2026 Second Quarter Letter

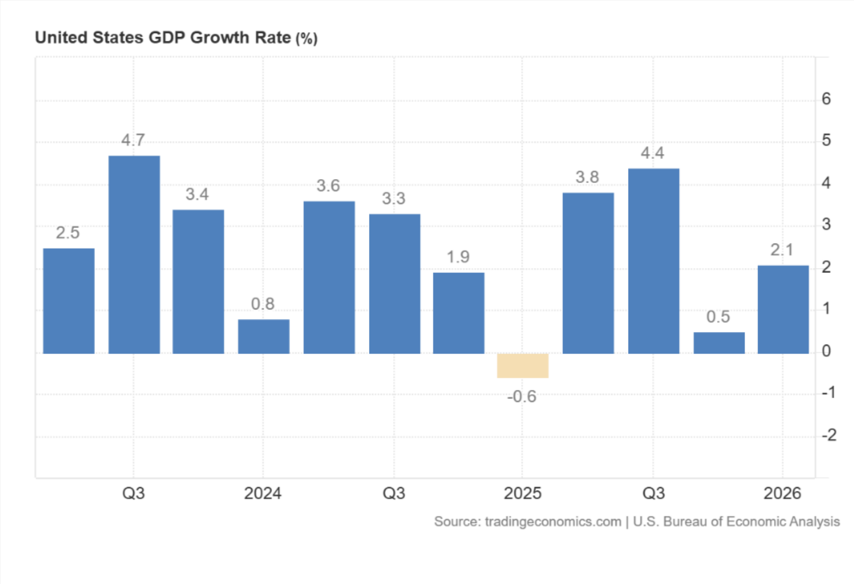
To Infinity and Beyond!

After a lackluster start for stocks in 2026, investors have recently felt like Buzz Lightyear from Toy Story, as if the sky was the limit! This enthusiasm for a potential future of unlimited possibilities was captured most recently in the heavily publicized IPO of SpaceX.

Rarely has there been so much “buzz” created around a private company’s entry into the public stock market, and understandably so. Elon Musk started SpaceX twenty-five years ago with little more than a dream and a handful of talented engineers. He defied the skeptics who thought he had no chance of breaking in against the entrenched incumbents and built SpaceX into the dominant global launch platform it is today, responsible for over 50% of global orbital payloads.

SpaceX has many aspects grabbing public imagination: giant rockets returning to Earth and captured by a giant set of “chopsticks”, a vast network of low earth satellites that promise the possibility of providing high-speed phone/internet connections anywhere on Earth, data centers in space, asteroid mining and even someday a permanent human base on Mars. Love him or hate him, you certainly can’t deny that Elon has big dreams.

The IPO set many records including the largest amount of proceeds raised (over $75 billion) and the largest valuation for a new company at just over $1.75 trillion based on the $135 per share offering. It was highly controversial and critics challenged the valuation for the company given its lack of profitability and relatively low revenue in the preceding 12 months. While we are sympathetic to these arguments based on normal valuation methodologies, we nevertheless can fully understand why investors are willing to take a stab at capturing a piece of the SpaceX dream regardless of price. And while the shares may very well be volatile over the coming year, we would be hesitant to bet against Mr. Musk.



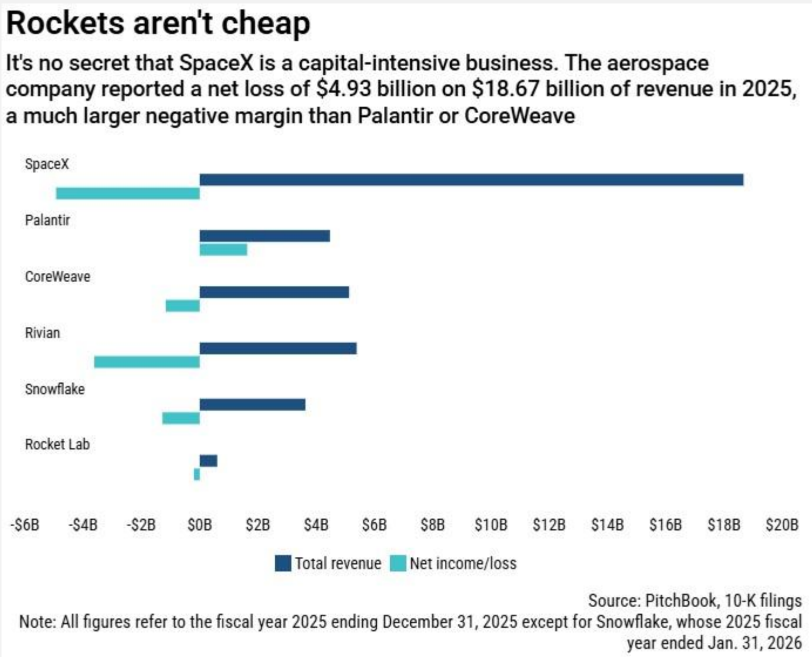
Another aspect of the markets that has taken off like a rocket this quarter is the earnings trajectory of the S&P 500 companies. Heading into the second quarter, analysts were expecting about 12.5% earnings growth for the index, but the final tally of over 28% year-over-year growth exceeded even the most bullish expectations. Once again, the sector leaders were Technology and Communication Services with earnings growth exceeding 50% each. Over 85% of these companies beat estimates, the highest percentage since Q2 of 2021.

The US economy continues to move forward, but with some unevenness between sectors. First quarter GDP of 2.1% represented an improvement from the sluggish finish to the prior year, with the boost from higher income tax refunds offset by higher energy prices in the final month of the quarter. The job market continues to slog along in a “no hire no fire” mode, with average job growth being uneven at best. Despite low levels of job creation, the unemployment rate has been steady recently, ticking down to just 4.2%. Inflation has been much more problematic, as higher energy prices resulting from the closure of the Straits of Hormuz have pushed both headline and core inflation higher. Headline CPI climbed 4.2% in May, the highest level in three years, with Core CPI less alarming at 2.9% year-over-year. The Fed’s preferred measure Core PCE came in at 3.4%, well above their 2% target rate.

Heading into 2026, investors were expecting the Federal Reserve to lower the rates several times over the course of the year. However, with the unanticipated spike in energy prices pushing inflation higher, the Fed has been forced to hold steady as they wait to see how geopolitical events unfold. At his initial meeting as Fed Chair in June, Kevin Warsh struck a hawkish tone reiterating several times that price stability was the primary objective at this time. Interest rates moved higher along with oil prices, with the 10-year treasury rate topping out at 4.75%. When crude oil pulled back with the Iran Conflict cease fire agreement, rates stabilized around 4.5%. Unfortunately, this has pushed the 30-year mortgage rate back above 6.5% doing little to help with housing affordability concerns.

This Isn't Flying, It's Falling with Style

At one point in the original Toy Story movie, Woody points out to Buzz that he's not REALLY an astronaut and that he can't really fly. Later Buzz acknowledges this fact, a recognition of his reality. We view the enthusiasm surrounding the SpaceX IPO in a somewhat similar manner.

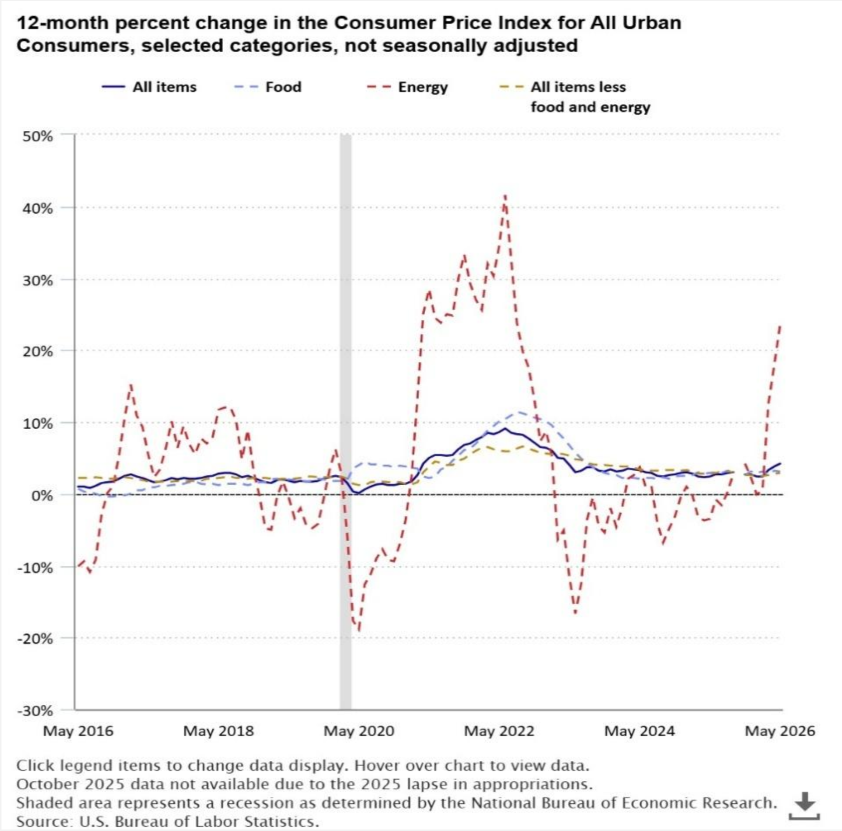


While the possibilities for the company are indeed limitless, there's a certain amount of reality that is likely to dim the near-term prospects. Designing and building new unproven rockets is not an easy task, and there are likely to be ups & downs along the journey. While putting data centers in space is most likely possible, it's not an easy thing to do either. Don't get us wrong, we believe that if there's anyone who could make these things a reality it's Mr. Musk, it's just that there could easily be moments where he "falls with style" along the way.

We are equally aware that there is a fair amount of skepticism regarding the unprecedented higher moves in the technology sector of the stock market (particularly the areas related to AI & data centers). Since the late March lows, the S&P has moved over 17% higher led by an unbelievable 75% plus return for the Semiconductor Index. Surely these stocks are flying much higher than is sustainably possible? While we appreciate these concerns, we would point out that these moves have been accompanied by an equally astonishing growth in both revenue and earnings. S&P 500 earnings expectations for the second quarter have increased from 18.8% to over 23% since March 31, 2026. Full year earnings estimates have grown so much that based on a forward price multiple the overall market is actually cheaper now than before the recent rally. So, while some price consolidation over the near-term is probably to be expected, we remain constructive on the outlook for the equity markets through year-end.

The US economy continues to be driven by the massive AI-related CapEx cycle which shows no signs of a near-term deceleration. Consumers continue to show increasingly bifurcated spending behavior. Upper income households continue to spend robustly but the bottom third of households are feeling increasingly pressured by high prices for energy and food. The apparent resolution of the Iran Conflict initially drove energy prices down significantly. If energy prices stay down, it may help to push second half GDP above trend into the 2.5 to 3% area. The job market continues to exhibit strength although total job creation is being constrained by demographic factors such as aging and immigration. Despite anxiety around AI displacing workers, layoffs remain low and unemployment levels should hold steady at current levels.

The Fed under new Chair Kevin Warsh is currently confounded by the recent inflation data running well above 3%. The markets have shifted from anticipating cuts in the overnight rate to now pricing in one or two hikes before year-end. We expect that the Fed will talk tough but hold steady as the disinflationary impacts of lower energy prices filter through the economy. If inflation data shows that the worst is behind us, and trending back towards their 2% target, we could even see a rate cut towards the end of 2026 or early 2027. Consequently, we project longer-term rates to hold steady around 4.5% for the 10-year treasury note. Unfortunately, this also means that mortgage rates will most likely remain above 6%, which will keep the housing market stuck in neutral.



In closing, we need to emphasize that our previous comments about SpaceX were not meant to be disparaging, on the contrary we are great admirers of their ambitious goals. The enthusiasm around the company encapsulates the fundamental strengths of our great country. Throughout our country's 250 years as a nation, America has consistently led the world in economic innovation. From the expansion of the railroads to the Industrial Revolution, the Info Age Revolution, and now the Age of Artificial Intelligence, America has paved the way. The combination of our capitalistic economy and inherent natural risk-taking nature has produced a track record of shared prosperity unmatched in history. While recognizing that our economic and political systems are far from perfect, we fervently believe that they will provide the framework for another 250 years of greatness.

We hope that you enjoy the summer days ahead. As always, our entire Pinnacle team maintains our full devotion towards assisting you reach your financial goals.

Don Garcia

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