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Stocks Stall as Inflation Rekindles

The S&P 500 spent the first half of May mostly climbing to new all-time highs. The truce with Iran was mainly holding, notwithstanding drone attacks and ships turned away from Iranian ports, and President Trump set out for China, looking to enlist Premier Xi in the peace process. Calendar 1Q26 earnings reports continued to scintillate and non-farm payrolls for April delivered another six-figure gain.

But after six straight weeks of strong gains, stock market momentum started to wane around mid-May. During the president's Asian trip, Premier Xi intensified rhetoric on China's desire for "reunification" with Taiwan. He acknowledged that the Strait of Hormuz needed to be reopened, but offered no concrete ideas or help. Then came a pair of inflation reports suggesting that the energy crisis triggered by the war with Iran was beginning to ripple across the U.S. economy.

Worrisome CPI, PPI Numbers

On May 12, the Bureau of Statistics (BLS) within the U.S. Department of Labor reported that the April 2026 Consumer Price Index (CPI) for all urban consumers rose 0.6% month over month from March and 3.8% over the past year. The "Core" CPI, which excludes food and energy, rose 0.4% month over month and was up 2.8% since April 2025.

The consensus of participating economists correctly predicted the monthly and annual change in all-items CPI, while underestimating growth in Core CPI by 10 basis points on both a monthly and annual basis. The monthly change in the all-items index was actually a step-down from the 0.9% gain recorded in March, when the war with Iran sent gasoline prices spiraling higher.

Within the April all-items CPI, the index for food increased 0.5% from March after being flat in the prior month. Interestingly, the index for food at home (up 0.7%) rose

more than the index for food away from home (up 0.2%), as restaurants sought to absorb rather than pass on rising input costs. In addition to 20% of the world's oil, 30% of the world's fertilizer passes through the Strait of Hormuz. Economists have warned that food costs will keep rising in coming months due to fertilizer scarcity and high diesel costs for shipping.

A handful of categories ticked lower on a month-over-month basis in April, including costs for new vehicles and for medical care commodities. Yet shelter rose 0.6% on a monthly basis, representing a discouraging trend after multiple months with rent inflation in the 0.2%-0.3% range.

Energy costs within the April all-items CPI rose 3.8% from March, after rising 10.9% in March 2026 from pre-war levels in February. Energy costs soared across March and then mainly stabilized in April, bobbing higher or lower depending on the pace of actual or potential negotiations. By mid-May, with China signaling no urgency to contribute to the peace process and with rhetoric from both sides heating up, the key global benchmarks of Brent and West Texas Intermediate (WTI) crude again moved higher.

Over the course of the president's first and second terms, companies have learned valuable lessons about navigating around tariffs. This includes sourcing locally, pursuing cost efficiencies, and replacing fixed costs with variable costs wherever possible. Mainly, they have learned to pass along higher costs to end users, be they businesses or consumers, in a judicious and nuanced manner.

The blended tariff rate is lower now than it was at the end of 2025, after the Supreme Court in February 2026 struck down use of the International Emergency Economic Powers Act (IEEPA) to levy duties on foreign goods. The effects of the war with Iran, however, are creating new strains that risk

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overwhelming companies' ability to hold the line on prices.

On 5/13/26, the BLS reported that the April Producer Price Index (PPI) for final demand increased 1.4% from March and rose 6.0% year over year. Unlike all-items CPI, April PPI for final demand badly missed consensus expectations, which were for a 0.5% month-over-month gain and a 4.8% annual gain. The monthly gain in April 2026 was the second-highest dating back to the series' inception in 2010, while the 12-month increase was the highest since December 2022.

Core PPI, excluding food, energy, and trade services, increased 1.0% month over month, versus a 0.3% consensus forecast; and rose 5.2% year over year, versus the 4.3% consensus call. According to the BLS, nearly 60% of the April rise in final demand can be attributed to a 1.2% rise in final demand for services. That was the biggest monthly jump in final demand for services since March 2022, when the initial recurrence of inflation was gathering momentum.

Prices for final demand goods moved up 2.0%, led by a 7.8% increase in final demand for energy. Over 40% of the rise in final demand for goods reflected a 15.6% increase in the index for gasoline.

PPI captures "pipeline" prices, with lags that can be weeks or months before reaching consumer prices. Even if PPI growth begins to slow, in other words, the ripple effect is still ahead as the April wave of higher prices reaches consumers in June or July. The status of the situation in Iran – currently a "no war, no peace, and no oil" situation – suggests that the Strait of Hormuz will remain largely closed for now. Even after normal shipping resumes in the Middle East and oil and other goods begin to flow, the time required for supply to normalize and for prices to start falling will be measured in months rather than weeks.

Employment, Earnings Remain Strong

While April PPI inflation unfortunately surprised to the upside, employment and jobs growth have been favorable counterweights. According to BLS, non-farm payrolls increased by 115,000 in April, nearly doubling the consensus forecast of 62,000. Given inclusion of the February jobs decline, three-month average jobs growth slipped to 48,000 from a prior 68,000.

The Healthcare sector, as usual, led jobs growth. Argus Chief Economist Chris Graja, CFA, (who forecast 125K new April jobs) pointed to notable increases in retail trade, transportation, and warehousing. Industries that normally would show signs of weakness in a down economy, including manufacturing, construction, professional & business services, and oil extraction, were stable. Federal government employment continued to decline and is now down by 12%, or about 348,000 jobs, since peaking in October 2024.

The unemployment rate was stable at 4.3%, in line with consensus expectations. Average hourly earnings increased 3.6% on an annual basis, within the 3.5%-4.0% range that has prevailed for the past several years. For the first time since early 2023, we can no longer say that annual wage growth is running ahead of inflation growth.

We came into 2026 expecting an average of about 50,000 new non-farm jobs per month; that forecast is now looking conservative. We also underestimated the potential for earnings growth, which is outpacing expectations despite macroeconomic and geopolitical challenges.

With over 90% of constituent companies having reported, S&P 500 earnings from continuing operations for the calendar 1Q26 reporting period are up about 28% from 1Q25 earnings. Three Magnificent 7 companies who report only GAAP results recognized one-time gains that collectively contributed over \$65 billion to S&P 500 earnings for 1Q26. Even excluding those one-time gains, calendar 1Q26 earnings growth is running at a mid- to high-teens rate, compared to expectations for high-single- to low-double-digit growth heading into the reporting period.

About 85% of companies that have posted earnings growth have beaten consensus EPS estimates, far above the usual mid- to upper-70% range. The magnitude of the EPS beat is in high-teen percentages. After backing out those Mag 7 one-time gains, the magnitude of the EPS beat is still in the high-single-digit percentage range and is well above the average 5%-7% beat for the past decade. Finally, revenue growth is running at low-double-digit growth rates, the best since 2022 when the economy was still revving up after the COVID-19 pandemic.

Second-quarter 2026 earnings, which will be reported mainly from mid-July into the end of August, will not have the benefits of those massive one-time gains. But the other underpinnings of EPS growth, including strong revenue gains, margin expansion, and AI-driven demand that remains white hot, should still be in place.

Conclusion

In our base-case 2026 economic and market outlook issued in December 2025, we forecast monthly non-farm payrolls growth in the 50,000-and-up range, S&P 500 continuing operations earnings growth in low-double-digit percentages, and headline inflation moderating to the 2.5% range by year-end. Based on those inputs, our base case was for GDP growth in the mid-2% range and stock market appreciation of 5%-10% as leadership shifted in the S&P 500.

We are sticking with our base-case forecast, while acknowledging that the ingredients of our forecast have changed. Inflation is heading up not down due to the oil shocks from the war with Iran as well as some tariff impacts. The jobs economy is proving not just resilient but appears

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to be gaining momentum as the AI revolution broadens out from hyperscalers to enterprise, sovereign, neocloud, and other customers. We are still finalizing our estimates S&P 500 earnings from continuing operations for 2026 and 2027, but we can say that earnings estimates are heading up simply because 1Q26 EPS has moved the baseline higher.

We continue to model mid-2% GDP growth for 2026. We also continue to model a 5%-10% advance for the S&P 500 in 2026. While the index is already up 7% for the year, that gain is not in the bank given the number of

variables ahead. The “known unknowns” most notably include the outcome of the war with Iran (and the related Israeli-Lebanese conflict) and the U.S. mid-term elections in November.

Consumers are strained, and divergence in the K-shaped economy is intensifying. At the same time, consumers are resilient and employed, businesses are spending, and AI is ushering in a period of change and growth that will take years to play out.

Jim Kelleher, CFA,
Director of Research

KEY ECONOMIC FORECASTS

- The \$32 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%, on average, through 2030 according to the Congressional Budget Office. AI is likely to raise productivity, offsetting slower growth in the labor force from an aging population and reduced immigration.
- The war in Iran is affecting millions of lives. Oil supply disruptions are a risk to affordability. We recently raised our 2026 oil price forecast to \$83 per barrel from \$75.
- The U.S. economy has become 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 have helped the economy.
- A simple rule of thumb: National gasoline prices above \$4.00 begin to hurt consumer spending. The current price of \$4.50 would be a concern if it persists into the back-to-school shopping season.
- The Misery Index, which is the Consumer Price Index (CPI) inflation rate plus the unemployment rate is below the average of 9.2% since 1949 but it has risen to 8.1% from 6.9% in January. Unemployment is low at 4.3% but the CPI rose to 3.8% in April from 2.4% in January.
- We are monitoring financial conditions and high-frequency indicators including Nowcasts and weekly jobless claims. We recently affirmed our 2026 forecast for GDP growth of 2.1%.
- 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 18.7% 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 driven by foreign demand for shares of innovative U.S. companies and economic resilience.
- Gold is likely to remain at elevated levels. The ancient safe-haven asset recently reached a record above \$5,000 an ounce. We expect gold to trade in a range of \$4,000 - \$6,000 in 2026.
- What could go right? Low unemployment, 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, a rising 10-year Treasury yield, a weak housing market, low income consumers are struggling, spending by affluent may depend on stock market gains.

CURRENT ECONOMIC RELEASES

Current Economic Releases

Date	Release	Month	Previous Report	Argus Estimate	Street Estimate	Actual
14-May	Retail Sales	April	4.2%	4.2%	NA	4.9%
	Retail Sales ex-autos	April	5.6%	5.6%	NA	6.3%
	Import Price Index	April	2.3%	2.4%	NA	4.2%
	Business Inventories	March	1.20%	1.2%	NA	2.0%
15-May	Industrial Production	April	0.8%	0.9%	NA	1.4%
	Capacity Utilization	April	75.7%	75.8%	NA	76.1%
21-May	Housing Starts	April	1,502K	1,350K	1,409K	NA
22-May	Leading Index	April	-0.6	-0.4	-0.30	NA
26-May	Consumer Confidence	May	92.8	92.0	92.5	NA
28-May	GDP Annualized QoQ	1Q "Second"	2.0%	2.0%	NA	NA
	GDP Price Index	1Q "Second"	3.6%	3.6%	NA	NA
	PCE Deflator	April	3.5%	3.8%	3.9%	NA
	PCE Core Deflator	April	3.2%	3.3%	3.3%	NA
	Personal Income	April	3.7%	3.5%	NA	NA
	Personal Spending	April	5.7%	5.8%	NA	NA
	Durable Goods Orders	April	2.8%	10.0%	NA	NA
	New Home Sales	April	682K	665K	655K	NA

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