

Balancing Opportunity and Discipline in 2026

by John E. Chapman

Economic Fundamentals: Strength with Mixed Signals

The U.S. economy enters March maintaining solid momentum yet operating within an environment of elevated uncertainty. Real GDP growth remains constructive at approximately 2.5 percent, supported by robust business investment and a consumer sector that continues to spend despite showing signs of strain in certain segments. Corporate earnings growth has sustained its trajectory in the high single-to-low double-digit range, with the fourth quarter marking the fifth consecutive quarter of double-digit earnings expansion.

This economic resilience comes against a backdrop of significant crosscurrents. Inflation remains sticky and problematic, with January's Producer Price Index rising 0.5 percent and core PPI accelerating to 0.8 percent, well above the 0.3 percent consensus expectations.

The Federal Reserve's preferred inflation measure, core PCE, came in at 4.3 percent annualized in December, with durable goods inflation reaching 6.8 percent month-over-month, the richest since 2021. These persistent price pressures have effectively looked to eliminate any possibility of first-half Fed rate cuts, leaving monetary policy in a holding pattern as we await clearer signals on the inflation trajectory.

The labor market presents a similarly mixed picture. While headline unemployment has held steady near 4.3 percent, beneath the surface, we observe a weakening quality of employment. Net job creation in 2025 marked the weakest year since the pandemic recovery began, once government and healthcare positions separated from core private sector payrolls. Labor force participation has slipped, and continuing unemployment claims have trended higher.

The Iran Situation: Geopolitical Risk in Real Time

The historical perspective of military conflict was recently addressed in a **Special Edition of The Private Client Letter**, as it represents a significant geopolitical development with immediate market implications. Since the publication of that special update, oil prices have surged over 8 percent, U.S. equity indices have initially declined, and ten-year Treasury yields have fallen below 4.0 percent in a classic flight-to-safety pattern.

While we acknowledge this conflict as a near-term threat to market stability, particularly regarding potential oil price spikes, several factors inform our measured response. First, the considerable supply overhang in global oil markets should provide a buffer against sustained price elevation absent a complete disruption of Iranian production. Second, with midterm elections approaching in November, the administration faces strong political incentives to avoid actions that could materially damage economic growth or consumer purchasing power. Third, crude oil currently trades in the upper half of its 52-week range, but at levels that, if hostilities diminish, could quickly revert lower.

We are monitoring oil markets closely, recognizing that a sustained move above \$80-85 per barrel WTI could represent a meaningful headwind to global growth and could pressure profit margins across energy-intensive industries.

Positive Signals

Several indicators point to continued economic expansion. The manufacturing sector has shown unexpected resilience, with European PMI readings reaching their highest levels since June 2022, and Germany posting its first manufacturing reading above 50 in nearly four years. This global industrial upturn coincides with strong performance in cyclical indicators: both the Dow Transportation Index and Philadelphia Semiconductor Index posted double-digit gains year-to-date through February 19. This combination has historically preceded continued S&P 500 strength.

Bank lending has tracked better than expected in Q1 at 6.6 percent year over year, and capital markets activity remains robust. Corporate balance sheets generally remain healthy, with private sector debt loads falling relative to GDP. This represents a sharp contrast to the pre-2008 financial crisis period.

In what our colleagues at Bespoke Investment Group call the “three-headed monster” - oil, the dollar, and interest rates - each currently sits in the lower quintiles of their respective one-year ranges. This configuration has historically provided tailwinds for equity returns.

Cautionary Flags

Yet, several warning signals deserve careful attention. Market valuations remain elevated, with the S&P 500 trading around 22 times forward earnings compared to a historical median of 16 times. This leaves very little margin for disappointment in either earnings delivery. Market leadership remains concentrated among a relatively small group of mega-cap technology companies, though this has broadened somewhat compared to late 2025.

The divergence between U.S. and international equity performance has reached historically extreme levels. Through February, the MSCI World Ex-U.S. Index outperformed the S&P 500 by 7.6 percentage points year-to-date, the second-widest performance spread in favor of international stocks since 1981 (The Bespoke Report).

Credit markets present a particularly notable area of concern. High-yield bond spreads have compressed to 294 basis points, a reading in the bottom 9th percentile since data began in 1997 (The Bespoke Report). While historically tight spreads don't guarantee imminent widening, they do signal that credit markets are pricing in very little risk of default or economic deterioration. The private credit sector has experienced notable stress, with redemptions elevated and several high-profile restructurings highlighting valuation concerns and potential liquidity challenges.

Perhaps most concerning is the behavior of the S&P 500 itself. Year-to-date, the index has traded in an exceptionally narrow range of just 2.7 percentage points, the second-narrowest spread in the index's history. This surface calm masks extreme single-stock volatility, with more than 25 percent of S&P 500 components already up or down more than 20 percent year-to-date. Such dispersion often precedes a resolution that involves either a breakout to new highs or a more meaningful correction.

The Midterm Election Factor: Planning for Volatility

The approaching November midterm election represents a principal source of macro and market risk for 2026. History provides clear guidance: midterm years exhibit notably higher volatility and significant declines of 10-20 percent or more in the 12-18 months preceding election day.

This particular midterm carries additional complexity. We face a new Federal Reserve chair transition in May, ongoing litigation regarding tariff policy following the Supreme Court's ruling on IEEPA tariffs. Policy uncertainty around these issues can meaningfully drag on business investment and hiring decisions precisely when the economy's underlying momentum depends on continued capital deployment.

Our positioning reflects this reality. We maintain meaningful equity exposure but with appropriate risk controls, recognizing that a sharp but temporary drawdown remains a distinct possibility between now and November. Such periods, if they occur, should be viewed as potential opportunities to add to positions in high-quality businesses trading at more attractive valuations.

Closing Perspective

The current environment rewards patience and discipline over aggressive positioning in either direction. The U.S. economy continues to grow, corporate profitability remains robust, and the AI investment cycle offers genuine long-term opportunity. Yet, valuations provide a limited cushion, inflation remains problematic, and multiple sources of potential volatility loom over the near term.

In this context, our commitment remains unchanged: working diligently to position your portfolios thoughtfully for long-term wealth creation while aiming to maintain appropriate guardrails against the risks we can identify, and sufficient diversification against those we cannot. We will continue to monitor developments closely, communicate transparently about evolving conditions, and adjust positioning as circumstances warrant.

Markets will do what markets do: oscillate, surprise, and periodically test investors' convictions. Our task is to maintain focus on fundamentals, resist the temptation to overreact to headlines, and make decisions grounded in evidence and aligned with your long-term goals.

Thank you for the trust you place in Clearwater Capital Partners. It remains our privilege to serve you and your family.

John E. Chapman

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