

# FROM THE DESK OF THE CHIEF INVESTMENT STRATEGIST

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## Dog Days Are Over

Summer is supposed to be the quiet season, but this year the heat came early. A war scare in the spring and the oil spike that rode with it made for an anxious first half, not the calm anyone sketched out in January. On the calendar, the dog days are only now arriving. In the markets, they may already be over, as the war is receding, oil has round-tripped, and equities produced a strong second quarter led by AI and the semiconductors.

The conflict with Iran defined the spring. It now looks to be largely behind us, though we would not be surprised by another flare up before it is all over. But with that risk fading, attention is shifting to some of the things that will actually drive returns from here: a new Federal Reserve, an economy that keeps threading the needle, an election ahead, and the long reach of artificial intelligence into both growth and inflation.

### Crisis Averted, but Inflation Remains

Oil told much of the story of the first half of 2026. Crude round-tripped, running from the high \$60s toward the low \$110s at the peak of the standoff before settling back into the low \$70s<sup>1</sup> as the Strait of Hormuz reopened and shipping continues to normalize. For consumers and central bankers alike, that is a welcome unwind.

We would not declare it fully resolved, as the path lower may stall from here. Governments drew heavily on strategic reserves to hold pump prices down during the crisis, releasing close to 400 million barrels<sup>2</sup>, and those barrels have to be bought back. Refilling that tank is itself a source of demand, and it can put a floor under prices even as the geopolitical premium bleeds away. The likelier outcome is a price range near current levels while inventories rebuild and the physical market finds its footing, rather than a clean slide lower.

One more inflation wrinkle bears watching. The build-out of AI infrastructure has pushed up the cost of memory and other electronics components, and some of that is starting to filter into the price of everyday products. Apple, for one, just raised prices on its Macs and iPads by 20% or more to cover the hit. Cheaper energy at the pump could soften some of that stress, but it will not erase it.

On oil, crisis possibly averted. On inflation, the all-clear hasn't quite sounded.

### A New Fed and a Nervous Rates Market

The backdrop everyone should keep in mind is the change in tone at the Fed with Kevin Warsh at the helm. The new Chair is reshaping how the central bank communicates, trimming the forward guidance that markets had leaned on for years and putting more weight on the incoming data. That may have been unsettling at first, but has since become accepted as the waters the markets swim in.

Since the conflict began in the Middle East, the concern from Fed watchers has been that sticky inflation might force the Fed toward higher rates. That concern has not gone away, as futures markets now lean toward a hike, potentially as soon as September and more likely by October.

Warsh has done little to discourage it. He has been unusually direct about his determination to bring inflation to heel after five years of the Fed missing its target, and he has made price stability the clear first priority of his tenure. And leaving markets without a specific roadmap is itself a tool, as it pushes investors to weigh the full range of outcomes rather than a single guided path.

## A Goldilocks Labor Market

The economy keeps earning the Goldilocks label, remaining not too hot and not too cold. Growth is steady, unemployment is stable, and hiring has stayed in an acceptable range. The June employment report also came in on the softer side, which took some air out of the rate-hike fears without signaling any real weakness.

We would flag one quieter concern. The labor force participation rate, the share of working-age adults either employed or looking for work, has slipped to its lowest level in roughly half a century once you set aside the pandemic distortions, and it is still drifting lower. A shrinking pool of workers can make the unemployment rate look better than the underlying demand for labor really is. It also feeds the dis-inflation story. Fewer people chasing jobs, and companies leaning on technology rather than headcount, takes pressure off wages. Still, it is worth keeping an eye on as a dwindling labor supply could eventually weigh on the employment side of the Fed's mandate.

## AI: Spending First, Productivity Later

Arguably the most important structural force in this market remains artificial intelligence, and its effects run in two directions on two different clocks. In the near term, the capex boom is a demand and cost event. Companies are spending enormous sums on chips, data centers, and power, and the strain on components is nudging some prices higher rather than lower.

The bigger prize sits further out. If AI does what its biggest backers expect, the payoff shows up as a supply expansion: more output per worker, more capacity, and lower unit costs. That is dis-inflationary, and it is a large part of why it makes sense to take a more benign view of the medium-term inflation picture even with prices still running above target today. The new Fed appears intellectually open to this idea, which seems like a meaningful shift from the recent past.

History argues for patience. The technology boom of the 1990s took the better part of a decade to show up convincingly in the productivity data, and the early years looked like all cost and no benefit. This cycle could move faster, since the cost of using these tools is falling more quickly than hardware did back then. It could also disappoint on timing. Either way, we would not expect the macro evidence to arrive on a convenient schedule.

## The T-Word

We hesitate to ever use the word transitory when describing inflation, given how badly it aged during the pandemic, when a supposedly temporary blip turned into a multi-year problem. It may fit better this time. The inflation impulse from the Iran shock was mostly an energy story, mechanically lifting the headline readings while the core pressures that actually worry policymakers, like housing, wages, and small-business pricing, stayed reasonably contained. As oil round-trips lower, that impulse should fade. Market-based measures point the same way, as five-year inflation break-evens, the market's read on where inflation is headed, have eased back toward 2.25%<sup>3</sup>.

The two broad offsets are the ones we have already named, which are the refilling of strategic reserves, which could keep energy firmer than the spot price suggests, and the AI-driven cost of components working its way into finished goods. Neither looks large enough to reset the trend, but both are worth watching.

This helps explain why we are more sanguine than the market on the Fed. Our base case is a central bank that might stay put through year-end, letting the inflation scare fade rather than tightening into an economy that is already cooling. If that holds, it would be a supportive backdrop for equities and credit; if the Fed instead moves toward a hike, as futures markets are currently leaning, that support would fade.

## Earnings Hold Up Their End

Also supporting equities are second quarter earnings expectations, with reporting season now getting underway and expectations running high. Consensus looks for earnings growth of roughly 23% in the S&P 500 for the quarter, following about 27% in the first quarter<sup>1</sup>. Those are strong numbers by any standard, and forward earnings estimates sit at record levels. Even after a powerful run, the index trades near 20 times forward earnings<sup>1</sup>, which is elevated but not outrageous considering current growth prospects.

One caveat has drawn attention lately. A meaningful slice of first quarter growth at a handful of the very largest companies came from investment and equity income rather than the core business, which flatters the headline. But stripping out the Mag 7 companies, the rest of the index still grew earnings around 17%<sup>1</sup>. That is the more telling number, and it points to real breadth beneath the mega-cap surface. We would expect the second quarter to show similar strength, though that is our estimate and not a guarantee of how results will come in.

## The Road Ahead

For now, the Fed and inflation remain the center of gravity. That likely won't last. As the calendar turns toward the fall, the November midterms will command a growing share of the market's attention, because a potentially divided Congress would affect everything from tax policy to spending to investigations to the odds of another standoff over the debt ceiling.

The prediction markets currently favor Democrats to retake the House, while giving Republicans a narrow edge to hold the Senate, though there is still time before the vote. A divided Congress is the base case, which historically has meant gridlock, and gridlock is something markets can usually live with, even if it is not the best historical outcome. We will pay closer attention as the odds firm up and the candidates sharpen their messages on the issues at the top of voters' minds.

## Enjoying the Quiet While it Lasts

Add it up and the setup is relatively benign. A war receding, a Fed improving, earnings still growing, and an inflation scare that seems more nuisance than major threat. Against that, a Fed hike, a flare-up in the Middle East, or a slower AI payoff than expected could each change the picture, and we are watching all three. On balance we are currently constructive.

But it is also the kind of calm that makes a careful investor pay close attention, watching for both the risks and the opportunities that lie ahead. The dog days may be over, but we are not letting our guard down.

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