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ARGUS ECONOMIC COMMENTARY

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The Second Quarter of 2026: Reset to Growth

As the nation observed the 250th anniversary of the first Fourth of July, partisan divides and internecine sniping took a back seat, at least for a day. And with the U.S. Men's National Soccer Team as a rallying point, the nation celebrated American exceptionalism and the ongoing belief that we can continually advance from where we began, be that in a humble or elevated manner.

The stock market cooperated in 2Q26, with a 15% gain in the S&P 500, following twin 5% declines (rounded) in 4Q25 and 1Q26. Earnings growth was exceptional, job gains were solid if somewhat below expectations exiting the quarter, and gasoline prices topped out below peak expectations as consumers limited their driving.

Market & Economic Environment 2Q26

The stock market in 2Q26 rallied across April and May, and then declined in June. That followed a similarly bifurcated 1Q26, in which stocks rallied across January and February, and then stumbled in March.

The S&P 500 soared 10.4% in April 2026 following the April 8, 2026, truce with Iran and a strong start to 1Q26 earnings season. The index rose 5.1% in May as an exceptionally strong earnings season played out, reassuring investors about valuation concerns, and as consumer demand elasticity (buying less gasoline) prevented a further spike in energy prices. The S&P 500 fell 1.1% in June 2026, even as energy prices came down and traffic improved through the Strait of Hormuz. Investors appeared to recognize that strong earnings growth was reliant on artificial intelligence (AI) build-outs, causing them to question the sustainability and return on investment from this spending. Altogether, the S&P 500 rose 14.9% in 2Q26, following consecutive 4.6% declines in 1Q26 and 4Q25. The index in 2Q26 delivered its best second quarter since 2020.

Meanwhile, the Nasdaq Composite Index rose about 26% in 2Q26 even with a late-quarter retracement, while the blue-chip Dow Jones Industrial Average (DJIA) advanced about 15% in the second quarter. The DJIA had its best first half in five years.

The memorandum of understanding signed between the U.S. and Iran appears to represent the best chance yet to end the war. But inflation reaccelerated across the second quarter, partly due to Iran war oil shocks, but also due to tariffs and lingering supply chain inefficiencies.

After multiple years of strength, the U.S. employment economy showed signs of slowing in the second half of 2025. Employment growth was better than expected across the first half of 2026 but has been erratic and challenging to predict. June 2026 nonfarm payrolls missed expectations, with a 57,000 gain, below the consensus estimate of 110,000. Given downward revisions to the prior two months, nonfarm payrolls averaged a monthly gain of 110,000 for the June-April period, versus 188,000 for May-March. The unemployment rate was 4.2% in June after three consecutive 4.3% readings. Average hourly earnings for June grew 3.5% annually. For the past few years, annual wage growth stayed ahead of rising prices, but wage growth may now be running behind inflation.

Another bulwark of the bull market has been corporate earnings growth. First-quarter 2026 annual earnings growth of 29%-30% was the highest since 4Q21, which had an easy comparison against the COVID-19 shutdown quarter of 4Q20. About 85% of companies reported results that were above consensus expectations, meaningfully higher than the long-term range of 75%-80%. Companies exceeded calendar 1Q26 EPS expectations in midteen percentages, compared to a historical beat against expectations in the 5%-7% range.

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Two factors consistently keeping earnings moving forward are revenue growth and margin expansion. From a mid-single-digit rate in recent years, annual revenue growth for 1Q26 was about 11%. Even amid war-related energy price shocks, companies have been able to expand margins as they incorporate lessons learned in other tough times (COVID-19, the supply chain crisis, inflation at 40-year highs, tariffs, etc.) and as they begin to incorporate AI-based efficiencies.

The final report of 1Q26 gross domestic product (GDP) indicated annualized growth of 2.1%, accelerating from 0.5% growth in 4Q25 that was impacted by the government shutdown. In broad strokes, the 1Q26 GDP report shows a commercial and industrial economy that appears to be benefiting from aggressive investment in AI. The consumer economy is struggling, with households making hard choices on spending amid existing and new inflation.

First-quarter 2026 Personal Consumption Expenditures (PCE) increased 0.5%, down from 1.9% in 4Q25, with both durable goods and nongoods spending rising 0.5%. Services, typically the biggest spending category within GDP, rose 0.5% in 1Q26 (down from 2.7% in 4Q25) and contributed just 0.26 percentage point to GDP growth.

Nonresidential fixed investment, the proxy for corporate capital spending, rose by 10.6% in 1Q26, up meaningfully from 2.4% growth in 4Q25. The AI boom drove 15.8% growth in equipment spending and 13.8% growth in intellectual property products. Nonresidential fixed investment contributed 1.42 percentage points to total 1Q26 GDP. PCE and nonresidential fixed investment contributed a combined 1.79 percentage points to 1Q26 GDP growth.

The purchasing managers' reports from the Institute for Supply Management showed the industrial and services economies clearly in expansion territory. The Manufacturing Purchasing Managers' Index (PMI) was at 53.3%, and the Services PMI was at 55.4% in June, both above the 50 demarcation line between expansion and contraction.

The Conference Board's Consumer Confidence Index edged up to 91.2 in June from 90.6 in April. The Index of Consumer Sentiment from the University of Michigan recovered to 49.5% in June from 44.8% in May but was down from 60.7% a year earlier as war-related inflation drove gas prices higher and consumers fretted about jobs availability.

Kevin Warsh became chairman of the Federal Reserve (Fed) in May 2026. The new Fed chair helms a board of governors more inclined to raise than reduce the fed funds rate.

The PCE Price Index within 1Q26 GDP rose 4.6%, up from 2.9% in 4Q25. Excluding energy and food, Core PCE (the Fed's preferred inflation gauge) rose 4.4% in 1Q26. In the Personal Income & Outlays report for May, the annual change of 3.4% in the Core PCE Price Index was the highest in three years.

The May all-items Consumer Price Index rose by 0.5% on a month-over-month basis and 4.2% on an annual basis. The Producer Price Index (PPI) for May 2026 rose 6.5% on an annual basis, while Core PPI (excluding food, energy, and trade services) was up 5.1%, the largest annual change since October 2022.

With inflation flaring, interest rates jumped in March and remained volatile across the second quarter. The 10-year Treasury yield was 4.45% as of the end of June 2026, compared with 4.45% as of the end of May and 4.14% at year-end 2025. The two-year Treasury yield was 4.15% as of the end of June 2026, versus 3.99% as of the end of May and 3.45% as of year-end 2025.

The 11 sectors within the S&P 500 began to shift away from growth and toward inflation hedge, defensive, rate sensitive, and cyclical in the second half of 2025. That shift intensified in 1Q26. Growth leadership reasserted itself in 2Q26. Information Technology (IT) rose over 35% in 2Q26, as agentic AI drove a new round of IT spending. Consumer Discretionary, Financial, Industrial, Healthcare, and Materials rose in 2Q26 on hopes an end to the war will drive down energy inflation and drive up consumer spending. Some of 1Q's winners were in the loss column for 2Q26, with Energy falling after a strong 1Q26. These two divergent quarters have led to a balanced advance for the market at midyear 2026. A balanced advance lessens the risk of a thin, toppy market.

We believe that rotation toward more diversity in sector leadership and away from overreliance on growth is positive for sustaining the health and length of the bull market.

Conclusion

The stock market always sits somewhere between greed and fear, and for most of 2Q26, greed was the dominant force. Fear -- mainly that exorbitant AI spending will not earn its rate of return -- began to creep back in as the quarter wound down. We are now in July, usually a strong market month. But nothing is usual this time around, amid historical AI spending, a new Fed chairman with a potentially new agenda, uncertainty around the direction of interest rates, and sure-to-be-contentious midterm elections just over the horizon.

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 Artificial Intelligence. Nvidia CFO Colette Kress estimated, on May 20, that AI infrastructure spending is on track to reach $3 - $4 trillion annually by the end of this decade.
- 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.
- We recently raised our 2026 gross domestic product (GDP) growth forecast to 2.3% from 2.1%, our 2Q26 estimate to 2.5% from 2.2%, and our 2027 growth forecast to 2.4% from 2.0%. The major change is that indicators point to even stronger domestic investment. The investment dollars will boost the AI-dominated Equipment and Intellectual property categories in the GDP report.
- News of an interim peace deal between the U.S. and Iran sent gasoline below $4.00 a gallon from a peak of more than $4.55 (according to AAA). Lower gas prices are welcome news for consumers as we enter the important back-to-school shopping season, which is getting underway.
- 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 8.4% from 6.9% in January. The June unemployment rate is low at 4.2% but the CPI rose to 4.2% in May from 2.4% in January.
- We are monitoring financial conditions and high-frequency indicators. They show ongoing economic resilience and financial system stability.
- Argus expects S&P 500 EPS to rise almost 25% to $340 in 2026 and increase about 15% to $390 in 2027. EPS is helped by an increase in operating margins to about 18.8% this year, well above 13.9% in pre-pandemic 2019. Growing tech giants such as MSFT and NVDA have operating margins of 47% and 64% respectively while Dow stalwarts Walmart and Caterpillar earn 4% and 17%, respectively.
- Argus Fixed Income Strategist Kevin Heal expects the Fed to maintain the funds target at 3.50% to 3.75% in 2026 and reduce the target by 25 basis points in 2027 as inflation is likely to abate. We expect the dollar to be slightly stronger in 2026 driven by foreign demand for shares of innovative U.S. companies and continuing economic growth.
- Gold is likely to remain at elevated levels amid global uncertainty. The safe-haven asset recently topped $5,000 an ounce. With seeming progress in winding down the Iran war, gold has declined.
- What could go right? Low unemployment, spending by wealthy consumers, strong S&P earnings, capital investment in Artificial Intelligence, productivity gains, slower inflation if the price of oil has peaked, a small economic boost from the World Cup, and ongoing innovation.
- Risks: Strains on affordability from years of elevated inflation, uncertainty related to the interim peace deal with Iran, a lower 10-year Treasury yield could depend on deficit reduction, a weak housing market, low income consumers are struggling, spending by affluent may depend on stock gains.

CURRENT ECONOMIC RELEASES

Current Economic Releases

Date	Release	Month	Previous Report	Argus Estimate	Street Estimate	Actual
2-Jul	Nonfarm Payrolls	June	**129K**	125K	110K	**57K**
	Unemployment Rate	June	4.3%	4.3%	4.3%	**4.2%**
	Average Weekly Hours	June	34.3	34.3	34.3	**34.3**
	Average Hourly Earnings	June	3.4%	3.4%	3.5%	**3.5%**
	Factory Orders	May	**12.2%**	2.5%	NA	**2.3%**
6-Jul	ISM Services Index	June	54.5	54.6	NA	**54.0**
7-Jul	Trade Balance	May	**-$54.6 Bln.**	-$77.8 Bln.	NA	**-$77.6 Bln.**
8-Jul	Wholesale Inventories	May	3.6%	4.3%	NA	**4.0%**
9-Jul	Existing Home Sales	June	4.17 Mln.	4.10 Mln.	4.20 Mln.	NA
14-Jul	Consumer Price Index	June	4,2%	3.9%	3.9%	NA
	CPI ex-Food & Energy	June	2.9%	2.9%	2.9%	NA
15-Jul	PPI Final Demand	June	6.5%	6.2%	NA	NA
	PPI ex-Food & Energy	June	4.9%	5.2%	NA	NA
16-Jul	Retail Sales	June	6.9%	6.2%	NA	NA
	Retail Sales ex-autos	June	7.5%	6.0%	NA	NA
	Business Inventories	May	2.7%	3.1%	NA	NA
17-Jul	Housing Starts	June	1,177K	1,400K	1,310K	NA
	Import Price Index	June	6.7%	6.3%	NA	NA
	Industrial Production	June	1.7%	1.3%	NA	NA
	Capacity Utilization	June	76.2%	76.1%	76.1%	NA
	U. Michigan Sentiment	July	49.5	50.5	51.0	NA

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