Aquarian Midyear Outlook

2026

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Executive Summary [1]

"The function of margin of safety is, in essence, that of rendering unnecessary an accurate estimate of the future."

Benjamin Graham

Volatility was the defining feature of the first half of 2026, as markets priced for perfection bowed under repeated shocks, but remained surprisingly resilient overall – even as widening cracks below the surface threatened to pierce the increasingly fragile veil of exuberance. This seemingly untamable elation has undoubtedly paralyzed those who follow the value-investing ethos of Benjamin Graham as record valuations and spreads render the notion of a 'margin of safety' scarce across asset classes. Of course, only time will tell whether centuries of financial theory and mean reversion will prevail once again or if the investing herd will finally celebrate a victory in proving that "this time is different."

The first half of the year showcased a widening rift between resilient macro indicators and shaky underlying conditions. The economic environment remained strong overall but grew increasingly reliant upon upper-income consumption and corporate earnings from a narrow cohort of companies which, in turn, depended heavily upon debt-fueled capital spending on Artificial Intelligence ("AI") infrastructure from an equally narrow cohort of companies financed, in many cases, by the very companies selling that AI infrastructure. At the same time, structural pressures are building beneath the surface, including rising financial strain among lower-income consumers, mounting concentration in equity markets exacerbated by the AI boom, emerging stress in corporate credit markets linked to asset-light Software and Services exposures, rate uncertainty driven by both policy and fiscal dynamics, and persistent geopolitical risk.

Against this backdrop, consumer resilience remains a stabilizing force in the aggregate, but that stability is becoming progressively more concentrated – and, therefore, more fragile. Aggregate consumption continues to hold above trend, supported primarily by higher-income households benefiting from sustained asset appreciation courtesy of a historic equity rally. In contrast, lower-income consumers – already contending with unsustainable debt loads and rising delinquencies – now face further inflationary headwinds on basic necessities, stemming from energy supply chain disruptions and rising electricity bills courtesy of the AI buildout.

Sticky inflation seems poised to cement a weakening of the lower-end consumer going forward. For now, though, tax refund-related liquidity is likely offsetting pronounced deterioration in consumer credit metrics. Higher tax refunds stemming from the One Big

[1] Note: Please refer to the corresponding sections below for detailed analyses and sourcing information relevant to the Executive Summary.

Beautiful Bill Act ("OBBBA") are providing a buffer against inflationary pressures felt most immediately in the recent rise in gas prices. This support is inevitably transient and looks set to fade just as inflationary pressures remain resilient. At the same time, other consumer liquidity buffers like credit cards look increasingly tapped out, particularly as subprime consumers show record-high utilization.

This lower-end consumer deterioration is unlikely to show up in headline consumption as long as asset prices remain firm, but mounting downside risks are naturally embedded in further expansion of extreme valuation and concentration in equity markets. A narrow reliance on a slim portion of consumers, in turn dependent on the performance of a narrow set of stocks, in turn hinging on the success of one singular theme – AI – raises the risk that a sustained asset price correction could threaten the fragile stability of the broader economy.

Persistent inflationary pressures accentuate this risk as the Fed's policy flexibility narrows. Markets began the year pricing in two Fed cuts as the latest round of supposedly "transitory" inflation was expected to dissipate. Lo and behold, yet another "transitory" inflation shock – this time brought on by energy supply chain disruptions stemming from the U.S.–Iran war – not only erased these two cuts, but reintroduced expectations of rate hikes.

Yet the full extent of go-forward rate pressure is likely underappreciated by the market, as inflation looks set to persist for longer than anticipated. While the market seemingly views a future reopening of the Strait of Hormuz as a clearing event, the reopening is itself only one component of the resumption of oil flows from the region. For example, the time required to ramp idle oil fields back to full output and replenish inventories around the globe rises disproportionately to the length of the strait's closure. As such, a prolonged closure of the Strait gives rise to an even more protracted recovery, allowing inflation to fester.

At the same time, long-end yields are likely to remain structurally elevated. While inflation is not the source, it is the spark, as the associated rise in monetary policy uncertainty collides with fresh fiscal policy volatility. Deficit expansion is already a foregone conclusion, further entrenched by the OBBBA. Kevin Warsh begins his Federal Reserve ("Fed") chairmanship in this already tenuous backdrop, placing a noted balance sheet hawk at the helm of the central bank. Chairman Warsh's intentions to rein in QE likely fuel a reallocation of treasury supply toward short-dated T-Bills just as AI-related financing in the Investment Grade ("IG") corporate bond market injects material duration supply into the bond market, siphoning off marginal demand at the long-end of the curve.

In defiance of rising uncertainty, equity markets notched fresh all-time highs in the first half of the year. While periods of volatility – the "SaaSpocalypse" at the start of the year, followed almost immediately by the U.S.–Iran conflict – triggered sharp de-risking episodes, the subsequent recovery was swift and decisive, driven by soaring earnings growth on the back of a rapid re-centering of the market narrative around AI. Markets continue to demonstrate a willingness to look through near-term disruptions as a narrow set of perceived AI beneficiaries fuels exuberance, reinforcing elevated valuations despite unproven return generation and the potential negative impacts on the labor market.

AI enthusiasm is increasingly detached from underlying economics, raising the risk of a sustained asset price correction if the record levels of capital being deployed into datacenter buildouts fail to produce adequate returns. Hyperscalers have shifted aggressively toward capital-intensive models, with Capital Expenditures ("CapEx") consuming an unprecedented share of cash flow while share buybacks have been replaced by share issuances – removing a key pillar of share price and EPS support – and free cash flow deteriorates. At the same time, reported earnings remain supported by accounting dynamics that lag the true economic cost of this investment, creating a widening gap between profitability and free cash flow generation. As this divergence builds alongside already elevated valuations and extreme market concentration, risks build that any shortfall in ultimate returns could force a reassessment of both earnings durability and asset prices.

Credit markets have similarly retraced most, and in some cases all, of the recent spread-widening, reverting to historical tights despite more apparent fragility. The asset class's overexposure to Technology – and particularly asset-light Software – is posing mounting headwinds as these exposures move closer to maturity just as AI forces a reevaluation of business models and a sharp repricing of valuations. Risks are already emerging as Technology default rates tick up and recovery rates plummet in the Leveraged Loan ("LL") market, tilting loss risks to the upside and placing further refinancing pressure on marginal borrowers.

Diverging credit manager and investment vehicle exposure to Technology/Software issuers, and asset-light Services more generally, therefore seems likely to drive widening dispersion in outcomes. While some managers accumulated outsized exposure to lower-quality Technology issuers – particularly in the Software space – others preserved diversified portfolios, perhaps sacrificing a little upfront return potential for greater downside protection in the long-run. Indeed, certain credit managers and funds across the LL and Private Credit ("PC") markets accumulated Technology exposures well overweight relative to already high market-wide exposure. As valuations reset and equity cushions diminish, these differences are likely to prove decisive as lower recovery potential in Technology issuers makes certain portfolios more vulnerable to capital impairment in the event of a true default cycle. In this way, Technology exposure will reveal a fault line across the leveraged finance markets between more disciplined managers and those that allowed concentration risk to build under the perfectly wrong conditions.

Meanwhile, the seeds for new and emerging risks are being planted through AI-related issuance – so far concentrated in the IG bond market – where elevated expectations, uncertain return potential, and increasing capital intensity introduce additional tail risks. The interaction between addressing legacy Software risk and absorbing go-forward AI-driven financing creates a more complex, and potentially more correlated, credit cycle than in prior periods.

Markets have thus far absorbed these pressures, but with a diminishing margin of safety. Equity performance remains supported by concentrated earnings growth, while credit markets continue to dismiss elevated pockets of risk. At the same time, a more expansionary fiscal stance and a less accommodative monetary policy regime are placing sustained pressure on the long-end of the yield curve. Taken together, elevated valuations, extreme concentration, tight credit spreads, and increasing macroeconomic and geopolitical uncertainty suggest that forward return potential is likely to be more constrained, with outcomes increasingly sensitive to both macro developments and idiosyncratic shocks.

Macroeconomic Landscape

K-Shaped Consumer Drives Fragile Resilience

"The finances of the well-to-do have never been better, their spending never stronger, and the economy never more dependent on that group."

Mark Zandi, Moody's Analytics Chief Economist

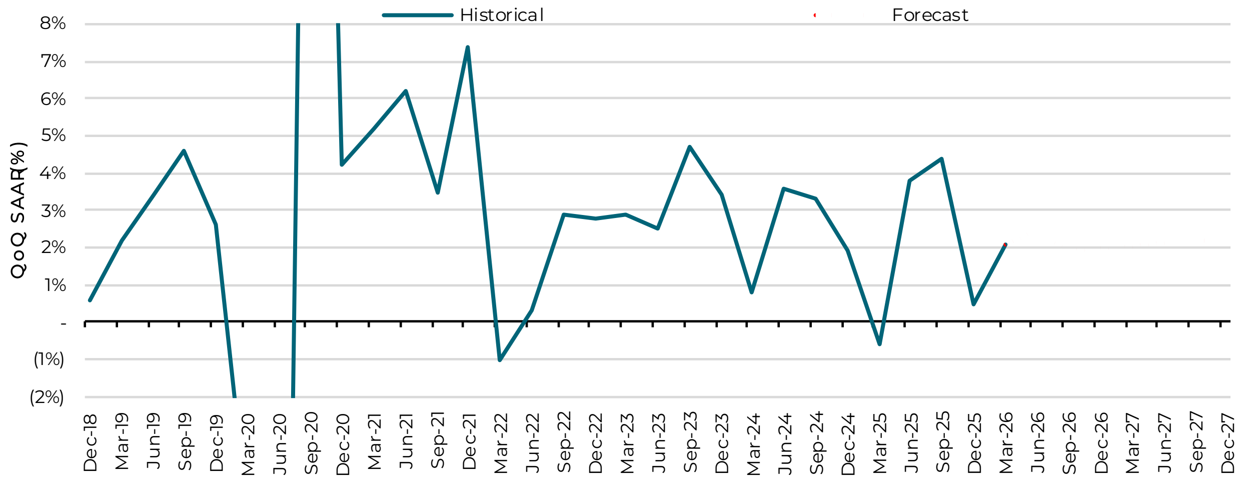
Key Section Takeaways

- Aggregate consumption remains near all-time highs relative to trend, but is increasingly reliant on equity gains from a narrow group of Technology companies accruing disproportionately to the wealthiest households
- Trailing five-year equity gains are near record highs as a share of gross domestic product ("GDP") going back to 1900, exceeded only slightly by the Dot-Com peak, and now equal roughly one full year of GDP
- Lower-quintile households are facing increasing difficulty absorbing inflationary pressures, with borrowing capacity increasingly tapped out, while credit card and auto delinquencies push record highs

Entering 2026, the prevailing macroeconomic consensus implied moderating inflation with markets pricing in two rate cuts by year-end. Subsequent geopolitical shocks emanating from the U.S.–Iran war swiftly upended these expectations as surging oil prices brought inflationary pressures roaring back to the forefront, not simply erasing expected cuts, but also bringing back expectations of rate hikes. Despite this volatility, the U.S. growth trajectory has remained resilient as a strong rebound in asset prices has largely offset budget headwinds for bottom quartile households. Quarterly U.S. GDP growth inflected higher on a sequential basis to +2.1% in Q1, while go-forward expectations likewise remain firmly in positive territory at around 2%. [2]

[2] Source: Bloomberg Finance, L.P. as of 7/22/26.

Real U.S. GDP Growth



Source: Bloomberg Finance, L.P. as of 7/22/26.

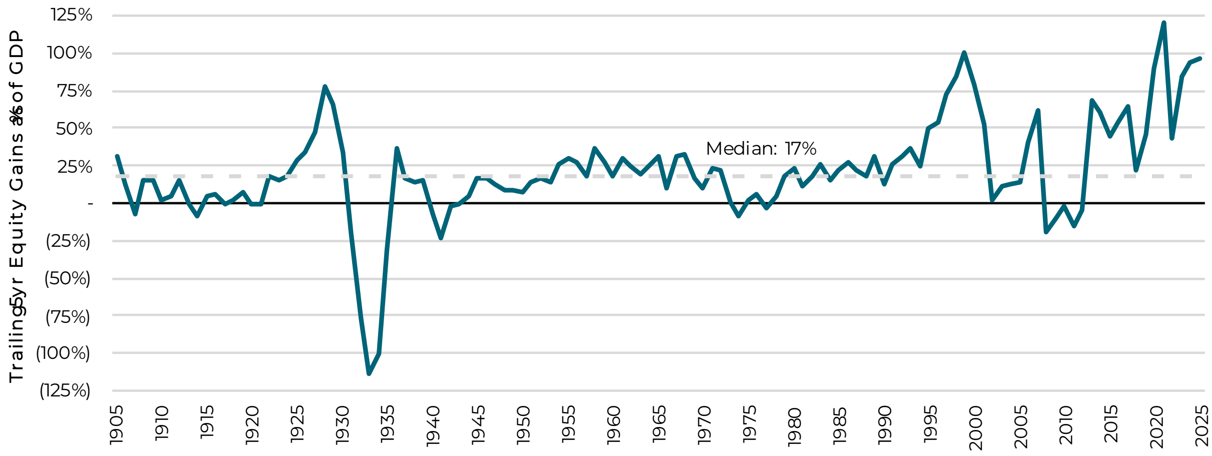
Resilient consumption remains one of the key underlying factors supporting this positive outlook. Real personal consumption continues to track at 105% of its long-term trend, a level matched only by the prior cycle peak in July 2005. [3] However, this resilience increasingly relies upon a narrow set of consumers with outsized purchasing power courtesy of asset appreciation in an even narrower cohort of equities. Indeed, roughly 75% of cumulative net worth gains since January 2019 have accrued to top-quintile households. Equity appreciation alone accounted for two-thirds of the roughly $30TN in total net worth accumulation over this time frame, a further ~75% of which originated from just 5 stocks. [4] [5]

~75% of cumulative net worth gains since January 2019 have accrued to top-quintile households.

Trailing 5-year equity gains are now approaching 100% of GDP – meaning the wealth created by equity appreciation over the last 5 years is roughly equivalent to an entire year of economic output – exceeded only slightly by the Dot-Com bubble and surpassing levels observed prior to the Great Depression, both of which were followed by sharp downturns. [6] More concerning, however, is that these gains are concentrated in a narrow cohort of stocks, leaving the market perched on an especially fragile foundation where any disappointment in earnings, AI-related investment returns, or investor sentiment in a handful of names could trigger a rapid unwind.

[3] Source: U.S. Bureau of Economic Analysis as of 5/26/26.
[4] Source: Federal Reserve as of 6/18/26.
[5] Source: Bloomberg Finance, L.P. as of 6/15/26.
[6] Source: U.S. Bureau of Economic Analysis as of 4/9/26, Bloomberg Finance, L.P. as of 12/31/25, and Measuring Worth as of 12/31/20.

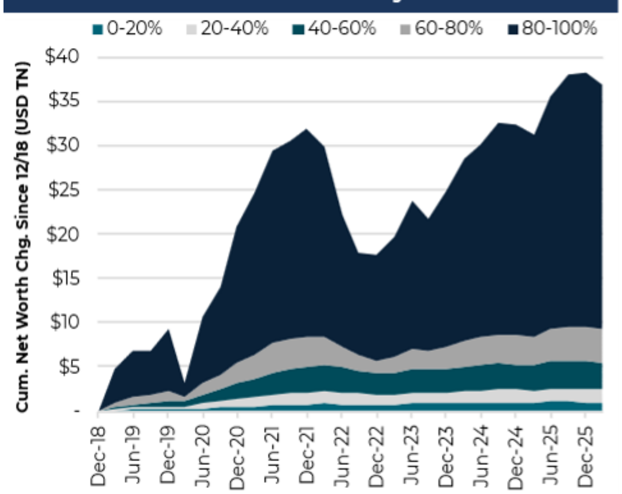
Equity Gains as a Share of GDP



Source: U.S. Bureau of Economic Analysis as of 4/9/26, Bloomberg Finance, L.P. as of 12/31/25, and Measuring Worth as of 12/31/20.

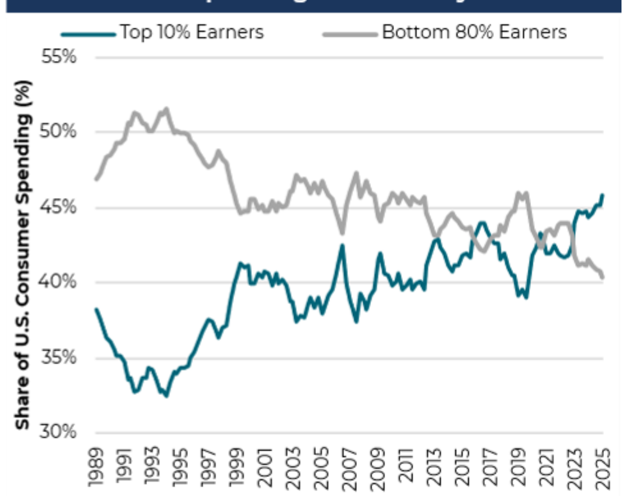
The increasingly concentrated nature of these wealth gains is likewise becoming evident in spending patterns. The “K-shaped” nature of the U.S. economy has widened, with higher-income households driving a disproportionate share of consumption. While similarly large spending disparities between income cohorts have emerged before, the bottom 80% of earners historically accounted for the majority of consumer spending. Since Q3 2023, however, the top 10% of earners have increasingly exceeded the spending of the bottom 80%, with the gap expanding to its widest point recorded since data collection began in 1989. [7]

Net Worth Evolution by Income



Source: Federal Reserve as of 6/18/26.

Consumer Spending Evolution by Income



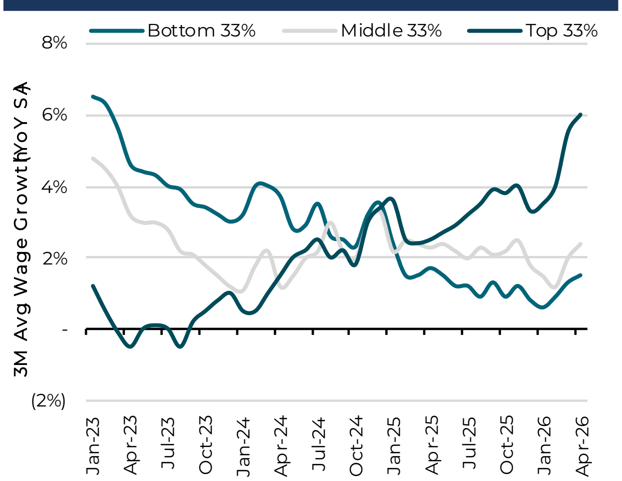
Source: Moody’s Analytics as of 4/7/26.

[7] Source: Moody’s Analytics as of 4/7/26.

This bifurcation has allowed aggregate demand to remain strong, but ultimately poses mounting vulnerabilities to the growth outlook. For the higher-end consumer, a sustained deterioration in asset prices could diminish spending – a risk that continues to build as asset valuations remain elevated relative to historical norms and concentration levels hover near the highest on record.

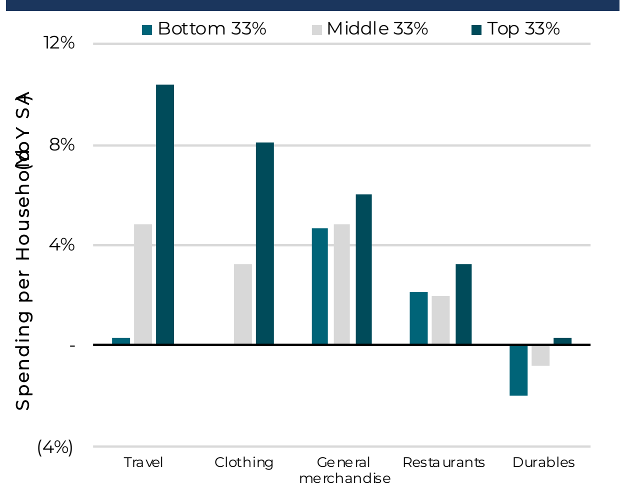
Lower-income consumers, more dependent on wages to fund consumption, are not only seeing inflation erode their spending power, but also slower wage growth relative to higher-income households. Income growth for top tercile wage-earners has outstripped that of bottom-tercile wage-earners since 2024, with April data – 6.0% YoY vs. 1.5% YoY, respectively – representing the widest gap in favor of top-tercile earners since at least 2015. Concentration further builds within the top tercile, where the top 5% of households saw wage growth of 10.0% YoY in April. [8] This divergence is reflected in spending for highly discretionary categories like travel, where lower-income households are pulling back, while asset appreciation tailwinds and wage growth continue to fuel resilient spending among upper-end cohorts.

Wage Growth by Income



Source: Bank of America as of 5/12/26.

Spending Growth by Income and Category



Source: Bank of America as of 5/12/26.

Meanwhile, consumer financing is becoming increasingly strained, placing further limitations on lower-income consumers' ability to sustain spending. Growing dependence on credit has begun to translate into measurable stress, with 90+ day delinquencies on credit cards and autos rising to 13%, the highest since 2011, and 6%, the highest rate ever, respectively. [9] Lower-tier cohorts have notched record high utilization in recent years, with nearly 50% of below-prime borrowers seeing 90%+ credit card utilization as of July 2024. [10]

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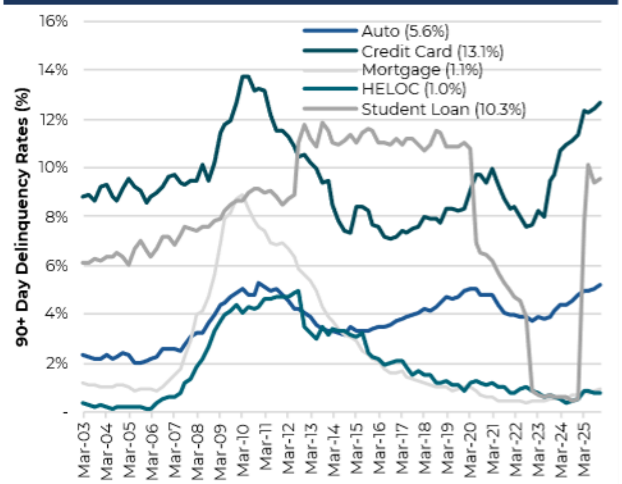
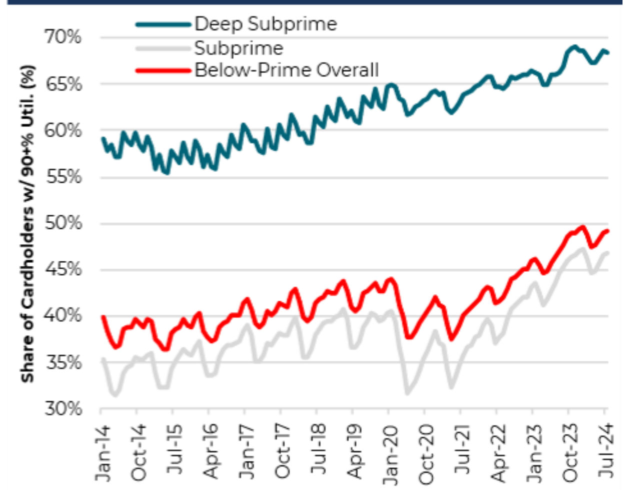
[8] Source: Bank of America as of 5/12/26.
[9] Source: Federal Reserve Bank of New York as of 5/12/26.
[10] Source: Census Bureau 2025 Consumer Credit Card Market Report as of 12/30/25.

90+ Day Delinquency Rate by Loan Type



Source: Federal Reserve Bank of New York as of 5/12/26.

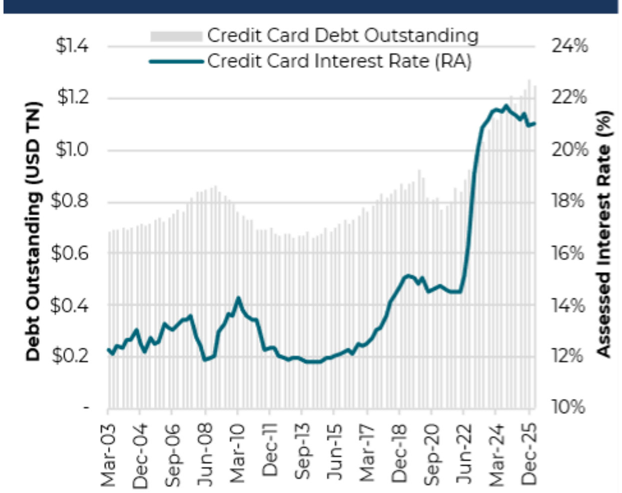
Card Holders with 90%+ Utilization



Source: Census Bureau 2025 Consumer Credit Card Market Report as of 12/30/25.

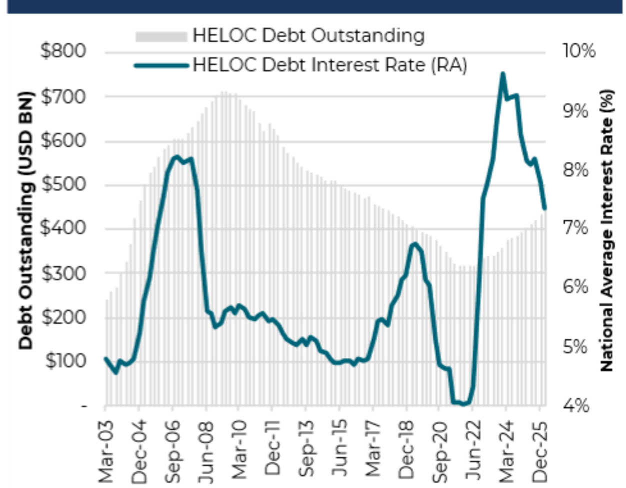
Revolving credit debt has grown considerably, with balances nearing $1.3TN while rates remain near all-time highs at 21%. [11] At the same time, HELOC balances inflected upwards in the wake of the pandemic and now stand at the highest levels since 2017, signaling that households are once again tapping home equity as a supplemental liquidity source, an indicator that more readily available financing channels are being tapped out. [12]

Credit Card Debt



Source: Federal Reserve Bank of New York as of 5/12/26 and Federal Reserve as of 4/7/26.

HELOC Debt



Source: Federal Reserve Bank of New York as of 5/12/26 and Bankrate Monitor National Index as of 6/11/26.

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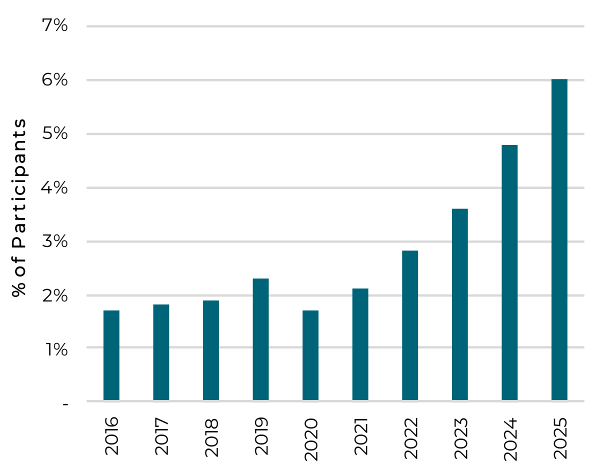
[11] Source: Federal Reserve Bank of New York as of 5/12/26 and Federal Reserve as of 4/7/26.
[12] Source: Federal Reserve as of 6/12/26 and Bankrate Monitor National Index as of 6/11/26.

Adding to these concerns, 401(k) hardship withdrawals are pointing to a steady erosion in household buffers. The share of participants taking withdrawals has consistently risen over the last 6 years, tripling from 2% in 2020 to 6% in 2025, with activity primarily driven by acute financial stress – most notably for the purpose of avoiding foreclosure or eviction (36%) and covering medical expenses (31%). (13)

401(k) hardship withdrawals have tripled since 2020, while tax refunds are providing a temporary buffer against mounting financial pressures.

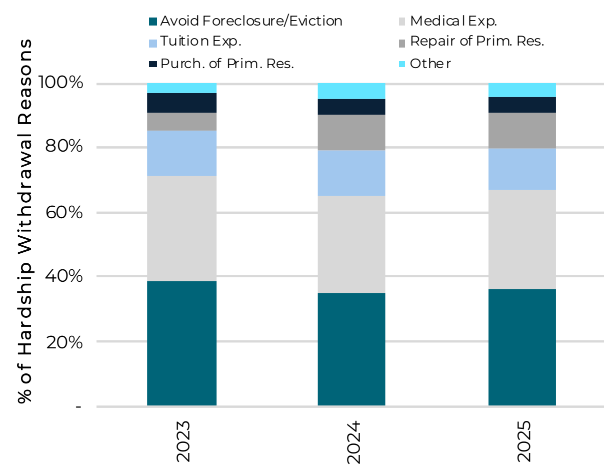
In sum, these trends suggest households are increasingly forced to turn to last-resort sources of liquidity to meet basic financial obligations, leaving lower-income households with limited capacity to absorb ongoing inflationary pressures, let alone maintain current levels of consumption.

401(k) Hardship Withdrawals



Source: Vanguard as of 6/16/26.

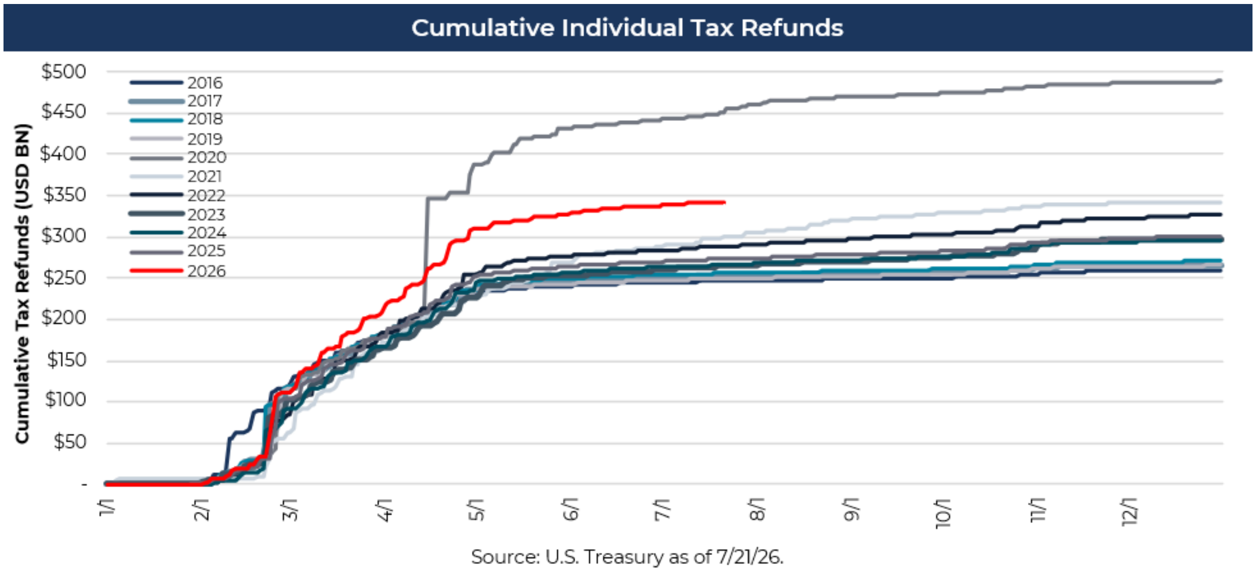
Reasons for 401(k) Hardship Withdrawals



Source: Vanguard as of 6/16/26.

These figures are already striking, yet may understate the full extent of underlying consumer stress. For all the headwinds consumers are facing, tax refunds have been an offsetting tailwind. Refunds for the 2025 tax year have risen 26% YoY so far through July 21, 2026 to ~$343BN, providing a temporary spending buffer and driving a ~35% increase in credit card payments among lower-income households in the 3 weeks following receipt (versus the 3 weeks prior to receipt). (14) (15)

(13) Source: Vanguard as of 6/16/26.
(14) Source: U.S. Treasury as of 7/21/26.
(15) Source: Bank of America as of 4/10/26.



This support is meaningful, but transitory. As refund-related liquidity fades and inflationary pressures remain sticky, underlying financial stresses are likely to reemerge forcefully, setting the stage for a more pronounced deterioration in consumer credit metrics.

Dual Mandate Spells Double Trouble for the Fed

"This is what it sounds like when doves cry."

Prince

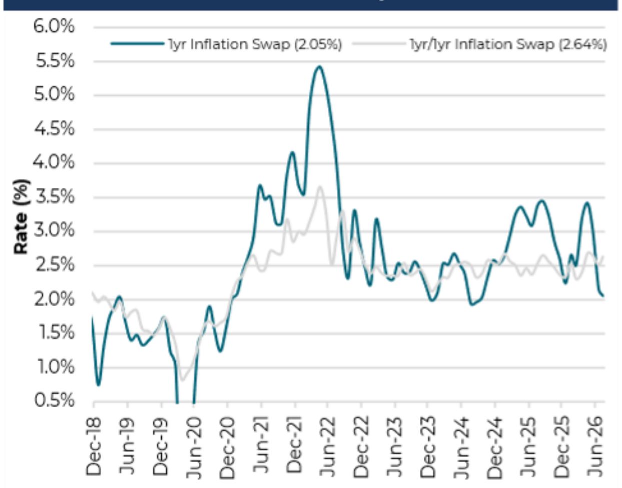
Key Section Takeaways

- Inflation risks remain skewed to the upside, as Technology spending, datacenter-driven electricity demand, geopolitical disruptions, and renewed tariff threats continue to pressure prices despite the recent retracement of oil prices and a more hawkish Fed
- The labor market appears resilient, but benchmark revision patterns and rising AI-related job-cut announcements suggest underlying conditions may be weaker than headline data indicates

The surge in energy prices spurred by the U.S–Iran war and effective closure of the Strait of Hormuz has had both immediate transmission to consumer budgets in the form of rising gas prices, and potentially more latent transmission in the form of second-order knock-on effects as firms pass through rising oil prices to a wide spectrum of consumer goods. The disruption of roughly one-fifth of global oil flows pushed crude prices materially higher in the first half of the year, with Brent and WTI both surging more than 60% above pre-war levels at their respective peaks. [16] As a result, 1-year inflation swaps surged back to post-Liberation Day peaks of 3.5%, sharply erasing inflation moderation assumptions embedded in markets earlier in the year. [17]

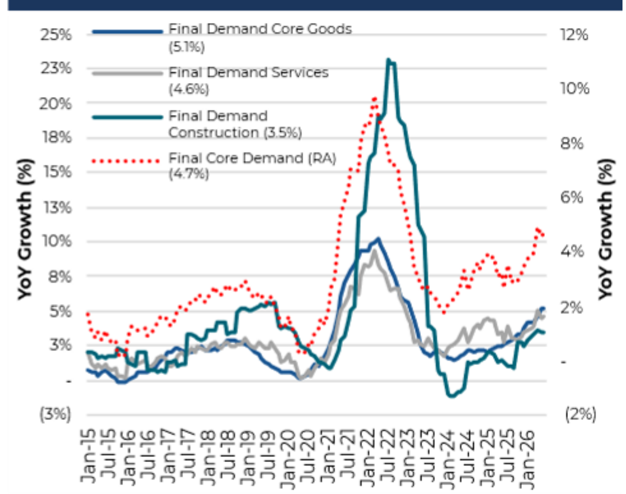
Additional inflationary pressures are evident within the supply chain, as reflected in the latest Producer Price Index print which showed a 4.7% YoY increase in final core demand in June – down just 0.2% from 4.9% in April, the highest print in over a decade outside of the pandemic – with pressure broadly distributed across core goods and services categories. [18]

Inflation Swaps



Source: Bloomberg Finance, L.P. as of 7/22/26.

Producer Price Index



Source: Bureau of Labor Statistics as of 7/15/26.

Meanwhile, geopolitical risk remains elevated at ~170% of pre-war levels, at rolling 30-day averages last seen in times of political strife including Hamas' attack on Israel and Israel's attack on Iran. [19]

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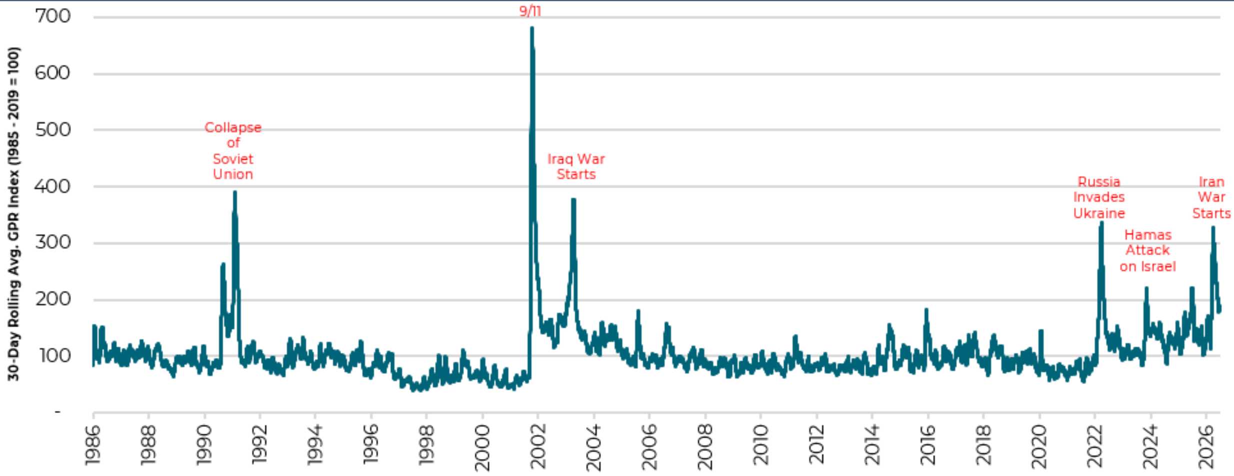
[16] Source: Bloomberg Finance, L.P. as of 6/30/26.
[17] Source: Bloomberg Finance, L.P. as of 7/22/26.
[18] Source: Bureau of Labor Statistics as of 7/15/26.
[19] Source: Caldara, Dario, and Matteo Iacoviello as of 7/20/26.

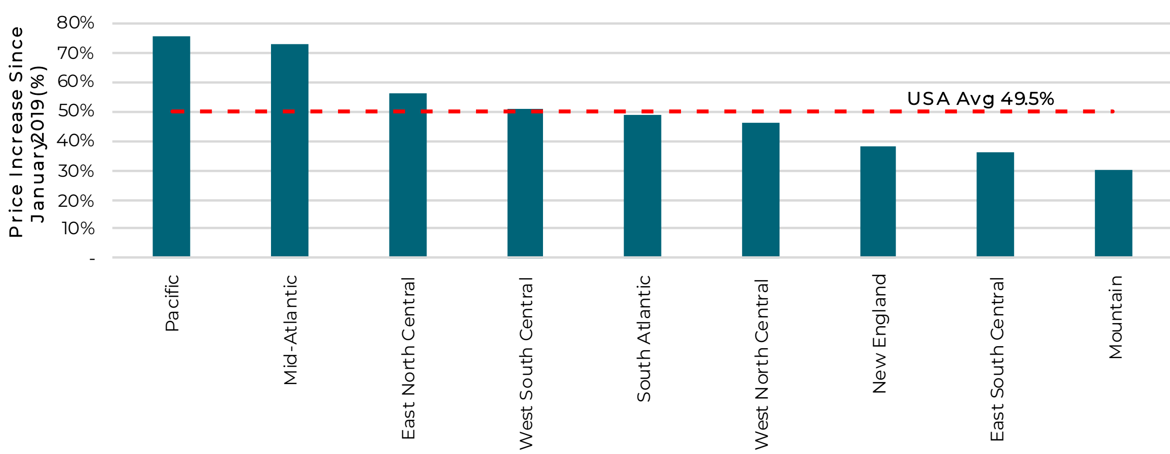
Geopolitical Risk Index



Source: Caldara, Dario, and Matteo Iacoviello as of 7/20/26.

These new and emerging risks to the inflation backdrop come as existing inflationary impulses continue to worsen. The unprecedented scope and scale of the datacenter buildout in the U.S. has exerted tremendous upward pressure on residential electricity prices, which have soared by 50%, on average, since January 2019. Price increases have been even greater in the Mid-Atlantic, where Virginia in particular accounts for a large share of datacenter construction, driving up prices by over 70% in the region over this time period. [20] As capital spending on datacenters is only set to increase from here and expand to more regions, the bite of higher electricity prices looks set to gain strength and be more widely felt.

Regional Impacts of Rising Electricity Prices



Source: U.S. Department of Energy as of 7/7/26.

Trade policy developments likewise continue to pose meaningful upside risks to inflation across consumer goods categories despite fading from market focus earlier in the year. While Section 122 tariffs expired on July 24, a more durable tariff framework is already underway,

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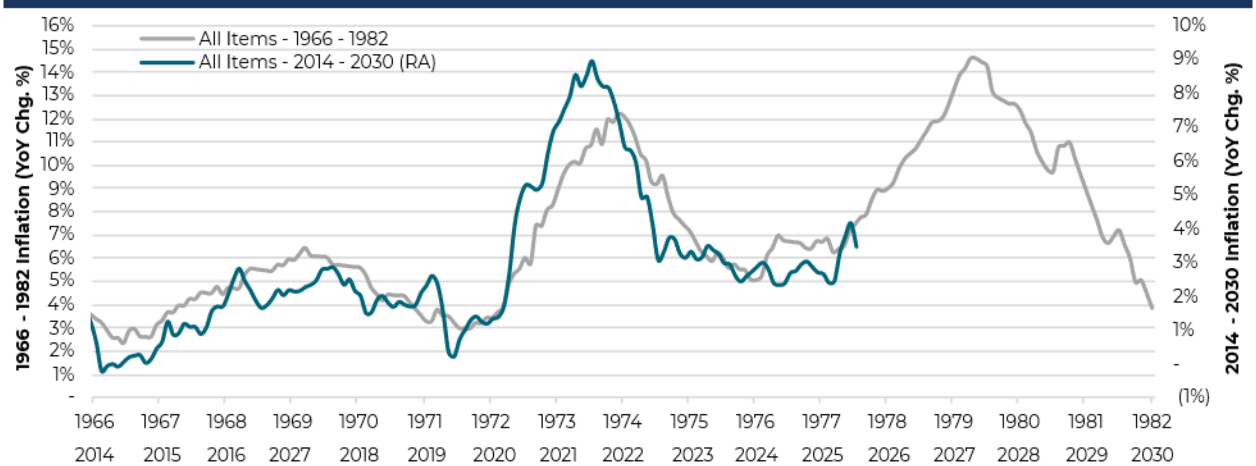
[20] Source: U.S. Department of Energy as of 7/7/26.

including two sweeping Section 301 investigations, a 25% tariff on key Brazilian exports, and planned 50% tariffs on many Canadian exports under Section 338. Findings from one investigation have already concluded that 59 countries and the EU failed to adequately prohibit forced labor imports and imposed tariffs in the range of 10-12.5%, effective as of 12:01 am on July 24. [21] A second investigation into excess manufacturing capacity remains ongoing. Compounding these risks, Trump declined a clean 16-year extension of the USMCA, triggering annual reviews and increasing the U.S.' negotiating leverage over trade relationships involving ~$1.9TN of annual trade with Canada and Mexico. [22] This evolving tariff regime appears collectively poised to firm up existing and emerging inflationary pressures.

Although optimism grows over recent price declines, the overall trajectory of headline inflation is eerily reminiscent of the 1970s when similar energy supply shocks and geopolitical upheaval in the Middle East resulted in global stagflation.

Déjà Vu All Over Again?

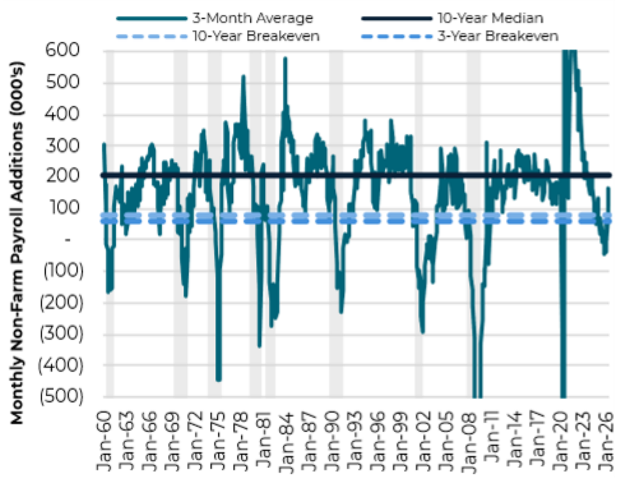


Source: U.S. Bureau of Labor Statistics as of 7/14/26.

On the other side of the Fed's dual mandate, headline payroll data rebounded sharply in the first half of the year, adding further complexity to the forward rate path. Headline payroll gains have exceeded expectations in aggregate over the last 3 months, with average monthly gains of 115k thus far exceeding average expectations of 88k – reinforcing the perception of a still-resilient labor backdrop. [23] However, this headline strength should be taken with a healthy dose of skepticism. Annual benchmark revisions have, in recent years, pointed to an overstatement of job creation in the initial labor figures – with the last revision period erasing nearly 50% of the jobs previously thought to have been created in the twelve months ended March 2025. [24]

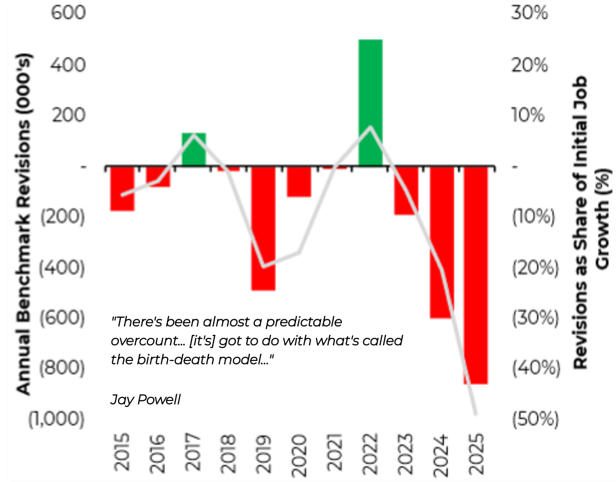
[21] Source: U.S. Trade Representatives as of 7/23/26.
[22] Source: Brookings as of 3/27/2026. Figure represents annual trade value between the U.S., Mexico, and Canada in 2024.
[23] Source: Bureau of Labor Statistics as of 7/2/26.
[24] Source: Bureau of Labor Statistics as of 2/11/26.

Nonfarm Payroll Additions



Source: Bureau of Labor Statistics as of 7/2/26.

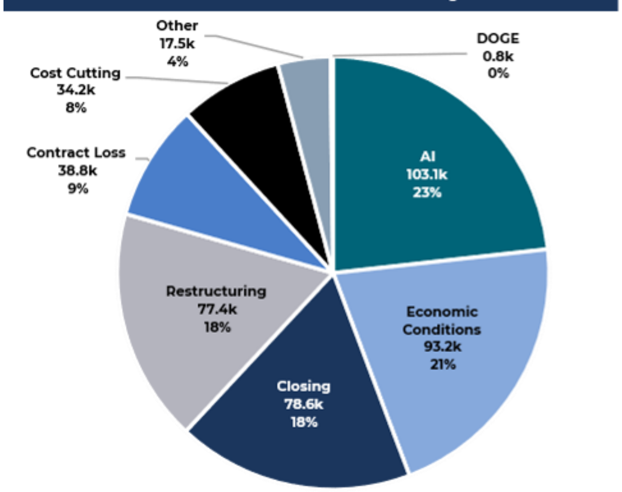
Annual Benchmark Revisions



Source: Bureau of Labor Statistics as of 2/11/26.

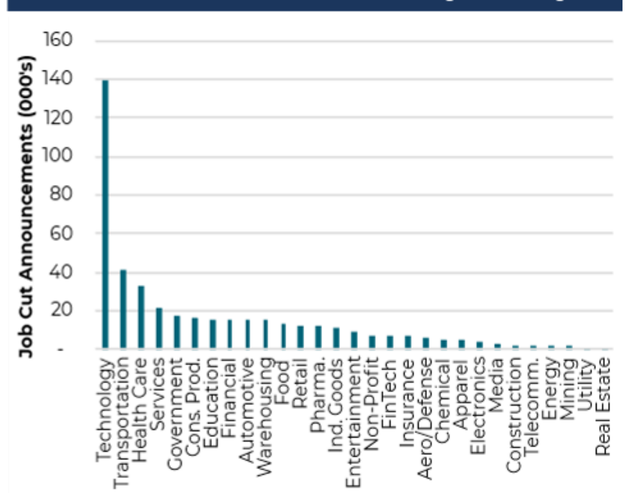
Meanwhile, forward-looking indicators – including rising job cut announcements and ongoing discussions around AI-related labor displacement – suggest the potential for softening ahead. According to the Challenger, Gray, & Christmas job cut announcements figures, AI is emerging as a top reason for job cuts, comprising 23% of all job cut announcements YTD through June, versus just 6% for all of 2025, underscoring the extent to which AI overhang is beginning to weigh on labor demand expectations. Unsurprisingly, job cut announcements are concentrated in the Technology sector, accounting for roughly 30% of YTD cuts. [25] While these trends do not appear to have materially weakened labor data in aggregate, they have reinforced the notion that risks to the labor market are building beneath the surface.

YTD Job Cut Announcements by Reason



Source: Challenger, Gray, and Christmas as of 7/1/26.

YTD Job Cut Announcements by Industry



Source: Challenger, Gray, and Christmas as of 7/1/26.

(25) Source: Challenger, Gray, and Christmas as of 7/1/26.

Rate Policy – Less Talk More Action?

"Run the printing press a little bit less. Let the balance sheet come down. *Let Secretary Bessent handle the fiscal accounts, and in doing so, you can have materially lower interest rates.****"***

Inflation has been running well ahead of the Fed's long-stated inflation goal of 2 percent... for more than 5 years... *members of the FOMC are unambiguous and unanimous:* ***This Committee will deliver price stability."***

Kevin Warsh

Key Section Takeaways

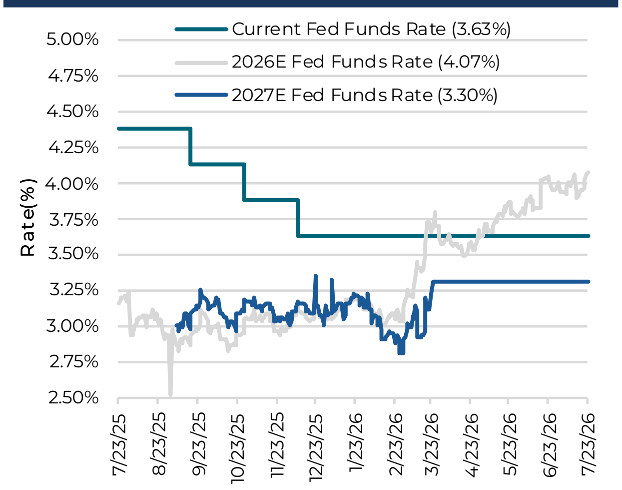
- The transition to a Warsh-led Fed marks a meaningful shift toward a more hawkish policy framework, with greater emphasis on inflation credibility, balance sheet stabilization, and reduced reliance on forward guidance
- Persistent fiscal deficits and the corresponding rise in Treasury issuance are starting to take a toll on long-end yields
- With inflation remaining sticky, deficits continuing to widen, and central banks globally stepping back from easing, long-term yields appear likely to remain higher for longer, extending pressure on financial conditions and consumer borrowing costs

Long-end yields moved higher over the first half of the year despite relatively stable growth expectations. While firmer inflation – driven in part by the energy shock – may have exacerbated the repricing, fiscal issues and a balance sheet hawk at the helm of the FOMC remain the main drivers. Amid structurally elevated fiscal deficits, Warsh's transition to Fed Chair brings with it his hawkish balance sheet tilt and critical stance toward QE, potentially leading to increased T-Bill issuance and upward pressure on the long-end of the curve.

While officials voted to hold rates steady at the June FOMC meeting, the updated dot plot marked a clear upward shift in the Fed's forward policy outlook. Median rate expectations for 2026 and 2027 moved meaningfully higher – from 3.38% to 3.75% and 3.13% to 3.63%, respectively, since March – while longer-term projections also drifted upward. [26] Notably, dispersion within the dot plot has widened, with several projections skewed above the median, highlighting a lack of conviction around the path of policy while showing a clear bias toward additional tightening.

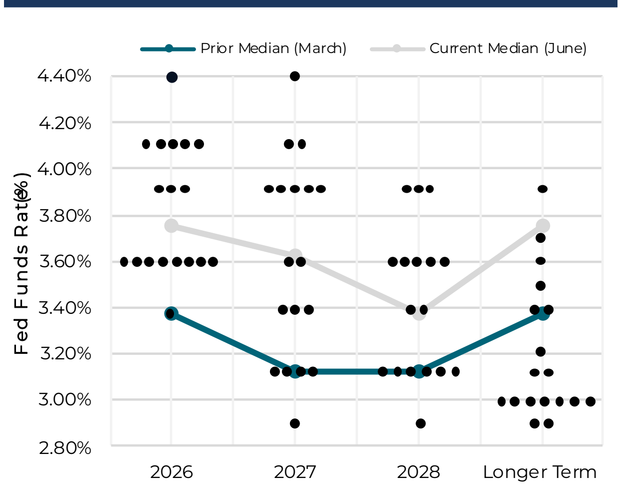
This shift reflects a broader change in tone under Chairman Warsh, who used his first press conference to emphasize that inflation is ultimately a function of policy choice and that the Committee is "unambiguous and unanimous" in restoring price stability. [27] At the same time, his decision to remove forward guidance and refrain from submitting his own dot underscores a shift away from signaling and toward a more data-dependent, reactive framework. The upward shift in expectations, combined with Chairman Warsh's emphasis on credibility and flexibility, reinforces a more hawkish and less predictable path forward for the Fed. Meanwhile, the market-expected path of policy has repriced higher with forward expectations for 2026 and 2027 sitting at ~4.1% and ~3.3%, respectively, reinforcing a higher-for-longer backdrop that continues to anchor long-end yields. [28]

Fed Funds Rate



Source: Bloomberg Finance, L.P. as of 7/22/26.

Fed Funds Dot Plot



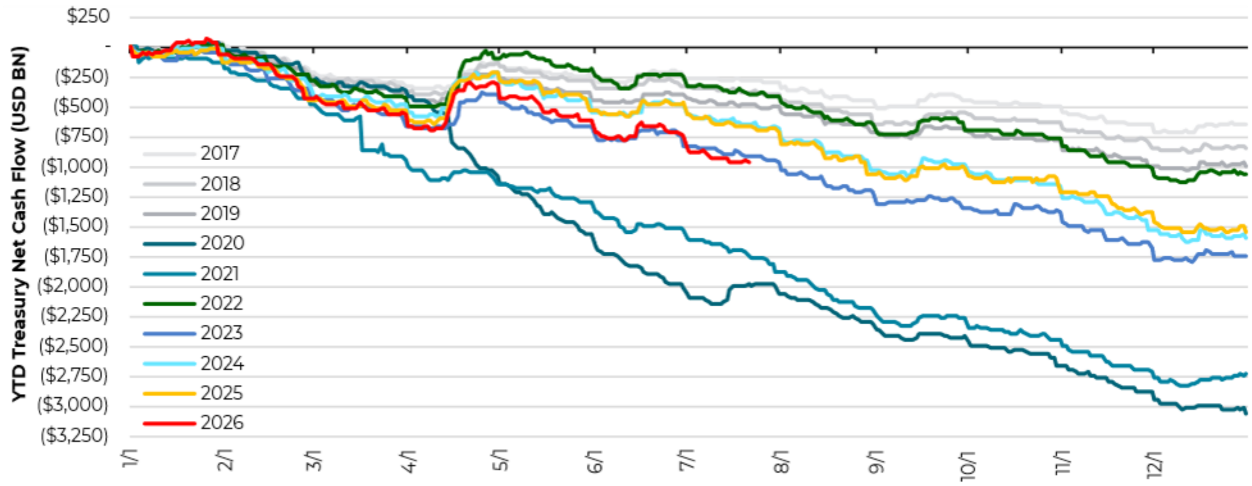
Source: Bloomberg Finance, L.P. as of 6/17/26.

Simultaneously, deficits remain elevated, tracking in the 6-7% of GDP range. [29] This reflects a combination of sustained government spending, rising interest expense, and continued fiscal stimulus embedded in transfers and tax refunds, which are on pace to reach among the highest levels ever recorded outside of the pandemic. [30]

[26] Source: Bloomberg Finance, L.P. as of 6/17/2026.
[27] Source: Federal Reserve Chair Kevin Warsh on 6/17/26.
[28] Source: Bloomberg Finance, L.P. as of 7/22/26.
[29] Source: U.S. Bureau of Economic Analysis.
[30] Source: U.S. Treasury as of 7/21/26.

As a result, longer-dated yields are becoming increasingly sensitive to both the magnitude and persistence of these deficits. Larger deficits translate directly into greater Treasury supply and a higher perceived risk premium, requiring markets to absorb more duration at higher yields.

Treasury Net Spending



Source: U.S. Treasury as of 7/21/26.

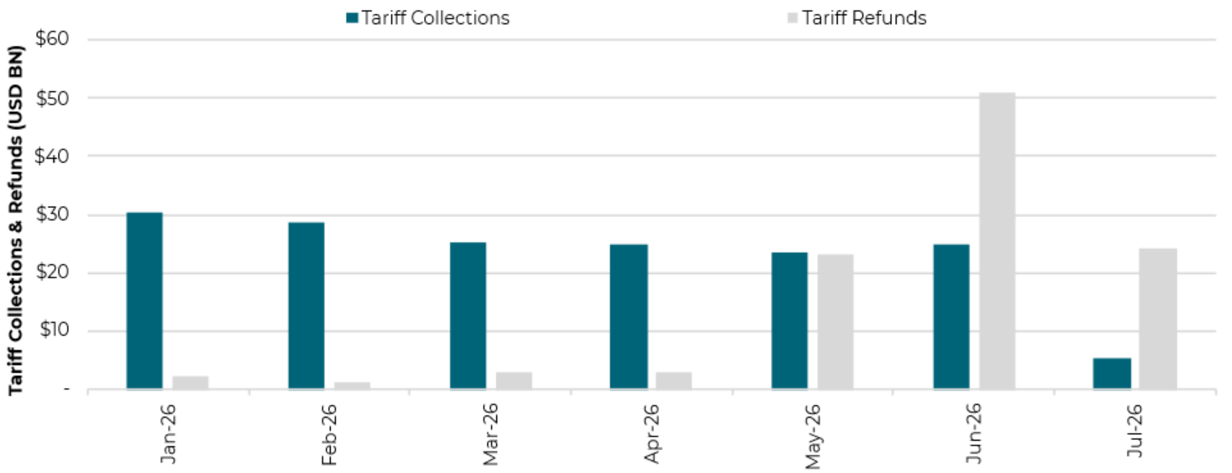
Thus far, incremental revenue sources have not been sufficient to offset this dynamic. While tariff revenues increased alongside shifts in trade policy – amounting to nearly $350BN over the past year – their contribution remains modest relative to the scale of projected fiscal expansion, with cumulative incremental deficit spending expected to exceed $24TN over the coming decade. [31] [32]

Importantly, the durability of these revenues remains uncertain, given ongoing IEEPA-related refund disputes and the evolving transition toward a new tariff framework under Section 301. Tariff refunds stepped up materially in May – effectively offsetting tariff collections for the month in full – amounting to double the amount of collections in June, and are pacing at ~4x of July collections to-date. [33]

Nearly **$350BN** in LTM tariff revenue pales in comparison to more than **$24TN** of projected cumulative deficit spending over the next decade.

[31] Source: U.S. Bureau of Economic Analysis, Congressional Budget Office as of 7/21/25.
[32] Source: Bloomberg Finance, L.P. 7/22/26.
[33] Source: U.S. Treasury as of 7/21/26.

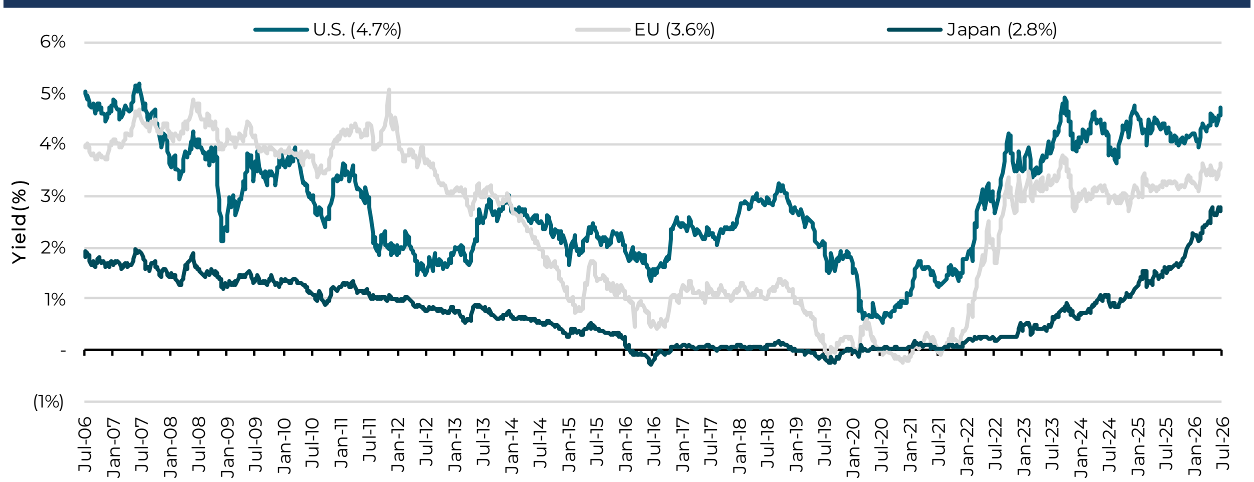
Tariff Collections and Refunds



Source: U.S. Treasury as of 7/21/26.

10-year UST yields remain at one of the highest levels over the last 20 years, with prevailing fiscal signals suggesting structural support for higher yields going forward. The U.S. is not alone in this worrisome fiscal picture. Long-end bond yields are rising around the world, with Japan's 10-year yields at their highest since 1997. [34]

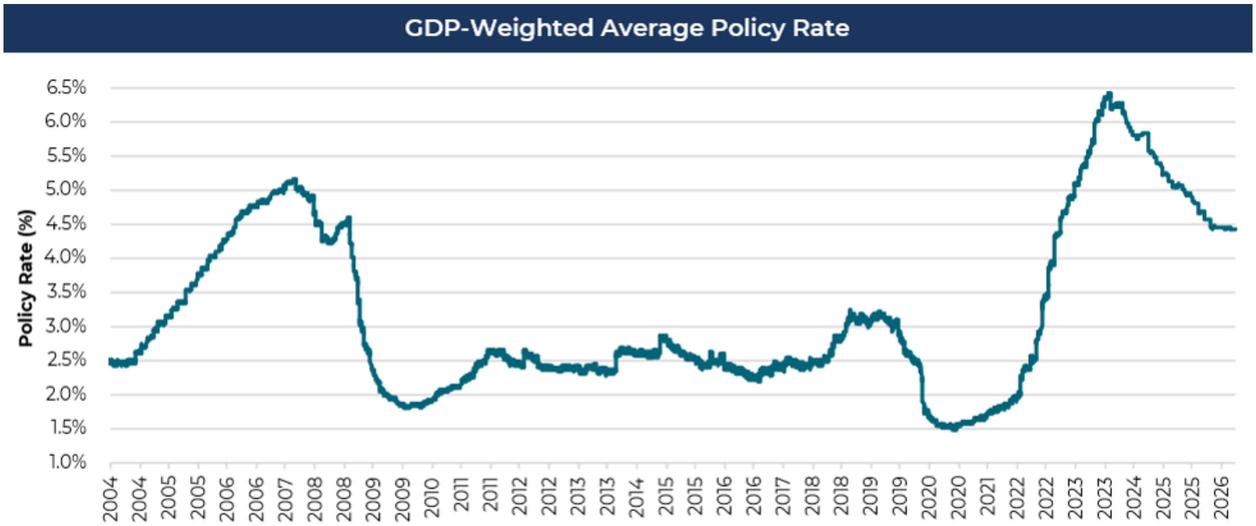
Global 10yr Government Bond Yields



Source: Bloomberg Finance, L.P. as of 7/22/26.

As in the U.S., resurgent inflationary pressures appear to have put central banks on the defensive. The prevailing easing bias that dominated global policy rate-setting since 2024 – with the GDP-weighted policy rate of the top 25 largest global economies having moderated to 4.5% from a peak of 6.5% in December 2023 – flatlined in the first half of 2026. [35]

[34] Source: Bloomberg Finance, L.P. as of 7/22/26.
[35] Source: Bloomberg Finance, L.P. as of 6/30/26.



Source: Bloomberg Finance, L.P. as of 6/30/26. Includes the 25 largest global economies by GDP with sufficient data available on Bloomberg. The EU is counted as one economy.

The evolving rates environment is increasingly defined by a convergence of structural forces rather than cyclical ones. A more hawkish and less prescriptive Warsh-led Fed, combined with persistently elevated deficits and rising duration supply, is reinforcing the idea that upward pressure on the long-end of the curve is likely to remain. As these dynamics persist, tighter financial conditions are likely to extend more broadly through the economy, further exposing the underlying fragility beneath otherwise resilient headline data.

Market Recap

Tale of the Tape

Tale of the Tape

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
EM (+74.5%)	Gold (+29.6%)	Gold (+10.1%)	Nikkei (+22.9%)	Nikkei (+56.7%)	U.S. REITS (+25.3%)	Nikkei (+9.1%)	U.S. HY (+17.3%)	Hang Seng (+36.0%)	Cash (+1.8%)	NASDAQ 100 (+38.0%)	NASDAQ 100 (+47.6%)	U.S. REITS (+38.8%)	Comdty (+16.1%)	NASDAQ 100 (+53.8%)	Gold (+27.2%)	Gold (+64.6%)	Nikkei (+31.9%)
APAC (ex-Japan) (+70.3%)	U.S. REITS (+23.5%)	USTs (+9.8%)	Hang Seng (+22.9%)	NASDAQ 100 (+35.0%)	NASDAQ 100 (+17.9%)	NASDAQ 100 (+8.4%)	Value Stocks (+14.3%)	EM (+34.3%)	U.S. Loans (+1.1%)	S&P 500 (+28.9%)	Gold (+25.1%)	Comdty (+27.1%)	Cash (+1.5%)	Nikkei (+28.2%)	NASDAQ 100 (+24.9%)	EM (+30.6%)	Comdty (+26.8%)
U.S. HY (+55.0%)	NASDAQ 100 (+19.2%)	U.S. IG (+8.1%)	APAC (ex-Japan) (+19.6%)	S&P 500 (+29.6%)	S&P 500 (+11.4%)	Euro Stoxx 600 (+6.8%)	Comdty (+11.8%)	APAC (ex-Japan) (+33.4%)	USTs (+0.9%)	Euro Stoxx 600 (+23.2%)	APAC (ex-Japan) (+23.1%)	S&P 500 (+26.9%)	U.S. Loans (+0.1%)	S&P 500 (+24.2%)	S&P 500 (+23.3%)	Hang Seng (+27.8%)	U.S. REITS (+18.9%)
NASDAQ 100 (+53.5%)	Comdty (+16.8%)	U.S. HY (+6.7%)	NASDAQ 100 (+16.8%)	Value Stocks (+29.4%)	Value Stocks (+10.9%)	USTs (+0.8%)	U.S. Loans (+9.8%)	NASDAQ 100 (+31.5%)	NASDAQ 100 (-1.0%)	Value Stocks (+23.2%)	S&P 500 (+16.3%)	NASDAQ 100 (+26.6%)	Gold (-0.3%)	U.S. HY (+13.5%)	Nikkei (+19.2%)	Nikkei (+26.2%)	EM (+17.8%)
Hang Seng (+52.0%)	APAC (ex-Japan) (+16.7%)	U.S. REITS (+4.7%)	U.S. HY (+16.1%)	Euro Stoxx 600 (+17.4%)	U.S. IG (+7.5%)	U.S. Loans (+0.5%)	S&P 500 (+9.5%)	S&P 500 (+19.4%)	Gold (-1.6%)	U.S. REITS (+20.9%)	Nikkei (+16.0%)	Value Stocks (+22.7%)	Nikkei (-9.4%)	U.S. Loans (+13.2%)	Hang Seng (+17.7%)	APAC (ex-Japan) (+25.2%)	APAC (ex-Japan) (+16.9%)
U.S. Loans (+51.8%)	EM (+16.4%)	NASDAQ 100 (+2.7%)	EM (+15.1%)	U.S. HY (+7.9%)	Nikkei (+7.1%)	Cash (+0.0%)	EM (+8.6%)	Nikkei (+19.1%)	U.S. HY (-1.9%)	Gold (+18.3%)	EM (+15.8%)	Euro Stoxx 600 (+22.2%)	Value Stocks (-9.6%)	Gold (+13.1%)	Value Stocks (+11.9%)	NASDAQ 100 (+20.2%)	Value Stocks (+16.7%)
Euro Stoxx 600 (+28.0%)	U.S. HY (+14.6%)	U.S. Loans (+1.8%)	Value Stocks (+14.5%)	U.S. Loans (+5.6%)	USTs (+5.1%)	S&P 500 (-0.7%)	Gold (+8.1%)	Gold (+13.5%)	U.S. IG (-2.5%)	Nikkei (+18.2%)	U.S. IG (+9.9%)	U.S. HY (+5.5%)	U.S. HY (-10.6%)	Euro Stoxx 600 (+12.7%)	U.S. Loans (+9.3%)	Euro Stoxx 600 (+16.7%)	NASDAQ 100 (+12.8%)
Gold (+24.4%)	Value Stocks (+12.9%)	Cash (+0.0%)	Euro Stoxx 600 (+14.4%)	Hang Seng (+2.9%)	Euro Stoxx 600 (+4.4%)	U.S. IG (-0.7%)	U.S. IG (+6.1%)	Value Stocks (+10.9%)	S&P 500 (-6.2%)	APAC (ex-Japan) (+15.5%)	USTs (+8.0%)	U.S. Loans (+5.5%)	USTs (-12.5%)	U.S. REITS (+9.0%)	U.S. HY (+8.6%)	S&P 500 (+16.4%)	S&P 500 (+8.1%)
S&P 500 (+23.5%)	S&P 500 (+12.8%)	S&P 500 (-0.0%)	U.S. REITS (+13.6%)	APAC (ex-Japan) (+1.4%)	U.S. HY (+3.0%)	U.S. REITS (-1.5%)	NASDAQ 100 (+5.9%)	Euro Stoxx 600 (+7.7%)	U.S. REITS (-8.6%)	EM (+15.4%)	U.S. HY (+6.9%)	Nikkei (+4.9%)	Euro Stoxx 600 (-12.9%)	Value Stocks (+8.8%)	APAC (ex-Japan) (+8.1%)	Comdty (+15.8%)	Euro Stoxx 600 (+8.0%)
U.S. REITS (+21.0%)	U.S. Loans (+10.1%)	Value Stocks (-2.1%)	S&P 500 (+13.4%)	Cash (+0.0%)	U.S. Loans (+2.0%)	U.S. HY (-3.7%)	APAC (ex-Japan) (+4.3%)	U.S. HY (+7.7%)	Value Stocks (-10.6%)	U.S. HY (+14.6%)	U.S. Loans (+3.2%)	Cash (+0.0%)	Hang Seng (-15.5%)	U.S. IG (+8.5%)	Euro Stoxx 600 (+6.0%)	Value Stocks (+13.6%)	U.S. Loans (+2.2%)
Nikkei (+19.0%)	U.S. IG (+9.0%)	Euro Stoxx 600 (-11.3%)	U.S. Loans (+10.0%)	U.S. REITS (-1.4%)	APAC (ex-Japan) (+1.9%)	Value Stocks (-6.2%)	U.S. REITS (+4.2%)	U.S. IG (+6.4%)	Comdty (-11.2%)	U.S. IG (+14.5%)	Cash (+0.6%)	U.S. IG (-1.0%)	U.S. IG (-15.8%)	EM (+7.0%)	Comdty (+5.4%)	U.S. HY (+9.0%)	U.S. HY (+2.1%)
Comdty (+18.9%)	Euro Stoxx 600 (+8.6%)	Comdty (-13.3%)	U.S. IG (+9.8%)	U.S. IG (-1.5%)	Hang Seng (+1.3%)	Hang Seng (-7.2%)	USTs (+1.0%)	U.S. Loans (+4.2%)	Nikkei (-12.1%)	Hang Seng (+9.1%)	Value Stocks (+0.1%)	APAC (ex-Japan) (-2.3%)	S&P 500 (-19.4%)	Cash (+5.1%)	Cash (+5.3%)	U.S. IG (+7.8%)	Cash (+2.0%)
U.S. IG (+18.7%)	USTs (+5.9%)	Nikkei (-17.3%)	Gold (+7.1%)	USTs (-2.7%)	Cash (+0.0%)	Gold (-10.4%)	Nikkei (+0.4%)	USTs (+2.3%)	Euro Stoxx 600 (-13.2%)	U.S. Loans (+8.6%)	Comdty (-3.1%)	USTs (-2.3%)	APAC (ex-Japan) (-20.4%)	USTs (+4.1%)	EM (+5.1%)	USTs (+6.3%)	U.S. IG (-0.5%)
Value Stocks (+16.3%)	Hang Seng (+5.3%)	APAC (ex-Japan) (-17.6%)	USTs (+2.0%)	EM (-5.0%)	Gold (-1.4%)	APAC (ex-Japan) (-10.9%)	Hang Seng (+0.4%)	Comdty (+1.7%)	Hang Seng (-13.6%)	Comdty (+7.7%)	Hang Seng (-3.4%)	Gold (-3.6%)	EM (-22.4%)	APAC (ex-Japan) (+2.8%)	U.S. REITS (+4.6%)	U.S. Loans (+6.0%)	USTs (-0.7%)
Cash (+0.1%)	Cash (+0.1%)	Hang Seng (-20.0%)	Cash (+0.1%)	Comdty (-9.5%)	EM (-4.6%)	EM (-17.0%)	Cash (+0.3%)	U.S. REITS (+0.9%)	APAC (ex-Japan) (-15.2%)	USTs (+6.9%)	Euro Stoxx 600 (-4.0%)	EM (-4.6%)	U.S. REITS (-27.3%)	Comdty (-7.9%)	U.S. IG (+2.1%)	Cash (+4.3%)	Hang Seng (-1.6%)
USTs (-3.6%)	Nikkei (-3.0%)	EM (-20.4%)	Comdty (-1.1%)	Gold (-28.3%)	Comdty (-17.0%)	Comdty (-24.7%)	Euro Stoxx 600 (-1.2%)	Cash (+0.8%)	EM (-16.6%)	Cash (+2.2%)	U.S. REITS (-11.1%)	Hang Seng (-14.1%)	NASDAQ 100 (-33.0%)	Hang Seng (-13.8%)	USTs (+0.6%)	U.S. REITS (-1.2%)	Gold (-6.2%)

Source: Bloomberg Finance, L.P. as of 7/22/26.

Equities | Meme Mania Trounces Margin of Safety

"History tells us that even if the party goes on for another week, month, three months or year, the resolution will be to much lower prices…we are getting into that rare air, so extreme that the consequences will be unavoidable, no matter where one hides."

Michael Burry

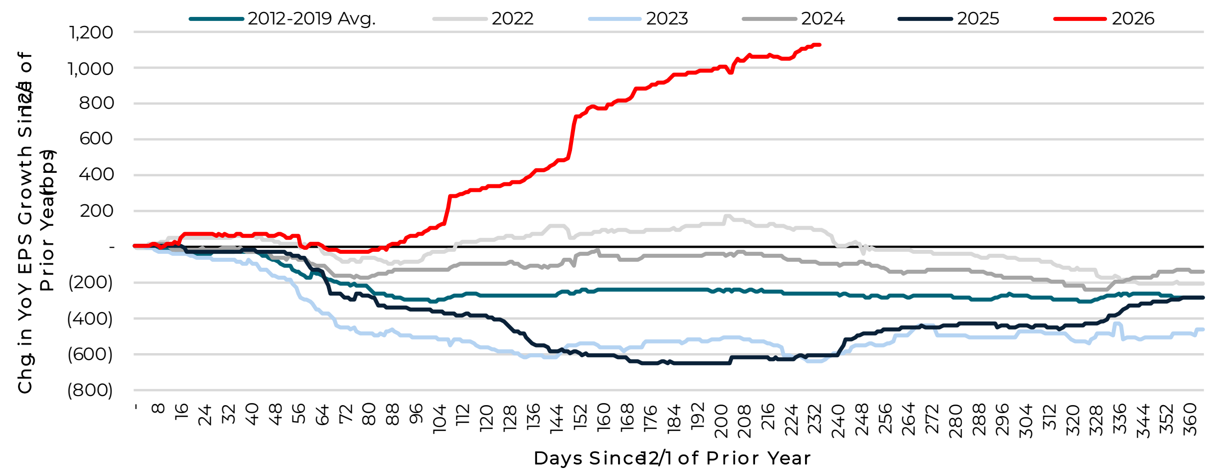
Key Section Takeaways

- U.S. equity strength masks underlying fragility from extreme concentration in the singular AI theme
- Elevated concentration increases the risk that any reassessment of AI-related ROIC could sharply reverse recent market gains
- Technology firm cash flows are increasingly being redirected to AI-related CapEx as hyperscalers shift from share repurchases to issuance, reducing a key source of EPS and valuation support
- The S&P 500 NTM P/E remains at levels correlated with subdued five-year forward annualized returns relative to recent history

In the first half of 2026, U.S. equity markets continued to demonstrate a remarkable reflex to look through intermittent shocks as favored subsectors of the market buoyed sentiment and valuations. Early-year volatility stemmed from geopolitical shocks and a sharp repricing in Software and growth-oriented sectors, as concerns around AI-driven disruption triggered a broad de-risking episode dubbed the "SaaSpocalypse." Although the S&P and Nasdaq closed Q1 in the red, major U.S. equity indices have since notched new all-time highs.

A remarkable surge in earnings further fueled this recovery, as 2026 earnings growth continues to materially exceed expectations. S&P 500 earnings growth for Q1 printed at approximately 27% YoY, relative to initial expectations of ~10%, lifting full-year estimates to roughly 25%. As such, 2026 earnings growth revisions are tracking at nearly +1,200bps since December – a pace far outstripping any year since 2022, as well as the 2016-2019 average. [36] However, this aggregate strength obscures meaningful dispersion below the surface.

YoY EPS Growth Evolution



Source: Bloomberg Finance, L.P. as of 7/22/26.

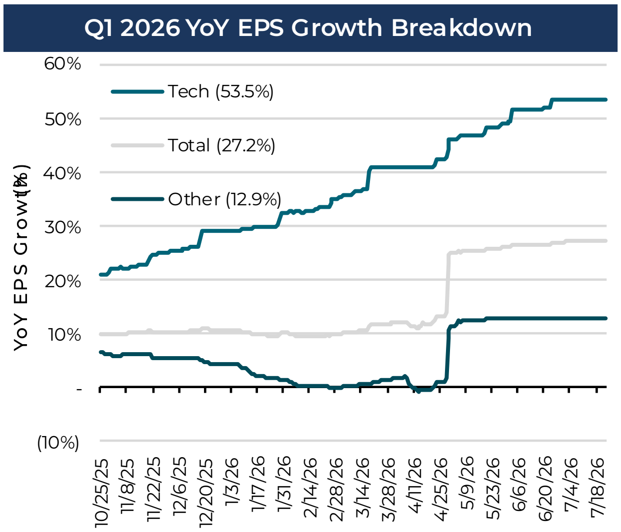
Indeed, mirroring the narrow breadth of the equity rally, this earnings growth is highly concentrated in a handful of names. Q1 2026 earnings growth – even more bifurcated than full-year 2026 expectations – came in at roughly 54% for the Technology sector, double the already strong ~27% for the overall index, which was itself more than twice the growth rate for the remaining 10 sectors of the S&P 500. [37]

Forward analyst forecasts imply this trend will only continue. Roughly 65% of 2027 earnings growth for the S&P 500 is forecasted to originate from the top 10 most highly weighted names, and 75% from the top 25, further entrenching index dependence on a narrow earnings base. At the same time, analysts expect that over half of names in the index will post flat or negative earnings growth, highlighting a growing disconnect between index-level performance and the experience of the median constituent. [38]

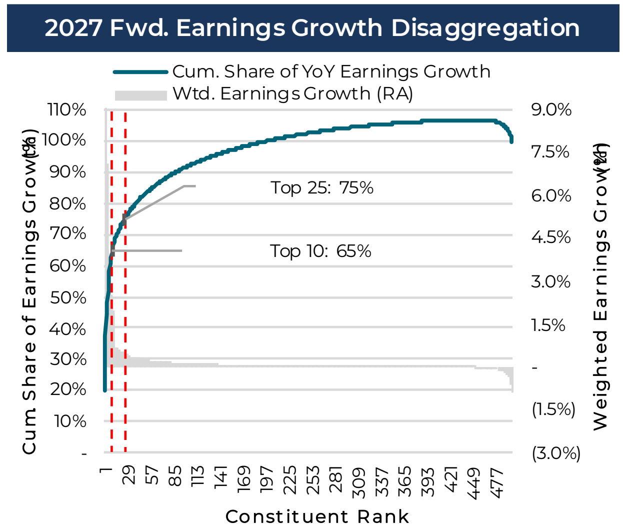
65% **of projected S&P 500 earnings growth is expected to come from just 10 companies.**

The gap between index performance and the experience of the median constituent continues to widen.

[36] Source: Bloomberg Finance, L.P. as of 7/22/26.
[37] Source: Bloomberg Finance, L.P. as of 7/22/26.
[38] Source: Bloomberg Finance, L.P. as of 7/22/26.

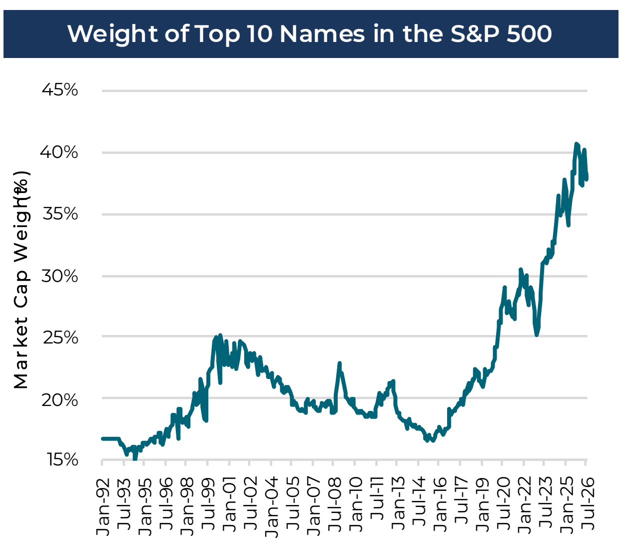


Source: Bloomberg Finance, L.P. as of 7/22/26. Tech refers to the Information Technology S&P 500 GICS sector.

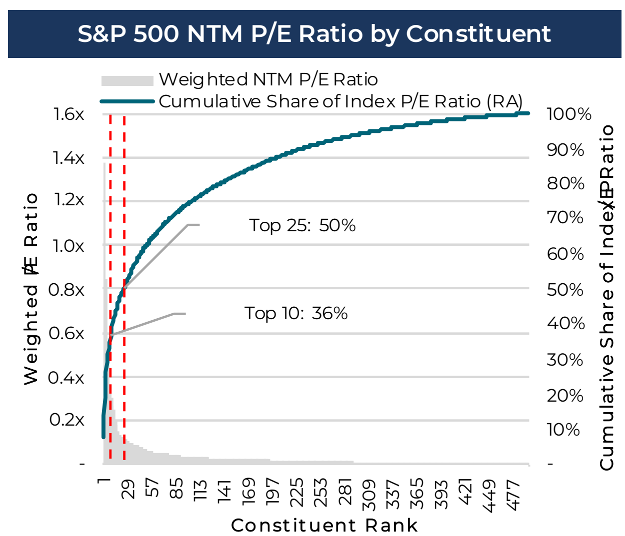


Source: Bloomberg Finance, L.P. as of 7/22/26.

Exacerbating this extreme bifurcation, the weight of the top 10 stocks in the S&P 500 remains at roughly 40% – far eclipsing the 25% weighting at the height of the Dot-Com bubble. Valuation looks similar with the top 10 names accounting for nearly 40% of the NTM P/E ratio of the S&P 500, leaving both earnings power and valuation multiples disproportionately dictated by a narrow cohort of firms. [39]



Source: Bloomberg Finance, L.P. as of 7/22/26.



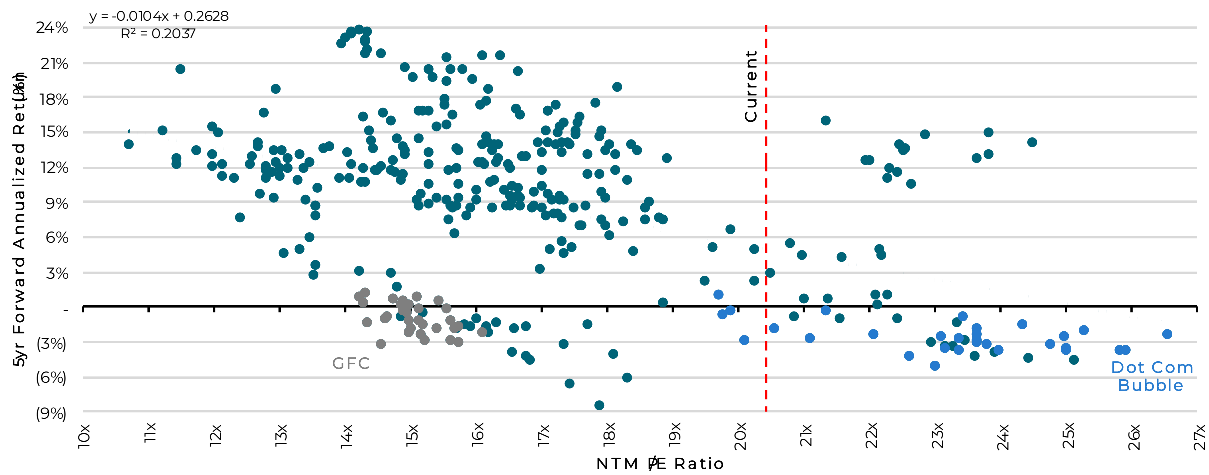
Source: Bloomberg Finance, L.P. as of 7/22/26.

Forward returns are one potential victim of inflated concentration and valuation. History suggests that higher S&P valuations are associated with diminished forward return potential

[39] Source: Bloomberg Finance, L.P. as of 7/22/26.

over a 5-year horizon. While surging earnings growth has compressed the S&P 500 NTM P/E relative to the beginning of the year, it remains at levels implying 5-year forward annualized returns toward the lower end of the recent historical range.

5yr Forward Annualized S&P 500 Returns



Source: Bloomberg Finance, L.P. as of 7/22/26.

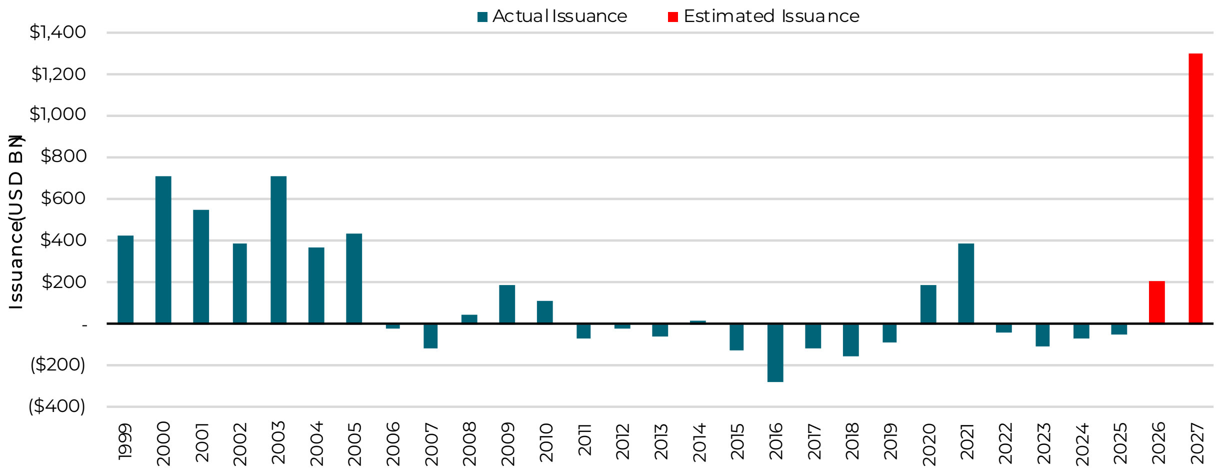
Some of the most heavily weighted names in the index, and therefore the biggest drivers of forward index performance, are tethered to one theme – AI. Record investments in AI-related infrastructure have propelled hyperscalers and AI-linked beneficiaries to new highs despite uncertain return potential. Investors have so far been willing to look through this all-encompassing fact. The key question remains when – and to what extent – skepticism will outweigh the hype.

Taken together, equity market stability is increasingly conditional not only on continued earnings delivery from a limited subset of companies, but also on sustained confidence that incremental AI-driven investment *will* ultimately translate into realized economic returns.

Should these investments prove successful, the result is likely to be further consolidation of earnings within this group, reinforcing their dominance while potentially compressing earnings capacity across the broader market. Conversely, if returns on these investments fail to materialize, the scale of capital deployed raises the risk of meaningful write-downs and earnings deterioration – an outcome which would undoubtedly drag the broader market down in tandem.

Further shrugging off these uncertainties, at least for now, major hyperscalers have announced plans to raise hundreds of billions of fresh capital via IPOs and secondary equity issuances, thus soaking up "excess cash on the sidelines" while also potentially revealing management and board views on prevailing valuations. Forecasts imply that markets will be flooded with $1.2TN of net issuance through 2027, a staggering sum that may be challenging to absorb. [40]

Net Equity Issuance



Source: J.P. Morgan as of 6/16/26.

This excess financing – spurred by hyperscalers in particular – is fueling a massive shift in Technology firm capital allocation priorities, as they deploy record sums into CapEx to finance AI infrastructure. CapEx for the largest public hyperscalers now consumes nearly 80% of cash flow from operations ("CFFO"), double the rate from 2016-2022. Meanwhile, share buybacks – historically a key pillar of share price and EPS support – have been slashed to 10% of CFFO, one-third the rate from 2016-2022. [41]

~80% of hyperscaler cash flow now goes toward CapEx—double the rate seen from 2016–2022.

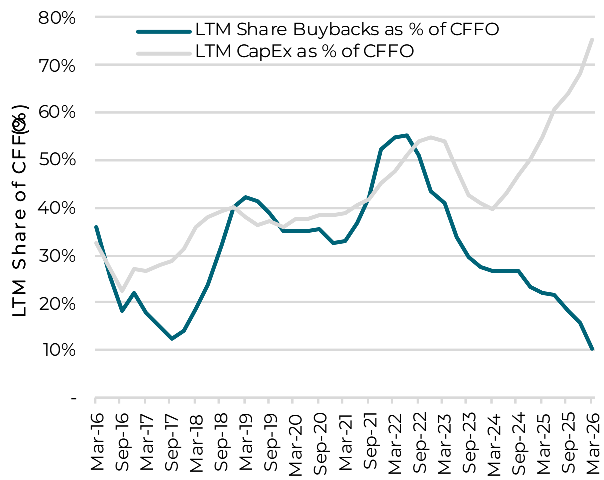
AI infrastructure spending is reshaping capital allocation priorities.

At the same time, while earnings for this cohort are growing at a strong clip, underlying cash flow has deteriorated. Part of the reason is that depreciation accounting is providing a temporary buffer, as depreciation and amortization ("D&A") inherently lags the surge in AI-related CapEx. This accounting mismatch is effectively front-loading earnings, a tailwind that hyperscalers are taking further advantage of by extending the useful lives of chips used in datacenters. The result is a growing divergence between reported profitability and economic reality. Indeed,

[40] Source: J.P. Morgan as of 6/16/26.
[41] Source: FactSet through Q1 2026.

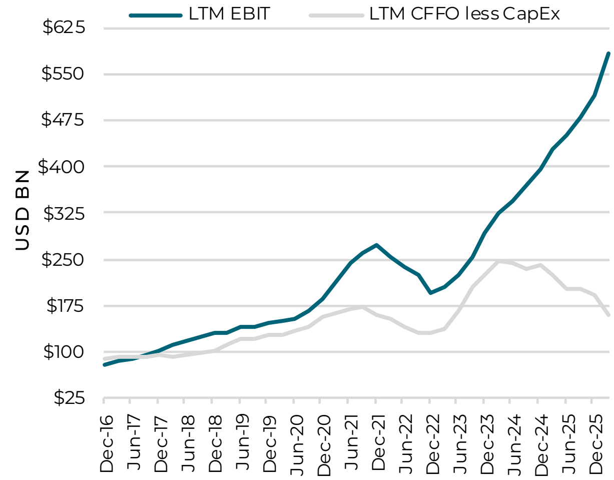
since the launch of ChatGPT in late 2022, EBIT for this cohort has nearly tripled, while free cash flow has inflected sharply lower.

Share Buybacks vs. CapEx as Share of CFFO



Source: FactSet through Q1 2026.

Earnings vs. Cash Flow



Source: FactSet through Q1 2026.

Ultimately, however, despite the equity markets' high degree of dependence upon the AI theme, equity investors at least benefit from any upside that materializes. Perhaps more concerning, then, is mounting concentration in credit markets that AI firms have tapped to finance datacenter buildouts, where even if all goes well, investors' upside is inherently capped at the rate of return promised up front.

Investment Grade Credit

"Hyperscalers are beginning to test the limits of how much supply the IG market will underwrite…"

Barclays Credit Research

Key Section Takeaways

- IG spreads as a share of all-in yields are near lows last seen before the Dot-Com bust and Global Financial Crisis, leaving incremental returns largely dependent on rates

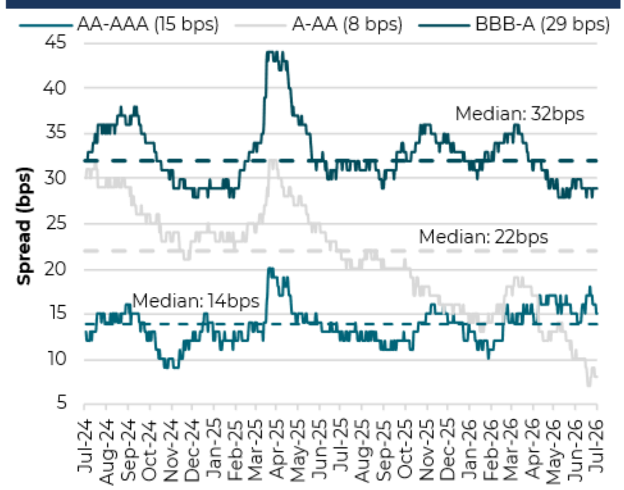
- Technology's growing share of IG issuance, including complex and circular datacenter financing structures, increases market sensitivity to scrutiny of the AI theme

IG credit markets have remained resilient in 2026, with returns supported in part by a rotation toward higher-quality credit as marginal investors reduced exposure to riskier, asset-light Software issuers in the LL and PC markets. Within the IG ratings spectrum, IG was defined by a reach for yield at the lower end of the stack – with the BBB-A spread basis compressing to the lowest levels in at least 2 years. [42] Overall, though, IG spreads have fully retraced the widening seen earlier in the year and returned to all-time tights, leaving spread contribution to all-in yields near all-time lows, at roughly 14%. [43] Total returns are now highly dependent on the rates market, with a very limited margin of safety to compensate investors for idiosyncratic risk.

Spread Contribution to IG Yields

Source: Bloomberg Finance, L.P. as of 7/22/26.

IG Ratings Spread Basis

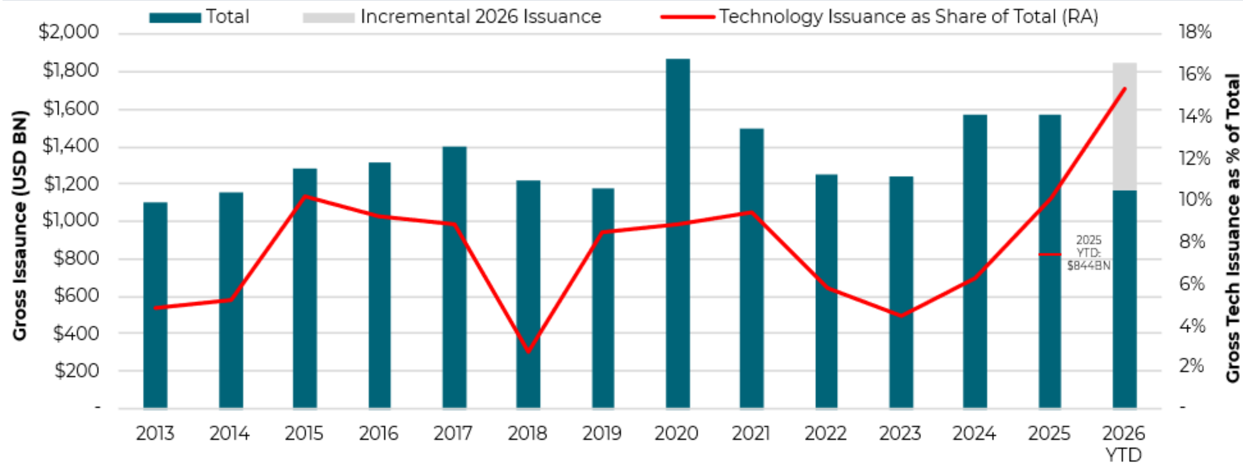


Source: J.P. Morgan as of 7/22/26.

This remarkable tightening bias in overall spreads comes despite elevated supply through the first half of the year of roughly $1.2TN, outpacing the $844BN of YTD issuance through June of last year, and in line with the record-setting 2020 pace. For the full year, forecasts suggest issuance is on pace to meet or exceed the prior record set in 2020. Part of the issuance deluge stems from hyperscalers tapping the IG market to fund capital spending: year-to-date, Technology issuance has accounted for roughly $180BN, or 15% of gross supply, versus ~10% in all of 2025. [44]

[42] Source: J.P. Morgan as of 7/22/26.
[43] Source: Bloomberg Finance, L.P. as of 7/22/26.
[44] Source: Bloomberg Finance, L.P. through June 2026. Incremental 2026 issuance based on Bloomberg Intelligence forecast.

Gross Investment Grade Corporate Bond Issuance



Source: Bloomberg Finance, L.P. through June 2026. Incremental 2026 issuance based on Bloomberg Intelligence forecast.

The IG market has thus far absorbed this excess supply relatively well, with spreads remaining contained despite the high quantum of issuance. However, continued issuance at this pace could still pressure spreads as mounting exposure introduces as-yet unknown risks into the IG universe – with further embedded downside risk if the AI theme unravels.

Complex and circular financing structures used by a growing number of hyperscaler and AI-linked firms encapsulate this risk. Off-balance sheet financings in particular have grown in popularity as these firms seek to raise financing without compromising headline credit metrics – therefore decoupling ultimate issuer spreads, and potentially ratings, from underlying economic risk.

The most extreme expression of these structures came in the form of a recent financing backed by graphics processing units ("GPUs") rather than a datacenter itself. While stated maturities at the time of underwriting are set to align with the useful lives of GPUs, the rapid pace of AI advancement risks pulling forward obsolescence and accelerating replacement cycles inside the initially underwritten maturity.

In either case, a realignment of spreads with the underlying economic risk embedded in these structures could serve as the spark for a correlated repricing across credit markets. Deterioration in cash flows beyond ratings agency expectations could trigger downgrades which, in the most severe case, could beget a wave of fallen angels. These issuers would necessarily migrate to the high yield credit market, pressuring spreads in that market not only as it absorbs large capital structures, but also as deteriorating performance for bellwether names risks dragging down the broader Technology sector in tandem.

High Yield Credit

"Prepare for war, but hope for peace."

Na Wei, Barclays Global Head of Leveraged Finance

Key Section Takeaways:

- Software maturities will be a key headwind for the LL market over the coming years as 85% of loans coming due through 2029 are rated B- or lower
- Technology exposure is likely to drive meaningful dispersion in HY fund returns with certain credit managers across the LL and PC markets running concentrations as high as 30-40%

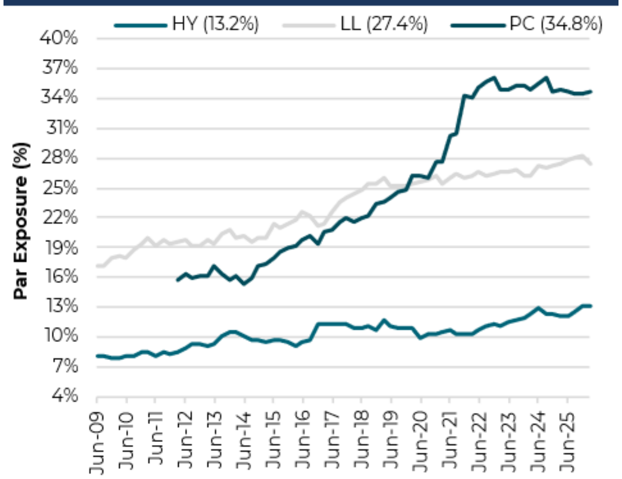
High Yield ("HY") credit markets have recovered substantially from the shocks in the beginning of the year, but the recovery has been uneven. The HY and LL markets have taken on different trajectories in a reflection of underlying risk. While HY spreads have fully retraced their YTD spread-widening, LL spreads continue to lag at a far lower 46% retracement. This divergence is beginning to align spreads with expectations of risk trajectories between the two markets. Over the past several decades, the LL market has taken on far riskier exposures, and experienced notable deterioration in ratings quality, while the HY market has trended in the opposite direction. In a similar fashion, credit investors expressed a clear preference for quality in the first half of the year with a rotation away from yield-seeking in favor of downside-protection – as demonstrated by remarkable decompression in the HY and LL BB-CCC spread bases, which widened out 139/201bps YTD, respectively. [45]

While **high yield spreads have fully retracted** their 2026 widening, **leveraged loans have recovered less than half.**

[45] Source: J.P. Morgan as of 7/22/26.

Technology exposure lies at the center of this widening bifurcation. The prior wave of Technology issuance, focused on enterprise software, was predominantly absorbed by leveraged credit markets – in particular the LL and PC markets – at the height of the 2020-2022 leveraged buyout ("LBO") boom. As this debt now comes due – starting with lower-quality issuers unable to refinance, or those that underwent unsuccessful restructurings – HY credit market participants are increasingly at risk of divergent outcomes depending on sectoral weighting.

HY/LL Services and Software Par Exposure



Source: J.P. Morgan as of 6/30/26.

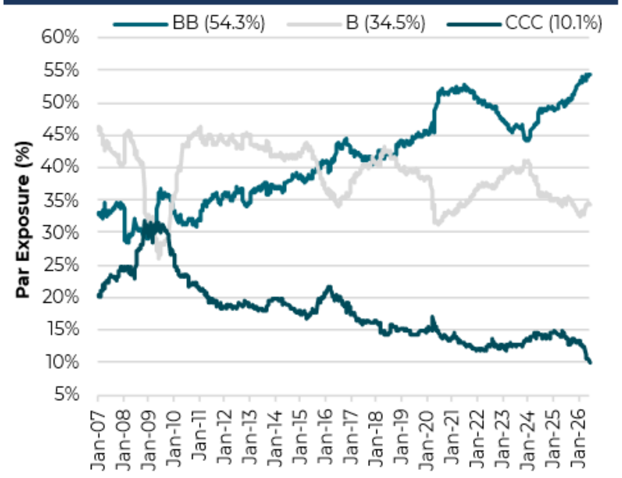
The pandemic-era surge in Software financings was part of a larger trend in the LL market which, over the past decade, migrated from a preference for asset-intensive toward asset-light issuers offering marginally better economics to offset the inherently higher risk of lower recoveries on the back end. From 2009 to the present, LL par exposure to Services and Software has roughly doubled, to just over 27%, while PC exposure has soared to nearly 35%. The HY market has maintained more modest exposure, sitting at 13%. [46]

This increase in asset-light exposure coincided with a deterioration in ratings quality, again concentrated in the LL index. Compared to 2007, when the LL market was evenly distributed between single-B and double-B risk, LL exposure to single-B rated paper now consumes nearly two-thirds of the LL index, implying higher default propensity. Meanwhile, the HY market has improved in quality, with BB risk now accounting for over half of the index – versus roughly one-third in 2007 – alongside a concurrent decline in CCC exposure. [47]

Credit quality has **improved in high yield bonds** since the financial crisis but **deteriorated in leveraged loans**, with nearly two-thirds of the leveraged loan market now rated single-B.

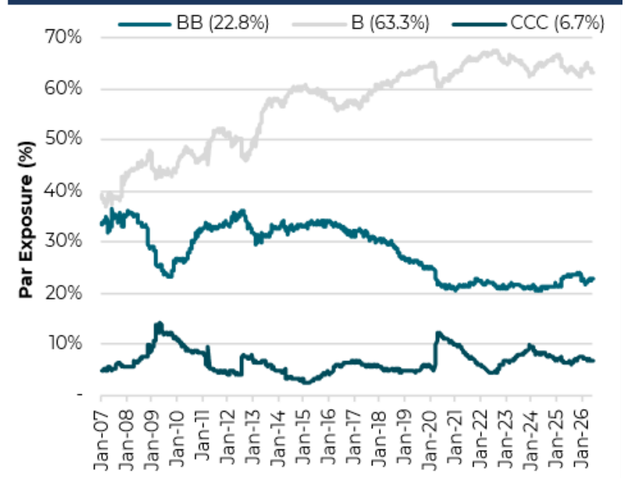
[46] Source: J.P. Morgan as of 6/30/26.
[47] Source: J.P. Morgan as of 6/30/26.

HY Ratings Distribution



Source: J.P. Morgan as of 6/30/26.

LL Ratings Distribution

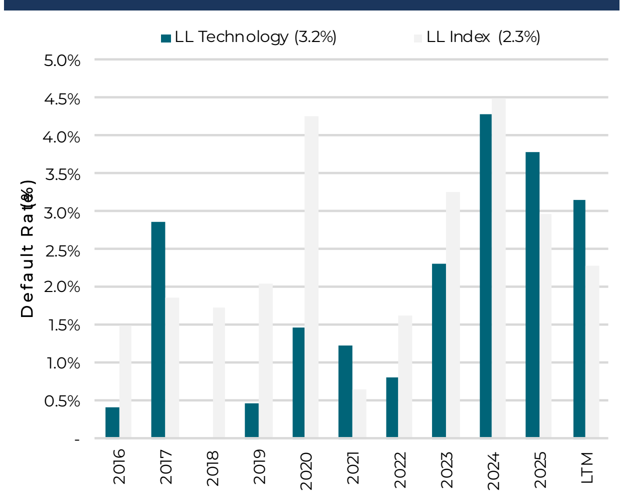


Source: J.P. Morgan as of 6/30/26.

The risks of lower recoveries stemming from this exposure profile are quickly becoming a reality. Indeed, last twelve months ("LTM") recoveries for LL Technology – predominantly comprised of asset-light, lower-rated Software – have plummeted below 10 cents on the dollar, a record low level far below already troubling index-wide recoveries. [48]

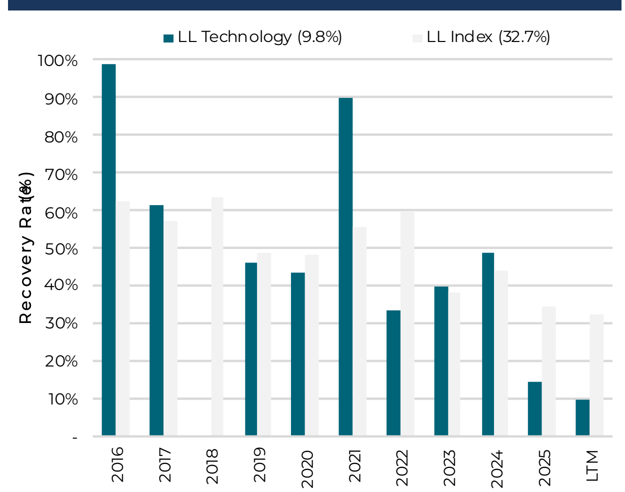
Despite lower recoveries, losses have been muted as defaults remain contained. But that, too, is quickly shifting as LTM LL Technology defaults remain elevated at 3.2% relative to the overall LL market at 2.3%. [49]

LL Technology Defaults



Source: J.P. Morgan as of 7/1/26.

LL Technology Recoveries

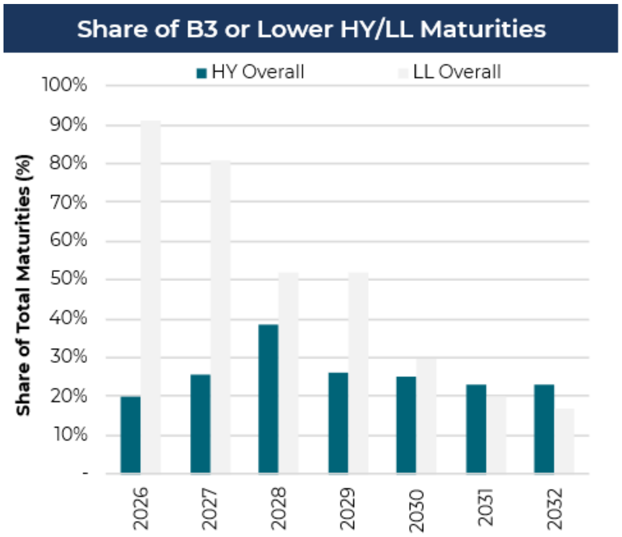


Source: J.P. Morgan as of 7/17/26.

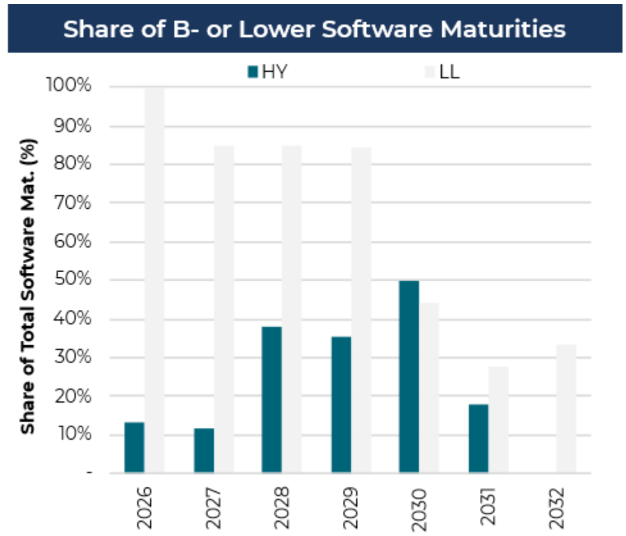
Concerns compound looking into the future. The ratings quality of near-term maturity walls implies elevated default risk concentrated in the LL market. Over 50% of loans maturing

[48] Source: J.P. Morgan as of 7/17/26.
[49] Source: J.P. Morgan as of 7/1/26.

through 2029 are rated B3 or lower, compared to only one-third of HY. [50] LL Software positioning is even riskier with 85% of maturities through 2029 rated B- or lower. [51]



Source: J.P. Morgan as of 5/31/26.



Source: J.P. Morgan as of 5/31/26.

As markets digest these lower-quality maturities, while risks to Software and Technology defaults remain tilted to the upside, LL defaults are expected to rise from current levels. J.P. Morgan forecasts call for 2026 and 2027 HY/LL default rates of 1.75%/3.00% and 2.25%/4.50%, respectively, from 2.70%/2.30% currently. [52]

Distress ratios reinforce this view, albeit with wide dispersion by sector. LL Technology has the second highest distressed share at ~25% (surpassed only by Telecom at ~31%), with Services likewise one of the most elevated at ~10%. [53]

Markdowns are also ticking up in PC loans within business development company ("BDC") portfolios, as 64% of Software loans were marked down in Q1, double the rate of non-Software loans. As a result, PC Technology has the second highest distressed share (defined as the par amount below 90) at 8.1%, followed by services-heavy Healthcare at 7.6%. [54]

While these markdowns are themselves a worrisome signal given the notorious illiquidity of this market, they do not reflect the full extent of embedded downside risks. Research from ratings agency KBRA shows that one year prior to default, PC marks for defaulted loans were 41 points higher than ultimate recoveries upon default, versus a gap of 28 points for LL and 33 points for HY. [55] PC loan "distress" ratios are therefore likely higher than reported figures suggest, but the sectoral trend is still telling.

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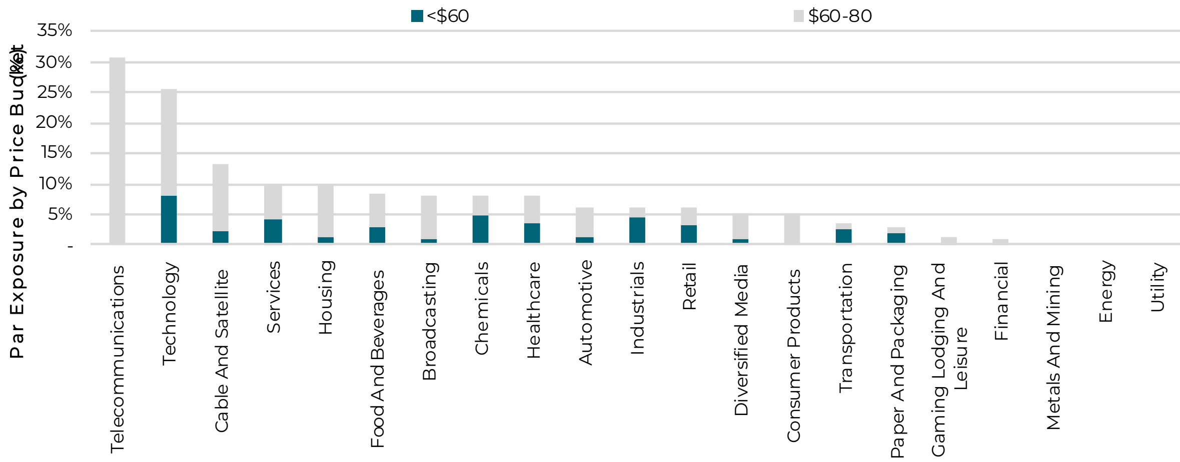
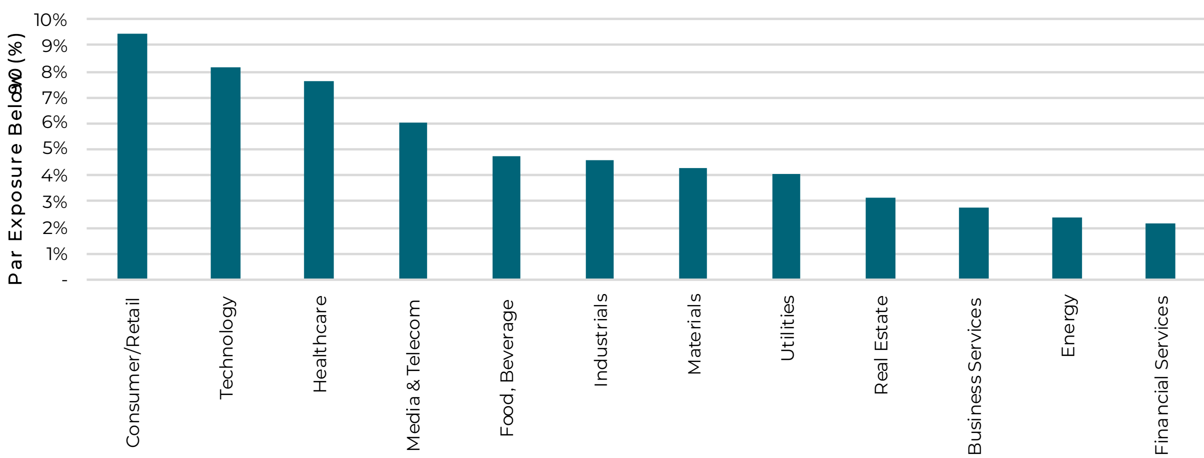
[50] Source: J.P. Morgan as of 5/31/26.
[51] Source: J.P. Morgan as of 5/31/26.
[52] Source: J.P. Morgan as of 7/1/26.
[53] Source: J.P. Morgan as of 7/10/26.
[54] Source: Cliffwater Direct Lending Index as of 3/31/26.
[55] Source: KBRA as of 3/12/24.

Distressed Leveraged Loans by Industry



Source: J.P. Morgan as of 7/10/26.

Distressed Private Credit Loans by Industry



Source: Cliffwater Direct Lending Index as of 3/31/26.

While the market will need to reckon with the consequences of this Technology concentration creep – a process already underway – the unwind is unlikely to be evenly distributed. Instead, it seems more likely to drive meaningful dispersion in outcomes among managers with differing approaches to portfolio construction and individual credit selection. Some managers accumulated outsized exposure to lower-quality Technology issuers – particularly in Software – while others maintained more diversified portfolios, potentially sacrificing some upfront return for greater downside protection. Indeed, certain credit managers and funds across the LL and PC markets built up Technology exposures as high as 30-40%, representing overweights relative to already elevated market levels. [56] [57]

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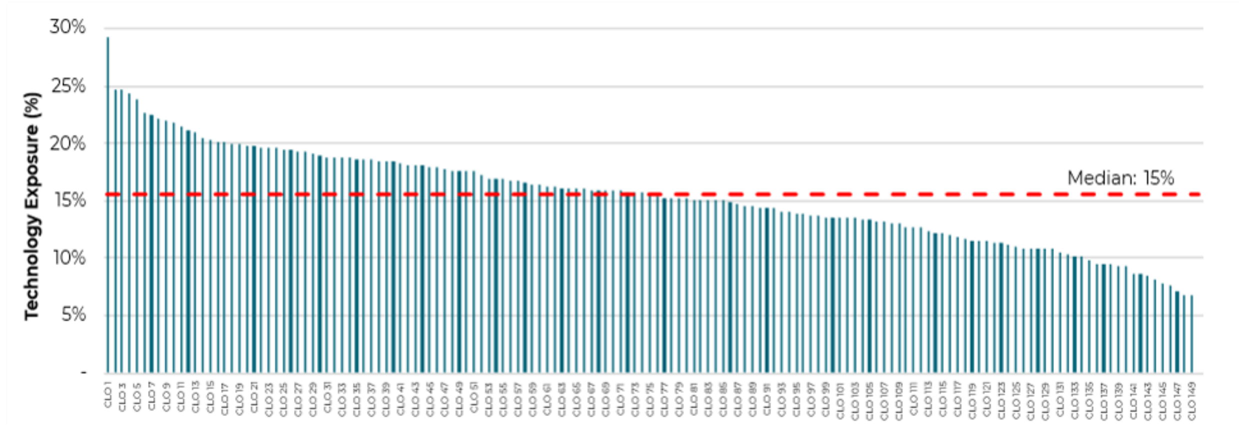
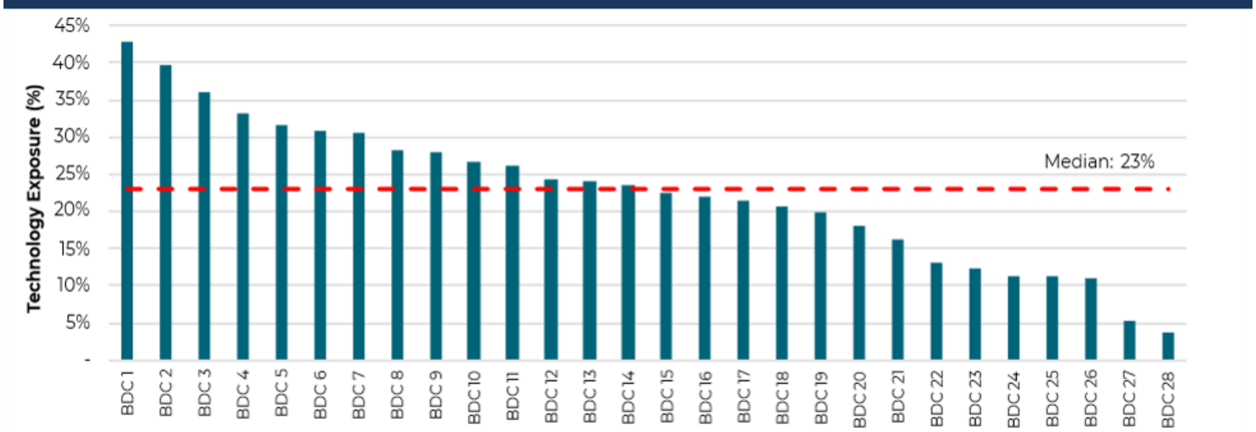
[56] Source: Bank of America as of 5/15/26.
[57] Source: J.P. Morgan as of 4/28/26.

BSL CLO Managers by Technology Exposure



Source: Bank of America as of 5/15/26.

Top BDCs by Technology Exposure



Source: J.P. Morgan as of 4/26/26.

As refinancing pressures build and valuations reset, these differences are likely to prove decisive, with lower expected recoveries in Technology issuers leaving some portfolios more exposed to capital impairment. In this sense, Technology exposure is likely to emerge as a fault line across leveraged finance markets, separating more disciplined managers from those that allowed concentration risk to build under precisely the wrong conditions.

Investor anxieties over these elevated exposures and deteriorating underwriting standards most immediately manifested in publicly traded BDCs. From October 2025 through March 2026, Software-heavy publicly traded BDCs experienced drawdowns in equity prices roughly 500bps greater than Software-light BDCs. Meanwhile, redemption requests for BDCs surged in Q1, in most cases exceeding the traditional 5% cap. [(58)] As funds opted to enforce these caps, more than $14BN in investor capital remained unredeemed in the first half of 2026 alone. [(59)]

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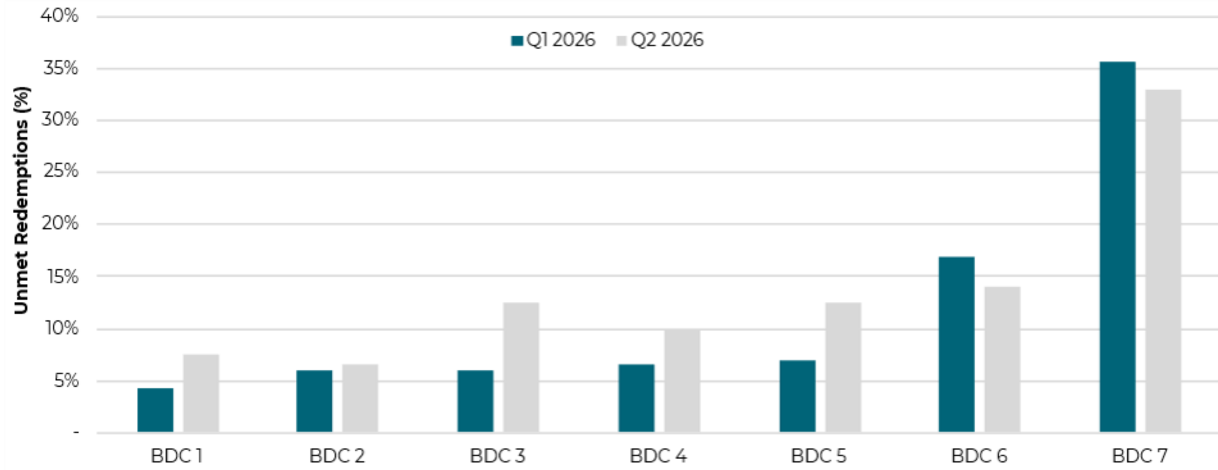
(58) Source: Morgan Stanley as of 4/21/26.
(59) Source: Bloomberg Finance, L.P. as of 7/2/26.

Unmet BDC Redemptions



Source: Bloomberg Finance, L.P. as of 7/2/26.

Key Takeaways and Conclusions

The go-forward macroeconomic and market environment looks set to further expose, rather than resolve, the imbalances that emerged, accumulated, or worsened in the first half of 2026, with growth holding at the surface but increasingly reliant on a narrow and fragile set of drivers.

Consumption is set to become more explicitly bifurcated, with spending strength concentrated among higher-end, asset-owning households while lower-income consumers face tightening liquidity, rising debt burdens, and sustained pressure from higher costs of everyday goods. As tax refund support fades and credit capacity becomes constrained, weakness at the lower end should intensify, leaving aggregate demand increasingly tied to equity market performance and therefore more fragile than headline data suggests.

Inflation is likely to remain persistent for longer than currently expected, as the initial energy shock continues to work its way through the economy with both immediate and lagged effects. While rising gas prices are already weighing on household budgets, the broader pass-through is still unfolding. Inflationary impulses look set to remain sticky and spread across a wider set of categories, leaving the Fed with limited policy flexibility.

Rates are likely to remain structurally elevated as continued expansion in fiscal deficits meets a new Fed policy regime under Chairman Warsh. At the same time, AI-related borrowing in the IG market will continue to inject meaningful duration supply into the market, siphoning marginal demand away from the long end of the curve.

Equity market performance is likely to remain narrow and increasingly conditional, with index-level outcomes dependent on a small group of companies whose earnings are tied to the promises and perils of AI. Soaring earnings expectations for a concentrated group of companies mask the fact that substantial capital spending on AI infrastructure is driving meaningful cash flow deterioration at others.

Leveraged credit markets look set to progress further into a realization phase marked by bifurcated outcomes courtesy of mounting stress in legacy Software and asset-light Technology exposures. Thin recoveries have already become a reality, and if defaults tick up, loss realization will accelerate. But these pressures are unlikely to be evenly distributed. Managers with elevated exposure to lower-quality Software and asset-light Services issuers are more directly exposed to impairment risk, while those with more diversified portfolios face a more contained adjustment.

Across asset classes, the defining feature of the evolving cycle is a steadily thinning margin of safety. At the macro level, growth is supported by an increasingly narrow subset of consumers and companies. That dynamic is transmitting directly into markets, where elevated valuations and compressed spreads leave precious little room for error. At the investment level, positive outcomes will increasingly hinge on avoiding capital impairment rather than chasing incremental upside. Vigilant asset selection and a bias toward quality remain key to navigating the fragile exuberance of current markets.

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