

# “Finding Religion or Finding Disruption”

*“Son, in 35 years of religious study, I have only come up with two hard, incontrovertible facts; there is a God and I’m not him.”*

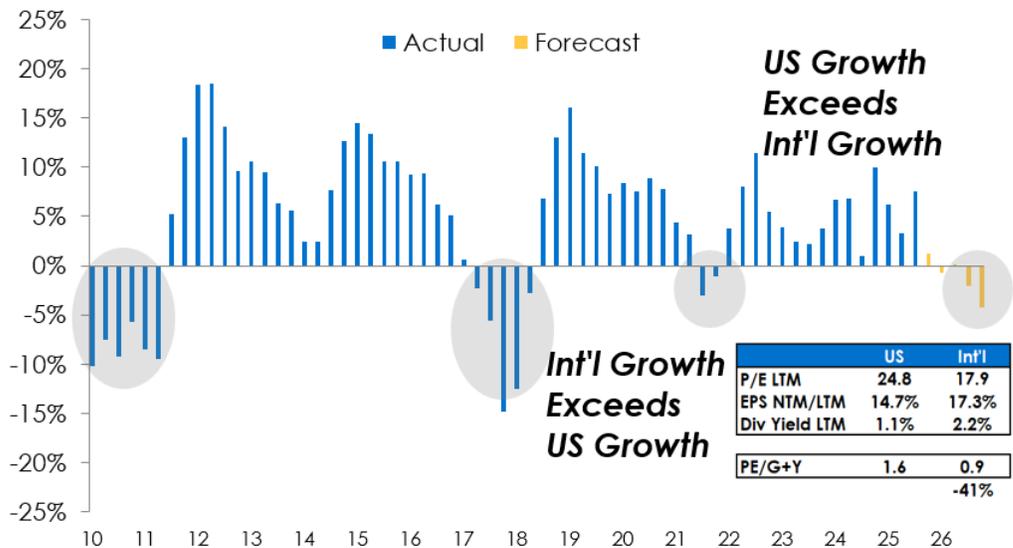
– Rudy (1993)

There’s been no shortage of eye-raising headlines to begin 2026. Since the end of February, US and Israel have launched strikes against Iran resulting in the killing of the Ayatollah Ali Khamenei. The objective seems to be the elimination of Iran’s capabilities regarding (1) nuclear weapons (2) ballistic missile programs (3) naval fleet and (4) proxy militant groups. The immediate effect on global markets has resulted in an inflationary impulse that’s seen a spike in oil prices – with the Strait of Hormuz a key focus (direction of travel for 20% of global oil). The wider the escalation and the longer the conflict ensues, the more likely a “risk-off” tone becomes entrenched. Conversely, the quicker path to resolution (via negotiations or regime change), the more likely a resumption of trend toward the fundamentals takes hold.

With regards to the latter, we made note of two main observations over the past month that continue to

evidence this being a year with no shortage of dichotomies – investors are finding both Religion and Disruption. Let’s explain. The first observation, to us, seems logical and one that finds investors searching for a broadening of opportunities. Market participants began flocking to overseas investments last year which resulted in material

**US Relative to Int’l Profit Cycle**  
(Year-on-Year Difference % Change in TTM EPS)



Source: Factset based on iShares ETF data IVV for US S&P 500 and ACWX for Int'l MSCI ACWI ex US. Forecast uses full year estimate and smooths over four quarters. Data as of 2/28/26.



outperformance (the MSCI All Country World Index ex US registered a price return last year of 32.6% versus the S&P 500 of 16.4%). That outperformance continued through the first two months of this year (ACWI ex US +10.9% vs S&P 500 +0.5%). To us that makes sense on several fronts. The chart on the prior page illustrates the earnings growth differential between International versus US markets. This year, overseas profit growth is expected to exceed the US market for the first time since 2021. This setup becomes even more compelling when one recognizes this growth premium comes at a substantial discount – as much as 40%+ after factoring in a lower Price to Earnings ratio, higher forward EPS growth rate and higher Dividend Yield (PE/G + Y). In short – investors are “Finding Religion” by comparative shopping – and markets are rewarding them with the ACWI ex US outperforming the S&P 500 by the most in over 15 years. Of course, the big caveat here is the kinetic activity in the Middle East that kicked off on the last day of February. Higher energy prices for oil dependent countries would negatively impact the overseas profit cycle and a flight to safety in the dollar would make the translation of returns less attractive. The margin of safety is significant but the opportunity is likely dependent on the duration of the military response.

The second major observation involves the Technology sector back at home – where investors are “Finding Disruption” with AI being speculated to replace entire industries. As can be seen in the chart below, the performance of semiconductor stocks (leveraged to the development and use of AI) has dramatically outperformed the subset of software stocks. In fact, the outperformance of software stocks that occurred from 2000 to 2019 has been completely erased in about a third of the time. Ironically, the dawn of AI has investors concerned about the tech obsolescence of entire business models. As investors, we’d be careful about pricing whole industry groups as complete winners or losers, especially with the advent of novel technology that is quickly evolving with many unknowns (including regulation). Bottom line, this hollowing out of the Tech industry (“Finding Disruption”) indicates a view that appears to be diametrically opposed to the notion that investors

are “Finding Religion” by seeking out a broadening set of opportunities as noted previously.

We think these examples, if nothing else, further confirms the “Year of the

Definitely, Maybe”. In such an environment, recognizing the art of nuance and allowing for flexibility of thought becomes paramount while drawing overly simplified conclusions becomes the danger.

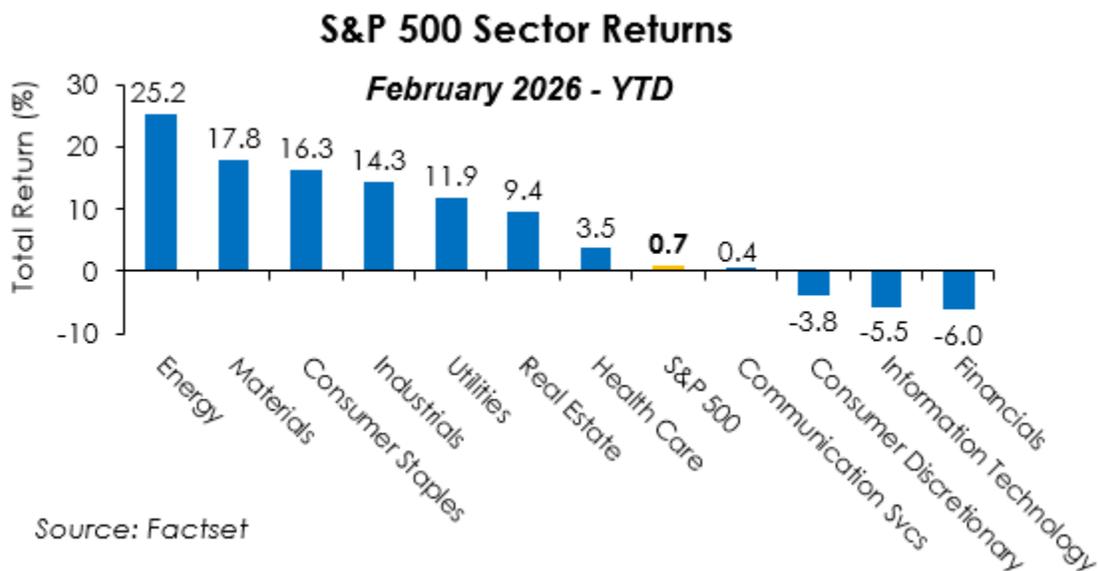
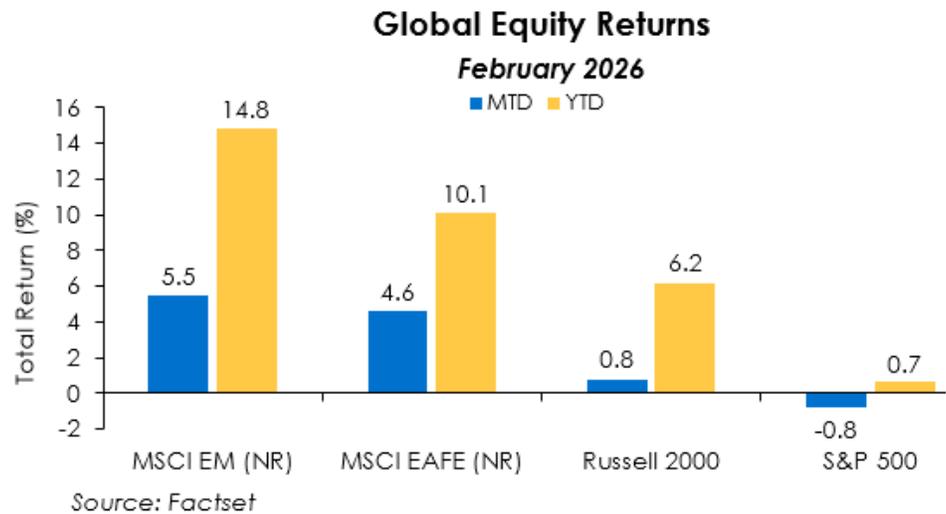


REITs, International Markets, and long dated Treasury Bonds led markets with strong returns in February. Bonds performed well as interest rates declined during the month. US Large Cap stocks were the outlier with negative returns as equity market rotation persisted in February.

## Stocks

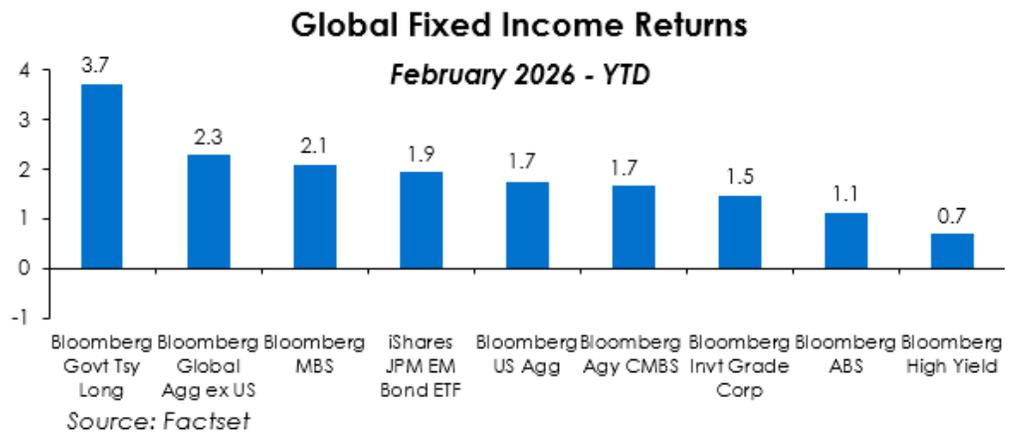
Emerging Markets (MSCI EM) and International Developed Markets (MSCI EAFE) posted another strong month of returns and were up double digits for the year due to fiscal stimulus, a marginally weaker dollar, and rotation out of US Large Cap growth. US Small Caps (Russell 2000) also

delivered solid returns spurred on by the prior year Fed rate cuts and expectations for accelerated earnings growth. US Large Caps (S&P 500) were down as investors took profits in mega cap technology and sought out more attractive investment opportunities elsewhere. From a sector perspective, February saw a continued rotation out of some of last year's leaders – Communication Services and Technology – and into previous year laggards like Energy, Materials, and Staples. Also of note, and contrary to last year, the majority of sectors are outperforming the S&P 500 year-to-date.



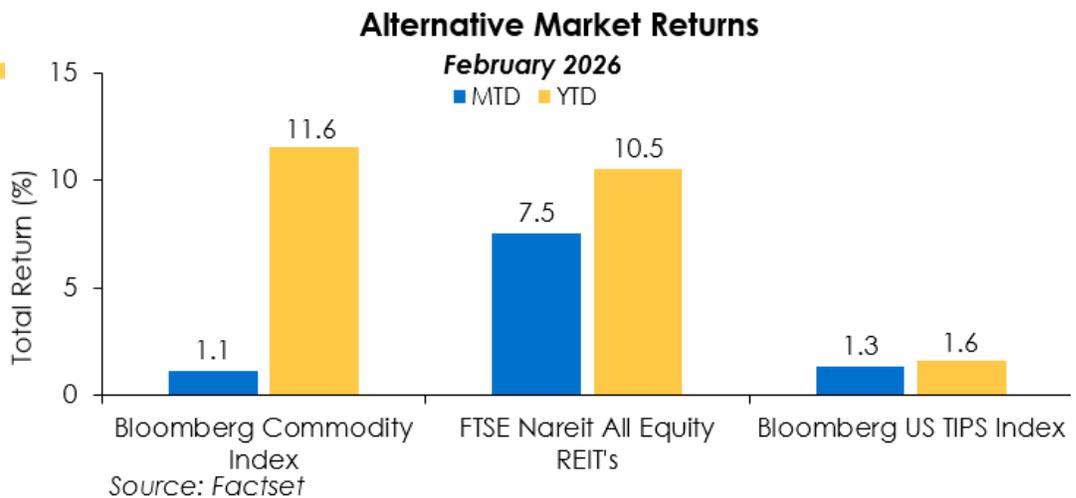
## Bonds

Policymakers continued their cut (2H24/2H25) and pause (1H25/January '26) approach. Following the January meeting, the Fed Funds rate remained unchanged at 3.5%-3.75% with the "dot plot" implying one additional cut (25 bps) this year and next year. Meanwhile, the forward curve of the rate market remains volatile and currently anticipates between one cut this year and one cut next year before a potential tightening in '28. With the recently announced Fed nominee (Kevin Warsh) along with the US military action in Iran (lifting energy prices), it will be worth observing how this evolves. Bond returns were solidly positive year-to-date as rates (particularly the long end) declined due to some combination of AI induced economic disruptions and/or productivity enhancements. Long dated Government Treasuries (Bloomberg Govt Tsy Long) were the standout due to the sharp decline in interest rates.



## Alternatives

REITs posted strong returns to begin the year – significantly rebounding after lagging last year. Commodities also delivered robust returns, helped by strong performance from Precious



Metals and Energy prices. Finally, year-to-date returns on Treasury Inflation-Protected Securities (TIPS) were relatively in line with nominal Treasuries as inflation expectations rose in January but eased in February.



## Market Outlook

**“There are two kinds of people in this world: those who believe there are two kinds of people in this world and those who are smart enough to know better.”**  
 – Tom Robbins (1980)

As we look ahead, we think the tactical vantage point for 2026 will require the awareness of more nuanced views and the avoidance of oversimplification. This will likely demand flexibility of thought that results in “strong convictions, loosely held”. Below is a framework for how we compare the generalized consensus view to the more nuanced views that investors are grappling with this year.

### 2026 - The Year of the "Definitely, Maybe"

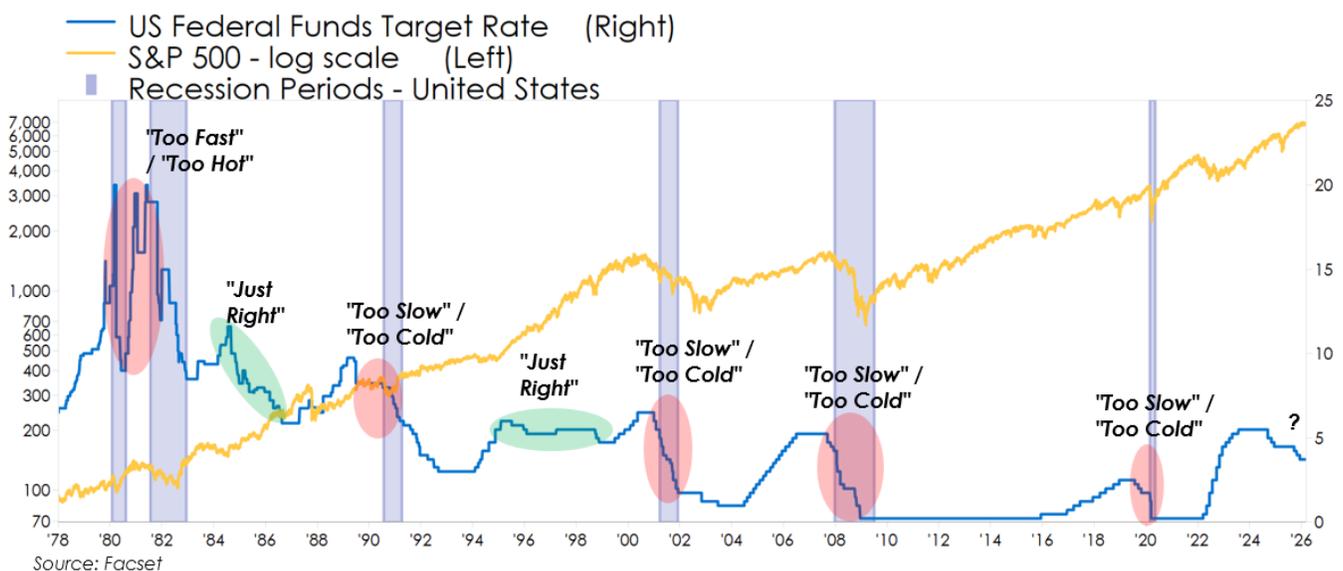
	<u>Generalized View</u>	<u>Nuanced View</u>	
Consumer	"The consumer remains resilient."	High-income consumers maintain strong spending power from the wealth effect	Low and middle-income households struggle from affordability pressure
Labor	"It's a no-hire, no-fire labor market."	Structural tightening results from aging demographics and immigration policy	Structural loosening results from AI productivity initiatives
Profits	"Profits are solid."	Earnings growth is improving for the small and mid-caps	Earnings growth is leveling off in the larger cap companies
Fed	"The Fed is getting more accommodative."	Lowering interest rates loosens policy to improve affordability as inflation cools	A new Fed chair is often tested by the market resulting in a tightening of financial conditions.
Policy	"Fiscal stimulus will be a tailwind."	Midterm election years often coincide with accelerating economic growth resulting from policies of the incoming Administration	Midterm election years tend to usher in above average intra-year volatility as markets "buy the rumor and sell the news"
Markets	"The AI story is early innings."	AI promises to be a transformative application	Leading edge AI stocks might be pricing in a lot of the good news



The last two months, we laid out thoughts on the Consumer, Policy and Profit categories. This month we'll be tackling the Fed – particularly timely given the recent spike in oil prices and what implications that might have on rate policy.

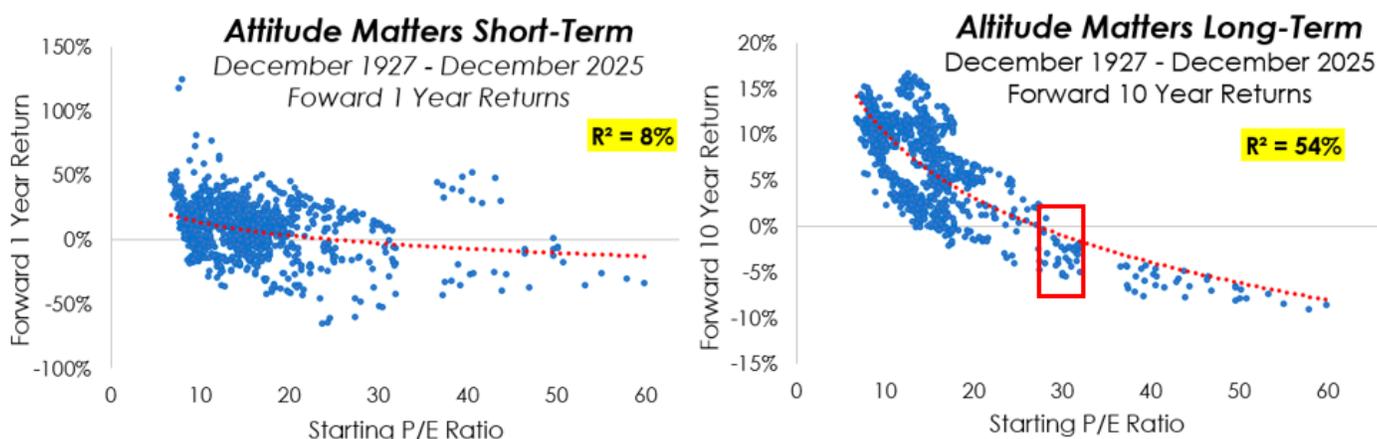
Coming into this year, the consensus view was that the Fed is generally getting more accommodative. While policymakers recently paused rate cuts at their most recent Fed meeting in January, they previously cut rates in each of their last three meetings to end 2025 and, with a new Fed chair beginning in May, it's not a stretch to presume that lower rates were likely a prerequisite for the President's nomination. But things aren't as simple and straight forward as they may appear. That's because the Fed has to walk a fine line regarding rate policy. If they're too anticipatory in cutting rates, they risk running the economy 'too hot' and fanning the flames of an already sticky inflation situation. If they're too reactionary in cutting rates, they risk running the economy 'too cold' and sidestepping growth. As can be seen in the chart below, in both cases the Fed has historically had to deal with recessionary outcomes. We refer to this sub-theme as "Goldilocks and the Two Bears" because the Fed's objective is to get it 'just right' in order to prolong the business cycle. In the past, the 'just right' scenario has looked more like a 'cut and pause' dynamic as was witnessed in the mid '90's. This might mean investors should be careful what they wish for. That's because the more the Fed cuts rates, the more it may be an indication that we're in either of the Two Bear related market outcomes – policymakers that might be too early or too late. That's the nuance to this view. A Fed that leans accommodative but is not overly so might be the most indicative of a constructive fundamental backdrop. Of course, the recent inflationary impulse from the spike in oil prices related to the US-Iran conflict adds additional complexity for the Fed to navigate this hoped for "Goldilocks" outcome.

### Goldilocks and the Two Bears



While the tactical frame means having a more flexible view of where opportunities and risks might be, the strategic frame requires the discipline to “keep the main thing the main thing”. As much as we opine on the factors that influence the shorter term setup, the fact remains that starting valuations tend to be the most influential factor on long-term returns. In short, what you see is what you get. In the past, we’ve described this as, “Attitude matters in the short run, but Altitude matters in the long run.”

Please see the charts below for context. In the short run (chart on the left), S&P 500 returns measured over a one year period have very little to no relationship with the starting price-to-earnings valuation multiple. Investor opinion – driven by a number of factors – can shape popularity for markets and drive short term results that can be both expected and unexpected. However, the chart on the right shows that the S&P 500 returns measured over a much longer ten-year period has a much more important relationship with the starting price to earnings valuation multiple. We think remembering this concept is an important step to maintaining discipline as a long-term investor.



Source: PE ratios were calculated monthly based on the value of the S&P 500 and trailing 12-month S&P 500 Normalized Earnings. Normalized Earnings were calculated by determining the constant long-term growth rate that best fit actual S&P 500 earnings. This process is meant to smooth out short term fluctuations in earnings caused by the business cycle. Forward returns are price appreciation only and do not include dividends. Historical S&P 500 data was gathered from Robert Schiller's website (<http://www.econ.yale.edu/~shiller/>) and Factset.

So what are the implications and key takeaways for portfolios?

- We think 2026 will require more of a chess than checkers mentality in understanding that nuanced views might mean multiple paths to an outcome. This means that shorter term decisions demand some degree of flexibility given the “K-shaped” dichotomies that exist.
- Having a balanced portfolio with some defense and offense may be helpful with diversification representing a compelling “twofer” (two for one) opportunity – risk reduction and upside optionality.
- Investors’ long-term discipline will continue to be tested and will likely require going against the grain (looking different than the benchmark).
- As the pendulum swings to one side, limiting exposure where the risk/reward is less favorable (and concentration risk is high) should be top of mind and lends itself to diversification.



Please see the summary table at right.

From a portfolio positioning perspective, we continue to emphasize the importance of diversification and balance. Our macro overweights and

2026 KEY TAKEAWAYS	
<b>Be flexible</b> with regards to views <b>in the short run</b>	"K shaped" nature of backdrop requires loosely held convictions
Diversification with a <b>mix of offense and defense</b> remains a compelling opportunity	"Twofer" benefit of risk reduction and upside optionality
<b>Stay disciplined</b> and keep the "main thing the main thing" <b>in the long run</b>	Don't let short run dynamics dictate long run decisions
<b>Limit exposure to speculative areas</b> and lean into diversification	Returns are highest where capital is scarce and lowest where capital is abundant

underweights have been relatively modest as we've opportunistically rebalanced portfolios in order to maintain that degree of balance. Where portfolios do look different is in the degree of diversification one level lower. As a result, we've remained UW the most expensive and concentrated areas where we've viewed the long-term risk reward less favorably. US Large Caps are a good example given that today's concentration in the largest companies has now made the S&P 500 quite top heavy with the top 10 holdings representing about twice the exposure it averaged during the period from 1990-2010. For investors willing to stay diversified, this mean-reversion potential offers upside which is likely to come when investors have deemed that the pendulum has swung too far. The timing of such an episode is a notoriously difficult question to answer with any kind of certainty. But perhaps investors should take comfort knowing that they generally don't need to. That's because staying diversified still allows one to participate in the solid absolute returns that help one achieve plan success. And at the same time, not overly exposing one to the extreme risks that may ultimately come in the form of exceedingly depressed returns when the bill comes due. In our opinion, that's what prudent investing is all about.

Within equities, our positioning incorporates balance geographically and within our US Large Cap exposure especially (away from the top of the market). Our bias has generally been to have more exposure to less expensive areas (down market cap). As such, we've maintained a larger OW in Cyclical Value and Defensive sectors combined with a smaller sized cap bias. We remain UW the most concentrated and expensive Cyclical Growth areas and think that if AI is as transformative as advertised its benefits will need to accrue to more than just the select few.

Within fixed income, we remain biased toward the higher quality US Core Fixed Income segment – where we're slightly longer in duration for diversification purposes. We've maintained an EW to International Fixed Income, where the end of negative interest rate conditions has led to more attractive opportunities. Maintaining a higher quality bias means that we still remain UW the most expensive part of the bond market (High Yield) where extremely tight spreads have made this unattractive in our view.



Within alternatives, we remain fairly balanced across the board with neutral positions in Diversified Alternatives, Real Estate and Commodities. Last year, we adjusted our mix of Diversified Alternative managers in order to provide greater insurance against market volatility by emphasizing income and short exposure – areas that can benefit from choppy market conditions, thus, enhancing diversification.

Thanks for giving this a read.

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