

Volatile Quarter, Durable Story

by John E. Chapman

The first quarter of 2026 reminded investors that strong long-term trends rarely move in a straight line. Stocks and bonds both pulled back in the quarter, largely because a sharp rise in oil prices, the war with Iran, and a reset in interest rate expectations all arrived at once. Even so, the quarter also showed meaningful economic strength, improving earnings expectations, and a market backdrop that looks more on hold than broken, provided the Middle East conflict does not broaden materially from here.

What is clear is that oil is now the market's main short-term variable, and the headlines of the next several days are likely to dominate sentiment and volatility. The U.S. economy remains more resilient than many expected, just as corporate earnings expectations have improved. History suggests that markets often recover once energy shocks begin to fade following periods of disruption and uncertainty.

A Brief Review of the First Quarter

The first quarter was a reminder that returns can diverge sharply beneath the surface. The S&P 500 fell 4.63 percent in the first quarter, the Nasdaq fell 7.11 percent, but the Russell 2000 gained 0.58 percent. Importantly, the S&P 500 forward price to earnings multiple fell from 23 times to 20 times during the quarter as stock prices declined while earnings expectations moved higher.

In its April 2 report, BESPOKE described the first three months of the year as a period in which oil became the dominant driver of stock prices, while the Equal Weight S&P 500 and small caps held up materially better than the cap-weighted large-cap benchmarks. Observations such as these underscore that recent weakness was concentrated in the largest growth stocks rather than the broad market as a whole.

This distinction matters. In periods like this, headlines can make the market appear weaker than the actual price movement of the average company. The 491 S&P 500 companies outside the mega cap leaders collectively finished the first quarter with an average gain of 1.02 percent.

Recent Economic Data

Recent economic data have not painted a picture of an economy rolling over. The most important near-term consumer update was found in the 0.6 percent rise in the February retail sales report, ahead of consensus expectations. The primary takeaway from the February report is that the consumer is still spending, even if not with the same ease or momentum seen earlier in the cycle.

By several key measures, the U.S. economy has shown more strength than many forecasters expected in the face of a major oil shock. BESPOKE's Economic Indicator Diffusion Index, which tracks whether economic reports are coming in above or below expectations, reached one of its highest readings since 2020 in late March. Among the most notable reports included a stronger than expected March ISM Manufacturing reading, respectable ADP payroll growth of 62,000 versus a 40,000 estimate, and still constructive jobless claims data.

This is an important point for clients. Markets often move first on fear, then spend the subsequent following weeks sorting through hard data to determine if the underlying economy is actually deteriorating. So far, the evidence suggests that growth is slowing somewhat, not collapsing.

Oil, the Middle East, and What it Could Mean

The short-term market story remains oil, yet it is important to observe that not all oil shocks are the same. Historically, there is no direct link between an oil price spike and recession. Instead, recession risk depends on a set of conditions, especially how long the disruption lasts, what inflation was doing beforehand, how the Federal Reserve responds, and how exposed the economy is to energy costs.

This framework is useful now because it supports a balanced message. Since the 1970s, the amount of oil the U.S. needs to produce each dollar of GDP has dropped by about 70 percent. The U.S. now exports more petroleum than it imports, and the government has stronger, better-developed strategic oil reserve tools than in past energy crises. The result is that the U.S. economy is better insulated than it once was, even if higher gasoline and input costs still pressure confidence and margins in the near term.

Our base case is predicated on this new energy dynamic and is, in many ways, quite practical. If the conflict settles down within weeks rather than months, we believe the oil market is likely to strip out much of its war premium. However, if the Strait of Hormuz remains closed for much longer, higher oil prices would quickly begin to weigh on global economic activity and would quickly increase the odds of a U.S. recession in 2026.

For investors, that means the right posture is caution without panic. The next several days matter because the market is looking for evidence of either escalation or an off-ramp. A durable easing in tensions would likely help oil prices retreat, improve inflation expectations, and allow investors to focus again on earnings and economic resilience.

Corporate Earnings Remain a Key Element

One reason the market has held up better than the headlines might suggest is that corporate earnings have continued to improve. Fourth quarter earnings for the S&P 500 were up 14 percent, and the bottom-up consensus estimate for 2026 earnings have been increasing: from \$323 per share from \$313 earlier in the year. It is important to note that earnings estimate revisions in March were lifted in part by higher energy company profits due to the rise in oil prices.

One recent summary of FactSet data cites forward S&P 500 EPS growth expectations of about 15 percent earlier in the year, with newer revisions nudging that figure toward roughly 17 percent as analysts continue to factor in stronger margins and AI-related productivity gains.

This said, a degree of caution is warranted here. The upcoming first-quarter earnings season, which begins the week of April 13, will be especially sensitive to management guidance and commentary, not just the reported numbers. If companies can absorb higher energy costs without materially cutting outlooks, that would support the constructive case. If not, the market may have to spend more time consolidating before a sustainable recovery can begin.

What This Means for Our Clients

At moments like this, investment discipline matters more than prediction. History suggests that markets can recover well after oil shocks if recession is avoided. However, deeper damage is possible if the shock persists long enough to erode confidence, employment, and policy flexibility. The focus right now is less on guessing headlines and more on maintaining portfolios that can withstand a variety of outcomes.

For balanced investors, that still argues for diversification, quality, and patience. High-quality fixed income continues to provide useful income and ballast. Equity exposure remains important because earnings and economic activity have not broken down, and because periods of fear often create better entry points than reasons to sell.

April may also provide a helpful seasonal backdrop. April has historically been one of the stronger months of the year for the S&P 500, with an average gain of 1.5 percent since 1990, and that in years when the S&P 500 entered April down year to date, the index averaged a gain of 1.93 percent (BESPOKE). Seasonality is never a thesis on its own, but in the current environment, it is a reminder that weak first quarters do not necessarily condemn the balance of the year.

Closing Thoughts

The near-term outlook deserves humility. The fluidity of the Middle East conflict means the headlines over the next days and weeks could still move markets sharply in either direction. That is the cautionary part of the message, and it should not be minimized.

The constructive part is equally important. The U.S. economy has performed better than feared, recent retail and labor-related data have been mixed but not recessionary, and earnings expectations have so far continued to trend higher. If the conflict begins to de-escalate and the Strait of Hormuz moves back toward normal operation, the combination of improving earnings, supportive seasonality, and still decent economic momentum could set the stage for a better market environment later this spring and summer.

In the meantime, portfolios remain positioned with that balance in mind, cautious enough to respect the risks, but constructive enough to recognize that strong economies and durable businesses often outlast temporary shocks.

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