

Under Pressure

“Pressure is something you feel when you don’t know what you’re doing.”

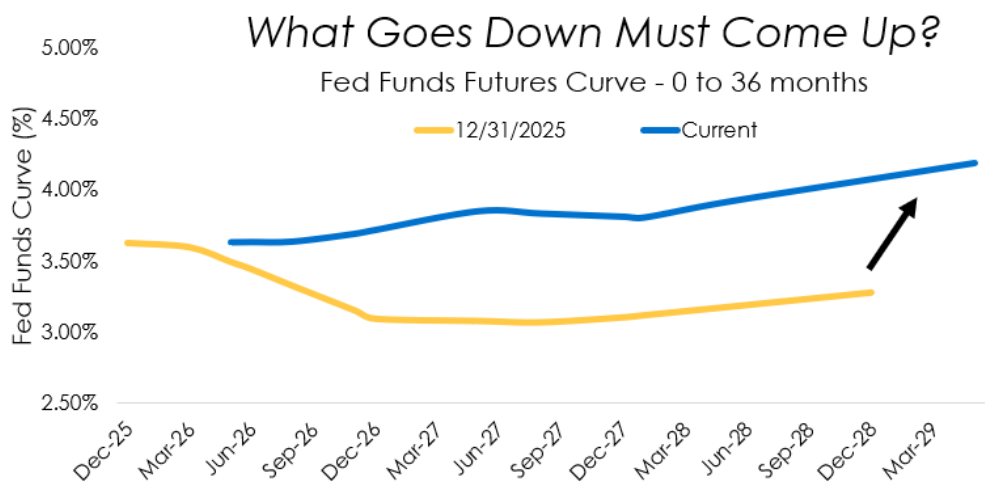
– Chuck Noll, Football Coach for the Pittsburgh Steelers (1969-1991)

While the above quote might be a bit tongue in cheek, pressure does have a way of separating what’s sturdy from what’s fragile. Anyone who’s tried to hold a beach ball underwater understands the concept. It can be done for a while, but the deeper it goes, the more force it takes to keep it there. That felt like a useful way to think about markets in May. Investors had been treating inflation as if it had been pushed safely below the surface. May challenged that view.

The pressure showed up in several places. Inflation reaccelerated, tied in part to higher energy prices and US-Iran uncertainty. The consumer remained resilient, but strain became more visible through depressed sentiment, a lower savings rate, and weakness in rate-sensitive areas like housing. Most importantly, the Fed narrative changed. Earlier in the year, investors were debating how many rate cuts the Fed might deliver. By the end of May, the better question was whether the next meaningful move could be in the other direction.

The Fed Funds futures curve – in the chart below – tells the story. At the start of the year, the forward curve anticipated lower policy rates. By the end of May, it had moved materially higher and was beginning to price in rate hikes rather than rate cuts. That means that in a reaccelerating inflation environment, the Fed is no longer just a potential source of support. It may increasingly become a source of pressure.

This matters because the market has relied, in part, on two key supports: strong earnings growth and the expectation that the Fed would eventually become more accommodative. The first support remains intact. The second is now in question.



Source: Factset; Current as of 5/31/26.



May's economic data reflected a higher inflation backdrop that pressured consumption and rate-sensitive areas, but not enough to meaningfully deter growth. Stable labor markets, the wealth effect, and strong capital expenditure (CAPEX) activity helped offset the drag.

In short, growth has not disappeared; its composition is changing. Consumption is slowing while business investment — particularly AI-related CAPEX — is ramping. That can support productivity, earnings, and nominal growth. But it also changes the market's behavior to one that's narrowed once again. Beneath the surface, fewer S&P 500 sectors are showing superior trend and momentum characteristics relative to the index itself.

That brings us back to valuation. If the Fed is moving away from an easing bias, inflation is reaccelerating, and leadership is narrowing, then earnings growth has to carry more of the burden. Fortunately, earnings have been strong. First quarter results surged above earlier expectations, forward estimates continue to improve, and companies have shown pricing power without obvious demand destruction.

Still, valuation is not independent of the policy regime. During the Quantitative Easing (QE)/liquidity period, higher multiples were supported by abundant liquidity and benign inflation. Today's backdrop is different. Inflation is no longer dormant, Fed flexibility is more limited, and the forward rate market has moved in the wrong direction for multiple expansion.

The table at right helps frame the issue. CPI is currently in the 3%–4% range, while the S&P 500 trades near 29x trailing reported earnings. That's elevated especially relative to the historical observations in the Pre-QE regime, when inflation was more cyclical and, thus, influential to equity valuations.

The point is not that valuations must immediately compress.

Earnings growth, AI-related CAPEX, pricing power, and the wealth effect can support elevated multiples. But the margin for error is thinner than it would be in a lower-inflation, easier-Fed environment. Said differently, May was not a month where growth broke under pressure. But for us, it was a month where the pressure of sustaining that growth came under greater scrutiny.

Fed Regime Under Pressure?

S&P 500 Price to Reported Earnings (TTM)

by Inflation Tranche 1962-Current

CPI Y/Y Tranche	Current	QT/Inflation 1/22-5/26	QE/Liquidity 12/08-12/21	Pre-QE 12/62-11/08
0% to 2%		N/A	21.4	18.9
2% to 3%		28.0	22.3	19.1
3% to 4%	28.9	25.2	14.7	18.5
4% to 6%		23.4	26.9	15.7
6%+		21.7	24.1	8.8

Source: Factset used for month end S&P 500 price data. Robert Shiller used for S&P 500 reported earnings 12/62-11/88. S&P Global used for reported earnings 12/88-12/25. Factset used for reported earnings 1/26-Current. Earnings are reported based on trailing four quarters and smoothed monthly. Current readings for CPI are as of 4/30/26 and for S&P 500 P/E are as of 5/31/26. The number of observations in each regime vary and include 52 months for QT/Inflation, 157 months for QE/Liquidity and 552 months for Pre-QE.

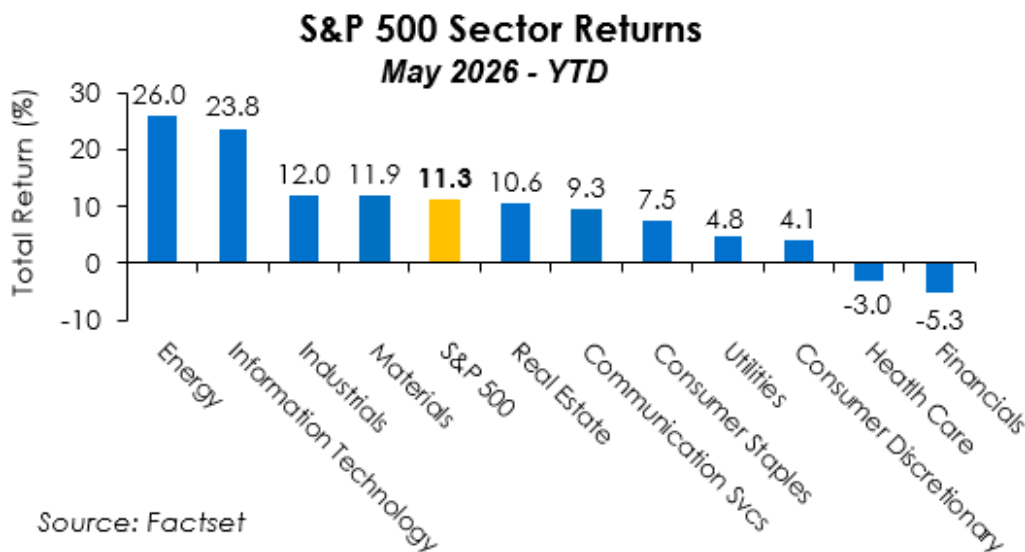
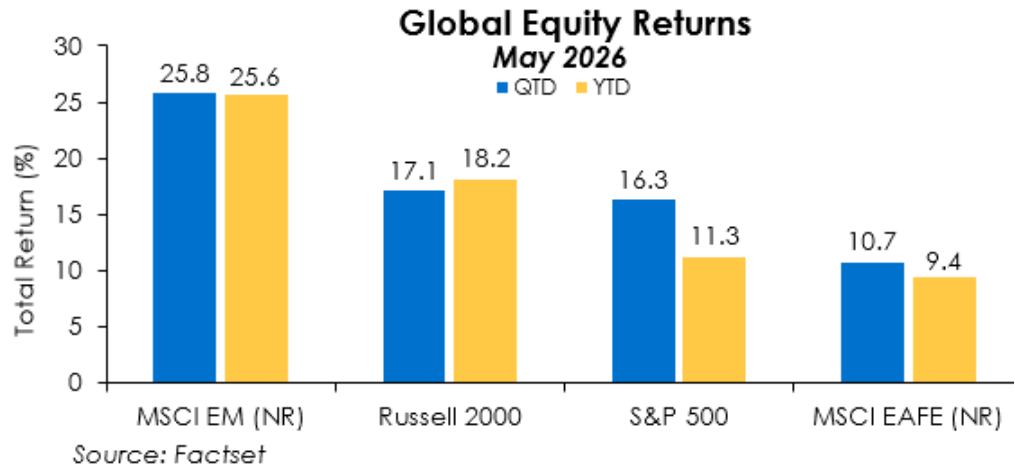


Stocks led broad asset classes in May as earnings growth, AI-related CAPEX and easing geopolitical concerns helped offset pressure from inflation and a changing Fed narrative. Bonds were marginally positive as higher rates began to stabilize late in the month. Alternatives were mixed with REITs little changed and Commodities weakened amid moderating (though still elevated) energy prices.

Stocks

Emerging Markets (MSCI EM) led equities higher both quarter-to-date and year-to-date on strong earnings growth from continued demand for AI-related components such as CPU/GPUs and

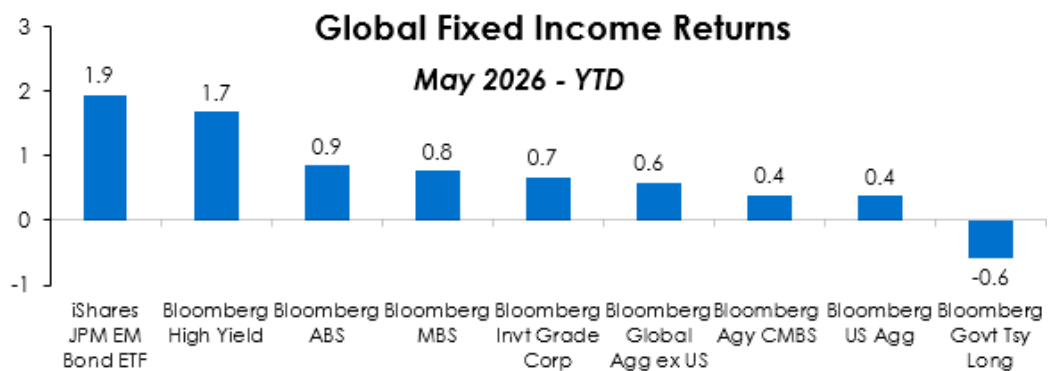
memory chips. US Small Caps (Russell 2000) and Large Caps (S&P 500) were also up strongly as the continued buildout of AI datacenters and a surge in CAPEX helped drive 2026 earnings estimates higher. Developed Markets (MSCI EAFE) have posted solid but lagging returns as geopolitics and their greater dependence on middle eastern oil has dampened sentiment. From a sector perspective, the last two months have seen a significant narrowing of the market with Technology and Communication Services the only sectors to outperform the S&P 500. Meanwhile – Energy, Technology, Industrials, and Materials outperformed year-to-date – a still relatively narrow list and one related to the main macro themes (AI and Iran).



Bonds

Policymakers continued their cut (2H24/2H25) and pause (1H25/1H26) approach. Following the April meeting, the Fed Funds rate remained unchanged at 3.5%-3.75% with the “dot plot” implying one additional cut (25 bps) this year and next year. Meanwhile, the forward curve for Fed Funds futures has shifted from forecasting potential rate cuts to pricing in potential rate hikes over the next few years. It will be worth observing how this evolves with the new Fed Chair (Kevin Warsh) set to take the helm given the more inflationary backdrop.

Bonds posted marginally positive returns in both May and year-to-date as inflation concerns partly offset the benefit of tighter spreads and carry. High Yield bonds and Emerging Market Debt have performed best due to their higher starting yields. Meanwhile, long-dated Treasuries have lagged due to increased inflation risks along with higher growth expectations that have lifted rates.

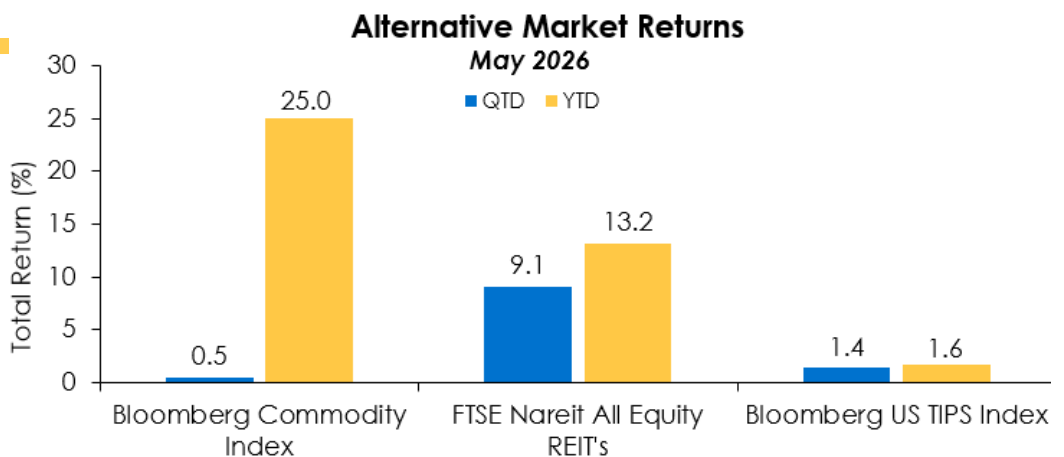


Source: Factset

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Alternatives

REITs were relatively unchanged in May, though they have offered more attractive returns year-to-date. Meanwhile, Commodities – the best-performing asset class and inflationary hedge so far this year



Source: Factset

– were down in May as energy prices retreated in anticipation of a peace deal with Iran. Finally, Treasury Inflation-Protected Securities (TIPS) outperformed nominal Treasuries as inflation expectations rose amid the Middle East conflict before moderating some near month-end.



Market Outlook

“There are two kinds of people in this world: those who believe there are two kinds of people in this world and those who are smart enough to know better.”
– Tom Robbins (1980)

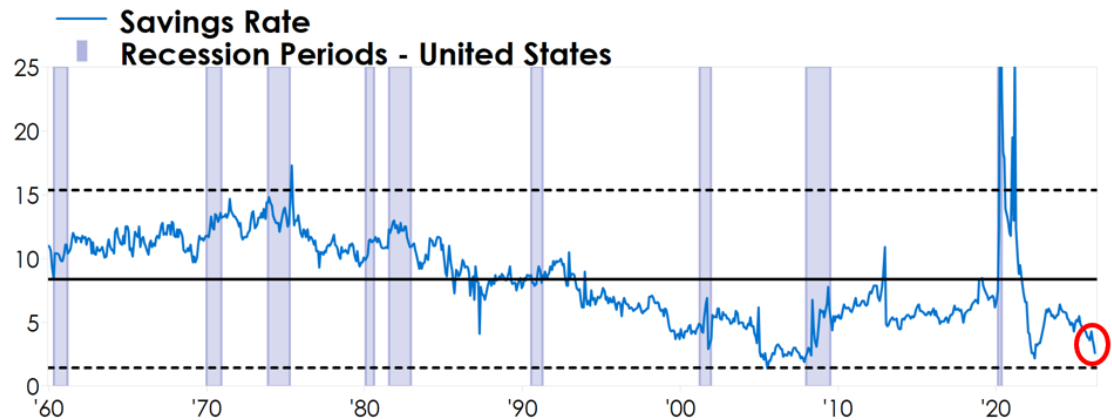
We came into 2026 with the tactical vantage point that this year would require the awareness of more nuanced views and the avoidance of oversimplification. To us, this meant that flexibility would be at a premium resulting in “strong convictions, loosely held”. Below is a framework for how we compared the generalized consensus view to the more nuanced views that investors were grappling with coming into this year.

2026 - The Year of the "Definitely, Maybe"

	<u>Generalized View</u>	<u>Nuanced View</u>	
Consumer	"The consumer remains resilient."	High-income consumers maintain strong spending power from the wealth effect	Low and middle-income households struggle from affordability pressure
Labor	"It's a no-hire, no-fire labor market."	Structural tightening results from aging demographics and immigration policy	Structural loosening results from AI productivity initiatives
Profits	"Profits are solid."	Earnings growth is improving for the small and mid-caps	Earnings growth is leveling off in the larger cap companies
Fed	"The Fed is getting more accommodative."	Lowering interest rates loosens policy to improve affordability as inflation cools	A new Fed chair is often tested by the market resulting in a tightening of financial conditions.
Policy	"Fiscal stimulus will be a tailwind."	Midterm election years often coincide with accelerating economic growth resulting from policies of the incoming Administration	Midterm election years tend to usher in above average intra-year volatility as markets "buy the rumor and sell the news"
Markets	"The AI story is early innings."	AI promises to be a transformative application	Leading edge AI stocks might be pricing in a lot of the good news



As we've cited previously – of the generalized/consensus views in the table – we think the two that are the most in question today are in the Fed and Policy categories. Fiscal policy may be less of a tailwind than originally thought if rising inflation creates affordability pressures for the US consumer (i.e. tax refunds get eaten up at the pump). This has shown up in the form of renewed pressure on the personal savings rate (percent of disposable income that is saved rather than spent) that's nearing a retest of its lows over this 60+ year time series.



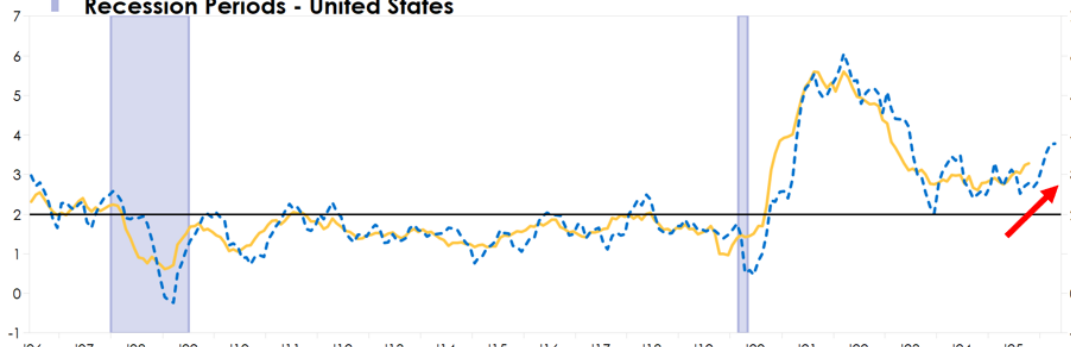
Source: Factset; as of 4/30/26. Dashed lines represent more extreme levels as designated by two standard deviation measures relative to the long-term average bolded line. The y-axis is truncated based on a peak reading of 31.8% on 4/30/20.

Meanwhile, the Fed is grappling with how to respond to a re-

acceleration of inflation. Initial inclinations were to treat this as temporary and related to a supply shock from the Strait of Hormuz closure. However, the duration of this disruption combined with the breadth of inflation data showing higher prices are starting to change the Fed narrative. As can be seen in the chart below, the

Core PCE

- Core PCE % 1 Yr (lagged 6 months) (Both)
- - - Core PCE % 6 mo annualized (Both)
- Recession Periods - United States



Source: Factset; as of 4/30/26.

Fed's preferred inflation gauge – the core PCE – is starting to quicken to a 30 month high from a level north of the Fed's 2% target. At the beginning of the year, the consensus view was that a new Fed

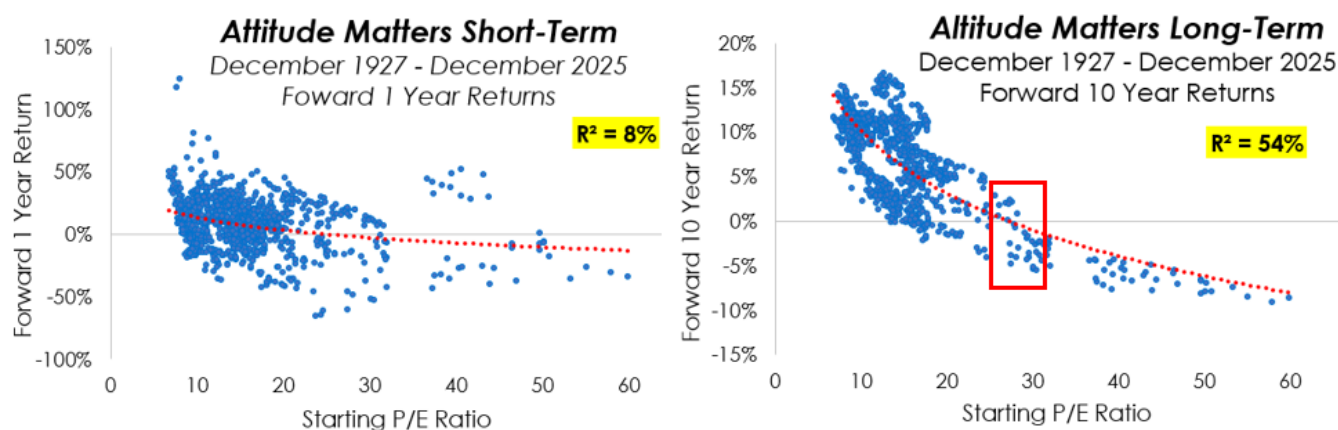
chair – nominated by the Administration – was likely to result in an accommodative Fed setup. Today's backdrop has replaced that view with a market that's now pricing in rates headed in the opposite direction (higher). As equity markets have rallied (more narrowly) amid elevated valuations, forward growth assumptions become increasingly important to support market levels. In short, investor sentiment is more reliant on the growth of tomorrow than the growth of today. To be sure, that growth is currently exceptional and



giving lots of confidence to the notion that multiples aren't that expensive when you assume that future growth leads to higher earnings and a lower valuation. The issue is when the growth stops, investors will replace the forward P/E multiple (21X NTM operating earnings) with the trailing P/E multiple (29X reported earnings). And in an environment where the Fed might be less amendable to accommodative policy, the air for select stocks can get pretty thin. Clearly that day isn't today but we think it's important not to lose sight of the rising pressure that comes from extrapolation.

The above folds nicely into our strategic frame which requires the discipline to "keep the main thing the main thing". As much as we opine on the factors that influence the shorter term setup, the fact remains that starting valuations tend to be the most influential factor for long-term returns. In short, what you see is what you get. In the past, we've described this as, "Attitude matters in the short run, but Altitude matters in the long run."

Please see the charts below for context. In the short run (chart on the left), S&P 500 returns measured over a one year period have very little to no relationship with the starting price-to-earnings valuation multiple. Investor



Source: PE ratios were calculated monthly based on the value of the S&P 500 and trailing 12-month S&P 500 Normalized Earnings. Normalized Earnings were calculated by determining the constant long-term growth rate that best fit actual S&P 500 earnings. This process is meant to smooth out short term fluctuations in earnings caused by the business cycle. Forward returns are price appreciation only and do not include dividends. Historical S&P 500 data was gathered from Robert Schiller's website (<http://www.econ.yale.edu/~shiller/>) and Factset.

opinion – driven by a number of factors – can shape popularity for markets and drive short term results that can be both expected and unexpected. However, the chart on the right shows that the S&P 500 returns measured over a much longer ten-year period have a much more important relationship with the starting price to earnings valuation multiple. We think remembering this concept is an important step to maintaining discipline as a long-term investor.

So what are the implications and key takeaways for portfolios?

- We think 2026 continues to require more of a chess-than-checkers mentality, recognizing that nuanced views can imply multiple paths to an outcome. This means that shorter term decisions demand some degree of flexibility given the "K-shaped" dichotomies that exist.



- Having a balanced portfolio with some defense and offense may be helpful with diversification representing a compelling “twofer” – risk reduction and upside optionality.
- Investors’ long-term discipline will continue to be tested and will likely require going against the grain (looking different than the benchmark).
- As the pendulum swings to one side, limiting exposure where the risk/reward is less favorable (and concentration risk is high) should be top of mind and lends itself to diversification.

From a portfolio positioning perspective, we continue to emphasize the importance of diversification and balance. Our flagship strategies – which we sometimes refer to as our “belt and suspenders” approach – have benefited from their allocation to Alternatives, especially during this year’s moments of market volatility and/or inflation concerns. While melt-up conditions and a buy-the-dip mentality might dampen their impact, Alternatives are intended to help preserve purchasing power when historical correlations between the more traditional asset classes break down. Managers that provide hedging characteristics have held up better during bouts of market volatility and exposure to real assets like real estate and commodities have been among the better defenders of value. We remain overweight this area and have recently added exposure to diversified alternative managers in May. In addition, profits were taken in equities, bringing the allocation back to EW and part of the proceeds added to bonds (though we still remain UW). See more specific detail below:

Within equities, our positioning incorporates balance geographically and within our US Large Cap exposure especially (away from the top of the market). Our bias has generally been to have more exposure to less expensive areas (down market cap). As such, we’ve maintained a larger OW in Cyclical Value and Defensive sectors, combined with a smaller sized cap bias. We remain UW the most concentrated and expensive Cyclical Growth areas.

Within fixed income, we remain biased toward the higher quality US Core Fixed Income segment – where we’re slightly longer in duration for diversification purposes. We’ve maintained an EW to International Fixed Income, where the end of negative interest rate conditions has led to more attractive opportunities. Maintaining a higher quality bias means that we still remain UW the most expensive part of the bond market – High Yield – where (still) tight spreads have made the risk/reward less attractive in our view.

Within alternatives, we remain fairly balanced though slightly overweight in both Commodities and Diversified Alternatives. Last year, we adjusted our mix in the latter in order to provide greater insurance against market volatility by emphasizing income and short exposure – areas that can benefit from choppy market conditions like what we’ve experienced episodically this year.

Thanks for giving this a read.



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