WESTERN PACIFIC
WEALTH MANAGEMENT

Investor Letter
Second Quarter 2026

Market Review

Stock prices rose sharply in the second quarter of 2026. The S&P 500 Total Return Index rose 15.2% during the quarter, while the NASDAQ Composite rose 21.4%. The Bloomberg U.S. Aggregate Bond Index was modestly positive, rising less than 1%. For the first half of the year, the S&P 500 was up 10.2%, the NASDAQ Composite was up 12.8%, and bonds were approximately flat.

As the quarter began, concerns about the War in Iran and the closing of the Strait of Hormuz still loomed over financial markets. In mid-April an initial cease-fire framework was announced which eased concerns about energy-related inflation. With markets depressed after a sharp six-week fall and improved prospects for peace, a strong rally started and was sustained for the rest of the quarter. That said, in our view the real story for investors was the continued strength in corporate earnings (see below).

A significant development during the quarter was a shift in leadership from the so-called Mag 7 stocks to other shares in the technology sector. In particular, shares of semiconductor manufacturers including Micron Technology were strong performers as it became clear to investors that the AI boom would drive demand not just for the highest performing chips from firms such as Nvidia, but also for traditional semiconductors which are needed for the computers, servers, data centers and other infrastructure required by the massive AI buildout.

The SpaceX IPO in June was the largest in stock market history and attracted significant investor attention. The company (which is 20 years old) is the leader in rocket launch services for NASA and commercial satellites. SpaceX also has a fast growing satellite television business which is currently its most profitable division. The company has a number of exciting projects it is working on including a plan to locate data centers in space (!) which would reduce the need and various concerns about locating them here on earth.

The large technology companies such as Microsoft, Meta and Google are investing huge amounts in AI. The reason this is significant is that it has the potential to change how these companies are valued. For several decades the large technology companies have enjoyed a “best of all worlds” scenario where they had high growth, earned high returns on capital, had relatively low capital requirements and had significant cash flow for dividends, stock buybacks or to make investments in other high return businesses. These factors justified the high earnings multiples these companies traded at compared to more capital intensive businesses. Should this situation change and these companies become highly capital intensive for the long term, the stocks would trade at lower multiples than they have in the past.

Making Sense of Cross Currents in Financial Markets

On a given day, investors may read stories predicting that AI will replace large parts of the economy, or that corporations are investing recklessly in AI projects that will never show any return, or that AI stocks are in a bubble and destined to crash. Making sense of this seemingly contradictory information can be frustrating. The reality is that often in financial markets there are multiple important developments happening at once, each with a different time frame, set of risks, and likelihood of occurring. It is helpful to break them down individually to make sense of each of them. Here are three important developments which are currently relevant to investors, and our thoughts on the risks and opportunities from each.

1. **AI technology boom**. There is no doubt that developments in Artificial Intelligence in the past few years have accelerated at a rapid pace, and almost certainly will continue to do so in the future. As Roger and I wrote in 2023, this is one of the most significant technological advances in history and the benefits (and risks) are just beginning to be understood. The implications of this technology will play out over years and decades to come, and there are certain to be ups and downs along the way.

2. **AI investment boom**. We are currently living through an unprecedented boom in capital spending to build out infrastructure and energy capacity for AI. Unlike the technology boom described above, investment booms are subject to boom and bust cycles (hence the name) and more often than not end with a period of over investment followed by a sudden slowdown or worse. If the future is like the past, we expect there will be such a slowdown at some point in the future. In our view this is the biggest risk for investors.

3. **Bull Market**. The current bull market started in October 2022, so it is coming up on 4 years in duration. On average bull markets last 3-5 years. That doesn't mean this one is almost over, but it is no longer in its early stages. In the mid to later stages of a bull market it is common to see speculative stocks make large moves, increased IPO activity, and increased participation in the market by smaller investors. All those things were seen in the second quarter.

Headlines Drive Markets in the Short Run, Earnings in the Long Run

One of the recurring lessons of investing is that stock prices are ultimately tied to corporate profits. In the short run, markets react to headlines, surprises, policy decisions, and changes in investor sentiment. Over longer periods, however, the value of a business depends on its ability to generate earnings and cash flow.

The second quarter was a good reminder of this principle. During the quarter, companies reported first-quarter earnings growth for the S&P 500 of 28% vs. the prior year. This figure topped estimates of 13% growth. The strength was broad-based. More than 80% of S&P 500 companies reported earnings above analysts' estimates, meaning more than 400 companies exceeded expectations. Ten of the eleven S&P 500 sectors reported year-over-year earnings growth, and seven sectors reported double-digit earnings growth.

Earnings expectations also increased during the quarter, which was unusual, since normally analysts reduce earnings estimates as a quarter progresses. Over the past ten years, earnings expectations have declined by an average of 2.7% during a typical quarter. This quarter, the opposite happened. Analysts raised their estimates for second-quarter earnings. At the end of March, analysts expected S&P 500 earnings for the second quarter to grow 18.8%. By late June, that estimate had increased to 23.1%.

In our view, strong earnings are a significant and underappreciated factor underlying continued strong stock market performance. While the earnings multiple on stocks is above the long term average, valuations may be justified for now by strong earnings growth.

AI and Capital Spending

As noted above, the most significant economic risk from AI is the possibility that AI-related capital spending will slow substantially at some point. Our view isn't based on a specific insight on AI but rather on our knowledge of previous investment cycles as new technologies are built out. Investment booms have a long history of overshooting. Railroads, electricity, telecommunications, the Internet, and housing all experienced periods when investors correctly identified an important long-term trend but overestimated how much capital could be profitably deployed in the short run. The result was not that the technology failed. Railroads transformed transportation. Electricity transformed industry and households. The Internet transformed communication and commerce. But investors in the early stages of these booms did not always earn attractive returns, and the economy often had to digest a period of overinvestment.

AI may follow a similar pattern. The long-term opportunity is enormous, while the capital spending cycle may still prove volatile. Data centers, semiconductors, power generation, electrical equipment, construction, and cloud infrastructure have all benefited from the AI investment boom. If companies eventually conclude that capacity has temporarily grown faster than demand, or that returns on incremental investment are lower than expected, capital spending could slow substantially.

The most significant question for investors and corporate leaders is whether the enormous amount of money being spent on chips, servers, data centers, power generation, and related infrastructure will earn adequate long-term returns. The largest technology companies have the balance sheets and cash flows to fund these investments, but shareholders will eventually require evidence that the spending is producing real economic value rather than simply larger infrastructure budgets.

Risks in the Second Half of 2026

As we look to the second half of the year, there are plenty of risks to consider. Inflation remains above the Federal Reserve's preferred level, which could lead to tighter than ideal monetary conditions. The situation in Iran is not resolved and could impact energy prices. Elections such as those in November are always a possible source of volatility.

The current environment is mixed but overall positive. Stocks are not cheap, but earnings are strong. AI spending is enormous, but the potential productivity benefits are meaningful. Market concentration is still high, but leadership has begun to broaden. Inflation remains above target, but the economy has so far continued to grow.

Thank you as always for being a client. Please feel free to reach out to Roger or me if you would like to discuss your portfolio or any of the topics discussed in this letter.

Best Regards,

William R. Andersen, C.F.A.
Chief Investment Officer and Principal

Roger L. Johnson
Principal