

MONTHLY Portfolio Pulse

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Running it Hot

The U.S. economy looks set to heat things up in 2026 – driven by recent economic data momentum (the kindling) and pro-growth initiatives (the potential gas), which are set to ignite heading into the 2026 midterm elections. January manufacturing activity jumped to its highest level since late-2022, joining continued strength in the services sector. The labor market welcomed a strong January jobs report – just as record tax refunds hit consumer bank accounts – while the housing market is seeing green shoots in the form of rising building permits. We recommend tactically increasing equities in areas that are most exposed to economic growth – Small/Mid Cap, Emerging Markets and International Developed – funded by further reductions in Fixed Income.

Our hot-economy expectations call into question whether the ever-so gradual inflation decline – core consumer prices up 2.5% the past year as of January – can continue toward the Federal Reserve’s 2% target. To do so, increased economic demand must be offset by increased supply – doable, we believe, given increased productivity (up 4.5% in the last two quarterly reports, after increasing just 1.2% in the year prior). Capped inflation is likely to allow renewed Fed engagement. We expect three 0.25% cuts in the back-half of the year – bringing Fed policy down to 3% – as Kevin Warsh takes the Fed Chair in June.

Grabbing recent headlines is the Supreme Court ruling that Trump-administration tariffs under the International Emergency Economic Powers Act (IEEPA) are unconstitutional – impacting up to ~\$175 billion of already-collected tariffs (~60%). While sorting out potential refunds will be a mess (and tied up in court for months), the tariff policy will mostly remain intact using different legal paths. We believe equity markets have largely moved on to new emerging threats to the post-Liberation Day rally. We are focused on three.

Iran Strike. With one-third of U.S. naval assets near the Persian Gulf, a confrontation is increasingly likely. Iran would need to accept a U.S.-friendly deal to avoid a strike, which is unlikely. At ~\$66/barrel, oil prices sit right between recent lows (~\$55) and highs (~\$75) – the high set just prior to the last Iran strike, dropping over \$10/barrel just after. A similarly efficient strike this time would likely cause similar

results, while quagmire may require oil markets to lean on current oversupply and increased Saudi pumping to prevent a price spike.

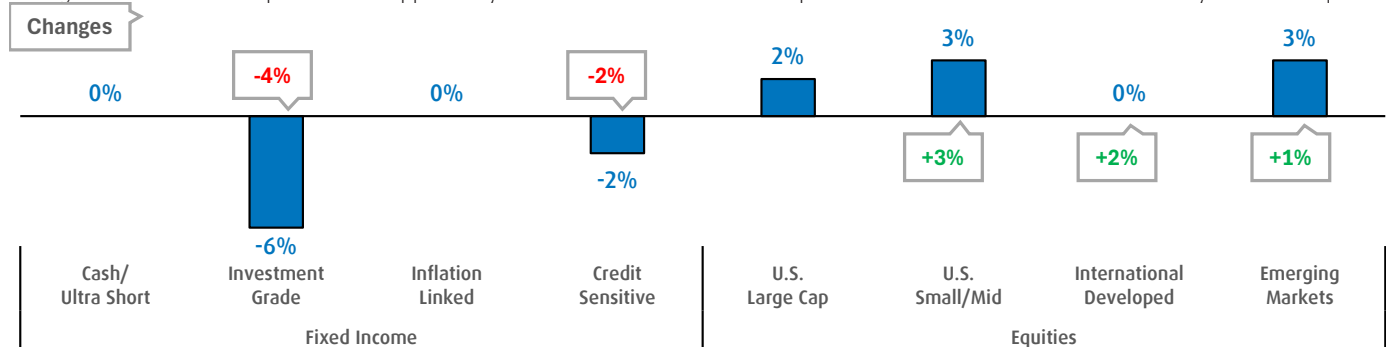
Private Credit Contagion. Concerns were recently renewed on news of investor withdrawal restrictions. Two lines of defense – underwriting standards and investor risk-taking capacity – protect against contagion into the broader credit markets. The former are being questioned while the latter is focused on bank exposure – mostly indirectly via investor credit lines (~10% of bank balance sheets). Thus far, the lines have held – with public-market credit spreads tight and contained.

AI Disruption. The computer-software sector has taken the brunt of AI disruption concerns – down ~24% this year. But we don’t think the markets can have it both ways – either the AI revolution is real (and the big investment is appropriate) or it’s a bubble (hurting big-tech prospects but sparing software and other legacy-tech companies). The truth, as is often the case, is likely somewhere in the middle, with benefits potentially accruing to a third category – those that can benefit from AI productivity (so, basically, all other companies).

The elevated economic-growth exposure of U.S. Small/Mid Cap, Emerging Markets and International Developed Equity should benefit from our expectations for a hot-running economy (both domestic and abroad). Meanwhile, the recent interest-rate drop to cyclical lows offers an opportunity to lighten fixed-income allocations.

Exhibit 1: Increased – and broadened – equity risk exposure

Falling interest rates have provided an opportunity to reduce our fixed-income exposure and reallocate across economically sensitive equities.



Allocations as of 2/23/2026. Based on the Base Portfolio Component of the Balanced Investment Objective.

Macro Outlook

Growth

As the economy begins to run hot, corporate earnings growth has spread from being concentrated in technology and financial sectors to now include industrial and commodity sectors as well. Consumer and healthcare sectors are still struggling to generate earnings growth momentum, but increased consumption in 2026 – driven by record tax refunds – should help them join the party. All said, 4Q2025 S&P 500 earnings growth is coming in at 12%. We expect this growth to continue into 2026 as a broader swath of sectors join in the gains.

The first read of 4Q2025 economic (GDP) growth came in at just 1.4% – hurt by the government shutdown that inhibited economic activity for approximately one-fifth of the quarter. 1Q2026 economic growth should capture some of that lost activity, while also receiving a consumer boost as tax refunds (estimated at ~\$520 billion, ~40% higher than last year) hit bank accounts. We believe full-year 2026 growth will outpace economist forecasts as a revived consumer adds to ongoing AI/tech investment.

Inflation

January’s consumer price index (CPI) showed a notable drop on a year-over-year basis. Headline inflation has fallen to 2.4%, while core inflation is now at 2.5%. As such, year-over-year inflation now sits within rounding error of the Fed’s 2% target – and may see another drop next month as the elevated 0.4% monthly inflation from last February (4.8% annualized) is replaced by what this February brings. The bottom line is that last year’s tariffs – while perhaps having an impact on specific imported goods – have not hit overall inflation.

Our expectations for strong economic growth – and the associated increase in economic demand – has historically pressured inflation higher. What may be different this time (as dangerous as those words are) is the role increased productivity – and the resulting increase in economic supply – can play in keeping inflation capped. Illustrating this point, the current 3.7% wage growth requires productivity growth to equal 1.7% (after stripping out the 2% inflation target) – meanwhile, recent productivity growth has been ~4.5%.

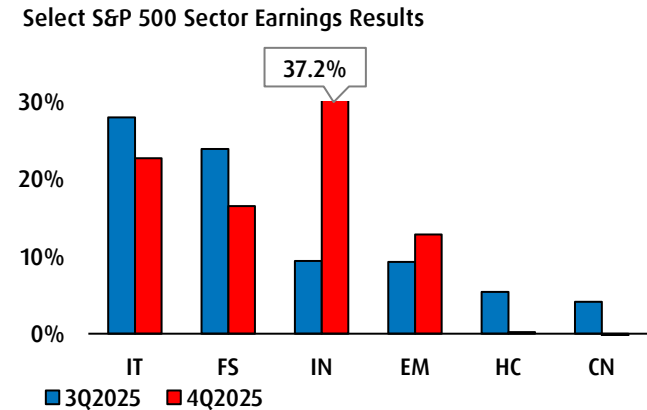
Monetary Policy

Kevin Warsh’s nomination to be the next Fed Chair came with some consternation in financial markets given his previously hawkish comments and reputation – but the true picture is a bit more nuanced. Warsh’s bigger focus is likely to be on reining in the Fed’s purview (more focused on setting policy rates) and reducing the Fed’s balance sheet. The latter will likely require further financial-industry deregulation, letting the big banks resume their pre-Global Financial Crisis role of providing interbank liquidity (but with better guardrails).

Based on our expectation that inflation can remain capped even as economic growth moves to a higher level, we expect the Fed will cut rates three times in 2026 (a 0.75% total reduction) with the first cut occurring when Warsh takes over monetary policy duties in June. We believe the resulting 3% Fed funds rate represents an appropriate (neutral) level for an economy growing at its (elevated) potential (consistent with the expectation for increased productivity).

Exhibit 2: Broadening economic participation

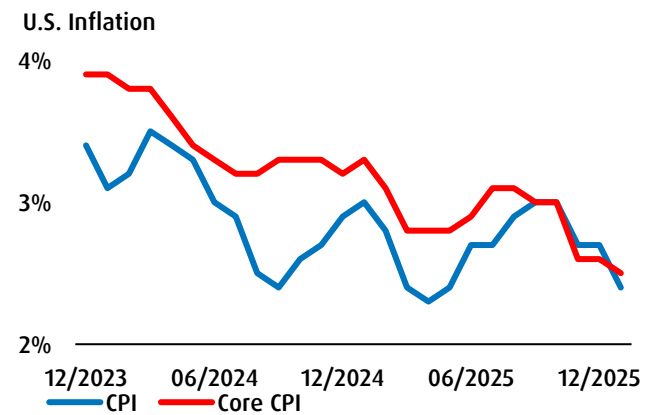
Earnings growth is spreading from tech to other areas of the market.



Source: Bloomberg L.P. (2026). 4Q2025 results. IN = Industrials, IT = Info. Tech., FS = Financials, EM = Energy & Materials, HC = Healthcare, CN = Consumer

Exhibit 3: Getting closer

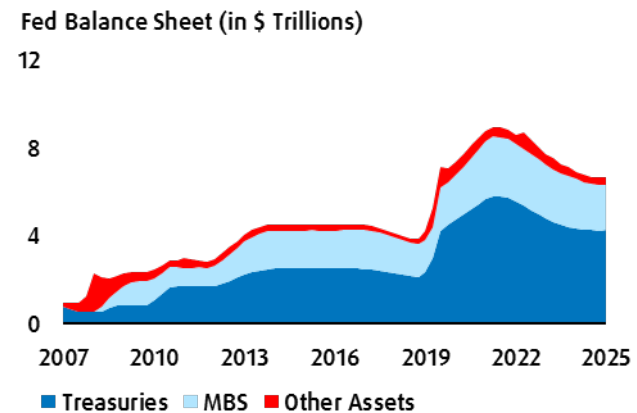
The most-recent inflation report has inflation just 0.5% off target.



Source: Bloomberg L.P. (2026). Data through January 2026.

Exhibit 4: Inheriting trillions

Fed Chair nominee Kevin Warsh is intent on reducing Fed assets.



Source: Bloomberg L.P. (2026). Data through December 2025.

Market Outlook

Fixed Income

Interest rates have eased from their January highs – driven by both lower real yields and lower longer-term inflation expectations. Also helping to bring down yields was the modest increase in anticipated rate cuts – Fed funds futures now imply an expectation of two to three rate cuts in 2026 – as inflation continues its slow trek toward the Fed’s 2% target. Now just above 4%, the 10-year U.S. Treasury yield now sits near the floor that markets have set over the past year – it will be difficult to go much lower absent disappointing economic growth, which we don’t expect.

Given the move lower in longer-duration yields, the yield curve – specifically, the difference between 10-year and 2-year U.S. Treasury yields – has flattened (though real yields have retained much of their steepness, see Exhibit 5). As such, not only have Investment Grade Fixed Income (IG) yields become less attractive, their potential for roll-down gains (the price appreciation that comes from “rolling down” yield-curve steepness) has been reduced as well. As such, we are further reducing our recommended IG allocation in order to fund an increased equity tactical recommendation.

Credit Markets

Credit markets are continuing to show strong appetite for funding hyperscalers’ capital spending plans despite investor unease over the scale of these investments. After raising \$65 billion of debt in 2025, it took Alphabet just a day to raise an additional \$32 billion this month. Additional debt issuance from the hyperscalers should be expected throughout 2026. The ease with which the credit markets have thus far absorbed increased credit supply has resulted in investment-grade and high-yield credit spreads remaining at historically (in fact, near-record) low levels.

We believe these currently tight spreads are justified in an environment of strong economic growth, moderate inflation and free-flowing credit. But this leads us to prefer equity markets over credit markets. Unlike the economic pie, the profit pie is relatively fixed – less gains to creditors (in the form of recently falling interest rates and historically tight credit spreads) means more gains to equity investors. To take advantage of the current environment – and alongside our recommended tactical reduction to IG – we have reduced our tactical Credit Sensitive recommendation.

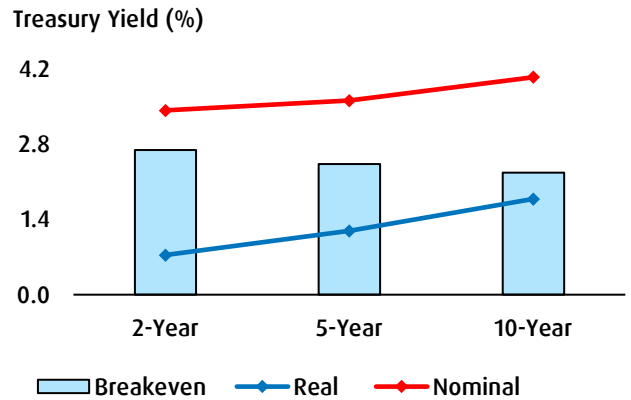
Equities

U.S. Small/Mid Cap returns have outpaced U.S. Large Cap by ~10% over the past three months – a feat that has only occurred five other times since 1990 (see Exhibit 7). In three of the five instances, Small/Mid Cap outperformed Large Cap by double-digits over the next year as well. In the other two episodes – April 2002 and November 2020 – U.S. Small/Mid Cap trailed Large Cap by ~5%. The former was at the tail-end of the dot-com bust, with large-cap valuations finally right-sized; the latter was a ~5% underperformance in the context of both cap sizes up 20%+.

We expect continued U.S. Small/Mid Cap outperformance as equity markets broaden. Alongside Emerging Markets and International Developed Equity, U.S. Small/Mid Cap has greater exposure to cyclical-growth sectors (e.g., Industrials, Energy/Material, Consumer, etc.) relative to U.S. Large Cap, which is heavily tilted towards structurally growing tech-related sectors. Cyclical-growth equities depend on – and benefit more from – accelerating economic growth. We recommend increased allocations to these cyclical growers, focusing on U.S. Mid/Small Cap and Emerging Market Equity.

Exhibit 5: Fed credibility

The markets are assuming the Fed can keep inflation under control.

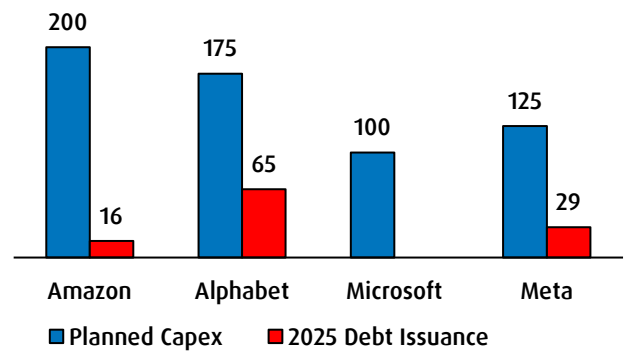


Source: Bloomberg L.P. (2026). As of February 17, 2026

Exhibit 6: Partial debt financing

Hyperscalers are issuing some debt to finance AI expenditures.

Investment Plans vs. Funding (in \$ Billions)

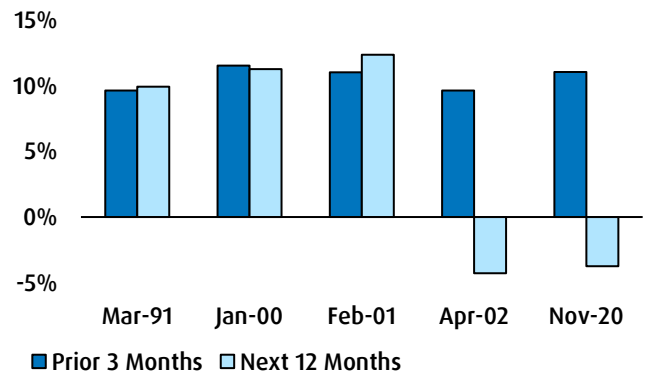


Source: Bloomberg L.P. (2026). As of February 17, 2026

Exhibit 7: Small caps beating large caps

A 3-month relative gain of 10%+ has occurred just five other times.

Small/Mid Cap Less Large Cap Returns



Source: Bloomberg L.P. (2026). Data through January 2026.

Exhibit 8: Macro Scenarios

DOWNSIDE RISK CASE: NON-BORING BONDS	BASE CASE: RUNNING IT HOT	UPSIDE RISK CASE: GOLDILOCKS
<i>20% Probability</i>	<i>50% Probability</i>	<i>30% Probability</i>
Too aggressive/poorly communicated Fed policy leads to increased interest rate volatility and spiking long-term rates. Rate volatility alongside a backup in currently tight credit spreads disrupts equity-market momentum.	Administration pro-growth policies and consumer focus ahead of the midterms complements continued AI investment. Contained inflation allows the Fed to cut rates three times (a total of 0.75%) in the back half of the year, supporting markets.	Strong economic growth coincides with continued improvement in inflation as AI-driven productivity measures gain traction. The “just right” backdrop allows for both strong earnings and higher valuations, combining to generate outsized gains.

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. Aggregate Bond (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.

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