed's latest projections reflect a shift away from earlier expectations for rate cuts, with estimates now pointing toward a rate hike by the end of 2026. This dynamic contributed to the rise in yields, but with oil prices now back to where they were prior to the conflict, inflationary pressures are likely to ease. We are focusing new bond purchases on investment-grade securities of moderate duration to take advantage of attractive yields and maintain the flexibility to adapt to a shifting interest rate environment.

EQUITIES

U.S. equity markets overcame pressures from geopolitical uncertainty, inflation and shifting monetary expectations to register sizable gains in the second quarter of 2026. The S&P 500 Index gained 15.2% for the quarter and is up 10.2% over the first half of the year, largely driven by exceptionally strong corporate earnings. International stocks experienced more uneven performance amid energy price fluctuations, and uncertain economic growth. A significant portion of the surge in profits this year is concentrated in a relatively narrow cohort of companies, specifically those benefiting from the massive, evolving capital expenditures in data center infrastructure, semiconductor manufacturing, and power generation. This transformative technology cycle continues to propel the overall market this year, complemented by broad-based returns across equity market sectors. The outlook for stocks remains constructive but warrants a degree of caution in view of substantial gains recorded over the past four years.

S&P 500 Index – Past Five Years

Source: Bloomberg

Valuations have declined in recent months as profits climbed faster than stock prices, but multiples remain near the high end of their historical range. A temporary pullback is possible if AI demand falls short of expectations or if inflation fails to moderate, but resilience of the U.S. consumer and steady underlying economic growth provide a solid foundation for the long-term outlook. Investor exuberance was on display last month with the successful IPO of SpaceX, the largest offering in history by far. Debuting at a $2 trillion market value as the world's eighth most valuable company, SpaceX is the first of several mega-capitalization companies expected to come to market over the coming year. In client equity portfolios we are maintaining ample exposure to high-quality technology companies driving the current productivity boom, while proactively diversifying into attractively valued sectors that offer durable earnings growth and strong cash flows. This balanced approach is designed to capture appreciation while positioning portfolios to weather volatility across a full economic cycle.