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First Quarter 2026 Market Commentary

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The first quarter was eventful for markets. Stocks traded higher to start the year, with the S&P 500 posting modest gains in January. However, the markets traded lower in March due to escalating geopolitical tensions in the Middle East and the Strait of Hormuz closure, which led to a spike in oil prices. The S&P 500 ended the quarter down 4.3%, but despite the late-quarter volatility, there were bright spots. The average stock in the S&P 500 outperformed the index by nearly 5% as market leadership broadened, and manufacturing data showed signs of improvement. In this commentary, we recap the key developments from the first quarter, discuss the impact of higher oil prices, highlight how diversification benefited investors, and look ahead to the second quarter.

The Middle East Conflict Led to Higher Oil Prices

Oil prices rose sharply in the first quarter as geopolitical tensions escalated over the course of the quarter. In January, crude oil gained nearly 13% due to supply concerns related to Venezuelan output and Middle East tensions. Oil rose another 4% in February as geopolitical tensions continued to build, followed by a sharp escalation in March. The U.S.-Iran conflict and the closure of the Strait of Hormuz, a chokepoint for roughly 20% of global oil flows, sent crude oil prices surging nearly 50% in a single month. The price of oil rose more than 70% in the first quarter, representing the highest levels since mid-2022.

This increase in oil prices is important as it relates to inflation and Federal Reserve policy. Higher energy costs can feed into the prices that consumers and businesses pay, and the average price of a gallon of gasoline has already risen nearly $1.00 since late February. Rising oil prices are particularly relevant right now because inflation was already firming before the conflict. The Federal Reserve's preferred inflation measure, Core PCE, remains near 3%, and producer-level price inflation has been rising in recent months.

The combination of rising oil prices and the risk of renewed inflation pressure led to a shift in rate cut expectations. At the start of 2026, the market expected the Federal Reserve to cut rates two to three times by year end. However, the forecast changed as the market steadily priced out rate cuts during the quarter. Those rate cuts were completely removed by the end of the quarter, with the possibility of a rate hike being discussed as oil prices spiked in March.

The April and May inflation data will be among the first reports to capture the impact of higher energy prices, and the market will be searching for clarity around inflation outlook and interest rate policy.

The situation remains fluid as we move into the second quarter. As of the end of March, the Strait of Hormuz is still closed, and negotiations are ongoing. Oil trades near $100 per barrel, an indication that the market expects the disruption to continue. The April and May inflation data will be among the first reports to capture the impact of higher energy prices, and the market will be searching for clarity around inflation outlook and interest rate policy. While the market waits for more data, headlines and developments in the Middle East will likely impact how stocks and bonds trade early in the second quarter.

Diversification Helped in the First Quarter

One of the quarter's most significant developments was the performance gap across different areas of the stock market. While the S&P 500 declined by 4.3%, diversified portfolios fared differently. The S&P 500 weights companies by market value, meaning the largest companies have the most influence on the index's return. The equal-weight S&P 500 assigns the same weight to each company, making it a proxy for the average stock's return. The Russell 2000 tracks an index of small-cap stocks, and the Nasdaq 100 tracks an index of leading tech companies. Like the S&P 500 index, both of these indexes are market-cap weighted.

Investors with diversified exposure across company sizes, styles, and geographies experienced a more moderate quarter than the S&P 500 return suggests.

The first quarter led to a significant gap across company size and performance. The Russell 2000 and equal-weight S&P 500 each gained nearly 1% in the first quarter, outperforming the S&P 500's 4.3% decline, an indication that smaller companies outperformed in the quarter. The Nasdaq 100 declined by approximately 5.8% for the full quarter. Investors with diversified exposure across company sizes, styles, and geographies experienced a more moderate quarter than the S&P 500 return suggests.

The gap shows a clear shift in market leadership in early 2026, with multiple catalysts driving the market rotation. In January, investors started moving away from the concentrated mega-cap stocks that dominated performance over the past two years. This rotation accelerated in February as concerns about disruption from artificial intelligence spread across the market, particularly among software companies that make up a large portion of growth-style indexes. The March market volatility narrowed the performance gap, but it didn't reverse it.

The market rotation showed the benefit of diversification. Diversification doesn't eliminate market volatility, but it helps to manage it by spreading exposure across different areas of the market.

The result was a quarter in which market leadership shifted dramatically. The companies and sectors that led the market in recent years weren't the ones that outperformed in the first quarter. The market rotation showed the benefit of diversification. Diversification doesn't eliminate market volatility, but it helps to manage it by spreading exposure across different areas of the market.

Manufacturing Data & Concerns of AI Disruption

Two competing themes stood out during the quarter, both of which contributed to the rotation mentioned above. The first theme is related to manufacturing activity, as measured by the ISM Manufacturing Index. This Index surveys purchasing managers at U.S. factories to gauge whether the sector is expanding or contracting. A reading above 50 signals expansion, while a reading below 50 signals contraction.

After spending nearly a year below 50, the index crossed into expansion in February and held that level in March. The rise above 50 suggests the manufacturing sector, which has been a soft spot in the economy since 2022, was gaining traction before the Middle East conflict. Equity markets reflected that shift, with the Industrials sector setting a new all-time high in late February.

The March stock market sell-off reflected expectations about the potential impact of higher oil prices on future conditions rather than current weakness.

The economic data released in the first quarter primarily covered activity through February, before the conflict and surge in oil prices. The data suggest the manufacturing sector entered the conflict with underlying momentum, which could cushion the impact. The March stock market sell-off reflected expectations about the potential impact of higher oil prices on future conditions rather than current weakness.

Incoming data over the next several months will start to measure the real economic impact, and markets will be looking for clarity on the future outlook.

The second theme was related to AI. For the past two years, AI has been seen as a productivity tool to help existing companies do more with less. However, multiple product launches in January and February changed the way investors view AI. The market started to price AI as a potential replacement for entire categories of professional services, not just a tool to make companies more efficient.

The broader question of how AI will reshape professional services and the enterprise software industry is far from resolved, and its impact may continue to surface across the market as AI tools evolve.

The software industry was hit particularly hard and declined nearly 30% from its peak last October, one of the largest non-recessionary drawdowns in over 30 years. The two largest drawdowns before the current one, the dot-com bust and the 2008 financial crisis, both occurred during recessions when corporate earnings were declining, and businesses were cutting spending. The 2022 sell-off, which was driven by the Fed's aggressive rate-hiking cycle, was the first major non-recessionary decline and saw software stocks fall nearly 40%. The current drawdown, at nearly 30%, surpasses the COVID pandemic. The broader question of how AI will reshape professional services and the enterprise software industry is far from resolved, and its impact may continue to surface across the market as AI tools evolve.

Equity Markets – Looking Beyond the Index

The decline was concentrated in March, while January was modestly positive and February was flat. As discussed earlier, company size impacted returns.

The S&P 500 declined 4.3% in the first quarter, ending its three-quarter streak of gains. The decline was concentrated in March, while January was modestly positive and February was flat. As discussed earlier, company size impacted returns. The first quarter's decline was mainly caused by the biggest companies, especially those in the technology industry. The Nasdaq, which has exposure to many of the leading mega-cap tech companies, declined nearly 6%. The sell-off weighed on growth stocks, which declined nearly 10%, while Value gained 2.1%. Value outperformed Growth in each month, a level of consistency that is notable regardless of the market environment. Small-cap stocks held up better despite the volatility, with the Russell 2000 Index gaining nearly 1%.

Sector performance reflected the quarter's key themes. Energy was the top-performing sector with a 38% return, benefiting from the sharp rise in oil prices. Materials, Utilities, and Consumer Staples each gained over 7.5%, with the Industrial and Real Estate sectors also trading higher. Conversely, Financials, Consumer Discretionary, and Technology each declined by over 9%. The gap between the top and bottom sectors was wide, with over 45% separating Energy and Financials. Six of the eleven S&P 500 sectors outperformed the broad index, a sharp contrast to recent years when a few sectors drove the S&P 500's gains.

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Shifting focus outside the U.S., international outperformed for a second consecutive quarter as these stocks finished the quarter with a gain of nearly 1%. International's outperformance was concentrated in January and February, while March was more challenging as international stocks declined alongside U.S. stocks. Emerging markets were down slightly, with a decline of 0.2% for the full quarter, with relative strength in Latin America tied to rising energy prices. Developed markets fell 1.2%, with Europe and Asia under pressure due to their reliance on energy imports from the Middle East.

Bonds Also Navigate a Volatile Quarter

The bond market also experienced a volatile quarter as Treasury yields reacted to the changing landscape. Interest rates rose in January as the administration issued another round of tariff threats, while February and March were nearly mirror images. Yields dropped in February due to AI disruption fears, then rebounded in March as oil prices rose and rate cut odds decreased. The 10-year yield ended the quarter near 4.32%, the highest since June 2025, after briefly touching 4.45% in late March. The 2-year yield ended near 3.79%, up nearly 35 basis points. The rise in shorter-term yields reflected the shift in rate cut expectations, as markets adjusted from pricing in rate cuts to the possibility that rates may remain at current levels for longer.

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The rise in interest rates weighed on bond returns. The Bloomberg U.S. Aggregate Bond Index was flat in the first quarter as Treasury yields rose, after returning 1% or more in the prior four quarters. Corporate bonds modestly underperformed

higher-quality bonds like U.S. Treasuries due to their credit risk exposure. Credit spreads, which measure the difference in yield between corporate and government bonds, widened during the quarter. The high yield spread widened to its highest level since early 2025, reflecting increased caution among investors and uncertainty about the impact of higher energy prices on the economy and corporate earnings. However, despite the recent widening, corporate credit spreads remain well below levels reached during past recessions and financial crises. The market is pricing in caution, but it's not signaling stress.

2026 Outlook – Things to Watch in the Second Quarter

We believe the key development to watch heading into the second quarter is the situation in the Middle East and its impact on oil prices. The Strait of Hormuz was still closed at quarter-end with negotiations ongoing. Progress toward a resolution would likely ease energy costs and reduce inflation pressures, giving the Federal Reserve more flexibility on interest rate policy. A prolonged disruption would give higher oil prices more time to work their way through to the economy, potentially affecting consumer spending and business investment while keeping inflation elevated.

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The connection between oil prices, inflation, and Federal Reserve policy is the thread that tied the quarter together. Higher oil prices contributed to the shift in rate cut expectations, and the upcoming April and May inflation data will be the first reports to capture the full impact of higher energy costs. How those readings come in will shape the outlook for interest rates and the broader economy.

While the market's decline in the first quarter drew attention, it's worth stepping back to look at the bigger picture. There is a high correlation between the S&P 500's price and its earnings over the past 26 years. The two have moved together with a 96% correlation. When earnings rise, stock prices generally follow. When earnings decline, as they did during the 2001 recession, the 2008 financial crisis, and the 2020 pandemic, stock prices tend to fall. What stands out about the current environment is that earnings estimates have continued to rise even as the S&P 500 has

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pulled back. Analysts still expect earnings growth in the coming quarters, and profit margins remain healthy. The market's decline has been driven by uncertainty around oil prices, inflation, and Fed policy, not by a deterioration in the fundamentals that drive stock prices over time. That distinction is important for long-term investors.

The first quarter also reinforced the importance of portfolio diversification. The areas of the market that led over the past two years underperformed in the first quarter. Investors with broad exposure across company sizes, investment styles, sectors, and geographies generally experienced a more moderate decline than the S&P 500. We believe staying invested through periods of market volatility, maintaining portfolio diversification, and keeping a long-term perspective remains one of the most effective approaches for building wealth.

Please contact us if you'd like to discuss,

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Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

S&P 500 Index is a capitalization-weighted index calculated on a total return basis with dividends reinvested. The index includes 500 widely held U.S. market industrial, utility, transportation and financial companies.

Asset allocation and diversification are investment methods used to help manage risk. They do not guarantee investment returns or eliminate risk of loss including in a declining market.

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