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SUMMARY

- We see a rotation into US and international 'value' stocks as the most likely outcome over the next 1-3 years.
- Covered call strategies should be an effective hedge against market volatility.
- Technology should also do well in the majority of our scenarios.

04.21.2026

A Scenic View of the Road Ahead

Seeing Some Clear Pathways Through the Recent Volatility

One of the great joys in my life is hiking. While I don't always enjoy the grind of the ascent, the eventual summit is always worth it. From this vantage, you can get perspective on both what you have accomplished and what is still to come.

In a way, this same concept is what draws me to investing. While we are currently in a particularly grueling climb (including the war in Iran – a situation in which we will provide an update at the end of this piece), we cannot lose our long-term perspective. We want to take this piece as a summit in the middle of our hike; one where we can see a path through the trees and hills and clearly see four potential paths from here. The details of how things actually unfold will not match our scenarios exactly, but we believe having a framework helps us know what to look for as earnings and economic data come in over the months ahead.

Four Paths Ahead: They Depend on Two Key Economic Variables

We see four likely outcomes for markets over the next one to three years, differentiated by the trajectory of long-term economic growth and inflation.

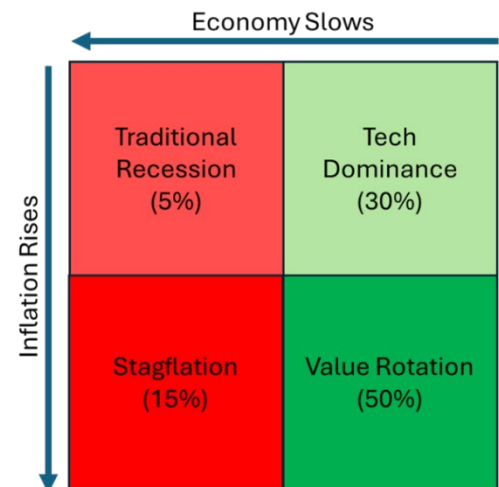
Path #1: Traditional Recession Scenario (Low Inflation / Low Growth) – 5%:

This scenario involves a significant demand collapse and disinflation, prompting the Federal Reserve to shift quickly toward accommodation. While anything is possible, we view this outcome as unlikely given the current strength of corporate earnings and resilient employment data.

Path #2: Stagflation (High Inflation / Low Growth) – 15%:

Stagflation would put the Fed in a difficult bind – unable to come to the market's aid without allowing inflation to spiral. This scenario could materialize if tariff-driven price pressures from last year are compounded by supply chain disruptions stemming from the Iran conflict and Strait of Hormuz instability. For this probability to rise meaningfully, we would need to see the Fed cutting short rates against a backdrop of rising inflation, with long-term core inflation exceeding 3%.

Table 1: Our Probabilities favor our 2 market positive outcomes.



Path #3: Tech Dominance (Low Inflation / High Growth) -30%: The AI-driven advances of recent years, combined with the valuation reset of the past six months, could allow technology to sustain a prolonged run – provided earnings continue to grow at elevated levels for longer than the market currently expects. While we expect positive returns from Technology, we believe a return to narrow technology leadership is less likely than a broad value rotation. Paradoxically, the market's own fear of an AI bubble may be its best defense against one forming, at least in the near term.

Path #4: Value Rotation (Moderate Inflation / High Growth)-50%: This is our base case, and it would bear some resemblance to the post-Korean War period (1950s-60s) or the 2004-2007 cycle. In this scenario, inflation settles in the 2.5-3% range, the 10-year Treasury finds equilibrium between 4.25-4.75%, and the Fed can lower short rates against a backdrop of strong nominal growth. This combination is also favorable for indebted governments, as it allows them to gradually inflate their debt down to more manageable levels over time.

We call this a value rotation because the asset classes that tend to benefit – US value, small-caps, international, and emerging markets – share the classic characteristics of traditional value investing: lower multiples and higher sensitivity to nominal economic growth. The specific mechanisms differ – lower short rates are the primary tailwind for small-caps, dollar weakness for international equities, and operating leverage for cyclicals. But they share a common driver – nominal growth strong enough to lift all boats without triggering a Fed response that chokes the cycle.

Implications of Different Environments on Select Asset Classes and Sectors

Asset Class/ Segment	Assessment of Fundamentals	Paths It Does Well	Paths It Is Average	Paths It Struggles
US Technology - Semiconductors and Hyperscalers	Valuation: high trailing P/E multiples, but forward earnings potential is strong enough that we view these as 'cheap' at current valuations.	Tech Dominance	Value Rotation	Recession Stagflation
US Technology - Software Companies	Multiples have been hit by AI threat, despite strong earnings growth; we view this segment as attractive for patient investors.	Tech Dominance Value Rotation	Recession	Stagflation
US Cyclical Value - Financials, Energy Materials and Industrials	We believe this segment has attractive potential – it has sold off along AI-themes that it has indirect exposure to.	Value Rotation Tech Dominance		Recession Stagflation
US Growth - Health Care and Discretionary	These sectors are highly fragmented in their themes – Pharma and Health Care Providers run on completely different economic drivers, as do retailers vs. restaurants. Our general take on these sectors is to only engage in industry-level selection; currently we prefer medical devices.	Mixed by Industry	Mixed by Industry	Mixed by Industry
US Defensives - Utilities / Reits Staples	We view defensive equities as having two current headwinds: 1.) Margin pressure from tariffs, and 2.) Interest rate sensitivity. We prefer covered calls for the defensive portion of the portfolio.	Recession	Value Rotation Tech Dominance	Stagflation
US Small Caps	Small Caps are dependent on lower short-term interest rates and tight credit spreads. After their strong run in the last year, earnings confirmation is now crucial. They are also vulnerable to recession or stagflation risks.	Value Rotation	Tech Dominance	Recession Stagflation
International Equities	International is priced attractively if it can grow revenue and earnings. Some early positive signs of earnings growth, but needs to persist after a decade-long drought. The expected currency effect is positive vs US dollar.	Value Rotation	Stagflation	Tech Dominance Recession
Out-of-the-Money Covered Call Equity Strategies	Volatility is elevated, which means current income is higher than average; this can provide some downside protection for small drawdowns.	Stagflation Recession	Tech Dominance	Value Rotation

Above is a summary of how some of the major equity segments and other asset classes we are evaluating might hold up if each of the four paths are taken by the market. Red and green highlights emphasize our belief that the asset class will hold up the best (or worst) in each scenario.

Conclusion: Stay Invested and Seek Out Value

After taking this moment of respite from our proverbial market grind, we believe there are 5 major takeaways for our portfolios:

1. **Our portfolios remain overweight equity relative to their benchmarks.** This positioning reflects the 75% combined probability we assign to our two market-positive scenarios.
2. **In the US, we prefer large-cap value over broad small-cap.** Small-caps would likely be hardest hit in either of our two downside scenarios, though we see compelling selection opportunities in specific sectors and individual stocks.
3. **Internationally, we are currently benchmark-neutral – though the case is becoming increasingly attractive.** Cheap valuations, a macro environment that is favorable to US-denominated Investors, and our expectation of moderate dollar weakness driven by tariffs all create strong tailwinds for international assets. The primary risks remain China growth and European political fragmentation.
4. **We remain invested in US Technology.** Long-term investors should likely see semiconductors grow into their valuations over time, and software valuations have compressed to levels where they may hold their own even in a value rotation environment.
5. **From a risk management perspective, it is important to diversify your diversifiers.** Risk-protection assets are scenario-dependent. As 2022 reminded us, in a rising rate environment, Treasuries can decline alongside equities. Balancing hedges – such as covered call strategies alongside bonds – is critical, as is maintaining the flexibility to be tactical.

Overall, this analysis reinforces our pro-risk bias and our desire to add to value-oriented positions where opportunities arise. We will look to Q1 earnings season for confirmation – expecting broad resilience, improvement in value-oriented segments, and earnings stability in technology. The key risk we are watching most closely is core inflation: a re-acceleration of long-term inflation above 3.0% would cause us to shift probability from Value Rotation toward Stagflation, with meaningful implications for our asset class preferences. **Absent that, our view from the summit is clear – this is not an environment for hiding in cash or defensives, but one that rewards a willingness to lean into economically sensitive assets.**

Postscript: Iran War Update – We Believe the Worst for Markets is Behind Us

The recent equity market rally - propelling the S&P 500 to a new all-time high - has been fueled by the hopes the ceasefire between the US and Iran leads to a resolution. While the two sides are still miles apart, we believe that the worst is behind us, and that the likely outcome will be our 'Muddle Through' scenario, where the war lasts less than four months. We do not believe the Trump Administration, nor the American people have the appetite for a protracted military engagement. This conflict's trajectory has followed the same pattern of escalation and de-escalation we have seen play out with tariffs, Greenland, and pharmaceutical negotiations – brinkmanship followed by pragmatic retreat. Consistent with that pattern, we have modestly raised our probability of favorable or non-disruptive resolution to 80% and reduced our probability of further escalation to 20% from [our last Iran-focused Weekly View](#).

We continue to maintain a constructive market outlook so long [as corporate earnings remain resilient](#), and we will continue update our scenario probabilities as the Iran situation develops. To that end, our shorter-horizon balanced portfolios added US and international equity exposure back to the portfolio last week after the ceasefire was announced. We are watching events with humility, but we are not abandoning our constructive market outlook – and we are already sizing up potential opportunities that resolution will eventually present.

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In a rising interest rate environment, the value of fixed-income securities generally declines.

Technology and internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

Index Definitions:

Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

Definitions:

Inflation is a gradual loss of purchasing power, reflected in a broad rise in prices for goods and services over time.

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