

Hello,

This is David Kelly, Chief Global Strategist here at J.P. Morgan Asset Management and I'd like to start by congratulating you on surviving the first quarter of 2026. However, even as we try to make sense of the first quarter, we need to survey the financial landscape entering the second. So here are some thoughts on the economy and markets using slides from our second quarter 2026 Guide to the Markets – 10 points in 10 slides in 10 minutes:

(1) Higher oil prices will temporarily increase inflation and worsen inequality – but they shouldn't push the economy into recession.

The most dramatic event of the first quarter was the joint U.S./Israeli attack on Iran. As this is being recorded, it is still very unclear how this war will end. That being said, the U.S. administration is under increasing pressure to find an off-ramp, given a declining U.S. stockpile of offensive and particularly defensive weapons and the rising economic damage from the conflict.

If, as we expect, the conflict ends fairly soon, energy prices may still remain somewhat elevated for months to come, with mixed implications for the U.S. economy as we show on page 31 of the Guide. The conflict has pushed gasoline prices to their highest level since 2022 and this could boost the year-over-year CPI inflation rate to roughly 3.5% by May or June. However, the oil shock is unlikely to push the U.S. into recession since, in contrast to oil price spikes of previous decades, the U.S. is now a net exporter of oil.

This implies that what domestic consumers lose from higher oil prices, domestic oil producers will gain. That being said, gasoline (and energy in general) absorb a much larger share of the income of lower and middle-income households than wealthier households. Because of this, higher oil prices are adding to an already very serious affordability problem, potentially hurting spending on other consumer basics and contributing to a negative public mood heading into the November elections.

(2) Lower net immigration will hurt economic growth but its impact could be partially offset by AI capital spending.

Data released in the first quarter shed significant light on the long term outlook for the U.S. economy both in terms of demographic headwinds and technological tailwinds. On the positive side, productivity in the non-farm business sector rose by 1.7% in 2025, following strong gains of 2.1% and 2.7% over the prior two years. As we show on the right hand side of page 21 of the Guide, output per worker has risen faster this decade than in either the 2000's or the 2010's. This productivity surge has been aided by a sharp increase in capital spending on intellectual property and R&D, a trend that is likely to continue in the years ahead as companies race to take advantage of the AI revolution.

On the negative side, the very sharp downshift in U.S. immigration over the past year, combined with the continuing aging of the baby boom, suggests that the working age

population is now shrinking. Given that we are starting from close to full-employment, this suggests that essentially all the economic growth in the second half of the 2020s will have to come from productivity – a trend that could well limit long-term U.S. economic growth to less than 2.0%.

(3) We expect economic growth to pick up this summer due to strong income tax refunds but then fall back towards 2% later in the year.

Returning to the short-term outlook, we expect relatively slow economic growth for the start of 2026, a pickup in the middle of the year and a resumption of slow growth by the fourth quarter. This forecast is based on an expectation of fiscal stimulus directed at the US consumer. The first dose of this stimulus will largely be received by consumers in April and May as tax cuts enacted last July lead to strong income tax refunds. A second dose could be received over the summer, if Congress enacts so-called “tariff rebate checks” ahead of the November elections. However, if, in November, Democrats win a majority in the House of Representatives, they would be unlikely to support further unfunded tax cuts or spending increases that could give a political advantage to the Republicans. Consequently, we expect fiscal stimulus to wind down or even turn negative in 2027, restraining overall economic growth despite a continuing AI capital spending boom.

(4) Job growth will like remain very weak. However, the unemployment rate should also remain low due to very slow net immigration.

Benchmark revisions to the establishment survey and updated population controls applied to the household survey mean that the government’s two main jobs reports are both showing stagnation in job growth, with payroll jobs rising just 0.1% and employment, as measured by the household survey, actually falling by 0.3% over the past year. Despite continued economic growth, we expect job gains to be lethargic in the year ahead with roughly 50,000 payroll jobs added per month. This reflects both a lack of available workers due to changes in immigration policies and solid gains in productivity. However, this lack of labor supply also means that the unemployment rate could actually fall to end the year at 4.0%, down from its current 4.4%. While the labor market isn’t strong, it is tight.

In addition, despite labor market tightness and higher CPI inflation in the first half of 2026, we expect only modest wage gains as companies hesitate to raise wages in an uncertain environment. This makes it much less likely that cost push inflation will take hold in the U.S. economy.

(5) Year-over-year inflation could peak at 3.5% this summer due to higher oil prices, tariffs and strong income tax refunds. However, it could retreat later in the year as these impacts fade.

We expect that year-over-year inflation rate will rise over the next few months, potentially hitting 3.5% in June, reflecting rising energy and raw materials from the Iran conflict, tariff effects on imported goods costs and a bumper crop of income tax refunds as a legacy of last year’s tax bill. However, inflation should fade quickly in the second half of the year, dragged down by a slightly lower level of tariffs after the IEEPA tariffs ruling and steadily falling housing inflation, reflecting slower rent growth which, in turn reflects weaker immigration. Going into 2027, year-over-year CPI inflation could well fall below 2% as these trends continue and comparisons with this year’s energy prices become much easier.

(6) We now expect the Fed to cut just once this year although we could see more significant rate cuts in 2027 if both inflation and real GDP growth fall below 2% entering 2027.

Futures markets, at the end of 2025, were pricing in two Federal Reserve rate cuts in 2026. However, three months into the New Year both of these projected rate cuts have disappeared to be replaced by a small risk of a Fed rate hike.

Projections of a more hawkish Fed are understandable given the apparent resilience of economic growth and the additional inflation expected due to higher oil prices. In addition, the Fed has demonstrated strong resistance to political pressure to ease. That being said, we think markets are probably pricing in a more hawkish Fed than the data will eventually justify. While we don't currently expect any rate cut before December, if both inflation and economic growth slip below 2% at the end of the year, we could get a rate cut at the last meeting in 2026 and a few more in 2027.

(7) Bond yields look close to fair value arguing for a neutral allocation.

Bond yields rose modestly in the first quarter, likely reflecting the temporary inflation shock of higher oil prices, a worsening federal fiscal situation and more hawkish expectations for the Fed. Meanwhile credit spreads widened on recession fears and, potentially, as a spillover effect from private credit worries.

Still even with now some higher bond yields, there is not a strong argument for making a bet either on duration or credit in bonds. Even if the economy weakens, any rally in bonds should be limited by rising federal borrowing and stubborn inflation. Moreover, at least in the short run, we expect the economy to avoid recession, partially justifying today's still tight credit spreads. However, we do think that roughly normal bond allocations make sense in this environment – historically, today's close-to-4.7% yield on the Bloomberg aggregate bond index has been associated with close to 4.7% annual returns over a 5-year period. Provided inflation fades later in 2026, these yields and potential returns seem reasonable.

(8) Large-cap U.S. equities still look expensive relative to their own history. rest of the market.

One anomaly, entering 2026, was the continued outperformance of the largest companies in the S&P500, both in terms of earnings and equity market gains. Much of this reflects the dominant market position of U.S. tech firms and a surge of interest in and investment spending on artificial intelligence. That being said, in recent years, the stock market outperformance of these companies has generally outpaced their outperformance in earnings, leaving their valuations at high levels relative to the rest of the market.

This anomaly persists today with the top 10 companies in the S&P500 representing close to 40% of the market value of the entire index. For long-term investors, it may make sense to increase allocations to other areas of financial markets in case, economic, geopolitical or idiosyncratic forces turns a mega-cap U.S. equity boom into a bust.

(9) International equities still look attractive relative to the U.S. market even if we ignore an overvalued USD.

In 2025, international stocks sharply outperformed their U.S. counterparts, as local-currency gains were amplified by the impact of a falling dollar. In the first quarter of 2026, despite a rally in the dollar, non-U.S. stocks still narrowly outperformed U.S.

stocks. Still, it has been close, perhaps causing some investors to wonder if 2025 was a flash in the pan for international stocks.

We don't believe so - for three reasons:

First, even after a 2025 rally, non-U.S. stocks still carry much lower valuations than their U.S. counterparts.

Second, the dollar remains very over-valued given our trade fundamentals and we expect it to fall in the years to come, and,

Third, given the outperformance of U.S. stocks over the last decade, most U.S. investors are likely very underweight international stocks relative to an appropriate long-term asset allocation. As they reallocate some funds to international this, on its own, should boost relative international returns.

(10) Alternative investments can add total return, income and diversifications to portfolios.

The last few years have seen very strong stock market gains. However, that very outperformance could limit future returns. Moreover, the traditional role that bonds play in zagging when stocks zig has been challenged in recent years by higher inflation which negatively impacts *both* stocks and bonds.

In this environment, many investors are exploring alternative assets, such as private equity, private credit, infrastructure and real estate. These assets are all quite different – some provide strong long-run returns, some generate strong current income and some act as good diversifiers to publicly-traded stocks and bonds. Many of them are quite illiquid and so should be thought of only as long-term investments. Moreover, the performance of different assets within the alternatives space has varied considerably depending on the manager. Still, adding alternatives to a traditional stock-bond portfolio may make sense for many investors and we expect this area of financial markets to continue to grow in the years ahead.

It should be noted, finally that, while alternatives can play a defensive role in portfolios, they can also be used for offense, allowing investors, for example to participate in the AI theme through smaller private firms building new AI applications or generating the electricity necessary to develop them.

However, more broadly, alternatives and international equities can both play an important role in rebalancing portfolios. This is important since, after three great years for U.S. equity markets, investor portfolios are not just significantly larger but also are more risky and more concentrated than most investors intended. Consequently, and particularly in a very volatile geopolitical environment, investors should consider whether they need to rebalance and how to do this in the most tax-efficient manner.

Thank you for watching!

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