MALVERN CAPITAL MANAGEMENT

# 2nd Quarter 2026 Review and Market Outlook

July 2026

## *2nd Quarter Review*

After a steep sell-off of the major indices in March to end the 1st quarter, the major equity market indices rebounded sharply in April to start the 2nd quarter. The March sell-off was triggered by the commencement of the bombing of Iran by the United States and Israel. The war on Iran sent oil prices much higher, causing investors to fear that inflation would climb further out of control. Oil prices were still quite volatile in April, but equity prices were able to bounce back. The S&P 500 Index jumped 10.49%, the Dow Jones Industrial Average added 7.24%, and the NASDAQ 100 Index rose an astounding 15.66% in April. Not to be ignored were U.S. small capitalization stocks, which rose 12.21% in April (as measured by the Russell 2000 Index). Emerging markets had a fantastic month in April by rising 14.73%.

Although most of the returns in the 2nd quarter came in April, the 2nd quarter results were quite impressive. The technology-heavy NASDAQ 100 Index rocketed forward by 27.74% as earnings reports came in showing impressive growth in the 1st quarter. The artificial intelligence spending is for real, as companies are significantly increasing capital expenditure dollars on this relatively new technology. Also benefiting from the artificial intelligence spending, the S&P 500 Index leapt ahead by 15.20% in the 2nd quarter, and U.S. small-cap companies rose 21.49%.

Beyond the equity markets, U.S. bonds had a positive quarter. Both high-quality and lower-quality junk bonds did well. The investment-grade bond index rose by 0.67%, and the lower-quality bond index was up 2.47% for the quarter.

### Indicies Performance

| Category | Representative Index | 2nd Qtr 2026 | Year-to Date | 12 Months | 3 yr* | 5 Yr* | 10 Yr* |
|---|---|---|---|---|---|---|---|
| Mature US Large Companies | DJ Industrial Average | 13.38 | 9.76 | 20.65 | 17.10 | 10.78 | 13.68 |
| Broad US Large Companies | S&P 500 Index | 15.20 | 10.21 | 22.32 | 20.61 | 13.41 | 15.51 |
| US Small Cap Companies | Russell 2000 Index | 21.49 | 22.57 | 40.78 | 18.60 | 6.98 | 11.62 |
| US Mid Cap Companies | Russell Mid Cap Index | 13.83 | 15.30 | 21.63 | 16.51 | 8.50 | 12.00 |
| Largest 100 NASDAQ Companies | NASDAQ 100 Index | 27.74 | 20.31 | 34.38 | 26.83 | 16.68 | 22.33 |
| Large Cap "Value" Stocks | Russell 1000 Value Index | 13.87 | 16.26 | 27.12 | 17.79 | 11.17 | 11.52 |
| Large Cap "Growth" Stocks | Russell 1000 Growth Index | 16.74 | 5.33 | 17.71 | 22.58 | 13.71 | 18.58 |
| Large Cap Stocks | Russell 1000 Index | 15.14 | 10.33 | 22.02 | 20.47 | 12.66 | 15.30 |
| Developed International | MSCI EAFE Index | 11.08 | 9.84 | 20.80 | 17.02 | 9.60 | 10.20 |
| Emerging Markets | MSCI Emerging Markets Index | 24.15 | 24.02 | 44.18 | 23.62 | 7.69 | 10.52 |
| Broad US Bonds | Bloomberg Barclays US Aggregate Bond | 0.67 | 0.62 | 3.79 | 4.16 | 0.08 | 1.54 |
| High Yield Bonds | Bloomberg Barclays US Corporate High Yld | 2.47 | 1.96 | 5.91 | 8.86 | 4.17 | 5.81 |
| Commodities | Bloomberg Commodity | -8.08 | 14.36 | 25.46 | 11.69 | 9.37 | 5.83 |
| Total US Market (all cap stocks) | Russell 3000 Index | 15.44 | 10.88 | 22.82 | 20.36 | 12.31 | 15.06 |
| Real Estate Investment Trusts | Wilshire US REIT Index | 12.30 | 17.67 | 21.16 | 12.81 | 5.95 | 6.16 |
| Cash | US T-Bill 90 Day | 0.88 | 1.79 | 4.04 | 4.83 | 3.57 | 2.34 |
| International Europe | MSCI Europe Index | 11.32 | 8.33 | 19.33 | 16.90 | 10.19 | 10.59 |
| International Asia Pacific | MSCI Pacific Index | 10.90 | 13.08 | 23.89 | 16.91 | 8.39 | 9.49 |
| Japan | Nikkei 225 Index (Yen) | 33.31 | 34.21 | 55.10 | 25.28 | 12.66 | 13.07 |

** 3 year, 5 year and 10 year returns are annualized. All periods ending June 30, 2026.*
*All returns include the reinvestment of dividends.*

Source: MorningStar Direct.

Commodities were a poor performer in the 2nd quarter, falling 8.08%. Gold, silver, and other commodities dropped considerably in the quarter but have risen significantly over the past 12 months. After trading as high as $5,440.50 an ounce in January of this year, gold traded down as low as $3,962.50 an ounce at the end of June. Commodities remain a good hedge in a portfolio as they tend to be non-correlated to the movement of stocks and bonds.

As we move into the 3rd quarter, big questions remain; will war break out in the Middle East and will oil prices stabilize? Will AI-driven earnings continue to shine, and will the consumer, ravaged by inflation and high gas prices, continue to spend and fuel the economy? Will the Federal Reserve help to lower the rate of inflation by raising interest rates? Will equity markets continue to move forward and reach additional all-time new highs? We look at these questions in greater depth.

## *The Federal Reserve; Is the Next Move a Rate Hike?*

In May, Kevin Warsh began his term as the Chairman of the Federal Reserve. With Warsh at the helm presiding over his first meeting of the Federal Open Market Committee (FOMC), the committee left interest rates unchanged. Many refer to its inaction as a "hawkish" pause. In other words, the committee left rates alone, but the statement after the meeting left investors thinking that an interest rate hike could be forthcoming. The Fed, although unanimous in the decision to leave rates unchanged, cited persistent inflation and a buoyant economy as reasons for potential future rate hikes.

The FOMC's so-called "dot-plot," which is a prediction of each Fed member's anticipated direction of interest rates, projects by year-end that the Fed Funds rate will be in a range of 3.6% to 4.10%. At least half of the members believe there will be at least one rate hike before the end of this year. The FOMC has noted that the economy is growing solidly, primarily driven by artificial intelligence spending, productivity, and capital expenditures that have outweighed the worries created by high energy prices and the war with Iran.

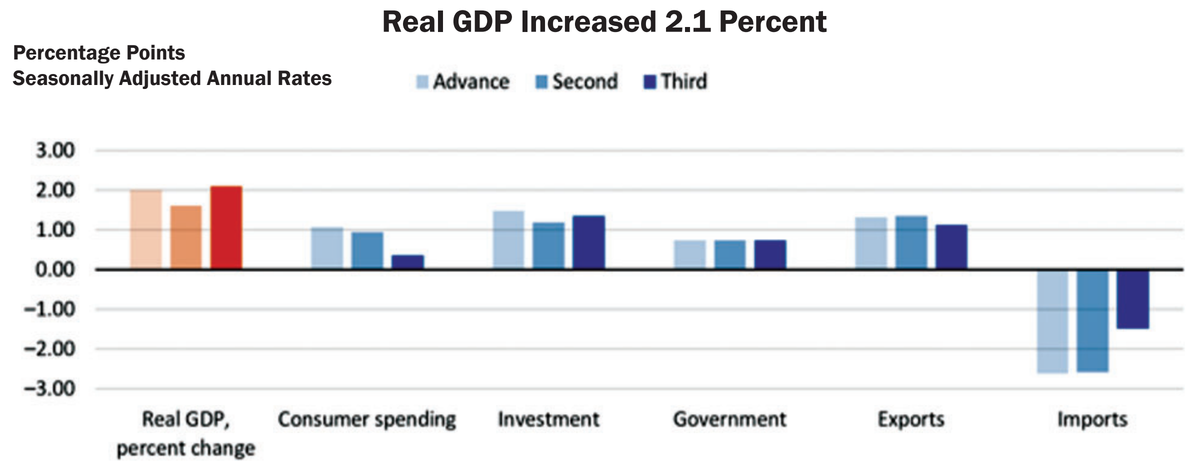
Given the tenacious inflation above the Federal Reserve's target inflation rate of 2%, we have concerns that the Fed will not be able to avoid raising the Fed Funds rate this year. Unless the economy slips into a recession, which we do not see, interest rate cuts are off the table. In fact, we expect that the Fed will raise the Fed Funds rate within the next few months. Perhaps by the time of the September meeting (September 15 -16) the Fed will implement a rate hike. This should not come as a total surprise to the equity markets, but we may see an initial negative reaction to such a rate hike by the markets. At this point, we do not foresee multiple rate hikes as the Fed's dual mandate of full employment and price stability creates an interesting balancing act. Too many aggressive rate hikes could jeopardize the somewhat fragile jobs market.

Longer-term market-driven rates, as represented by the 10-year U.S. Treasury Note, began the 2nd quarter at 4.311% and ended the quarter at 4.418%. The yield hit a high in May of 4.687% before backing off. Given the current inflation rate of change, the market may push these longer-term rates to the 5% level this year. Again, this should not be a total surprise to the equity markets.

## *The U.S. Economy*

For the 1st quarter of 2026, real Gross Domestic Product (GDP) grew at an annual rate of 2.1%. The prior quarter registered real GDP growth of just 0.5%. Contributors to the growth in the 1st quarter were consumer spending, investments, government spending, and exports, while imports were a detractor. Perhaps the tariffs are having an impact on trade policy and are positively impacting GDP. Although not robust growth, the GDP number suggests that the economy is in reasonably good shape at present. But what are the underlying fundamentals of the economy telling us?

## Contributions to the Percent in Real GDP, 2026:Q1




GDP Gross Domestic Product Source: U.S. Bureau of Economic Analysis

Note: Imports are a subtraction in the calculation of GDP. An increase in imports results in a negative contribution to GDP, and a drecrease in imports results in a positive contribution to GDP.

The jobs reports are giving us a mixed picture of the economy. The June non-farm payroll number showed that the economy created 57,000 new jobs in June. This followed the May report, which showed the economy created a revised 129,000 jobs. The May report initially had shown that 172,000 jobs were created. For April, a revised 148,000 jobs were created. The initial April report had shown that 179,000 jobs had been created. Although the jobs are positive, the low number in June and the downward revisions of the prior two months are concerning.

The Conference Board's Consumer Confidence Index increased in June to 91.2 from a May reading of 90.6. The Present Situations Index dropped by 3.0 points to 116.4. The Present Situations Index is a reading on how consumers feel about the current business and labor markets. Consumers' short-term outlook for income, business, and labor markets is measured by the Expectations Index, which increased by 3 points to 74.4 in June.

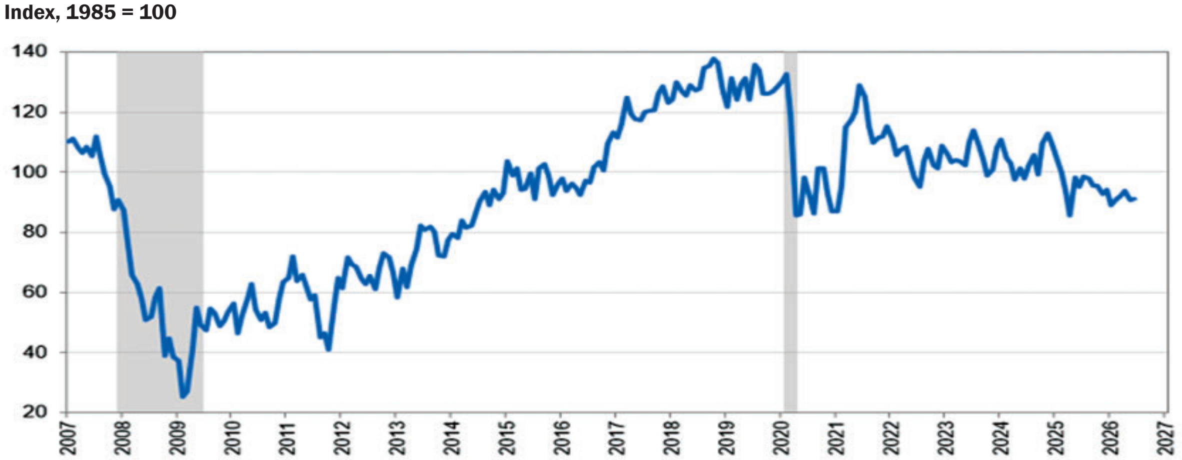
Perhaps declining gasoline prices had an impact on the Consumer Confidence Index and Expectations Index. Higher gas prices can certainly affect consumer confidence in a negative way. According to some estimates, every 1-cent increase in the price of gasoline costs the American consumer about $1 billion per year. In other words, every penny drop at the pump puts an additional billion dollars a year into consumers' pockets.

Other economic reports we like to look at for an indication of the health of the economy are the Purchasing Managers' Indices from the Institute for Supply Management (ISM). The Services PMI report for June came in at a reading of 54%, which is an expansionary number. Any number over 50% in the Services PMI report is considered expansionary. With the June reading, the ISM Services PMI report has shown 24 straight months of expansion.

As for the ISM Manufacturing PMI report, it reported a reading of 53.3% in June. The June report was the 20th consecutive report showing expansion in the economy. Any reading over 47.5% over a period of time in the Manufacturing PMI indicates expansion in the economy.

Although not robust, many of the economic reports we look at paint a positive picture of the economy and not an economy on the brink of a recession. The full impact of the oil shock may not be showing up in the economy yet, but such a shock may have been offset by tax refunds received under the "One Big Beautiful Bill Act".

## Consumer Confidence Index®

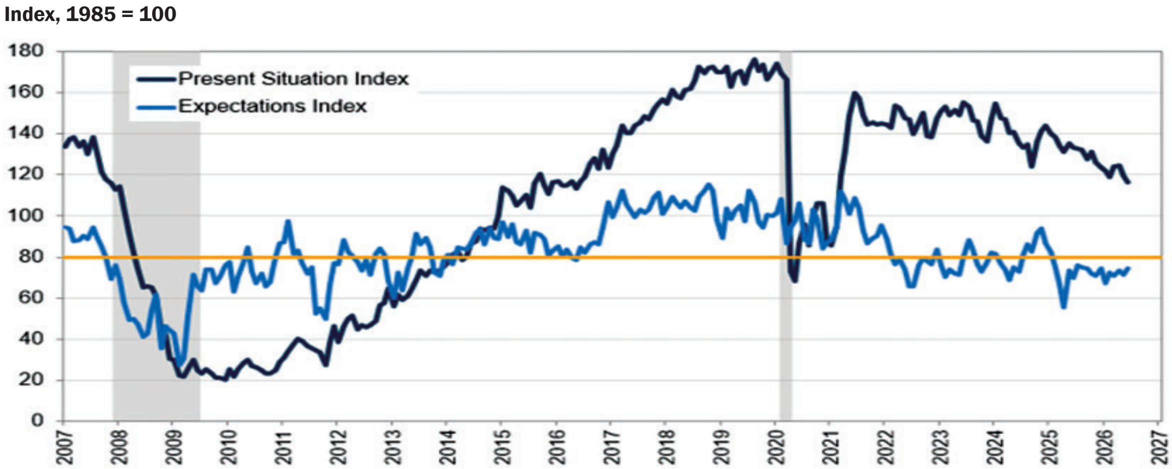



*Shaded areas represent periods of recession.

Sources: The Conference Board; NBER.



## Present Situation and Expectations Index




*Shaded areas represent periods of recession.

Sources: The Conference Board; NBER.



## *The New Technology Revolution; Artificial Intelligence*

New technology is sweeping through the world, which is being embraced by companies and individuals to help transform how we see, hear, and think. Artificial intelligence (AI) uses computer learning to perform tasks that ordinarily would require human intelligence to undertake. We all know what impact the internet has had on the way we live our lives and how companies conduct their business. AI is in the process of doing the same.

From a business standpoint, there are 1) “hyperscalers”, 2) the businesses that utilize the output from the hyperscalers, and 3) individuals who derive benefit from both the output of hyperscalers and the businesses that utilize the output of hyperscalers. What is a hyperscaler? Hyperscalers are companies that deliver cloud, networking, and storage to end-user companies and individuals. Examples of hyperscalers would be Alphabet, Amazon, Meta, Microsoft, and Oracle. These companies manage enormous networks of data centers, allowing their customers to immediately scale their computing functions. An example of businesses that utilize the output of hyperscalers would be the automobile industry. All new cars are made with voice-activated commands to do things in the car. Voice activation is an example of AI. Individuals operate their cars and utilize the AI functions within their cars.

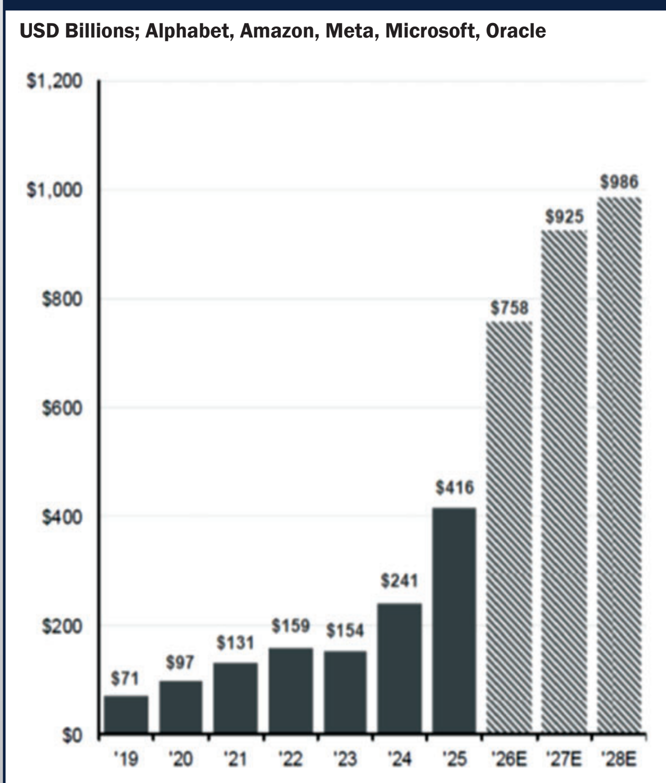
Hyperscalers are investing billions of dollars in AI capital expenditures (Capex). Companies that utilize AI are also investing billions of dollars in AI, and individuals are using AI in their everyday lives. AI is a productivity enhancer at both the business level and the individual level. With all the money being invested and spent on AI, this is translating into earnings for companies.

With all the investment and potential productivity benefits of AI, there remains public fear and apprehension. Much of that fear centers on jobs. People fear that AI is going to cost them their jobs. Jobs will indeed be lost because of AI. But with the lost jobs, there will be new jobs created. This happens anytime there is a new way of doing things that are created. Look back at when the railroads came around. The creation of the automobile. The creation of airlines. The creation of the personal computer and the creation of the internet. Jobs were lost each time. But new jobs were created. Instead of fear, people have to be able to adapt to the ever-changing world.

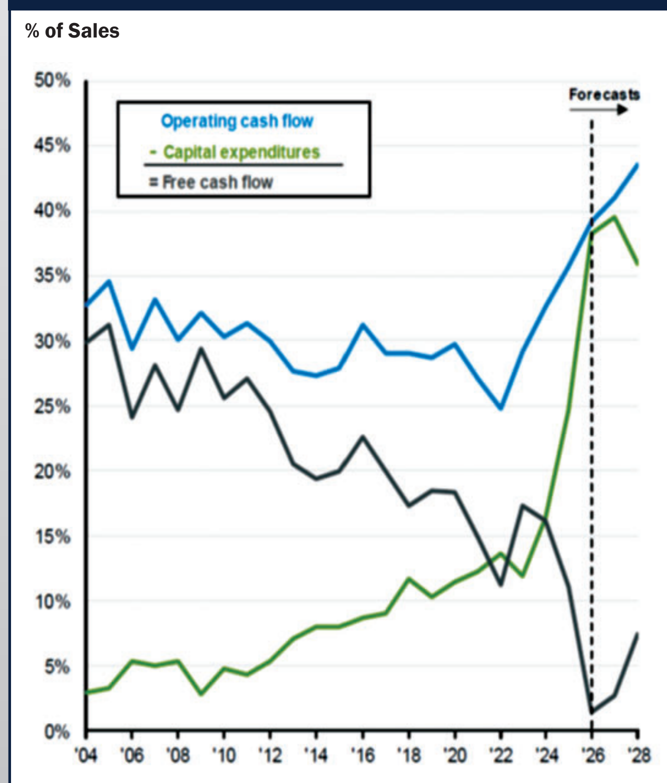
Also, there is fear of the data centers needed for AI. Data centers are physical locations that house servers and other infrastructure for the hyperscalers. It seems like no one wants a data center in their backyard because data centers use a lot of electricity and water and can be an eyesore. But a positive for data centers is that they can bring jobs to a community.

How are we invested in this new technology? We have exposure to all the major hyperscalers within our portfolios, as well as many of the companies that utilize AI.

## Capex from the Major AI Hyperscalers*




## Hyperscalers' Cash Flow and Capex



## *Corporate Earnings*

Corporate earnings continue to grow on the heels of the massive Capex spending on artificial intelligence projects, favorable corporate tax rates, and impressive and improving profit margins. The consensus analyst estimates for the 12-month "forward" earnings is $369.33 per share for the S&P 500 Index component companies. For the prior 12 months (ending March 31, 2026), the S&P 500 Index companies earned $287.66 per share. Analysts forecast strong growth in earnings for the upcoming year. Earnings for the full year of 2026 are projected to be $339.77 per share.

Corporate sales are quite strong and are forecasted to grow over the next 12 months. The 12-month forward revenue forecast is projected to be $2,306.41 per share. How much a company makes in profits on a dollar of sales is its profit margin. The profit margin on the S&P 500 Index (as of the 3rd quarter of 2025) is 13.7%. Profit margins have been increasing over the past few years and are expected to reach 16.0% over the next 12 months, according to consensus analyst estimates.

For small capitalization stocks as represented by the Russell 2000 Index, the forecasted 12-month earnings per share are $277.71 on revenues of $5,539.62, giving us a profit margin of just 5%. However, keeping this in perspective, 40% of the companies in the Russell 2000 Index are not profitable.

## *Market Valuation*

The current forward price-to-earnings (P/E) ratio on the S&P 500 Index is 20.3 times earnings. The 30-year average forward P/E ratio is 17.2 times (according to JP Morgan). The current forward P/E ratio suggests that the market is overvalued currently. However, if we assume projected earnings growth into the calculation, it tells a different story. The PEG ratio divides the current forward P/E ratio by the five-year growth rate of earnings. The current PEG Ratio of the S&P 500 Index is 0.79. A PEG Ratio below 1.0 is generally suggestive of an undervalued market. A PEG ratio of 1.0 is a fair-valued market, and a PEG over 1.0 is considered an expensive market. With the consideration of earnings growth, we can put the P/E ratio into perspective and see a different market valuation.

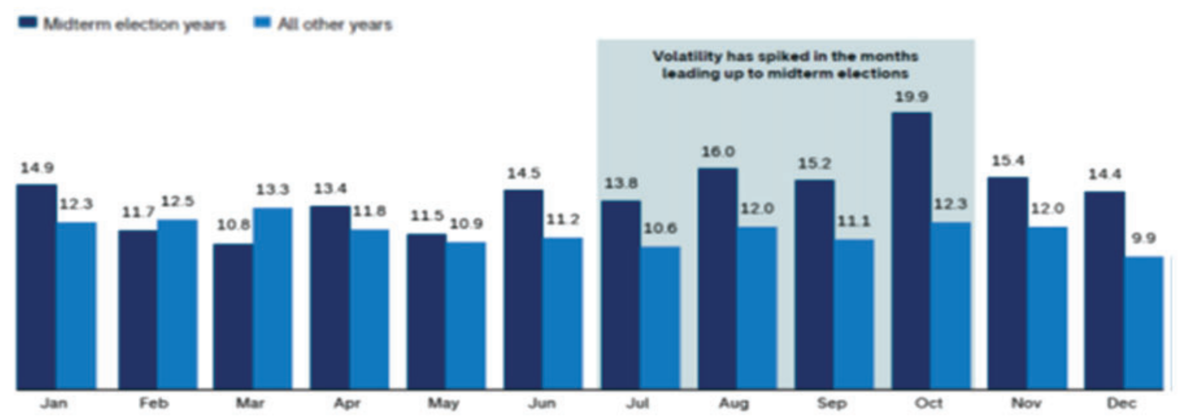
The so-called Fed Model considers interest rates in valuing the stock market. It says that if the yield on the 10-year US Treasury Note is less than the earnings yield on stocks, the market is undervalued. The earnings yield on stocks is simply the inverse of the P/E ratio. At present (6/30/2026), the yield on the 10-year U.S. Treasury Note is 4.418%, and the earnings yield on stocks is 4.93%. Thus, the 10-year US Treasury note is less than the earnings yield, suggesting that stocks are undervalued.

One last valuation indicator to look at would be the Cyclically Adjusted Price Earnings (CAPE) Ratio, which takes inflation into consideration. The current CAPE Ratio is 40.7 times, and the 30-year average CAPE Ratio is 28.8 times, which suggests the market is overvalued. We consider all these indicators, as well as others, when we assess the value of the market.

As far as where we see the market going for the remainder of the year, we believe that with the current year-end consensus estimate for full-year earnings of $339.77 and an assumed trailing P/E Ratio of 23.5 times, we get a valuation of 7984.60 for the S&P 500 Index. This suggests an additional 6.5% price return and, with the reinvestment of dividends, an additional total return of 7.25% for the remainder of the year. We adjusted down our assumed trailing P/E ratio from the 24.0 times used last quarter to 23.5 times due to our anticipation of an interest rate hike this year. With the S&P 500 Index returning 10.21% in the first half of the year, our year-end forecast return for the full year of 2026 is 17.50%.

Lastly, we are in an election year, and as is usually the case, volatility should pick up this year compared to non-election years. Although we expect an additional 7.25% total return between now and the end of the year, it may be a bumpy road getting there.

## Midterm Election Years Have Come with Higher Volatility




Sources: Capital Group, RIMES, S&P Global. Volatility is calculated using the standard deviation of daily returns for each individual month. The median volatility for each month is then displayed in the chart on an annualized basis. Standard deviation is a measure of how returns over time have varied from the average. A lower number signifies lower volatility. As of December 31, 2025. GUIDE TO MIDTERM ELECTIONS

## *Internationals; A Multi-year Investment Thesis*

Developed international equities are continuing to perform well this year, as they did last year. A falling U.S. dollar versus the major currencies such as the Euro and British Pound has contributed to this out-performance. There is also a vast valuation difference between the developed international markets and the U.S. markets, with developed internationals being much cheaper. As we mentioned, the forward P/E ratio in the U.S. markets is 20.4 times. In Japan, it is 16.8 times, and in the Eurozone, 15.3 times.

Corporate governance reforms in Japan have also helped. There is a commitment by NATO members to increase their defense spending to 5% of GDP, which has caused and will continue to cause a lot of spending by these countries, especially in the aerospace and defense sectors. We believe we are in the early innings of the developed international outperformance of the U.S. markets.

The emerging markets are also outperforming other markets this year. The MSCI Emerging Markets Index is up 24.03% through June 30, 2026. Over the past 12 months, the Index is up 44.18%. The reasons for the out-performance are the weaker U.S. dollar versus emerging market currencies and the heavy capital expenditures on the artificial intelligence supply chain in Asia. Many of the emerging market countries are also a single commodity producer which has benefited those countries. Reforms of corporate governance in South Korea have benefited its market. The valuations of emerging markets' stocks compared to U.S. stocks are very favorable on a price-to-earnings ratio basis. The 12-month forward P/E ratio of the emerging markets is 11.7 times versus 20.4 times in the United States. Lastly, earnings in the developing economies have been quite strong this year, and we expect that to continue.

In our portfolios, we have a strong commitment to developed international and emerging markets.

## *U.S. Small Companies Leading the U.S. Markets this Year*

It has been nearly 13 years since U.S. small-capitalization stocks outperformed large-capitalization stocks. The last time small-cap stocks outperformed large-cap stocks was the period April 1999 through November 2013. A lot of this current out-performance is due to huge AI spending and strong earnings growth. Keep in mind that roughly 40% of the companies in the Russell 2000 Index (a U.S. small-cap company index) are not profitable. The other 60% are carrying the weight.  In addition, there is more perceived value in the small-cap sector than in the large-cap sector. Small caps are cheaper than large caps.

One negative point for small-cap stocks is that they tend to perform better when interest rates are falling rather than rising. Small-cap companies tend to rely on borrowing to operate their businesses. As we discussed earlier, we expect the Federal Reserve's next move will be an interest rate increase, and such an increase could adversely impact these companies. Another negative point for small-cap companies is that many tend to be reliant on a single product or service, making their businesses undiversified and adding to the risk of the companies. But we are still committed to investing in these stocks.

Mid-cap companies deserve some recognition as they are also performing well this year, although not to the same extent as small-cap companies. Year-to-date, small-cap companies have returned 22.57% while mid-cap companies have returned an impressive 15.30%. However, for the last 12 months, small-cap stocks have returned 40.78% versus mid-cap stocks' return of 21.63%.

Our expectation is for small-cap companies to continue to outperform large-cap companies for the foreseeable future, despite a possible interest rate increase. We maintain an overweighting in our portfolios to small-cap stocks relative to their weighting in the overall U.S. stock market as represented by the Russell 3000 Index.

## *Summary*

After a war-triggered sell-off in the month of March, equity markets rebounded strongly in the 2nd quarter of 2026. We saw some of the best one-quarter returns we have seen in a long time. Bonds also did well while commodities sank.

Inflation is still a problem, and the Federal Reserve remains challenged as it maneuvers its dual mandate of full employment and price stability. We expect the Fed to hike interest rates once this year, probably at the September meeting. It is an election year, so the last thing the independent Fed wants to do is seem political, but a rate hike may be necessary to help combat inflation. Despite inflation higher than the Fed wants to see, the economy continues to grow with the real GDP growth of 2.1% in the 1st quarter of 2026. Job growth also continues to be positive, although the latest downward revisions in the monthly jobs numbers are concerning. However, many of the economic indicators we follow paint a decent picture of the economy. We now believe that the recession odds over the next 12 months are less than 20%.

A new technology revolution is upon us, which will transform the economy. Artificial intelligence will enhance productivity and ultimately increase jobs in the economy, although there will be some near-term job dislocation. Corporate earnings will be a major beneficiary of this new revolution. We are seeing strong earnings in recent earnings reports, and we continue to think earnings will continue to grow, driving stock prices higher. Even though the market appears to be overvalued by some measures, other metrics show a market that is reasonably valued at this time.

Further driving the markets this year and into the foreseeable future are developed internationals and emerging markets. Lower relative valuations than in the United States, a falling dollar, and improved corporate governance reforms overseas are among the reasons non-U.S. stocks should continue to do well. We also see a lot of value in U.S. small capitalization stocks.

We face challenging times as well as great opportunities. As such, we are here to listen, counsel, and provide direction to all of our clients.

**Olsen, CFA, CFP®**
President & Chief Investment Officer

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