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Midyear U.S. Equity Outlook: Looking Toward 2026 for Upside

July 2025

Key Takeaways

- ▶ We believe tariffs remain the key risk to corporate profits in the second half of the year and are less concerned about geopolitical events or the outlook for fiscal and monetary policy.
- ▶ Credit trends and market breadth support the thesis that the current advance is both healthy and sustainable while inflation expectations remain well anchored, which should keep Treasury yields rangebound.
- ▶ While more neutral on the near-term outlook for equities due to tariff uncertainty and valuations, multiple catalysts could drive an earnings acceleration in 2026 as current risks are likely to dissipate.

U.S. Stocks Near Fair Value Amid Tariff Complacency

After two outside positive performance years in 2023 and 2024, U.S. equity markets are digesting a mixed bag of risks and opportunities in 2025. While the second quarter saw increased volatility from concerns over the impact of tariffs on economic growth and inflation, markets quickly dismissed those concerns, rallying back to all-time highs. In our opinion, the U.S. stock market currently stands near fair value, lacking material upside in the short run and vulnerable to potential negative surprises in the second half of the year. We are more focused on the outlook in 2026 when multiple catalysts could drive an acceleration in corporate profits and many of the current risks are likely to dissipate.

We believe tariffs remain the key risk to corporate profits in the second half of the year and are less concerned about geopolitical events or the outlook for fiscal and monetary policy. While the tariff deal deadline has been extended, there has been slow progress beyond a few broad deal “frameworks” announced. Tariffs on our biggest trading partners in the European Union and China are likely to stay high and take longer to resolve, while tariffs on secondary trading partners will remain in place for extended periods. To date, the impact on both growth and inflation has been muted by existing inventory and a fear of backlash for raising prices. However, conversations with corporate management teams tell us that while they are willing to absorb some cost, prices are likely to rise in the coming months as pre-tariff inventory is absorbed. We estimate that the average effective tariff rate will ultimately settle in the 14%–15% range from approximately 2.5% in the prior year (Exhibit 1).

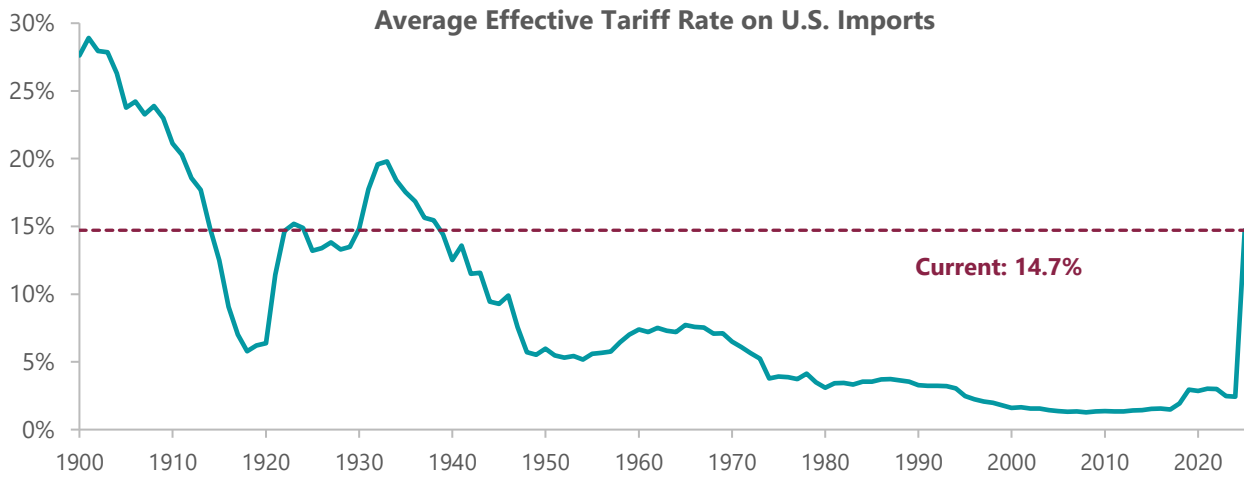
While the overall economy can absorb that impact without recession, we believe that current profit estimates are too high and likely to weaken. Earnings estimate revisions are likely to begin declining more significantly starting in the fall. Housing, autos and investment spending excluding AI are all weakening and should become more pronounced in the months ahead.

Fortunately, inflation expectations to date remain well anchored and, while higher tariffs are likely to lead to higher goods inflation, lower oil prices and a slowing housing market should help to offset those pressures, keeping 10-year Treasury yields rangebound. Longer term, Treasury yields remain a risk for equity investors as concerns about higher deficits are real and worrisome. So far, the market has been

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willing to look past those concerns as rising deficits from the One Big Beautiful Bill (OBBB) won't be visible to investors for some time.

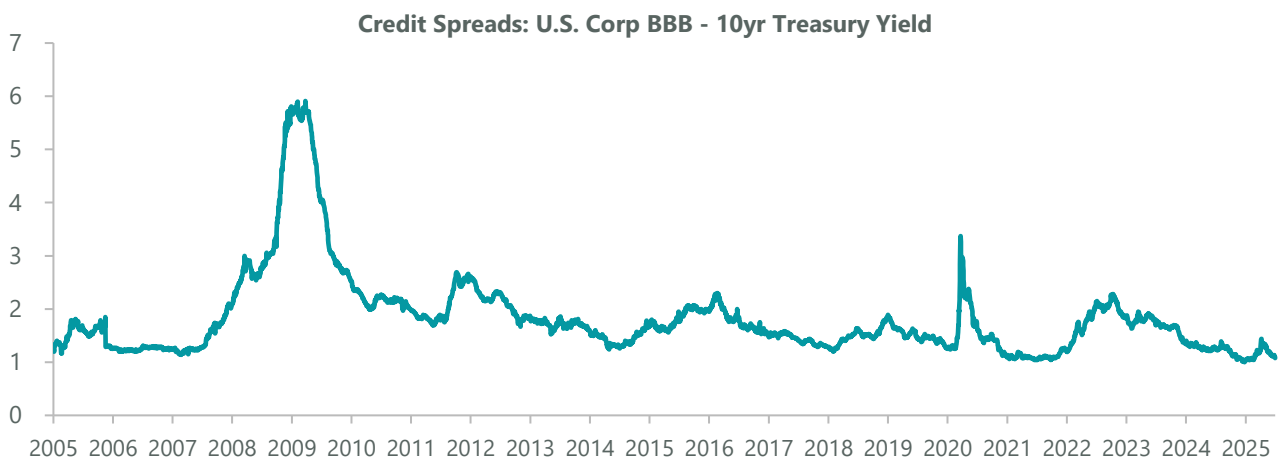
Exhibit 1: Tariff Headwind



Data as of 30 June 2025. Source: Yale Budget Lab.

Despite our near-term caution, we acknowledge that credit trends and market breadth support the bull thesis that the current advance is both healthy and sustainable. Bond spreads, historically a good measure of expectations for future financial distress, remain tight and supportive of growth. Current market breadth, or the level of participation of stocks in the market advance, is sufficiently broad. Finally, leadership in sectors like technology, industrials and financials are indicative of a strong and resilient market outlook.

Exhibit 2: Low Credit Spreads Supportive of Growth



Data as of 30 June 2025. Source: Bloomberg, ClearBridge.

While we are more neutral on the near-term outlook for equities based on tariff uncertainty and valuations, we are more bullish on the outlook for 2026 when we believe that S&P 500 Index profits can return to double-digit growth. Our expectations assume a broader resolution of most tariff negotiations resulting in more of a one-time price adjustment than a lasting impact on both prices and profits. We expect continued strong investment in all things related to AI, but also in other industries as deregulation boosts investment and capital markets activity resumes amid declining corporate uncertainty. Finally, we expect both monetary stimulus from lower Fed Funds rates in the next year, and fiscal stimulus from the front-loaded impact of the OBBS to support profit growth.

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