MONTHLY
Portfolio Pulse

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AI Acceleration

Q1 earnings season successfully distracted investors from the ongoing stalemate over the Strait of Hormuz and refocused their attention on what is a very impressive fundamental backdrop. Aggregate Q1 earnings growth across the ~90% of S&P 500 companies that have reported thus far has clocked in at a ~25% year-over-year growth rate, racing past investor expectations by ~18%. Providing an economic foundation is the U.S. consumer – aided by two consecutive months of jobs growth and billions of tax-refund dollars in their pockets. But the true accelerant is the expanding AI buildout, which we conservatively estimate to be ~$1 trillion in 2026 (~3% of total U.S. economic output) and to which we recommend increasing investment-portfolio exposure.

Everything everywhere all at once. With Q1 technology-sector earnings blowing past expectations – a ~40% year-over-year growth rate (vs. expectations for ~31%) – AI has moved back into the limelight. Investors are increasingly viewing AI as a utility that will be as vital to economic functioning and as ubiquitous in daily life over the next century as electricity was over the last. When viewed under that lens, the ~$1 trillion of investment expected in 2026 looks to be money well spent – and in the early days of a multi-year super-cycle. The AI buildout's durability comes from its widespread application. More than just a technological achievement, it is serving as an enabler for the advancement of other technologies – both present and past. Cars can now drive themselves; factory-line robots can do more tasks; genetic sequencing can be done far more rapidly; cloud computing can exponentially expand as the datacenters being built for AI-compute power increase server space – just to name a few.

AI's resurgence has made investors forget about energy prices. We still have a standoff over the Strait of Hormuz – and oil prices still hover above $100/barrel – but, in the nearly 12 weeks since the Iran strike, a few things have become increasingly clear: 1.) AI is serving as the driving force of the economy (see above), 2.) Oil prices have ever-dwindling sway over U.S. economic functioning (as economic output per barrel of oil consumed grows and energy-price impact on overall inflation shrinks), 3.) Oil prices have even less sway over U.S. equity markets (with the technology and communication-services sectors – less vulnerable to oil-price shocks – now representing nearly half of the S&P 500), and 4.) company profit margins, across nearly all sectors (not just tech), continue to expand despite higher energy costs from higher oil prices and higher financing costs from higher interest rates – likely getting a productivity assist from AI.

What could possibly go wrong (or right)? While AI Acceleration is our base case, we do assign a 20% probability of AI Bugs – that AI is slowed either by regulatory issues (we need to balance AI's potential societal harm) or buildout bottlenecks (we need a lot more power generation). However, we must also envision what happens if we (finally) get a reopened Strait (also assigned a 20% probability). Investors are now largely ignoring the geopolitical issue, but resumed passage of oil tankers would lower gas prices (albeit likely slowly), giving consumers relief and the Fed the opportunity to revisit resumed rate cuts that are currently viewed as off the table.

Getting on board. AI took a break over the past two full quarters – with the Magnificent 7 (the tech stocks driving the AI revolution) falling ~8%. So far in Q2, they are up 21% – but their Q1 earnings[1] outpaced expectations by 43%. We believe there's still time to safely get on board – adding broad exposure via broad U.S. Large Cap and more-dedicated exposure to the AI theme – as we believe the AI train is still accelerating, with a lot of track still ahead of it.

Exhibit 1: AI back in focus

Q1 earnings season has returned investor attention to AI, which continues to shine.

Downside Risk Case: **AI Bugs**	Base Case: **AI Acceleration**	Upside Risk Case: **We Have a Deal!**
20% Probability	*60% Probability*	*20% Probability*
AI build out – the primary driver of the economic expansion – stalls due to regulatory issues or buildout bottlenecks. Slowing AI spend combined with an overextended and exhausted consumer prompts an equity-market correction.	The economic expansion continues - fueled by an AI buildout still in its early innings – driving equities ever higher. Energy prices remain elevated, preventing the Fed from rate cuts, but equity markets don't need them.	A near-term deal is reached to reopen the Strait of Hormuz, allowing for back-half-of 2026 energy price deflation. Greater energy-price certainty allows the Fed to cut rates – further enhancing an already constructive market outlook.

[1]with six of seven companies reported – Nvidia reports Q1 earnings on May 20.

Macro Outlook

Growth

The U.S. economy, thus far, has weathered the recent geopolitical storm well. Business activity continues to expand (thanks in large part to the ongoing AI build out) and the consumer (at least in aggregate) continues to spend (thanks to bigger tax refunds and recently strong monthly payroll increases). Simply put, the U.S. economy's sensitivity to higher energy costs just isn't what it used to be – a result of greater energy efficiencies and increased domestic energy production. Even with extended energy cost pressures, we expect the AI buildout to power U.S. economic expansion throughout 2026.

Europe – alongside other energy-dependent economies – hasn't been so lucky. This is best visualized by the recent divergence of the U.S. and Eurozone Economic Surprise Indexes (Exhibit 2), which measure actual economic data vs. consensus expectations. While recent U.S. data readings are surprising to the upside, Europe's data continues to come in below expectations. We believe higher energy costs and other geopolitical risks will continue to hamper Europe's economy.

Inflation

A key explanation of the variance in U.S. and Eurozone economic fortunes is the cost of natural gas. Europe's costs for the vital energy source have jumped by over 40% this year – in large part due to its dependence on Middle East liquified natural gas and the loss of near-term supplies and longer-term production. Meanwhile, the U.S. is well supplied on this front, with natural-gas prices actually falling year to date given robust domestic production and more regionally based supply and demand – and resulting pricing – dynamics.

While U.S. natural-gas prices have fallen, gasoline prices remain elevated – up to ~$4.50/gallon on average (+59% year-to-date). Increased prices at the pump have shown up in the inflation readings, which jumped to 3.8% year-over-year vs. the 2.4% of two months ago. The longer the standoff over the Strait of Hormuz drags on, the longer it will take to normalize inflation levels – not only because of daily lost supplies but also the increase in required time to reset inventories. All said, higher gas prices may be with us for awhile.

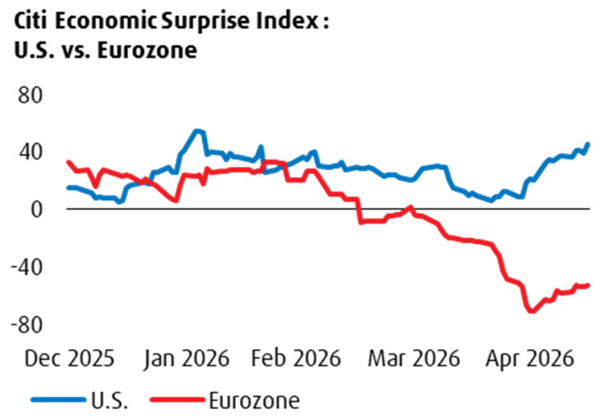
Monetary Policy

Kevin Warsh has officially taken over Chair duties of the Federal Open Market Committee – the Fed's monetary-policy-setting body – from Jerome Powell. But the current Fed funds rate may remain in place for some time. Investors were surprised at Warsh's nomination because he wasn't the devil-may-care rate-cutter everyone presumed President Trump was looking for – but many investors still expected rate cuts to at least get the policy rate back to neutral. The extended Strait standoff and lingering inflation has changed that calculus.

While Fed policy may remain more restrictive than expected, overall money supply (as measured by M2 – a key measure of the aggregate dollars flowing through the economy) remain in a healthy place – sporting a 4.6% year-over-year growth rate (vs. a -3.9% level as recently as mid-2023). Helping to support overall money supply are healthy banks that continue to lend. Per Exhibit 4, banks have eased lending standards to long-term averages over recent years – allowing money growth to continue even as the Fed continues its pause.

Exhibit 2: Divergent paths

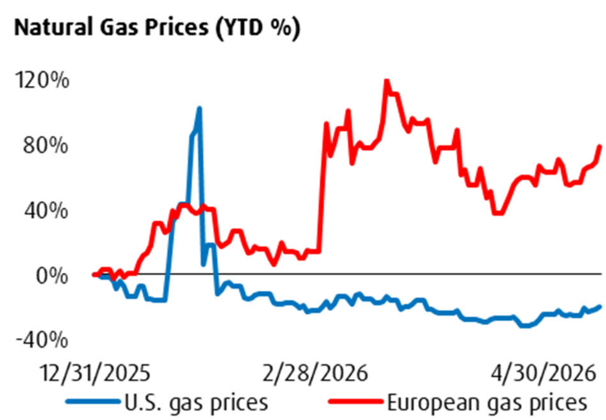
The U.S. and European economies are going in opposite directions.



Source: Bloomberg L.P. (2026). YTD data through May 15, 2026.

Exhibit 3: Divergent paths – part 2

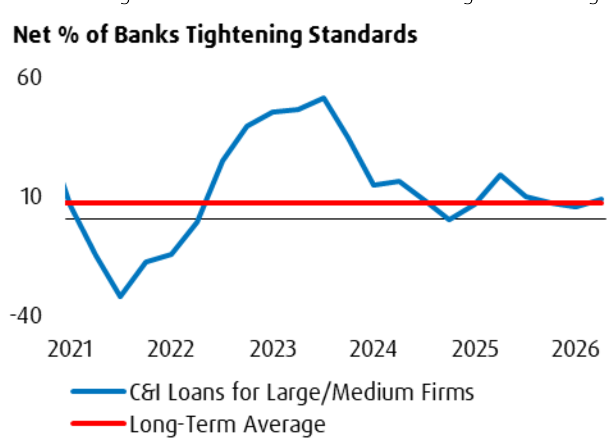
Driving the U.S./Europe divergence are differing energy backdrops.



Source: Bloomberg L.P. (2026). YTD data through May 15, 2026.

Exhibit 4: Giving credit

Bank lending standards continue to be near long-term averages.



Source: Bloomberg L.P. (2026). Commercial and industrial loans to large and middle-market firms with annual sales of $50 million or more. Data from Jan 2021 through April 2026. Long-term average from 1995 - 2026.

Market Outlook

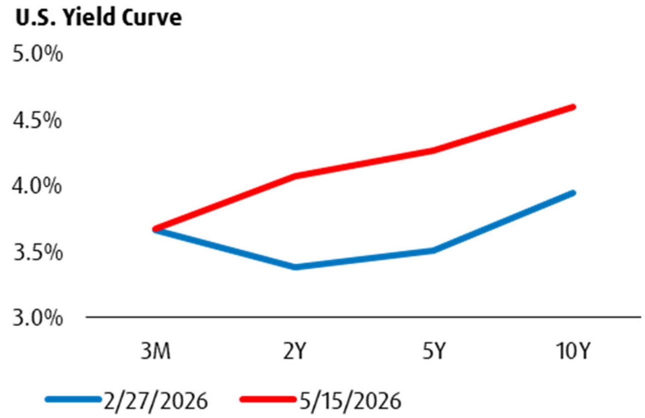
Fixed Income

Since the Iran conflict started, interest rates have shifted outward across the yield curve (Exhibit 5). The front-end yields (specifically the 2-year) have recalibrated to incorporate the removal of an expectations for further Fed rate cuts this year – reversing the downward slope previously seen between the 3-month and 2-year segment. The front-end's drift higher has started to impact longer-dated yields as well, with the 10-year yield now sitting at 4.6% – a level it briefly touched in the aftermath of Liberation Day before moving back toward ~4.0% over the following six months.

We likely won't get the same reversal this time – as the economy is firing on both business- and consumer-cylinders and lingering energy-cost pressures likely keep the Fed on hold. Instead, we expect interest rates to remain near current levels at the end of one-year tactical horizon with elevated volatility in the interim. This increased interest-rate risk is another reason to deemphasize fixed-income allocations in favor of still-attractive equities, which – all else equal – should be able to withstand 10-year yields anywhere below the psychologically important 5% level.

Exhibit 5: Recalibrated rates

The yield curve has shifted upward as rate cuts become less likely.



Source: Bloomberg L.P. (2026).

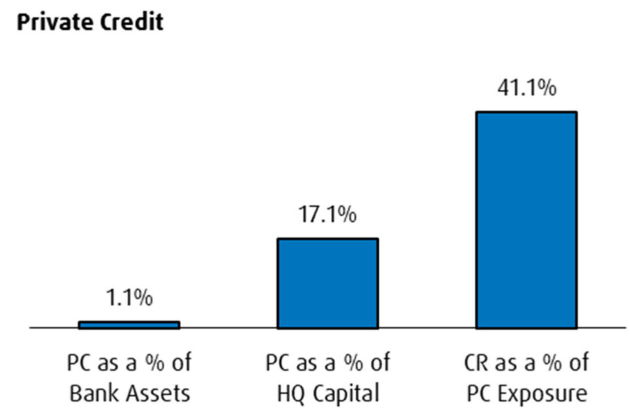
Credit Markets

Recently higher interest rates combined with headline-grabbing one-off private-credit defaults and specific concerns over software-company viability amid the ongoing AI renaissance have created investor fear in the asset class. Over recent years, private credit rapidly grew to fill the void left by less loan extension as banks circled the wagons to deal with post-pandemic real-estate stresses (see tightened lending standards from 2022-2024 in Exhibit 4). Now at ~$2 trillion in size, the less-regulated private-credit market represents a possible systemic risk to the economy.

The good news is the risk appears very manageable at this point. There is some concern over reduced lending standards as private-credit funds rushed to deploy recently large inflows. But the small increase in defaults thus far is easily absorbed by mostly institutional investors and the funds themselves, which employ modest leverage of 1-2x (far below the 8-12x leverage of a typical bank). The banks themselves mostly have secondary exposure to private-credit funds, representing just ~1% of assets. There's "nothing (really) to see here" as it pertains to the broader credit markets.

Exhibit 6: Calmed credit concerns

Q1 bank earnings revealed private-credit exposure is under control.



Source: Bloomberg L.P. (2026). Based on Q1 2026 financial statements and quarterly filings of select top U.S. banks. PC = Private Credit, CR = Credit Reserves

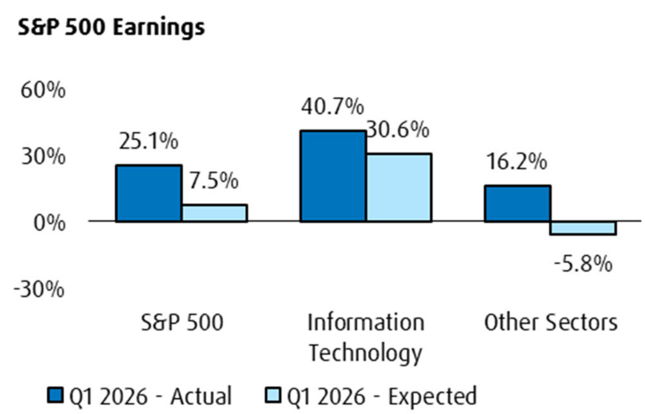
Equities

We have retained our aggregate tactical overweight to equities but have shifted our equity mix – increasing our tactical overweight U.S. Large Cap and moving to a tactical underweight in International Developed. A key focus for us this month was to reduce our European exposure (~65% of International Developed) – an equity region that we believe will struggle in the face of higher energy costs (for an economy that's more industrial than the U.S.) as well as bigger vulnerabilities to today's geopolitical risks (including the U.S.-China divide and any potential NATO restructuring).

U.S. Large Cap and/or AI-specific equity strategies represent the most attractive destination for the International Developed divestment. With Q1 earnings season nearly over, S&P 500 aggregate earnings growth blew past consensus expectations – growing at ~25% vs. an ~8% expectation. AI-related names were the stars, with technology-sector year-over-year earnings growth coming in at an astounding ~40% (vs. ~31% expected). But the earnings growth of the other 10 sectors also impressed, turning negative-growth expectations into strongly positive results.

Exhibit 7: Blowout quarter

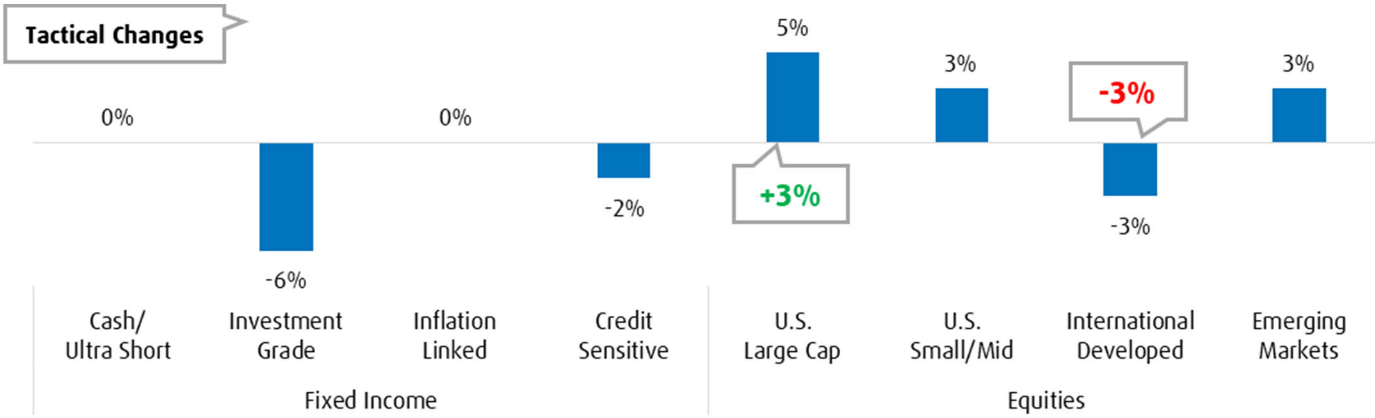
S&P 500 earnings far surpassed investor expectations.



Source: Bloomberg L.P. (2026). As of May 15, 2026.

Exhibit 8: Reshoring tactical exposure

We recommend a shift back toward U.S. Large Cap and away from International Developed given AI buildout and energy-cost dynamics.



Tactical positioning represents BWM Investment Strategy Group policy-level recommendations as of 5/18/2026 and are subject to individual client situations.

Index Definitions

Bloomberg US Treasury Bill: 1-3 Months Index (Cash/Ultra Short) tracks the market for treasury bills with 1 to 2.9999 months to maturity issued by the US government. **Bloomberg U.S. Treasury Index** measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. **Bloomberg U.S. Aggregate Bond Index (Investment Grade)** is a broad-based, market capitalization-weighted index that represents the investment-grade, U.S. dollar-denominated fixed-rate taxable bond market. **Bloomberg US Treasury Inflation-Linked Bond Index (Inflation Linked)** measures the performance of the US Treasury Inflation Protected Securities (TIPS) market. **The Bloomberg U.S. Municipal Index (Muni)** covers the USD-denominated long-term tax-exempt bond market. **Bloomberg U.S. Corporate High-Yield Bond Index (Credit Sensitive)** is an unmanaged index that covers the U.S.D-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. **S&P 500® Index (U.S. Large Cap)** is an unmanaged index of large-cap common stocks. **Russell 2500 Index (U.S. Small/Mid)** is a market-cap-weighted index that tracks the performance of approximately 2,500 small to mid-cap companies in the U.S. equity market. **MSCI EAFE Index (International Developed)** — MSCI EAFE Index Europe, Australasia, and Far East Index (EAFE) is a standard unmanaged foreign securities index representing major non-U.S. stock markets, as monitored by Morgan Stanley Capital International. **MSCI Emerging Markets Index (Emerging Markets)** is a market capitalization weighted index representative of the market structure of the emerging markets in Europe, Latin America, Africa, Middle East and Asia. **The MSCI ACWI** captures large and mid-cap representation across 23 Developed Markets (DM) and 24 Emerging Markets (EM) countries. The index covers approximately 85% of the global investable equity opportunity set.

Disclosures