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Employment, War, Stagflation: Investment Mood Darkens

The U.S. stock market as of mid-February 2026 was not exactly sailing along, but it had notched a modest gain for the year. The calendar 4Q25 earnings season playing out at the time was strongly positive. Concerns about the AI trade had transitioned from bubble fears to fears that AI agents would replace application software companies. AI worries were confined mainly to the Information Technology sector; other sectors continued higher. As well, the worst of the tariff turmoil appeared to be receding.

Past geopolitical events -- the April 2025 tariff announcements, the June 2025 bombing of Iranian nuclear sites, the January 2026 capture of Venezuela's President Maduro -- briefly disrupted the upward trend in equities. But U.S. investors subsequently returned to optimism, bidding stocks higher amid rising earnings and solid economic growth.

Now, a series of events since mid-February have darkened the market mood. In a relatively short space, investors have had to absorb weak 4Q25 GDP growth, a surprisingly high Producer Price Index (PPI) report, the decline in February non-farm payrolls, the Trump administration replacing IEEPA tariffs (struck down by the Supreme Court) with new levies, and the U.S.-Israeli war with Iran. The conflict with Iran initially sent oil prices soaring. Meanwhile, the risk of stagflation has intensified.

Employment and Pre-War Inflation Worries

In the wake of the Iranian conflict, the jobs economy too has receded from the top of investors' minds. Still, the February jobs report was full of concerning data. After the employment economy showed surprising strength in January, February 2026 non-farm payrolls declined by an unanticipated 92,000. The consensus estimate was for a gain of 60,000. January payrolls were reduced by 4,000 to a still-strong

gain of 130,000, but the reduction in December payrolls pushed the tally for that month to a decline of 17,000 jobs. Actual February results and prior-months revisions reduced the three-month average gain to 6,000, from 70,000 before the February data.

The unemployment rate, which had been in a positive (downward) three-month trend, ticked back up to 4.4% for February from 4.3% in January. The average work week was unchanged at 34.3 hours, and annual wage growth of 3.8% for February remained relatively healthy. Multiple industries lost workers, however. The usually strong Healthcare sector shed 28,000 positions, which was partly related to strikes impacting physicians' offices. The manufacturing sector lost 12,000 positions. Federal government employment declined in February and is now down by 330,000, or 11%, from its peak in October 2024.

For the past several years, the jobs report has had an immediate impact on the likelihood of Federal Reserve policy changes, as expressed by the CME FedWatch tool. Following February non-farm payrolls, the FedWatch tool shifted the likelihood of the first rate cut of the year to June from July. But bond investors' expectations for Fed policy have been subsumed by other events. These include the Supreme Court blocking the Trump administration's use of the International Emergency Economic Powers Act (IEEPA) as justification for imposing tariffs. The administration responded by invoking 10% tariffs (subsequently raised to 15%) under Section 232 of the 1962 Trade Expansion Act. Those tariffs will be in effect for 150 days, after which they must be approved by Congress.

On the same day as the IEEPA ruling, GDP for 4Q25 was reported to have increased 1.4%, below the consensus call for

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ECONOMIC & MARKET COMMENTARY (CONT.)

3.0% growth. The GDP reports for the middle quarters of 2025 were strong, raising the bar for quarter-over-quarter change; and consensus economists failed to fully factor in the 42-day government shutdown. Excluding the impact of the shutdown, GDP is estimated to have risen in the 2.5% range. But consumer spending was also below expectations in 4Q25, with durable goods spending falling into negative territory.

A slowing economy is a problem given worsening affordability concerns. On the final trading day of February, investor sentiment took another blow when the Producer Price Index (PPI) was reported to have risen 0.5% month over month in January. The annual change of 2.9% showed that the past year's progress on pipeline inflation has largely been unwound. The index for final demand excluding food, energy, and trade services rose 0.3% month over month. But the annual change of 3.4% in core PPI was the highest since 3.5% in February 2025.

The Fed, charged with the dual mandate of fostering full employment and containing inflation, faced a worsening quandary as of the end of February. The sharp rise in January PPI argued against any near-term rate cuts, while the February jobs report argued for a more-accommodative stance. The Fed's policy conundrum, however, was about to get more complicated.

War and Stagflation Worries

On the final day of February 2026, Israel and the U.S. launched missile strikes on Iran. The attack took out Iranian missile and radar sites, killed key members of Iran's government and military forces, and within days was revealed to have killed Supreme Leader Ayatollah Khamenei.

Iran has responded with drone and missile attacks partly on U.S. forces in the region but mainly on industrial, oil, and military sites in neighboring states. This has pressured recent collaboration between the U.S. and Gulf states, who publicly claimed they had not been warned in advance of the U.S. and Israeli attacks. These states are firing \$1 million-plus interceptor missiles at Iranian drones that cost less than \$50,000, and have expressed concern about running out of defensive weapons.

Iran appears to have dug in, appointing one of Ayatollah Khamenei's sons as the new Supreme Leader and ruling out any talks with the U.S. Iran also announced it would fire on any ship passing through the Strait of Hormuz, effectively closing down the world's most-important oil corridor. Oil prices have moved above \$100 per barrel for the first time since Russia invaded Ukraine four years ago.

The Trump administration has proposed a \$20 billion insurance program for tankers traversing the Strait of Hormuz. The U.S., which has largely eliminated the Iranian Navy, has also spoken about positioning ships in and around the Strait. While a handful of ships with Chinese

transponder signals have made it through, overall traffic is at a trickle, and that does not solve the world's oil problem.

Brent crude oil, which traded at \$73 prior to the war with Iran, briefly spiked to \$119 before settling back to \$102. That's a nearly 40% increase in less than two weeks. Relatively low prices for gasoline and for natural gas and oil for heating had been a positive amid the affordability crisis. Higher energy prices are not just felt at the gas pump; they percolate through all parts of the economy, from airfares to industrial production to DoorDash deliveries. Until oil (in high volumes) begins moving through the Strait of Hormuz again, global oil prices are likely to remain elevated.

Within the war, the energy situation is complicated and fluid, with no easy solutions in prospect. If Iranian offensive capabilities are sufficiently degraded to allow resumed traffic through the Strait, oil prices could return to their prior status. If, on the other hand, Iran succeeds in attacking oil production in Saudi Arabia and other states, and the U.S. and Israel respond by attacking Iranian oil infrastructure, higher prices may well be here to stay.

The PCE (personal consumption expenditures) portion of the 4Q25 GDP report signaled that consumers are already strained, particularly when it comes to spending on discretionary goods. If oil prices remain elevated, spending on food and gasoline will absorb an even higher proportion of consumer dollars, leaving little room for discretionary spending on goods and services.

Conclusion

The war with Iran and the worrisome jobs data have, for now, sidelined the main issue concerning investors in the year to date, which was the replacement of jobs by AI agents. That is a secular issue that will play out over years and decades. The immediate concern is the rising risk of stagflation, in which economic activity remains tepid while overall prices remain elevated or even rise.

The second year of the current Trump administration has been challenging for investors, as second years of a president's term often are. As of midday on 3/10/26, the S&P 500 was down about 1% for the first quarter of the year. For the first quarter of 2022, the second year of the Biden administration, the S&P 500 declined about 5%.

In this challenging environment, we continue to identify multiple positive and countervailing forces in the U.S. economy, including high-quality and growing corporate earnings, a still fully employed U.S. workforce, and the net positives of the AI investment spending. We are cautiously maintaining our forecast for a positive year for equities in 2026, while continuing to monitor the complex and ever-changing environment.

Jim Kelleher, CFA,
Director of Research

KEY ECONOMIC FORECASTS

- The \$31 trillion U.S. economy remains on course for productive long term growth, powered by corporate investments in AI and outsized spending by wealthy households. Nvidia CEO Jensen Huang estimated, in November, that \$3 - \$4 trillion will be spent on AI infrastructure in the next 5 years.
- Real Potential GDP – the sustainable speed limit of the US economy is poised to increase to 2.1% through 2030 according to the Congressional Budget Office. AI is likely to raise productivity, offsetting slower growth in the potential labor force from an aging population and reduced immigration.
- The war in Iran is affecting millions of lives. Oil supply disruptions are an economic risk to affordability that companies and consumers have faced before.
- The U.S. economy is more resilient, more diversified and less oil dependent, but it is managing additional supply headwinds from tariffs and reduced immigration. This triumvirate could raise inflation, slow growth, and complicate Fed policy. Tax benefits and AI should help the economy.
- A simple rule of thumb: National gasoline prices above \$4.00 begin to hurt consumer spending.
- We are monitoring financial conditions and high-frequency indicators including Nowcasts and weekly job-less claims. We will adjust our 2026 forecast for 2.5% GDP growth if necessary.
- Argus expects S&P 500 EPS to rise almost 16% to \$315 in 2026 and increase about 15% to \$363 in 2027. EPS is helped by an increase in operating margins to about 18.0% this year, well above 13.9% in pre-pandemic 2019. Growing tech giants such as MSFT and NVDA have operating margins of 47% and 60% respectively while Dow stalwarts Walmart and Caterpillar earn 4% and 17%, respectively.
- Argus Fixed Income Strategist Kevin Heal expects the Fed to reduce the funds rate by 25 basis points in 2026 and by another 25 basis points in 2027 taking the target range to 3%-3.25%. We expect the dollar to be slightly stronger in 2026 as foreign demand for shares of innovative U.S. companies and economic resilience offset monetary easing.
- Gold is likely to remain at elevated levels. The ancient safe-haven asset recently reached an all-time record above \$5,000 an ounce.
- Despite last year's economic-and-policy "uncertainty," the Misery Index, which is the Consumer Price Index (CPI) inflation rate plus the unemployment rate, is approximately 6.8%, well below the average of 9.2% since 1949.
- What could go right? Big tax refunds, spending by wealthy consumers, strong S&P earnings, capital investment, productivity gains, inflation expectations remaining anchored, and ongoing innovation.
- Risks: Elevated Inflation, high fuel prices, weak housing market, low income consumers are struggling, spending by affluent may depend on stock market gains, AI may reduce entry-level hiring.
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CURRENT ECONOMIC RELEASES

Current Economic Releases

Date	Release	Month	Previous Report	Argus Estimate	Street Estimate	Actual
6-Mar	Nonfarm Payrolls	February	126K	65K	60K	-92K
	Unemployment Rate	February	4.3%	4.3%	4.4%	4.4%
	Average Weekly Hours	February	34.3	34.3	34.3	34.3
	Average Hourly Earnings	February	3.7%	3.7%	3.7%	3.8%
	Retail Sales	January	2.4%	3.0%	NA	3.2%
	Retail Sales ex-autos	January	3.3%	3.5%	NA	3.9%
	Business Inventories	December	1.2%	1.0%	NA	1.6%
	10-Mar	Existing Home Sales	February	4.02 Mln.	4.00 Mln.	3.88 Mln.
11-Mar	Consumer Price Index	February	2.4%	2.4%	2.4%	2.4%
	CPI ex-Food & Energy	February	2.5%	2.5%	2.5%	2.5%
12-Mar	Trade Balance	January	-\$70.3 Bln.	-\$55.0 Bln.	-\$65.9 Bln.	NA
	Housing Starts	January	1,404K	1,300K	1,340K	NA
13-Mar	GDP Annualized QoQ	4Q "Second"	1.4%	1.4%	1.4%	NA
	GDP Price Index	4Q "Second"	3.6%	3.6%	3.6%	NA
	PCE Deflator	January	2.9%	2.8%	2.9%	NA
	PCE Core Deflator	January	3.0%	3.0%	3.0%	NA
	Personal Income	January	4.3%	4.5%	NA	NA
	Personal Spending	January	4.7%	4.9%	NA	NA
	Durable Goods Orders	January	12.5%	10.0%	NA	NA
	U. Michigan Sentiment	March	56.6	54.0	55.3	NA
16-Mar	Industrial Production	February	2.3%	1.6%	NA	NA
	Capacity Utilization	February	76.2%	76.3%	76.5%	NA
17-Mar	Leading Index	January	-0.2%	0.1%	NA	NA
18-Mar	PPI Final Demand	February	2.9%	2.8%	NA	NA
	PPI ex-Food & Energy	February	3.6%	3.5%	NA	NA
	Factory Orders	January	4.3%	5.5%	NA	NA
19-Mar	New Home Sales	January	745K	725K	725K	NA

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