

First Quarter 2026

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Highlights:

- Is “stability” really the “norm”?
- Policy disrupts market, this time from attack on Iran
- “Low hire, low fire” employment environment
- Inflation threatens to move higher
- Investors demanding AI monetize
- Investment discipline and fundamentals prevail
- Kevin Warsh nominated to the Fed Board as its Chairman

Introduction

This quarter, the celebration of the 250th anniversary of our nation’s birth will begin in earnest. Two hundred fifty years ago, on July 4th, 1776, we ratified the Declaration of Independence, what might be called our country’s “source of truth.”

Like every generation, the Founders were influenced by their time. Two hundred fifty years prior to them, Nicolaus Copernicus transformed human perception when he proved that the earth revolved around the sun (rather than the other way around). The Founders were also processing the implications of Isaac Newton’s breakthroughs regarding the mechanisms of the physical universe. And a decade or two prior to American independence, the first Industrial Revolution began, demonstrating that rational engagement with the world brought practical benefits as well.

In other words, the Founders were scientifically minded, and that includes social science. They were interested in the nascent field of economics, called “political arithmetic” at the time, and presumably would have enthusiastically embraced disciplines like statistics, game theory, and macroeconomics. This basic scientific orientation extends to their posterity—that is, to us.

In many respects, the Declaration of Independence was a product of the British Enlightenment, which held (among other things) that rational individuals—whether Left, Right, or Center—see the same world. We may think of Americans as hopelessly divided, but there is data showing that we are less divided than we believe, and perhaps this hidden singularity involves the intellectual heritage which helped lead to the formation of our country in the first place.

In keeping with our Enlightenment roots, we tend to regard government policies as a source of external shock to the market, but it may be more sensible to regard those policies as *part* of the financial system, creating both challenges and opportunities. While policy involves conscious choices, as opposed to unconscious market mechanisms, its presence is an organic fact, spilling into our portfolios and their valuations. We have seen ample examples of this over the past year, with the market reacting to changes in tariff policies, regulatory policies, and foreign policy.

The Prussian officer and military theorist, Carl von Clausewitz, said that “war is a continuation of diplomacy by other means.” He was also a product of the Enlightenment, and despite his deep familiarity with the chaotic and emotional nature of human conflict, the underlying assumption of the von Clausewitz formulation is that diplomacy comes first and war is the exception. While the reverse sometimes seems truer, it is encouraging that humanity has evolved policy and its forms of “soft power” as an alternative to the privation and suffering created by “hard power.”

In the real world, of course, not all people are motivated by Enlightenment precepts like personhood, reason, science, democracy, free markets, and rule of law. For Americans, trained to expect rational order, repeated injections of instability can be disorienting. A world where human beings are more responsive to the stick than the carrot may not be the world we prefer, but it is sometimes the world we inhabit. We are reminded of Abraham Maslow’s “Hierarchy of Needs,” where factors like safety and security, and love and belonging, come before the more exalted realms of self-esteem and self-actualization.

When we think about portfolio construction in such a world, we are thankful that investing does not have to be a zero-sum game. Capital investment is not gambling, where there is a loser to match every winner. Rather, American-style free-enterprise is the greatest engine of economic growth the world has ever known, and we invest to share in the benefits of that engine.

Over time, policymakers will follow a range of different strategies. As free men and women, we will agree with some and disagree with others, but wherever we stand on the issues of the day, policy can, and does, send the market veering into directions unanticipated by market analysis alone. In the end, though, policy disruptions are just part of the deal: like the market itself, a natural outcropping of human behavior. And again, for those investors who can hold steady and look past the apparently all-encompassing moment, these disruptions create opportunities as well as challenges.

Review and Outlook

The first quarter began decently. Growth was resilient; inflation, though still elevated, seemed to be moderating; and the market was largely focused on the timing and extent of rate cuts from the Federal Reserve. But the outbreak of hostilities in the Middle East drove the price of gasoline 35% higher and influenced the market to reprice its expectations regarding inflation and growth.

From a growth standpoint, the American economy exited 2025 with more whimper than bang. After negative GDP growth in the first quarter of 2025, and despite histrionics about the woeful impact of tariffs, growth popped in the second and third quarters to 3.8% and 4.4% respectively. For a moment it seemed that the economy had a shot at breaching 3% GDP growth, something which has only occurred twice since 2005 (one of those being the Covid snapback of 2021). Instead, GDP growth decelerated in Q4 to 0.7%, resulting in an altogether normal 2.1% for the year. Still, notwithstanding the slow start, and the purposeful, planned disruptions of the new administration, we think the American economy performed impressively in 2025.

The loss of data during the government shutdown late last year hindered our ability to read the economic picture, and the recent data flow has been in catchup mode. The “K” shaped economy persists, where the lower three quartiles of the economy show little capacity to increase spending. Consumer sentiment remains low, but credit card delinquencies have largely moved sideways over the past few years. We think it is interesting that, despite the unemployment rate increasing over the same span, delinquencies have not gotten materially worse.

For employment, the picture is complex. There is great uncertainty about the operationalization of AI; at the same time, layoff rates are below the 10-year average. Unemployment is currently at 4.3%. While it has risen from its low of 3.4%, unemployment is still off its recent high of 4.6%. It seems that companies do not want to let go of their workers, even though they are not looking to hire.

While “the day after tomorrow” feels perilous for “knowledge workers” collecting paychecks, the employment picture may not be as terrible as all that. With employment, there are often deeper, more counter-intuitive, forces at work. As outgoing Federal Reserve Chairman Jerome Powell put it at a recent Harvard symposium, “there is probably something more longer-term, more secular, that is happening around technology and AI.” But he added that the American economy is “incredibly dynamic and productive,” arguing higher productivity is the key to long-term growth in compensation.

It does appear that, after years of an indiscriminate bid for all things artificial intelligence, investors are demanding a clear pathway to an acceptable return. This has led to a broad

repricing of the technology “mega caps.” We look at that more closely in the “Equity Report” section below.

Inflation remains well above the Fed’s 2% target. The Fed’s chief benchmark, PCE Core, is 3.1%. This is a January number, an example of the delayed data flow, and reflects inflation excluding food and energy prices. It does include shelter, however, and although shelter remains elevated at 3.2%, it is in a disinflationary trend.

Headline CPI, which *does* include groceries and gas, had been trending lower—in February, it was 2.4%. However, it is expected that the recent price spike in oil is likely to send it higher—perhaps much higher. There are some estimates that CPI will shoot to 3.4%. It is important to note that oil price shocks over the past 40 years did not leave lasting effects on inflation expectations—and right now, though short-term measures have moved higher, long-term market-based measures of inflation expectations reflect little concern that inflation will get out of hand.

With unemployment trends improving as inflation remains above target level, the Federal Reserve has made no changes this year to its interest rate policy. The Fed seems to like its spot right now, neutral to slightly restrictive (depending upon who is talking). We shall discuss some of the goings-on at the Fed in a separate section below, including thoughts about Fed Chair nominee Kevin Warsh.

With reference to our outlook, we think policy will continue to play a big role in market outcomes, even as we stay focused on the economic fundamentals. While the Iran conflict injects a whole new tranche of uncertainty, we note that the American economy is service-oriented and uses less oil per dollar of output versus thirty years ago. Although higher oil prices may hurt consumers and some businesses, they do boost the energy sector, which has become a larger part of the economy. The price shock has offsets and, just as we are skeptical about its long-term effect on inflation, we do not think that the higher energy costs will cascade into layoffs.

The ability of the American economy to withstand disruptive policy points to baseline strength and directional growth. Apparent negatives, such as more restrictive tariff and immigration policies, are not causing derailment; positives, such as “animal spirits” being released through reduced regulation and taxes, and the prospect of increased fiscal and monetary support, remain in play.

We live in a world where the projected outcomes are wildly dissimilar and often dependent on non-economic factors. It is distinctly possible, for instance, that the Iran conflict results in a quagmire with permanently higher fuel prices, a long-time adversary engaged in even more mischief, and an erosion of American prestige. It is also distinctly possible that the Iran conflict results in the restoration of low fuel costs, a resurgence

of American prestige, and a diminished or even overturned Iranian regime. These are radically different outcomes, and each is distinctly possible, as are combinations therein.

As investors in such a world, we are not looking to strike pay dirt with lopsided bets. Rather, we are looking to strike a balance between the extreme outcomes. Our premise is that the American economy is uniquely robust, uniquely capable, and that here, when the cards are properly played, investors do well over the medium- and long-term. We see nothing to dissuade us from this viewpoint, even as we acknowledge the presence of extra-economic variables. If anything, in a market environment characterized by exogenous shocks, investment fundamentals assume heightened relevance. They are the lodestar for a fast-moving world.

Equity Report

U.S. equity markets entered 2026 building on the strong momentum of the past several years. Major indices advanced modestly at the beginning of the quarter, only to relinquish those gains at quarter-end under heightened geopolitical risks. At the headline level, the economy and market appear resilient; beneath the surface, we are beginning to see a shift in the drivers of returns and the broader investment backdrop.

The first quarter was defined by three key developments: 1) a softening in labor market conditions, 2) escalating geopolitical tensions, notably involving Iran, and 3) an emerging rotation in equity leadership away from a narrow group of Growth stocks and toward more Value-oriented areas of the market. Taken together, these dynamics reinforce our view that 2026 is shaping up to be a transitional year, where returns become more dependent on sustainability of fundamentals, and less driven by multiple expansion and momentum.

The U.S. economy continues to grow, supported by solid consumer spending and ongoing infrastructure investment, particularly in areas tied to productivity and technology. That said, the pace of growth appears to be moderating, at least in the margins.

The most notable shift has been in the labor market. After several years of steady strength, hiring has meaningfully slowed. We are now operating in what can best be described as a “low hire, low fire” environment, where employers are reluctant to aggressively expand headcount but are also not significantly reducing it. While this dynamic does not suggest an imminent downturn, it does imply that labor expansion is no longer providing the same level of incremental support to economic growth.

At the same time, inflation remains elevated, particularly in services, but is increasingly influenced by energy prices as well. The combination of moderating growth and persistent inflation creates a more complicated backdrop for the Federal Reserve and decreases its flexibility to reduce rates in the near term.

Lower rates would have provided a welcome boost to certain areas of the economy, such as housing and other large-ticket items, that consumers tend to finance.

The key development during the quarter was the escalation of tensions with Iran into a direct regional conflict, leading to disruptions in the Strait of Hormuz. As one of the most critical chokepoints in global energy markets, any instability in this region carries meaningful economic implications. While the closure of the strait is disruptive to global supply chains, it would need to stay closed for an extended period to create a lasting shock to the global economy.

We have already seen increased oil price volatility, which feeds into inflation expectations. Beyond the direct impact on energy markets, heightened geopolitical risk has contributed to volatility in equities and a more cautious tone among investors.

Perhaps the most important development in the first quarter of 2026 has been the shift in equity market leadership. For the better part of the last several years, returns have been highly concentrated in a relatively small group of mega-cap Technology companies. This past quarter, however, we began to see signs of a more durable rotation toward Value-oriented sectors.

The rotation was led by Energy. There are several drivers behind the shift, chief among them the likely persistence of higher interest rates. This creates headwinds for longer-duration assets and, assuming the economic expansion still has legs to run, more attractive relative valuations for sectors outside of Technology.

Strength in energy prices and an improving demand outlook to support AI datacenter usage has strengthened returns in Energy equities this quarter. During the quarter, investors increasingly gravitated toward companies with current earnings, strong free cash flow, and more attractive valuations. This occurred due to intensified focus on the monetization of massive AI investments and elevated geopolitical volatility.

We continue to concentrate on identifying high-quality businesses trading at a discount to intrinsic value. This approach delivered solid absolute returns to start the year and significant relative performance in our Dividend Income portfolio. We have been rebalancing exposure away from areas where valuations have become extended, while selectively increasing exposure to sectors offering stronger free cash flow yields and more attractive valuation support.

Energy, Healthcare, and Financials remain our primary areas of interest. Across portfolios, our focus is consistent: strong balance sheets, durable cash generation, and disciplined capital allocation.

Looking ahead, we expect U.S. economic growth to maintain a moderate pace, driven by above average infrastructure investment and solid consumer spending. As noted in the “Review and Outlook” section, we see bifurcation between upper- and lower-income households, where spending is flat among the latter. Inflation is likely to remain above target, and policy developments will continue to influence market sentiment. Since we do not anticipate an energy price spike large enough to tip the global economy into outright recession, we remain constructive on the economy and equity markets.

We do believe, however, that equity market *returns* are evolving. Earnings delivery, valuation discipline, and stock selection are likely to play a more significant role going forward. Volatility may remain elevated as investors recalibrate expectations and risk premiums.

The first quarter of 2026 reinforces our view that we are in a transitional phase of the market cycle. While the economic backdrop remains constructive, softer labor trends, elevated geopolitical risk, and shifting equity leadership suggest a more complex environment ahead.

In an era of increased hyperbole and wild swings in policy pronouncements—on a daily and even intra-day basis—we continue to stress prudent risk-taking. In our mind, this involves disciplined and balanced portfolio construction, and a focus on high-quality businesses trading at reasonable valuations.

Fixed Income Report

The fixed income markets underwent a “bear flattener” this quarter, meaning that rates moved higher across the curve, but more so on the short end than the long end. This flattening was mostly driven by the repricing of Fed Funds futures, with the market reducing its rate cut expectations from two to zero. The Fed’s “hawkish pause” contributed to the sell-off on the short end, and the launching of the Iran war in late February spurred expectations of higher fuel prices and larger budget deficits, both of which are inflationary.

With our taxable bond products, the first quarter marked a good start to the year, with seven out of our seven strategies beating their respective benchmarks. Credit spreads remained near recent tight levels until the Iran War drove more cautious market positioning. Concerns regarding AI and private credit also helped create headwinds, leading to some sector-specific widening. Balance sheets continue to be strong; 2025 ended with reports of solid earnings growth.

New corporate issuance remains at elevated levels. The \$678 billion issued in the first quarter amounted to a 13.5% increase over 2025. Even while widening, credit spreads remain on the low side, which keeps our positioning cautious. We prefer companies with high recurring revenues that are less exposed to commodity price movements. Our energy overweight

remains focused on the MLP/Pipeline subsector. Our financial overweight is primarily expressed in “global systemically important banks,” since large balance sheets and regulated capital levels protect bondholder interests.

While we still see good relative value in individual credits and sectors, we recognize that spreads in the corporate market do not constitute great value and may look for opportunities to reduce our exposure. Right now, we are avoiding Treasury Inflation Protected Securities (TIPS), which we view as expensive given our inflation outlook. We are also avoiding Agencies, as they do not provide adequate compensation for the lack of liquidity (versus Treasuries).

One useful thing about the high level of uncertainty is that idiosyncratic volatility appears to be increasing. This helps generate more alpha opportunities for steady, actively-managed strategies. We continue to think that “carry” strategies work well in an economy characterized by low (but positive) growth. The combination of opportune trading and extra yield should continue to help our portfolios outperform.

For our tax-exempt products, the relative value of municipals compared to Treasuries improved this quarter. The 10-year Muni-to-Treasury ratio ended March at 71% (up from 65% at year-end), while the 30-year ratio rose to 92% from 86%. We see this shift as largely a function of record-breaking supply in the tax-exempt space. 2025 was the strongest year on record for municipal issuance, and yet new supply in the first quarter was up 6% year-over-year.

2026 got off to good start, with strong investor flows and reinvestment demand providing a performance tailwind. The tax-exempt market was in “bull-steepener” mode (rates dropping across the yield curve, more on the short end than further out) during January and February. As March rolled around, though, reinvestment demand waned in the face of elevated supply. This led to a rough month, wiping out much of the gains from January and February. Despite the March sell-off, both our MQI and MQS strategies managed to eke out positive returns. We think that the internal dynamics of the municipal market are becoming increasingly compelling for long-term investors:

We pointed out in the 2025 year-end Market Letter that the AAA yield remained stubbornly inverted from one to six years. After years of curve inversion in one form or another, the yield curve is now positively sloped from top to bottom. Roll opportunities are back in the playbook, with especially attractive roll downs in the 7–20 year “belly” of the curve. With the curve’s new shape, we expect to slowly transition some of our barbell positioning to capture these opportunities.

As we have stressed many times in past commentary, the new issue market is our focus throughout all tax-exempt strategies. The value available in the primary market eclipses the value in

the secondary market. While there are constraints which keep us from using the primary market *exclusively* for portfolios with short or intermediate durations, we regard new issue credit selection as a critical component to our investment approach.

In terms of duration positioning, we expect our flagship intermediate products to continue slightly long of benchmark. We see technical factors improving in our market, and while we cannot, by definition, foresee “shocks” to the rate environment, we do think this an attractive entry point for buyers of tax-exempt income.

The Federal Reserve

We said at the start of the year that we expected fireworks at the Federal Reserve, and it has proven true. In January, the *Trump v. Cook* case was heard by the Supreme Court. The decision is pending and likely to be handed down this quarter.

The case involves the firing of Federal Reserve Governor Lisa Cook “for cause,” meaning that, in the judgment of the President, Cook’s behavior crossed ethical (and possibly legal) lines, meriting dismissal. She is accused of misstating information on a loan document. At issue is the procedure by which an official at the Federal Reserve can be fired by the President. The Court has shown a willingness to vest the Presidency with “unitary powers” over the executive branch, regardless of Congressional statutes on how a given agency is to be managed.

But recent decisions, particularly *Trump v. Wilcox*, have shown a willingness to carve out an exception for the Federal Reserve, citing its unique character and the distinctive history of central banking in our country. In the pending decision, the Supreme Court will presumably define a mechanism which allows the Fed to retain its independence while holding its officials accountable to ethical and legal standards.

Separately, at the end of last year, the Department of Justice launched a criminal investigation into cost overruns for renovations to the Fed’s Washington D.C. headquarters. The project was budgeted at \$1.9 billion in 2021 but is now projected to cost \$2.5 billion. It is alleged that outgoing Fed Chair Jerome Powell lied about the project in congressional testimony and that the overruns are the result of criminal mismanagement. In January, the DOJ began issuing subpoenas.

The matter is now with the courts, but the criminal investigation is proving to be a bit of a headache for the Trump administration. It currently looks as though Powell’s designated successor, Kevin Warsh, will have his nomination held up in committee. While there is little doubt that Warsh will be confirmed by the Senate, he first must clear the Banking Committee before his nomination hits the Senate floor for a vote.

Powell himself has indicated that he will not resign until the criminal investigation is “well and truly over, with transparency and finality.” Although Powell’s four-year term as Chair expires on May 15th, he is entitled to remain on the Board as a governor. Those terms are 14 years, and Powell’s gubernatorial term expires in January 2028.

If Powell does stay on the Board, then a unique dynamic will be created at the Fed. The only time in history it has happened was when Marriner Eccles was demoted by President Truman in 1948. Through gritted teeth, Truman asked Eccles to stay on, basically to circumvent market turmoil. President Trump, who has been riding Powell hard almost since he selected him back in 2018, wants him done and gone.

But apart from the drama, what will the Warsh tenure look like? A former Fed governor, Kevin Warsh has been highly critical of the Federal Reserve over the past several years. While he agreed to the first iteration of quantitative easing during the global financial crisis in 2008, he was staunchly opposed to QE2, which led to his resignation from the Board in early 2011. Warsh claimed that QE2 would produce galloping inflation for goods and services (which did not happen), and that it would distort and inflate capital markets (which did).

Warsh has also been critical of both the forward guidance regime established by Benjamin Bernanke during the low-rate, low-inflation, slow-growth 2010s, and the data-dependency regime established by Jerome Powell over the past eight years. Warsh’s central bank sweet spot involves getting rate policy “about right” and maintaining a level of institutional constancy. He holds to the “family fight” model, where Fed officials have free and open debate inside the corridors of the Federal Reserve, but are closed lipped towards the wider world, maintaining a united front. This is basically how the Fed operated until the mid-1990s.

Warsh thinks the Federal Reserve has gone far afield from its institutional purpose, which is to maintain price stability and maximum employment. He cites the “mission creep” of climate change and DEI initiatives. He also thinks that the Federal Reserve has become bloated. He may have a point there. The Federal Reserve is the world’s largest employer of PhD economists, with roughly six hundred on the professional staff systemwide.

Finally, and perhaps most importantly, Warsh wants to combine a resumption of building down the balance sheet with lower rates. He has said that he thinks further rate reduction is appropriate, given technology-based productivity gains and the business-friendly policies of the current administration. We imagine that other Fed officials would *also* prefer a smaller balance sheet but are inhibited by signals in the money market showing the draw-down of the Fed’s assets is affecting its reserve liability in a hazardous manner. Presumably, there will

be some intensive “family discussions” on this point when Warsh assumes the chair.

The Fed chairman is one governor among seven, but also has the power to shape the agenda, drive the discussion, and form the consensus. Like all power, it requires some form of assent from those being led. While we certainly do not expect a revolt from Fed officialdom, we do think that Warsh’s criticisms and proposed reforms will meet with internal resistance. We would expect to see dissent and would not be surprised to find Warsh himself dissenting at some point, although dissent from the chair would be highly unusual. The last time that happened was in 1978, when then-Chair William Miller dissented from his colleagues because he thought they were overly fixated on inflation.

Time will tell if Warsh engages in a similarly quixotic battle, although we doubt it. The chair has powers over and above the other six governors, and one crosses him with care. While we do not expect Warsh to be subsumed by the “Fedborg,” we do think that he is committed to the principle of central bank independence, and that will matter to his colleagues. Warsh is also a charismatic and interesting person, and that will matter as well.

We believe the Federal Reserve will become less “transparent” and more tight-lipped, as it were, but we also wonder what happens the next time there is a market scare, such as when the Silicon Valley Bank and First Republic Bank failed in 2023. We scarcely think that Warsh regards stability in the financial markets as beyond the Fed’s proper mandate, since it is the reason why the Federal Reserve System was instituted in the first place; still, market blowups, should they come, will create tensions with Warsh’s goal to refocus and reform, especially where the balance sheet is concerned.

At any rate, we will get a clearer picture of Warsh’s views and priorities at his testimony before the Senate Banking Committee, which is scheduled for mid-April. We do expect, in the years ahead, a relatively sharp departure from the views and priorities of the past few decades. If Powell stays on, we do not expect him to become a rallying point for opposition to his successor, but we do think that Warsh, behind closed doors, may have a tough time getting buy-in to his foundational reforms. With Warsh’s nomination, an interesting aspect of the American economy is definitely becoming more interesting.

Conclusion

When the Declaration of Independence was conceived, written, and signed, two hundred fifty years ago, the rebellion was in full throttle. Its outcome was far from certain. The Founders relied upon “the protection of divine Providence,” and pledged to each other “our Lives, our Fortunes, and our sacred Honor,” but their situation was fraught with peril. As Benjamin Franklin is alleged to have said, “We must, indeed, all hang together, or most assuredly we will all hang separately.” It was a grim form of humor which was every bit as grim as it was humorous.

When we look back on the Founding Generation, we might remember that they were not unlike us, using the knowledge they had at their disposal, but in the dark even so, feeling their way towards an unknown fate. They had their hopes and expectations, to be sure, but they did not know how things would turn out. We have the benefit of two hundred fifty more years of historical experience, two hundred fifty more years of accumulated knowledge, and it helps augment our vision, but, where the future is concerned, we are still basically in the dark, still feeling our way towards an unknown fate.

To put it another way, we are not clairvoyant, but our Enlightenment heritage, with its emphasis on reason and liberty, gives us an important leg up, and our country’s impending semiquincentennial provides a good reason to reflect upon the blessings and bounty. It is in our national character to pursue happiness, to be hopeful, optimistic, and forward looking. If these things are delusional (and they are not), then they are delusions which have generated the most spectacular growth engine this world has ever seen. And *that*, along with many other fine things about our nation, is worth celebrating.