

Economic Commentary Q1 2026

The first quarter of 2026 began on a constructive note, supported by resilient economic activity and expectations that the Federal Reserve would continue to ease monetary policy through additional cuts. As the quarter progressed, sentiment shifted materially. The late-February escalation in the Middle East and the effective closure of the Strait of Hormuz introduced a major energy shock, disrupting a route that carries nearly 20% of global oil supply. By early April, daily Brent crude prices had reached almost \$128 per barrel after averaging \$103 in March, a stunning reversal from the calm tone that defined the start of the year. What began as a quarter characterized by broadening participation and steady economic momentum ended with markets focused on higher energy costs, renewed inflation pressure, and a much more uncertain policy outlook.

Domestic Fixed Income Markets

U.S. fixed income markets faced a more challenging environment during the first quarter as rising oil prices and firmer inflation expectations pushed Treasury yields higher across the curve. The 2-year Treasury yield increased the largest degree, from 3.47% at year-end to 3.79% by March 31, while the 10-year Treasury yield rose from 4.17% to 4.32%. As a result, the Bloomberg U.S. Aggregate Bond Index declined 0.05% for the quarter, ending a four-quarter streak of positive returns. Credit spreads also widened modestly, particularly in lower-quality bonds, as investors grew more cautious about the economic impact of higher energy prices. Unlike periods when bonds benefit from a flight to safety, fixed income offered less downside protection this quarter as markets were reacting more to the risk of inflation than recession concerns.

Domestic Equity Market

Domestic equities moved lower in the quarter, though headline index returns masked a more nuanced story beneath the surface. The S&P 500 declined 4.35%, with much of the weakness concentrated in March as geopolitical tensions intensified and oil prices surged. At the same time, market leadership broadened considerably. Smaller-cap stocks and value-oriented areas of the market outperformed, with the Russell 2000 gaining 0.89% and the Russell 1000 Value Index rising 2.07%, while the Russell 1000 Growth Index fell 9.78%. Sector performance also reflected the quarter's shifting backdrop. Energy was the strongest area of the market, advancing 37.15% as oil prices moved sharply higher, while technology, consumer discretionary, and financials lagged. The quarter served as a reminder that broader diversification across sectors, styles, and market capitalizations can help reduce the impact of concentrated weakness in the largest growth-oriented stocks, which have generated the majority of returns in recent years.

Federal Reserve

The Federal Reserve maintained a steady policy stance throughout the quarter, leaving the Federal Funds target range unchanged at 3.50% to 3.75% at both its January and March meetings. In its March communication, the Committee acknowledged that economic activity had continued to expand at a solid pace, while also noting that uncertainty had increased. Consumer spending also remained constructive, with personal consumption expenditures rising 0.5% in February. In addition, manufacturing activity improved during the quarter, with the ISM Manufacturing PMI rising to 52.7 in March, its third consecutive month of expansion. The Fed's preferred measure showed PCE inflation running at 2.8% year over year in February, with core PCE at 3.0%. The first post-quarter CPI release then showed headline inflation accelerating to 3.3% in March, driven in large part by a sharp rise in gasoline prices. At the same time, the labor market moderated but did not materially weaken, with payroll growth of 178,000 in March and the unemployment rate at 4.3%. The Fed's updated projections continued to imply modest easing later this year, with the median projection pointing to a year-end federal funds rate of 3.4%. Market expectations, however, shifted notably over the course of the quarter. At the start of the year, investors were expecting multiple rate cuts in 2026. By quarter-end, much of that easing had been priced out as higher oil prices and renewed inflation concerns complicated the policy outlook.

The Fed's broader balance sheet approach remained largely unchanged. In March, the Committee continued reinvestment activity designed to maintain ample reserves, signaling continuity in its operating framework rather than any broader shift toward accommodation. As a result, the market's focus remained firmly on inflation, labor market data, and the extent to which higher energy prices might delay future policy easing.

Summary

While the rise in oil prices and the repricing of rate expectations created volatility across both stocks and bonds, the quarter also highlighted the value of diversification, as areas outside the largest U.S. growth stocks held up relatively well. Looking ahead, markets will remain focused on the path of inflation, the persistence of elevated energy prices, and whether economic growth can continue to absorb these pressures without a more material slowdown. The biggest driver of volatility will remain on the resolution of the conflict in Iran, which continues to exhibit negative impacts across the global economy.