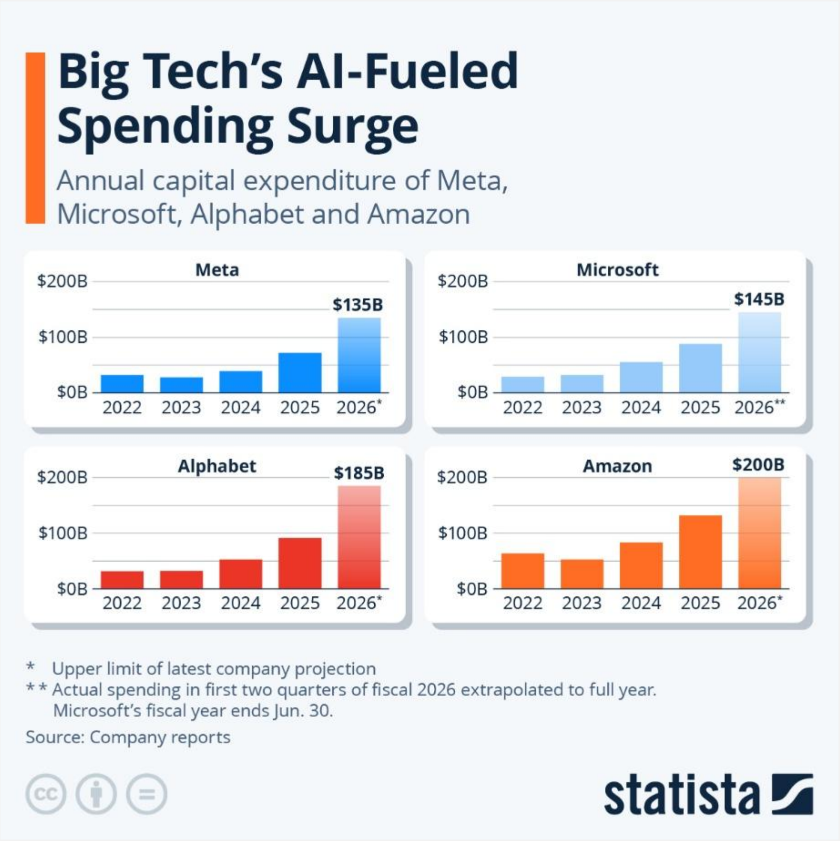
2026 First Quarter Letter

One Battle After Another

In this year's Best Picture award winner *One Battle After Another*, the story's main character is a washed-up revolutionary who finds himself forced back into a battle with his arch nemesis, despite his search for a quiet existence. Stock market participants in 2026 can clearly relate to this series of never-ending unexpected conflicts, as fears related to the risks and impacts of Artificial Intelligence (AI) on our economy transform themselves on a seemingly daily basis. And of course, markets are now grappling with the implications of a real battle being fought in the Middle East.



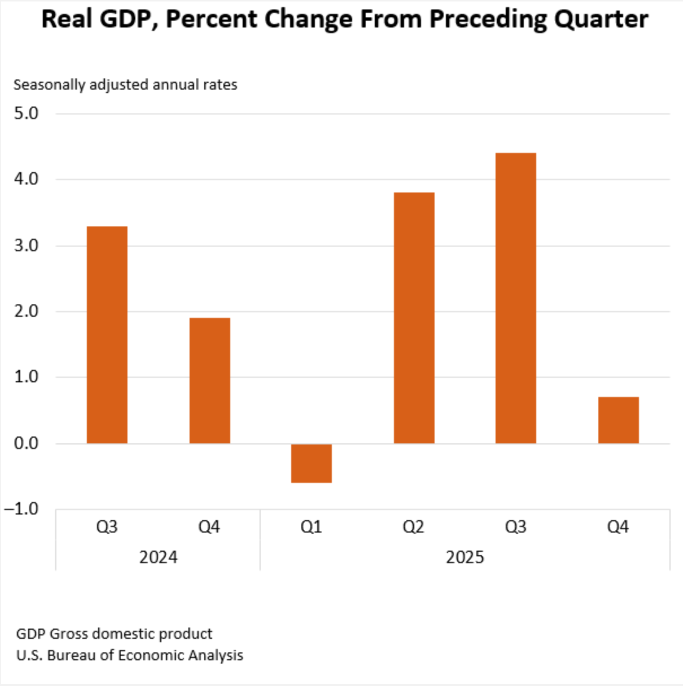
Heading into this year, the investors were primarily concerned about whether we were caught up in another market bubble similar to the "Dot.Com" crash in 2000. However, before too long these fears morphed into a new threat – perhaps AI would be SO effective at changing how we do everything in the future, that whole sectors of the economy would be disrupted and rendered obsolete.

The panic peaked in February when a small niche independent firm Citrini Research published a piece titled "The 2028 Global Intelligence Crisis". The company wrote it as "a memo from the future", and it detailed a dystopian future where AI has resulted in mass disruption across nearly all established industries of today, leading to soaring white-collar unemployment and a 38% drop in the S&P 500. The markets were so spooked that virtually every company mentioned in the piece – companies with solid operating fundamentals like Visa, American Express, IBM and Blackstone – saw their stocks fall sharply on the day.

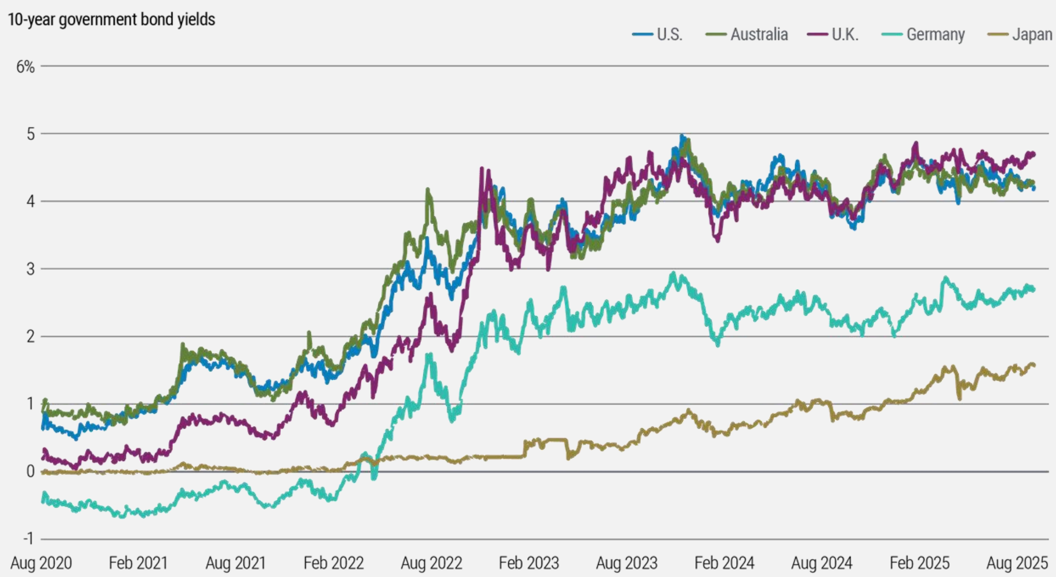
Will AI lead to this nightmarish outcome in the next few years, destroying everything in its path? We think it's important to remember that speculation around how ***anything*** will play out over a multi-year time frame is difficult at best. And given the rapidly changing impacts of AI we believe that making investment decisions based on such conjectures is unwise to say the least.

While investors fear the wide-spread disruptive impacts of AI-implementation, they simultaneously punished the mega-cap technology companies for *over* investing in data center expansion. It doesn't seem possible for AI to be **BOTH** an agent of disruption and chaos, while being a bad investment for those who provide it. We suspect that markets are overreacting on both sides of this question as is often the case. We do believe that AI technology will provide some of the most significant work & lifestyle changes of our lifetimes. However, the near-term impacts are likely overstated as such dramatic changes often take longer than anticipated.

Meanwhile, the US economy continues to move forward at a steady, if not spectacular pace. As anticipated, 4th quarter GDP was negatively impacted by the prolonged government shutdown coming in at just 1.4%. But full-year growth of 2.2% was solid despite uncertainty over tariffs, geopolitical events and fiscal constraints. The job market has been uneven at best, with less than 10,000 jobs per month being added on average in the last 3 months. Nevertheless, layoffs have yet to tick up and the unemployment rate remains below 4.5%. Inflation trends have been mixed, with a better-than-expected CPI figure at 2.4% in January although the Fed's preferred measure Core PCE remains stubbornly closer to 3% than their 2% target rate.



The one area that seems unambiguously positive is the continuing earnings performance of US corporations. The S&P 500 companies are on track for a better than 14% earnings growth in Q4 2025, which will mark the 5th straight quarter of double-digit results. Although you wouldn't guess this from their stock performance this quarter, the "Magnificent 7" once again posted a stunning 27% earnings growth rate which marks the 10th time in the last 11 quarters that they've reported growth above 25%.



The Federal Reserve held rates steady at their January & March meetings and signaled that they would hold rates steady as they continue to monitor both inflation (which is above their target) and the job market (which is a little bit weak). Interest rates have been mostly steady, with the benchmark 10-year treasury stuck in a range between 4.0% to 4.5%. The 30-year mortgage rate briefly dipped below 6% for the first time since September 2022 but has since moved higher in the aftermath of conflict in the Middle East.

Everything Everywhere All at Once

The Best Picture winner from 2022 is the mind-bending story of a Chinese-American woman who finds herself jumping from one time & place to another repeatedly to battle a mysterious evil foe. If it sounds confusing it is, but no more so than the current market environment. Many things are changing, all at once it sometimes seems, and with market reactions that sometimes seem perplexing. The Supreme Court decision to void the Administration's tariff deals based on constitutionality grounds was met with a collective "yawn" by both equity and fixed income markets. Artificial Intelligence is good, then it's bad. And now you also have to factor in a military conflict that has potentially significant impacts on energy prices, the economy, and inflation.

In a world where the eventual outcomes are this unclear, we believe that a balanced approach without an overemphasis on any one portion of the market makes the most sense. We expect that there will be winners & losers in the battle for the AI market but feel more comfortable owning these large cap stocks now that valuations have come down. At the same time, we think that owning international equities where valuations remain very reasonable makes sense, as well as Small & Mid Cap stocks that will benefit from a recovery in the domestic economy. And most importantly, this is the kind of market where owning companies with solid fundamentals and strong balance sheets is critical.

The outlook for the US economy also presents a puzzling set of potential outcomes as we move into Spring. For the most part, the fiscal tailwinds coming from the One Big Beautiful Bill lead us to believe that both consumer spending and business investment activity should lead to better GDP growth. And although the overall job market may remain challenged, we don't see any reasons to believe that AI induced layoffs are an imminent threat. The one wildcard recently added to the cloud of uncertainty is the potential inflationary impact from higher oil prices. Assuming that the global supply of oil is returned to the levels prior to the Iranian Conflict within a reasonably short time frame, the spike in energy related costs should be brief and only have a minimal impact on inflation. However, as of this time, this uncertainty could have damaging effects on both consumer and business confidence.

The Fed clearly finds itself in a challenging position, and the prospect of an energy supply shock only complicates their decision-making process. We believe that the prospects of more rate cuts before newly nominated Fed Chairman Warsh assumes office in May are extremely low, and the new Chairman will need to tread carefully before he pushes the Federal Reserve Committee members for lower rates. The markets also need to be convinced the new Chairman is serious about the risk of higher inflation, or else we could see longer term rates move higher.

Consequently, our Fixed Income holdings continue to be focused on shorter maturity bonds with minimal credit risk from corporate bonds. Recent concerns over private credit funds seem somewhat overblown but could lead to some widening of historically tight credit spreads in the public corporate bond markets.

The stock market volatility we have seen so far this year is a normal, and rational response to an economic environment filled with uncertainties. How Artificial Intelligence will impact different companies, and people's jobs, is an evolving story. But if this "Fourth Industrial Revolution" unfolds as the three preceding it, while there will certainly some jobs destroyed there should as many or more created. And improved productivity and overall quality of life make things better for us all eventually.

Rest assured that our team here at Pinnacle is working relentlessly to help you navigate these uncertain waters. And we believe strongly that if we stay the course, we will ultimately reach your financial destination together.

Don Garcia

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