



# Quarterly Economic and Market Review

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**David Lundgren, CFA**

Executive Vice President & Chief Investment Officer

**Stephen Morgan**

Senior Vice President & Investment Director

**Paul Teten, CFA**

Senior Vice President & Chief Investment Strategist

**Martin Sirera, CFA**

Senior Vice President & Director of Equities

**Jeffery Tanguis**

Senior Vice President & Director of Fixed Income



## 1Q26 Market & Economic Review: Resilience Tested by Rising Uncertainty

David Lundgren, CFA

After three consecutive years of exceptional returns for equity markets and the strongest year for bonds since 2002, investors entered 2026 with a high degree of confidence and optimism. The economic backdrop appeared supportive, inflation had moderated meaningfully, and expectations for at least two Federal Reserve rate cuts were firmly embedded in market pricing. The consumer remained resilient, supported by a healthy labor market and rising real incomes, and early-year market performance reflected that optimism with equities and fixed income both getting off to a strong start.

However, that favorable narrative proved short-lived. A convergence of geopolitical and political shocks—including escalating military conflicts involving Venezuela and Iran, along with a partial U.S. government shutdown—quickly tested market resilience. While each contributed to rising uncertainty, it was the Iranian conflict that marked a clear inflection point. The rapid escalation in the Middle East sent oil prices sharply higher, triggering a cascade of effects across financial markets. Volatility surged, inflation fears reemerged, and bond yields moved higher as investors reassessed the path of monetary policy. Expectations for Federal Reserve easing diminished rapidly as inflation expectations rose and deficit concerns intensified, creating a markedly different environment than just weeks prior.

Against this backdrop, equity markets have entered a more complex phase. After three consecutive years of strong returns, expectations were already tempered given elevated valuations and a more mature cycle. Still, the fundamental backdrop remains supportive. Earnings expectations continue to rise, driven in part by sustained capital investment—particularly in artificial intelligence—which is increasingly translating into measurable productivity gains and improved corporate profitability.

At the same time, market behavior has become increasingly driven by near-term risks. The escalation of the Iranian conflict in early March triggered a sharp increase in volatility and a broad-based selloff, underscoring how quickly sentiment can shift. Surprisingly, the S&P 500 has demonstrated notable resilience and is down only modestly—just over 4% for the quarter—despite elevated valuations and heightened uncertainty. Beneath the surface, leadership has shifted meaningfully. Large-cap growth stocks have lagged, while smaller capitalization companies, international equities, and value-oriented sectors have generally held up better, reflecting both relative valuation advantages and improving growth expectations. This broadening of performance reinforces a theme that has been building: diversification is once again being rewarded after a prolonged period of narrow market leadership. While recent declines have modestly improved valuations, they remain elevated in a longer-term context, leaving markets sensitive to further shocks.

Fixed income markets have experienced a similarly abrupt shift. After entering the year with optimism around declining rates, bond markets have faced renewed headwinds. Early-quarter performance reflected a tug-of-war between moderating inflation and





## 1Q26 Key Themes

Stephen Morgan

### MACROECONOMICS

#### Oil Price Shock Ahead

Last year's relatively sanguine assessment of the tariff impact on consumer goods inflation was already on alert to rising inflation trends in imported goods and early-stage producer goods when the Persian Gulf conflict burst into view and crude oil prices surged 58% in March. Everything depends on the duration of the war but it's clear that an oil price shock is coming soon that will drain consumer liquidity and destabilize the global economy.

#### U.S. Economy Base Case: Modest, Stable Growth for the Moment but Disruption Risk Rising Fast

Despite the chaotic rollout of the tariff agenda last year, noisy trade flows, supply shocks and a lengthy government shutdown, the underlying trend in the U.S. economy persisted at a healthy, robust at times, 2-3% growth rate and a relatively low unemployment rate. We expect a solid rebound in 1Q26 in a 3-4% range, a bounce-back from government

shutdown suppressed 4Q25. Our crystal ball is dark though looking ahead as the duration of the war and its disruptive impact on oil prices is the key determinant of inflation and growth risks in the months ahead. A U.S. recession is not our base case but the risk of one is rising uncomfortably.

#### Emergence of AI Adoption as a Differentiator in Productivity Growth

U.S. labor productivity growth has been a current of strength in the U.S. economy for the last three years, during which it trended impressively around 3% annually, bringing benefits of corporate profitability and non-inflationary compensation growth. Market observers have been both thrilled by the concurrent build-out of artificial intelligence technologies and perplexed over the lack of insight as to who and where the benefits of those massive investments might accrue to, if at all. New research has put a bright light on the productivity benefits to the early adopters of AI tools, validating the innovative technology as a profit driver and workforce energizer.

### STOCK MARKET

#### Resilience and Rising Expectations

2026 is still expected to be a strong year for the U.S. private sector. Expectations continue to rise as the promises of productivity enhancements continue to spur massive business investment.

## Rising Risks

Risks from multiple sources – not only geopolitical ones – are building, causing anxiousness among investors and a diminishing risk-appetite notwithstanding increasing expectations.

## Diversification Still Matters

For the first time in nearly a decade and with a bit of durability, equity sub-categories outside of U.S. Large Cap Growth have added value, in some cases significantly, to portfolio results of late.

## POLICY AND POLITICS

### Escalating Geopolitical Conflict ▶ Energy & Market Shock

The attack on Iran by the U.S. and Israel has further heightened geopolitical instability. The closure of the Strait of Hormuz and attacks on energy infrastructure across the region have sent oil and gas prices skyrocketing. Some damage will take years to repair.

### Trade Policy Uncertainty

The Supreme Court's rejection of the International Emergency Powers Act as authority to impose the bulk of the administration's tariffs has injected more uncertainty into trade and investment patterns. The White House has moved quickly to restore tariffs using more established pathways. Meanwhile refunds of tariffs imposed under the authority may provide a tailwind of liquidity into the economy when court cases are settled.

### Funding Dysfunction

Congress has passed 11 of the 12 annual appropriations packages, all of them well after the beginning of current fiscal year. The Department of Homeland Security, however, has been unfunded since the February 13 expiration of the Continuing Resolution that provided stopgap spending as Democrats demand immigration enforcement reform after the shooting of two American citizens in Minneapolis while Republicans, especially in the House, have shown little appetite for compromise. In a partial government shutdown that promises to surpass last fall's record-setting closure, the highest profile impact has been to air travel as Transportation Security Administration officers have left their posts in large numbers.



### Federal Reserve Policy

Investors and lawmakers became more concerned about the independence of the Federal Reserve Bank from undue administrative interference after the Department of Justice launched an investigation of the Fed and Chair Jerome Powell. That investigation appears to be the one significant hurdle to Senate confirmation of the President's choice for next head of the bank, Kevin Warsh, who is generally viewed as an independent analyst typically hawkish to inflation.

### Strategic Realignment

The U.S. has continued to pursue a unilateral agenda on trade, defense, and diplomacy, upending long-held norms. Allies have responded by moving to increase their military readiness and seek alternative trade deals, though cooperation continues overall. Notably, the U.S. used a program of tariffs and military action to exert greater influence on world energy trade while also pursuing industrial policy reform especially in artificial intelligence and strategic minerals.

## FIXED INCOME

### Elevated Inflation Keeps Bond Investors on Edge

The recent surge in energy prices has disrupted the disinflationary progress that had been taking hold across the economy, reintroducing upward pressure on headline inflation and complicating the outlook for fixed income markets. While long-term inflation expectations remain broadly anchored for now, the persistence of supply-driven price shocks, particularly from energy, has increased uncertainty and left bond investors more sensitive to incoming data and geopolitical developments.

### Cautious Federal Reserve Hits the Pause Button

Against this backdrop, the Federal Reserve has adopted a more cautious stance, signaling that current policy is sufficiently restrictive to navigate an oil-price shock without immediate adjustment. Chair Powell has emphasized patience, reinforcing the view that the Fed is willing to hold rates steady as it evaluates evolving risks. At the same time, anticipated leadership changes by mid-year introduce an additional layer of uncertainty, as new policymakers may bring different perspectives on inflation dynamics and the appropriate policy path.

### Bond Market Outlook Stabilizes in 2H26

Looking ahead, the bond market outlook is expected to stabilize in the second half of 2026 as slowing global growth begins to re-anchor expectations for eventual rate cuts. This shift should help restore a more balanced environment for fixed income investors after a period of heightened volatility. As macro conditions normalize, bond market volatility is also expected to revert toward more typical levels, providing a more constructive backdrop for duration exposure.



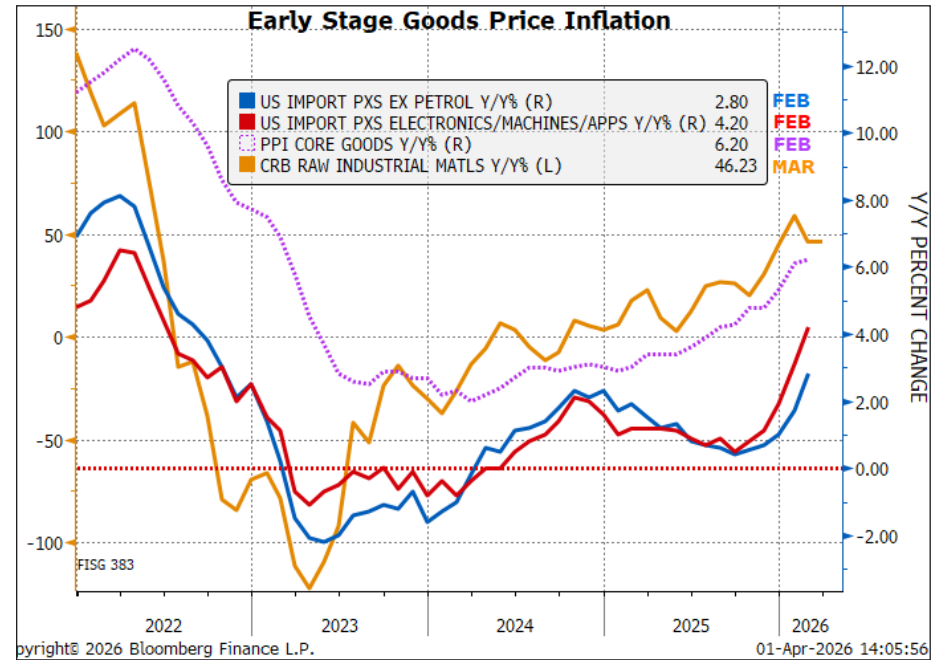


## Macroeconomics 1,2

Paul Teten, CFA

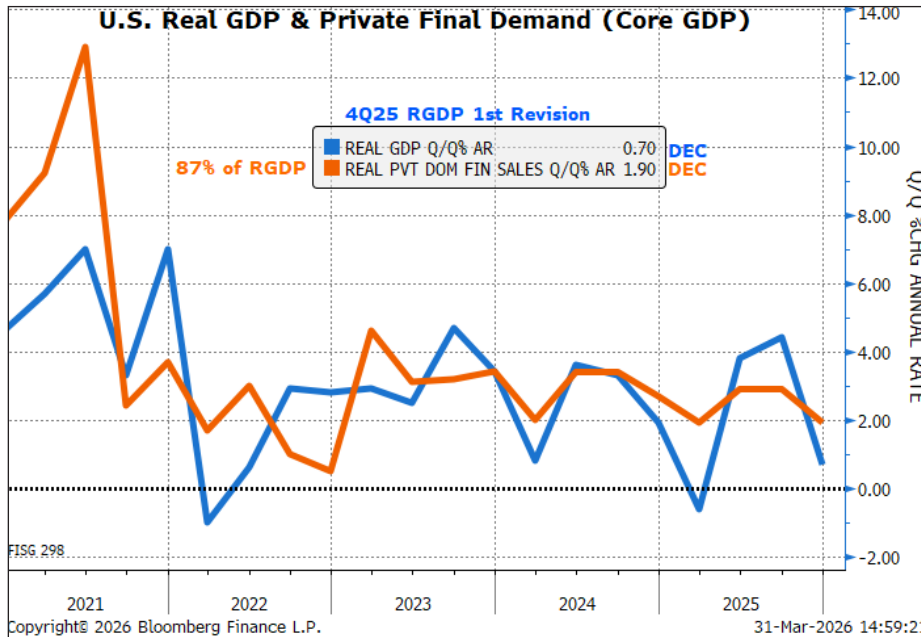
### OIL PRICE SHOCK AHEAD

Last year's tariff rollouts and countermeasures aimed at export controls on rare earth minerals produced a substantial supply-chain shock which the global economy has so far absorbed without a meaningful impact on U.S. consumer goods prices. Core consumer price index and personal consumption expenditure deflators (excluding food and energy prices) have inched up from 2.5% trends last spring/summer to 3.0% in recent months. However, there is growing evidence that early-stage core goods prices for manufactured products are on the rise, note the acceleration in producer price index core goods inflation in the adjacent chart. Our assessment is that both imported goods and industrial materials inputs are contributors to the boil in early-stage pricing. The stranglehold on oil supply through the Strait of Hormuz has caused price spikes in crude oil, gasoline, liquified natural gas, fertilizer inputs and other petrochemicals, e.g., helium is a critical input in the production of semiconductor chips used in iPhones and other electronics; surely to be reflected in early-stage pricing in the months ahead. Much depends on the duration of the conflict with Iran as it pertains to the ultimate impact of the oil price shock on global inflation trends. But it is apparent that U.S. consumer inflation metrics for March will feature a gasoline price jolt from the 37% increase in pump prices in the month. And the longer the conflict persists the higher the likelihood that sky high energy prices infect the price of nearly everything.



### U.S. ECONOMY BASE CASE: MODEST, STABLE GROWTH FOR NOW BUT DISRUPTION RISK RISING FAST

The disrupted and nearly flat Real GDP growth in 4Q25, largely due to the collapse in federal spending during the 6-week shutdown last fall, should bounce back to 3-4% quarterly annual rate growth in 1Q26. Under the hood, we expect core Real GDP growth, comprising 87% of Real GDP and which has steadily trended in a narrow 2-3% channel in recent years, to inch up from 1.9% in 4Q25 toward 2.5% in 1Q26, signaling continuing stable growth in the U.S. economy. However, the outlook beyond in 2026 has become acutely uncertain due to the oil price shock emanating from the Persian Gulf. While the U.S. is energy interdependent, we still have to pay the world price for domestic consumption. Most of our trading partners do not share our advantage and are experiencing substantial recession risk, a clear headwind to U.S. growth. The relatively fully employed U.S. economy has enjoyed at least modest household income and spending growth, and a healthy savings rate, augmented by strong capital investment largely focused on artificial intelligence (AI) technologies and related infrastructure. An expected wave of tax refunds this spring and lower paycheck withholding taxes this year should help offset some of the price escalation at gas pumps and on utility bills. Nevertheless, the pre-war expectations that fiscal stimulus to households would be an



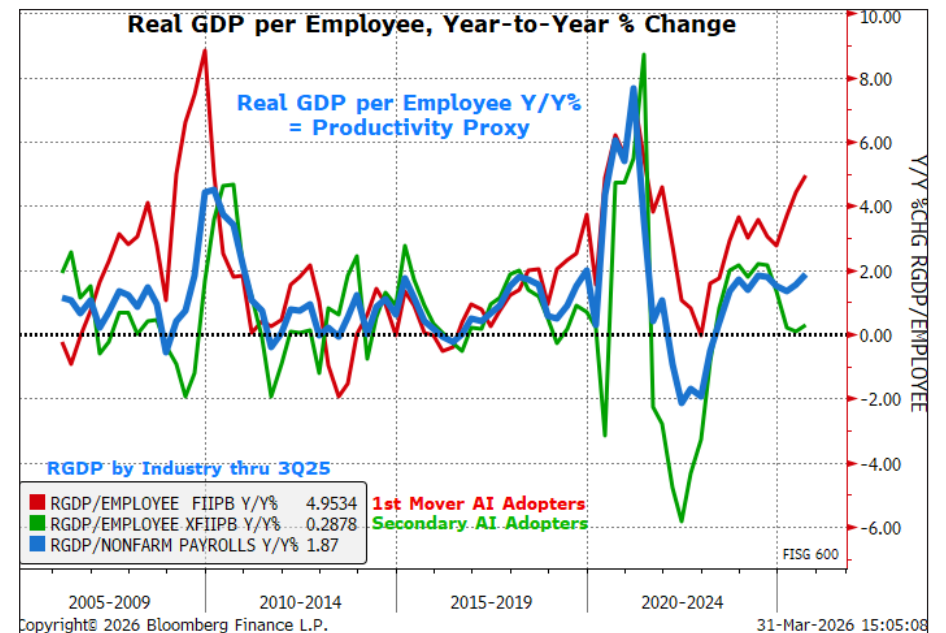
accelerant to consumer spending have faded. Finally, the strong tailwind of robust labor productivity growth continues to be a key advantage to the U.S. economy, boosting corporate profitability and funding the capital spending cycle, while also facilitating healthy workforce compensation growth. A U.S. recession is not our base case but until an acceptable outcome to the conflict in Iran emerges as a clearer prospect U.S. economic growth projections for this summer are losing altitude and inflation expectations are gaining it. Caution notwithstanding, there is a plausible and perhaps probable scenario that the war may end favorably to U.S. interests, to be followed by a market friendly retreat in near-term inflationary pressures.

## EMERGENCE OF AI ADOPTION AS A DIFFERENTIATOR IN PRODUCTIVITY GROWTH

Last fall U.S. equity markets struggled with high valuations for many technology stocks, with competing theories as to the impact of AI tools on employment growth and a lack of insight to end user profitability undermining confidence in the durability of the innovation to justify such massive investment. New research from the Burning Glass Institute at Princeton University has made important strides in identifying which industries are benefitting most from the adoption of AI technologies. Those first mover adopters turn out to be the mostly white-collar professional, data-centric enterprises marshaling research

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processes to drive solutions for customers. These businesses are mostly in banking and finance, insurance, information processing and media, and a variety of business consulting in the legal, accounting, architectural and engineering professions (FIIPB). It is increasingly apparent that the early adopters of AI tools to manage databases and process efficiency are the major beneficiaries of accelerating labor force productivity and the remunerative rewards of profitability and compensation growth. Separation is occurring between the first movers and the secondary adopters, creating a powerful incentive for the laggards to self-examine and identify opportunities to improve workflows and efficiency. This is a continuing theme that is likely to dominate and galvanize U.S. corporate strategies this year. The impact on labor force growth is profound and will likely generate a great deal of study on hiring strategies, career development and more targeted business school curriculum.





## Stock Market <sup>3</sup>

Martin Sirera, CFA

### UNCERTAINTY IN THE FACE OF GEOPOLITICAL TURMOIL

As 2026 opened, hopes for a continuation of the bull market in stocks that began in late 2022 were guarded yet rested on fairly solid footing. After the third straight-year of strong stock market returns (S&P 500 total return, 2023: 26%, 2024: 25%, 2025: 18%), it was natural to temper expectations for another banner year. After all, four straight years of S&P 500 annual returns greater than 10% is something that has only happened 4% of the time over the last 100 years. Without a booming economy, and with elevated equity valuations, the stock market advance had become extended, the bull market was old and tired.

Nevertheless, an economic contraction was not anticipated and business investment spending, among other things, had expectations for S&P 500 profit growth rising. Underlying economic fundamentals combined with new incentives from federal budget and tax initiatives supported a view that stocks could deliver, if not another year greater than 10%, at least solid, positive results.

But while the year started off with some hopeful trends, joint U.S. and Israel military action in Iran has thrown certainty about near-term economic activity, and therefore financial market performance, out of the window. The action began on the weekend after the last trading day in February, so the March performance of stocks is a good guide for what the war is doing to investor psychology.

Volatility, which had been fairly contained in 2025 after the tariff tantrum in March and April of that year, began to rise again as the war loomed. The rise accelerated in March as markets broadly sold off in reaction to the conflict. Investors have clearly become much less certain about their outlook as a result of the situation in the Middle East.

	INDEX	JAN–FEB 2026	MAR 2026	YTD 2026
US	S&P 500	0.7%	-5.0%	-4.3%
	S&P 500 EQUAL WEIGHTED	6.8%	-6.2%	0.2%
	S&P 500 GROWTH	-2.9%	-5.3%	-8.1%
	S&P 500 VALUE	4.8%	-4.6%	-0.0%
	S&P MID CAP 400	8.3%	-5.4%	2.5%
	S&P SMALL CAP 600	7.9%	-4.1%	3.5%
INTERNATIONAL	MSCI ACWI	4.3%	-7.2%	-3.2%
	MSCI EAFE	10.1%	-10.3%	-1.2%
	MSCI EAFE SMALL CAP	10.9%	-10.9%	-1.3%
	MSCI EMERGING MARKETS	14.8%	-13.1%	-0.2%



## RESILIENCE AND RISING EXPECTATIONS

And yet, even in the face of investor retreat from publicly traded equities, investor expectations, represented by analysts' estimates of future quarter profits, are on the rise again. Since mid-February, estimates of S&P 500 EPS growth for the 2nd, 3rd, and 4th quarters of 2026 have risen on average, 4.2 percentage points. As of the beginning of April, S&P 500 EPS are forecast to grow 17.2% for the full year of 2026 compared to the full year of 2025.

In line with the recent past, the strongest growth is forecast for the Information Technology sector. The street expects Tech sector earnings to grow more than 37% in 2026. Other sectors where analysts expect strong growth include Materials (28%), Energy (25%), Communication Services (13%), and Utilities (12%). No sectors are expected to see Earnings decline in 2026. The lowest growth rate, 4%, is for the Real Estate sector, which is mostly composed of REITs, which normally face challenges in a rising interest rate environment.

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The strength and acceleration in analysts' estimates are largely influenced by the ongoing capital spending boom in the Technology sector. Businesses, across the spectrum, have a voracious appetite for artificial intelligence, betting that it will greatly improve their productivity, allowing them to do more – reach more customers, provide better service, build more efficient – with less.

Accompanying the positive expectations for growth in chip sales and the like, are the positive expectations for tech-driven productivity improvements economy-wide. Add to that some artificial stimulants to private sector growth coming from Washington D.C. and it becomes easy to see why growth expectations remain resilient.



## RISING RISKS

Although there were signs of increasing pressure on the Iranian regime, the attacks by Israel and the U.S. on the first weekend of March surprised the financial markets. Unsurprisingly, stocks sold off from the opening salvo. On March 2, the S&P 500 Index opened 1% below the preceding Friday close. Although that first day turned out to be positive, not many more days in the month were. The majority of the trading days in the month saw prices decline, and the full month S&P 500 return, noted in the table above, was -5.0%. That level decline (or worse) has only occurred about 10% of the time in the last 100 years.

For the financial markets, and for stocks in particular, geopolitical risk is almost always present and almost always difficult to quantify. Often, strife in some limited theater somewhere in the globe is initially met with some negative shock but then quickly navigated around as investors conclude impacts to the global economy will be limited. This case is different, as it includes global oil supplies, superpower sub-texts, and the race for nuclear weapons. The spike in oil prices is the likely proximate cause for the slippage in stock prices through nearly the last day in March. An oil price shock that quickly reverses, as this one might should the U.S. and Israel soon decide their objectives have been met, would have limited effect on the global economy. An

extended oil price shock would be a different story, as it would have a depressing effect on economic growth as energy users have to divert expenditures from other uses to rising energy costs. At this point, investors are naturally skittish and weak stock prices are the result.

Unfortunately, risks have been rising in other ways that could negatively impact equity markets. Although beneficial to societal wealth and living standards, the productivity improvements likely to be brought about by the technology investment spending boom, will disrupt employment in the short term. Technology improvements are a permanent feature of the human condition, but the pace of change brought about by AI may be the new component of this cycle. Recent lackluster employment growth is an indicator of this risk and in the short term could have detrimental effects on economic growth.

Equity valuations have frequently been cited in the recent past as a source of risk. With price ratios (price-to-earnings, price-to-cash flow, etc.) hovering near the top of the range experienced in the last 100 years, unexpected developments that cause investors to have the jitters, spark increases in volatility. This risk has actually diminished lately: profit growth has been recently strong (and better than expected), and prices have declined. Stocks have gotten cheaper. Yet valuations are still high in a long-term context.

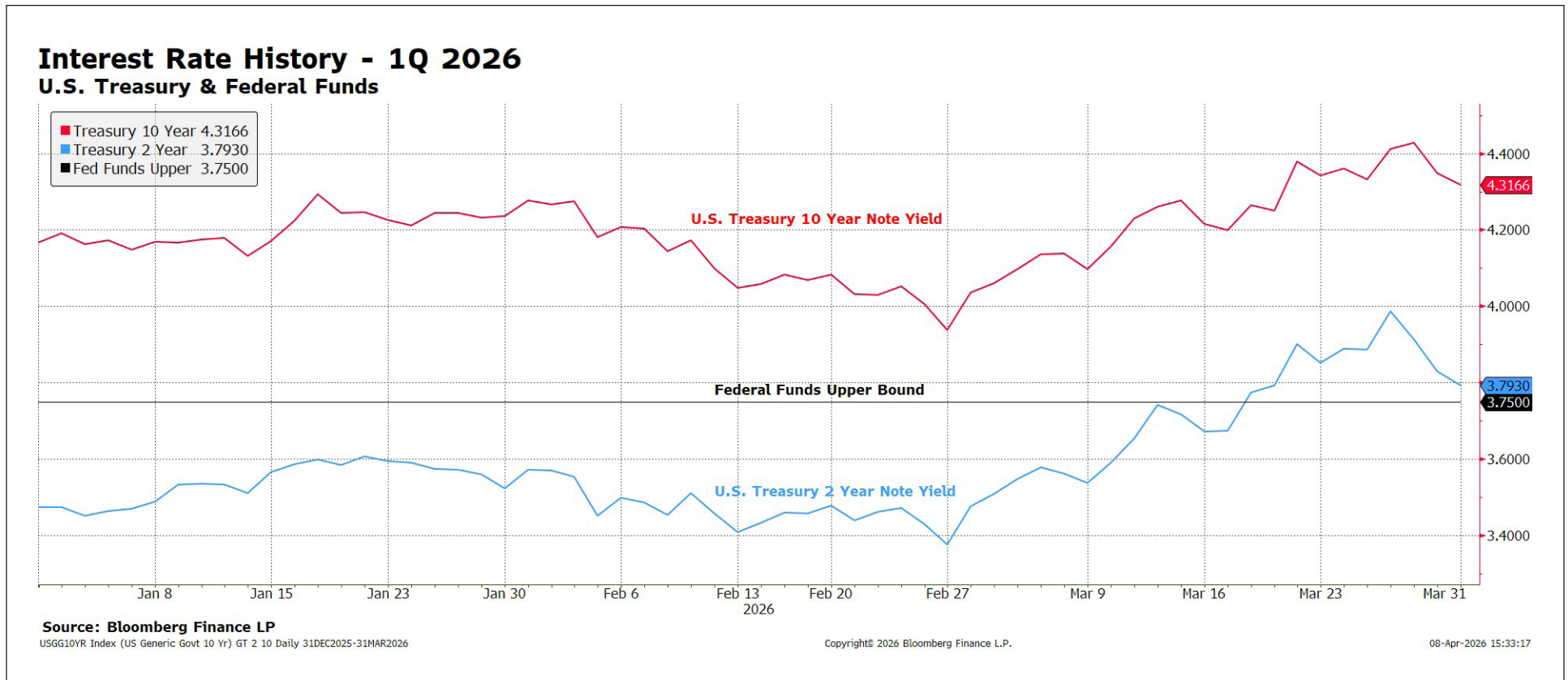
# Bond Market <sup>1</sup>

Jeffery Tanguis

## ELEVATED INFLATION KEEPS BOND INVESTORS ON EDGE

Seasoned bond investors entered 2026 with their guard up but optimistic. After the stellar fixed income returns of 2025, the best since 2002, some bond market consolidation was to be expected. Statisticians refer to it as a “reversion to the mean” while battle-tested traders call it old fashioned profit taking. Call it what you like but the quarter delivered right on cue. Investors began the quarter mostly preoccupied with gaming out the multi-faceted impact of A.I. on the U.S. economy, evolving tariff policy and a stimulative overhaul of tax policy under the One Big Beautiful Bill. Investors were keeping a keen eye out for resurgent inflationary impulses after being stuck well above the Fed’s 2% target. A mild January bond market selloff was followed by a surprise February rally sparked by

the Trump nomination of Kevin Warsh as the next Chairman of the Federal Reserve. The bond market reversed course again in March with the outbreak of the Iran war, rising oil prices and deteriorating inflation outlook. Interest rates ticked higher throughout March in lockstep fashion with crude oil prices. March’s market decline reversed all of February’s gains. By the end of the quarter, heightened inflation fears in tandem with fading Fed rate cut hopes had catapulted the Treasury 2-year yield 32 basis points higher to 3.79%. The bellwether Treasury 10 year note yield rose 15 basis points to 4.32%. Mortgage-backed securities were the better performing sector for the quarter producing a 0.40% return largely as the result of a Trump administration directive that Fannie Mae and Freddie Mac purchase \$200 billion in mortgage debt. The intermediate Treasury securities sector and intermediate Government-Related securities sector returned 0.05% and 0.12% respectively. Intermediate investment grade corporate bonds were a casualty of the volatile risk-off environment slipping -0.22% for the period. Overall, despite the chaotic quarter the broad-based Bloomberg Intermediate U.S. Aggregate Bond Index still generated a modestly positive +0.11% total return for the 3-month period.



## CAUTIOUS FEDERAL RESERVE HITS THE PAUSE BUTTON

The fact that Federal Reserve Chairman Jay Powell mentioned the word “uncertain” seven times during his recent post policy meeting press conference says a great deal about the challenging environment central bankers are currently facing. He was not exaggerating for effect. The Fed has opted to leave its benchmark federal funds rate unchanged at 3.50% to 3.75% two times since December while it assesses the implications of a tsunami of fast changing economic factors. On again off again tariff policies, skyrocketing wartime energy prices, stimulative government legislation, exploding federal debt and an A.I. capital spending craze to name just the really big ones. Overlay the foggy data hangover left by the government shutdown and most anyone can see a patient deliberate approach to changes in monetary policy is warranted. Of the Fed’s twin mandates, maximum employment and stable prices, Powell says the risks to each are balanced. Truth is inflation is much more of a near term wild card. Even before the war, inflation appeared to be stuck well above the Fed’s stated 2% target mostly due to tariffs. The Fed’s preferred inflation measure, Core Personal Consumption Expenditures (Core PCE) Deflator for the 12 months ending in January, was 3.0%. Powell has stated policymakers are inclined to look past tariff and energy shock inflation for some time but that “can’t last forever”. Powell stated interest rate hikes cannot be ruled out either. However, the bar appears to be set high for any move to raise rates. Policymakers believe current monetary policy is well positioned to handle the oil price shock thus far, but the size and duration of the disruption could change the Fed’s response. On a positive note, Powell has pointed out most measures of longer-term inflation expectations remain consistent with the Fed’s 2% inflation goal. The Fed’s own median forecast calls for PCE inflation to return to 2.2% in 2027. The financial markets also anticipate inflation will drop below 2.5% in late 2027. Powell also played down the risk of stagflation by describing the 1970’s as very different than today’s economic circumstances. For now, Powell & Co. are prepared to wait out the uncertainty and gather more data. It is not clear how long Powell as Chairman will be waiting however given his term as Chair expires in May and his presumed replacement, Kevin Warsh, has yet to be confirmed by the Senate. A significant hurdle remains ahead of Warsh because Senator Thom Tillis has vowed to hold up any confirmation until a DOJ investigation into Federal Reserve headquarters remodeling cost overruns is wrapped up. Warsh, if confirmed, is likely to bring a fresh but less aggressive approach to policy. Powell remains noncommittal about his longer-term committee plans after his Chairmanship ends.



## BOND MARKET OUTLOOK STABILIZES IN 2H26

Somewhat like last year the most promising risk/reward outlook for fixed income investments likely occurs in the back half of the year. The duration of the Iranian war and its toll on inflation and the U.S. economy is difficult if not impossible to predict given the currently unknown scale and duration of the conflict. More extreme bond market volatility over the near term seems almost a given. Investors are advised to remain alert. History teaches us that market volatility amid uncertainty can present unique investment opportunities for nimble investors. Already we have seen interest rates spike to relatively attractive levels on panic selling only to quickly recover. More opportunities likely lay ahead. Eventually the economic headwinds of higher energy prices and softening labor markets should slow growth and open the door to Fed rate cuts providing a more constructive backdrop for longer term fixed income investors.



# Policy and Politics 4-23

Stephen Morgan

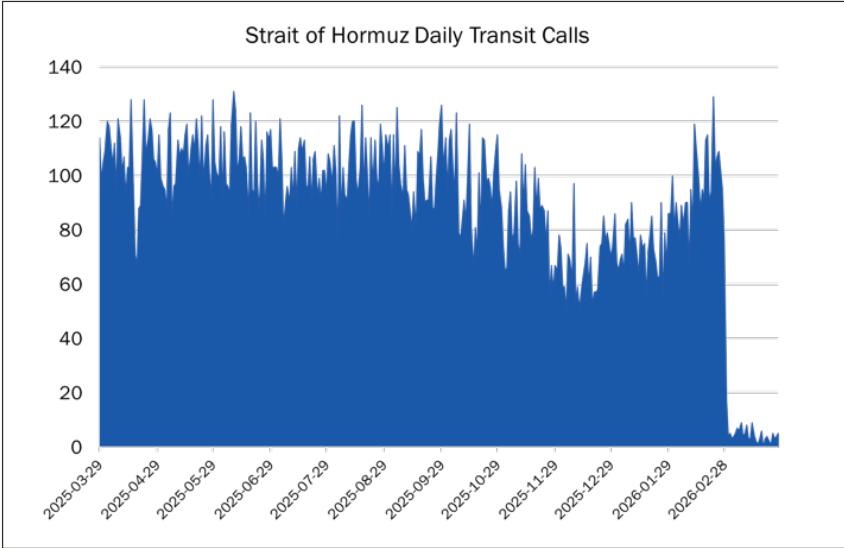
## GLOBAL ENERGY FLOW CHOKES ON CONFLICT

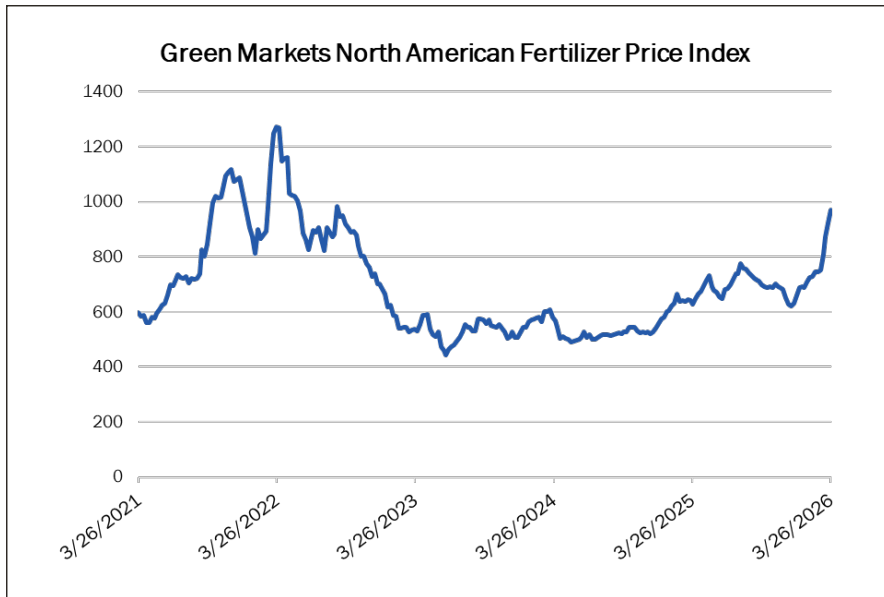
The dominant development of the quarter was the rapid escalation of conflict involving the United States, Israel, and Iran. What began as heightened tensions early in the year evolved into direct military engagement at the end of February, with sustained strikes on Iranian military infrastructure and leadership followed by retaliatory actions across the region. The conflict quickly expanded beyond a bilateral confrontation, drawing in regional actors and disrupting key global energy corridors.

The most immediate and consequential impact has been on global energy markets. The effective closure of the Strait of Hormuz—a transit point for roughly 20% of global oil and liquefied natural gas—combined with attacks on tankers and energy infrastructure, triggered a sharp spike in oil prices from the mid-\$50s per barrel at the start of the year to near \$100 by late March. While prices remain below historical peaks in real terms, apprehensions are rising especially in light of the entry of Houthi rebels in Yemen into the battle, menacing the Bab al-Mandab Strait, another chokepoint that sees about 10% of global oil and gas supply.

The economic transmission channels of the conflict are broad. Higher energy costs are feeding through to inflation, though the effect is likely to be more muted than in past

decades given structural changes in the economy. More importantly, rising fuel costs are already weighing on consumer behavior, particularly discretionary spending, while also increasing input costs for agriculture through higher fertilizer prices. At the same time, military spending is set to increase substantially, with the Pentagon requesting significant supplemental funding to sustain operations and replenish depleted inventories, potentially providing a boost to economic activity alongside the already robust pace of capital expenditures in the private sector.





Meanwhile, the potential for terrorist activity has increased, with policymakers and markets alike factoring in the possibility of domestic or allied-target attacks. Additionally, the diversion of U.S. military resources has raised concerns about opportunistic actions by other global powers, most notably the possibility that China could view the situation as a strategic opening to act on long-standing ambitions regarding Taiwan.

Importantly, the current situation reflects a broader shift in how geopolitical tools are deployed. Alongside traditional military engagement, the administration has demonstrated a willingness to use economic and coercive measures more aggressively. The seizure of the Venezuelan president in a coordinated enforcement action early in January underscores a more assertive posture in the Western Hemisphere, signaling that geopolitical risk is no longer confined to a single region but is instead part of a broader strategy of influence. The administration's decision to cut off oil supplies to Cuba from all sources seems to set the stage for a confrontation there, though one Russian tanker was allowed to make a delivery late in the quarter.

The economic outlook remains highly dependent on the trajectory of the conflict. In an extended attrition scenario—currently viewed as the most likely—energy prices would remain elevated, growth would slow, and consumer sentiment would deteriorate. Even in a quicker resolution, the damage to energy infrastructure is likely to constrain supply for years, suggesting that the effects of the conflict will persist even after active hostilities subside.

## THE FOG OF TRADE?

The Supreme Court's rejection of the International Emergency Economic Powers Act (IEEPA) as a valid basis for broad tariff implementation introduced a significant legal constraint on the administration's trade agenda. While the ruling itself was not entirely unexpected, it forced a rapid recalibration of policy tools.

In response, the administration moved quickly to reimpose tariffs through more established statutory authorities, most notably Section 122 of the Trade Act of 1974. This resulted in a broad-based tariff regime, initially set at 10% with the potential for further increases. While these measures provide continuity in the administration's protectionist approach, their temporary nature and the ongoing legal challenges surrounding prior tariffs have created a high degree of uncertainty for businesses and investors.

One notable development has been the prospect of large-scale refunds for tariffs previously collected under IEEPA authority. As these cases move through the courts, the potential return of funds—estimated in the tens of billions of dollars—could act as a short-term liquidity injection into the economy. However, this potential stimulus is offset by the broader uncertainty surrounding future trade policy, including the possibility of additional tariffs or retaliatory measures from trading partners.

Trade policy has also become increasingly intertwined with broader geopolitical strategy. The administration's use of tariffs as both an economic and diplomatic tool reflects a shift toward a more unilateral approach, even as allies pursue alternative trade arrangements.

For markets, the key issue is not the level of tariffs per se, but the lack of a stable and predictable framework. Businesses are facing a constantly evolving policy environment, complicating decisions around investment, sourcing, and pricing. This uncertainty is likely to weigh on capital expenditure and global trade flows, reinforcing the role of trade policy as a central macro risk.

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## FUNDING DYSFUNCTION

Domestic governance challenges have further compounded the uncertain environment. While Congress has passed 11 of 12 annual appropriations bills, failure to fund the Department of Homeland Security (DHS) has resulted in a prolonged partial government shutdown. This impasse, driven primarily by disagreements over immigration enforcement policy, showed itself particularly intractable.

Hours into the second quarter, however, Congressional Republican leadership announced they had reached an agreement to fund the department when both chambers return from recess. The plan strongly echoes one passed by the Senate on its last legislative day of the quarter which House Republicans initially rejected. Under the plan, the appropriations bill will fund all of the DHS except the parts directly involved in immigration enforcements which Republicans will then fund in a separate budget reconciliation measure, avoiding a filibuster in the Senate.

The consequences of the shutdown have been both immediate and visible. The most prominent impact has been on air travel, as Transportation Security Administration personnel have left their posts in significant numbers due to missed paychecks, leading to delays and operational disruptions. More broadly, concerns emerged about the ability of DHS to fulfill its core functions, including border security, disaster response, and cybersecurity, underscored by criticism of Kristi Noem's leadership of the department which eventually led President Donald Trump to replace her as Secretary with Senator Markwayne Mullin, a step that likely helped enable the funding compromise.

The political system has increasingly struggled to deliver timely and consistent funding. The reliance on continuing resolutions and last-minute negotiations has become the norm rather than the exception, increasing the likelihood of future disruptions and putting incumbents on a hot seat ahead of the fall mid-terms.



## FED INDEPENDENCE DAZE

Concerns about Federal Reserve independence intensified during the quarter following the launch of a Department of Justice investigation into the central bank and Chair Jerome Powell. While the investigation itself has not materially altered policy decisions, it has added a layer of political risk to the Fed's operating environment.

The investigation also raises questions about the confirmation of Kevin Warsh, President Trump's nominee to lead the Fed. Some senators have expressed reluctance to proceed with confirmation until the investigation is ended and reassurance about Fed independence provided. Failure to anoint a new Fed President before the expiration of Powell's term heightens worries that the Fed may not be able to make meaningful policy choices while internal struggles play out.

## STRATEGIC FRAGMENTATION

As the quarter drew to a close, the President was again threatening to leave NATO based this time on other members' unwillingness to provide more support in Iran. This is further evidence of a broader realignment in global economic and political relationships. The United States has continued to pursue a more unilateral approach across trade, defense, and diplomacy, prompting allies to reassess their own strategies. This has included increased military spending, efforts to diversify trade partnerships, and a renewed focus on industrial policy in areas such as artificial intelligence and critical minerals.

While cooperation remains intact in many areas, the direction of travel suggests a more fragmented and competitive global system. Over time, this shift is likely to reshape supply chains, trade flows, and the balance of economic power.

### Sources

Sources: <sup>1</sup> Bloomberg Finance, L.P., <sup>2</sup> Dr. Gad Levanon, Chief Economist of the Burning Glass Institute at Princeton U., <sup>3</sup> FactSet, <sup>4</sup> Strategas Research Partners, <sup>5</sup> Piper Sandler Research, <sup>6</sup> The Hill, <sup>7</sup> Politico, <sup>8</sup> Roll Call, <sup>9</sup> Punchbowl News, <sup>10</sup> Associated Press, <sup>11</sup> Reuters, <sup>12</sup> Washington Post, <sup>13</sup> The New York Times, <sup>14</sup> Economist, <sup>15</sup> Market Watch, <sup>16</sup> Defense News, <sup>17</sup> Institute for the Study of War, <sup>18</sup> Foreign Affairs, <sup>19</sup> Al Jazeera, <sup>20</sup> Times of Israel, <sup>21</sup> whitehouse.gov, <sup>22</sup> Bloomberg, <sup>23</sup> International Monetary Fund PortWatch

## About the Authors



**David Lundgren, CFA**  
**Executive Vice President & Chief Investment Officer**

David Lundgren, CFA is the chief investment officer at Hancock Whitney. He is responsible for directing the bank's investment approach; the delivery of asset allocation solutions to institutional and high net worth clients; the management of a platform of client-focused internal and external money managers; and ensuring the bank meets all regulatory requirements.

Additionally, he has been in the banking industry for almost 30 years.

Prior to joining Hancock Whitney, he was a portfolio manager at First Commerce Corporation. David has a Bachelor's Degree in Finance and a Masters in Business Administration from the University of New Orleans, and holds the Chartered Financial Analyst designation.



**Stephen Morgan**  
**Senior Vice President & Investment Director**

Stephen Morgan is the investment director at Hancock Whitney, where he facilitates a team of investment professionals focused on delivering superior investment strategies and client outcomes. Stephen has been in the investment industry for 25 years. He joined Hancock Whitney as part of the acquisition of Capital One Asset Management LLC. Prior to joining Capital One, Stephen worked at Morgan Stanley, efolio.com, Hibernia Bank and Waterhouse Securities. He has a Bachelor of Mathematics from Carleton College and a Master of Mathematics from the University of Wisconsin.



**Paul Teten, CFA**  
**Senior Vice President & Chief Investment Strategist**

Paul Teten, is a chief investment strategist at Hancock Whitney, where he supervises the formulation and implementation of proprietary equity and fixed income strategies. Paul has over 40 years of experience in the finance industry. He joined Hancock Whitney as part of the acquisition of Capital One Asset Management LLC. His prior experience includes portfolio management for the Bank of America Private Bank and fixed income trading and portfolio management at Criterion Investment Management in Houston. He earned his Bachelor's Degree in Finance and Masters of Business Administration from the University of Texas at Austin. Paul is a Chartered Financial Analyst and remains active at the College of Natural Sciences at the University of Texas and serves on the Board of Visitors of McDonald Observatory.



**Martin Sirera, CFA**  
**Senior Vice President & Director of Equities**

Martin Sirera is an investment director at Hancock Whitney, where he is responsible for management of Equity Strategies and client relationships; for participation in firm Asset Allocation decisions. Martin has been in the banking industry for 28 years. Prior to joining Hancock Whitney, Martin worked for Capital One and Hibernia Corp. He has a Bachelor's of Science in Finance from the University of New Orleans and holds the Chartered Financial Analyst Designation. Martin is a Past President of the CFA Society of New Orleans, has served as a Grader for CFA Exams, and is a member of CFA Institute and Chicago Quantitative Alliance.



**Jeffery Tanguis**  
**Senior Vice President & Director of Fixed Income**

Jeffery Tanguis is an investment director at Hancock Whitney, where he is responsible for developing and implementing fixed income strategy and serves as a portfolio manager for high net worth clients. Additionally, Jeff has been in the banking industry for 37 years. Prior to joining Hancock Whitney, Jeff worked with Hibernia Bank as a senior fixed income portfolio manager. He has a Bachelor's of Science in Finance from Louisiana State University. Jeff is a MSRB registered Series 55 Municipal Advisor.

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