Chemung Canal Trust Company

Capital Bank
A Division of Chemung Canal Trust Company

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2026 Third Quarter

Investment Outlook

Executive Summary

- The U. S. economy continues to perform remarkably well, despite the uncertainty surrounding the Iranian conflict, volatile energy prices, and overarching questions regarding the validity of tariffs. The manufacturing sector of the economy has started expanding, while the services sector continues to remain strong.
- The unemployment rate inched down to 4.2% in the June report and is now 0.3% below the near-term high. For the first time in four years, the number of job openings in the economy has materially increased, rising by about 1 million jobs in the first five months of the year.
- Inflation remains the blemish on an otherwise robust U. S. economy. Not only has inflation not returned to the Federal Reserve's 2% core PCE target, it has increasingly trended higher. In the May report, core PCE is currently running at 3.4% on a year-over-year basis. Stubborn inflation and a strong labor market give the Fed little basis for lowering their policy rate.
- The S&P 500 posted its best quarterly in return in six years, gaining 15.2%. The Nasdaq 100 Index, dominated by technology stocks, performed even better with an almost 28% gain. The average stock, as measured by the S&P 500 Equal-Weight Index generated the "lowest" return, increasing by about 11%. On the other hand, bonds had a relatively quiet quarter, with the Bloomberg U.S Aggregate Index gaining just 0.7%.
- Like many previous quarters, stocks in the Information Technology sector generated the best performance. Looking at the tech sector as a whole is misleading, however. Semiconductor stocks posted their best quarterly return on record, while software companies and the Magnificent 7 group languished.
- A major change occurred at the Federal Reserve, Kevin Warsh was confirmed as the next Chairman of the Fed. Warsh has ambitious goals for reforming the institution. He is particularly focused on taking a less interventionalist approach to monetary policy and scaling back communication at the central bank. Warsh has previous experience at the Fed and helped guide the organization during the Great Financial Crisis.
- The recent strong performance in the S&P 500 has been fueled entirely by earnings growth, meaning that valuation levels have not worsened. Even though the absolute valuation level is stretched, investors can take some comfort in that earnings multiples have not expanded. Market participants must be realistic that rapid earnings growth cannot continue indefinitely. But until the growth fizzles out, it appears that investors have the potential to drive the equity market higher.

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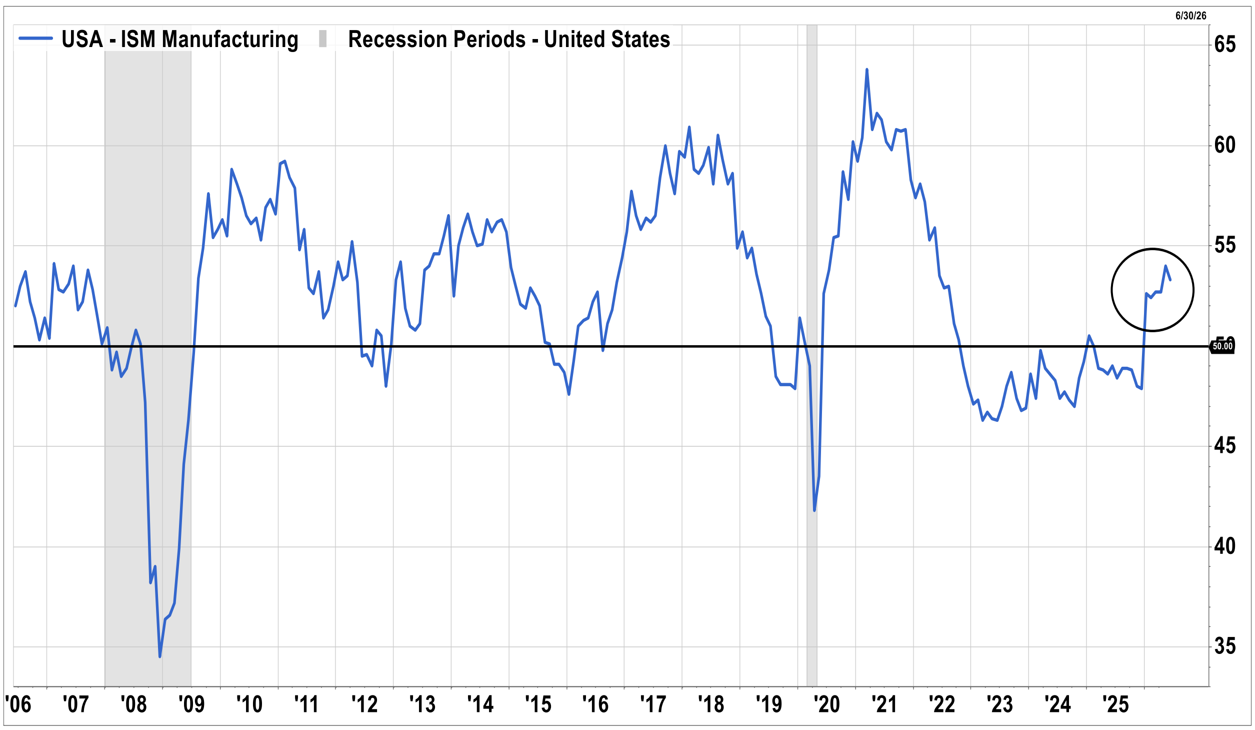
Economic Review

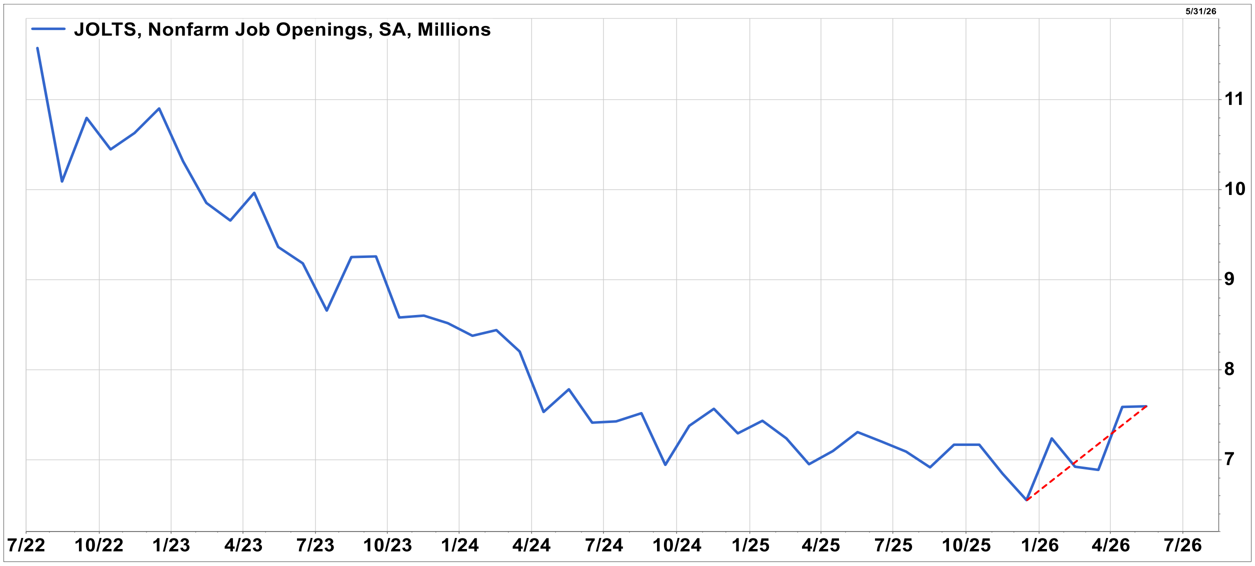
Despite an on-again, off-again war, a spike in global energy prices, and lingering global tariff uncertainty, the U. S. economy has shown little sign of wavering. The manufacturing sector, which has been in a contraction mode for three years, has now comfortably returned to an expansionary state based on the latest ISM data. While manufacturing only represents about 10% of the nation's employment, it's still an incredibly important segment of our economy and finally seeing positive data is encouraging.



The services segment of the economy, which accounts for approximately 80% of employment, has also trended further into expansionary territory. As we have noted in prior *Outlooks*, the U.S. has never experienced a recession with the services sector in an expansion.

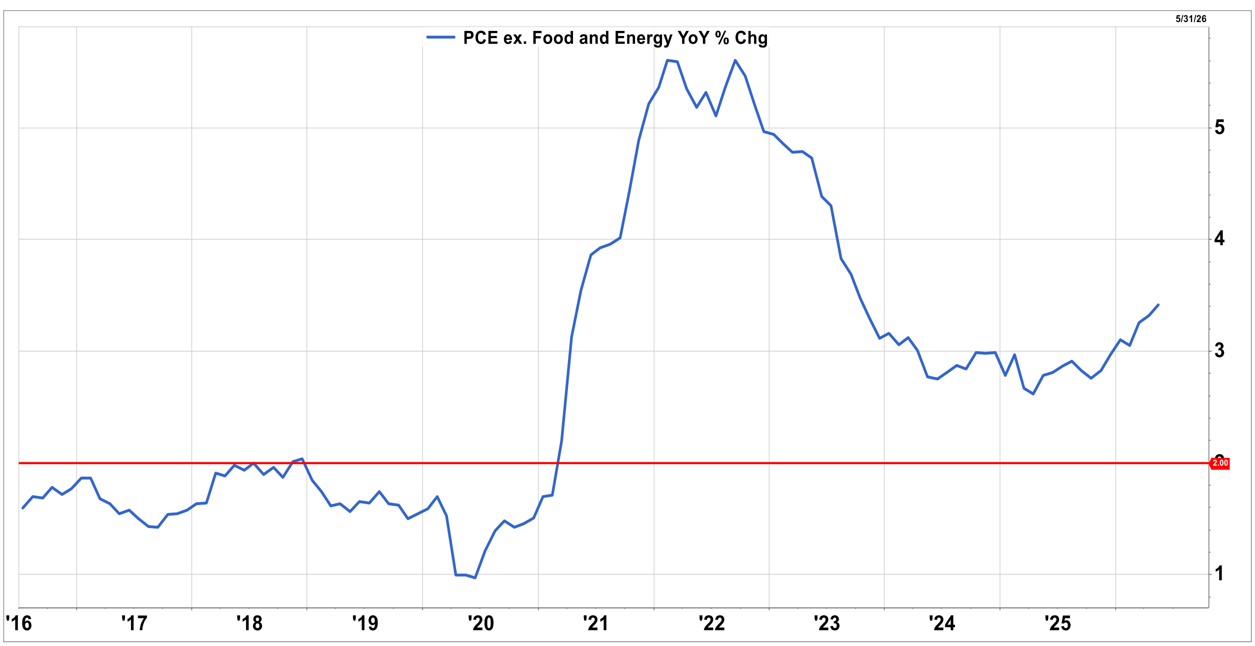
The labor market continues to remain steady at the moment. The unemployment rate inched down to 4.2% in the June report, which is 0.3% below the near-term high of 4.5% experienced in November of 2025. In the last three months, the U. S. economy has added 334,000 jobs based on the nonfarm payrolls figures. Payrolls reports need to be viewed with a healthy degree on skepticism due to the large revisions that are applied over time, but the potential growth in jobs is a welcome occurrence, nonetheless.

In a reversal of a four-year trend, the number of job openings increased during the first half of 2026. Based on the latest Job Openings and Labor Turnover Survey (JOLTS) report, the number of available jobs has increased by more than one million jobs, relative to the start of the year.



With the rise in job availability, there is now effectively one available job per unemployed person. While this is still materially lower than the peak labor market imbalance experienced after Covid in 2022, it does provide some additional evidence that the job market is stable. Initial unemployment claims have also remained low, giving no early warning signs of a softening in the employment situation.

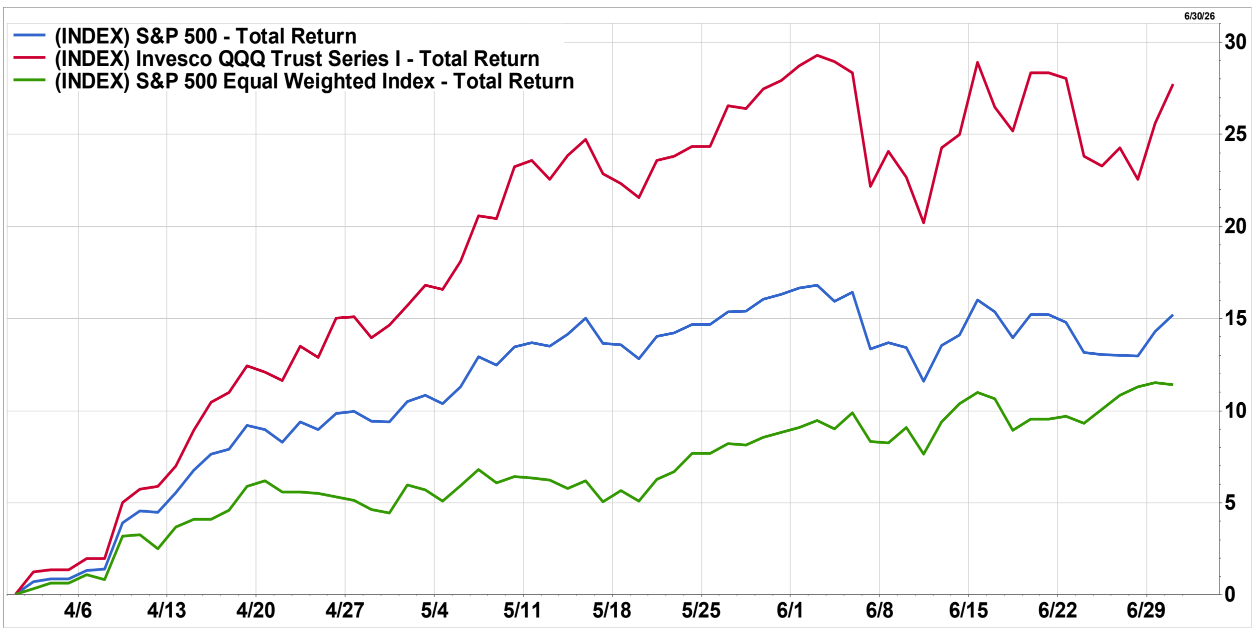
The main blemish on an otherwise clean record for this economy continues to be inflation. Not only has core PCE inflation not returned to the Federal Reserve's 2% target, it is increasingly trending in the opposite direction.



From the April 2025 low point, the Fed's preferred inflation gauge has risen by 0.8% on a year-over-year basis, and is now running 1.4% above their target rate. Some of this increase can be attributed to higher global energy commodity prices. Even though energy prices are not directly included in core inflation, they still act as second-order effect and influence the inflation gauge. As energy prices have declined following the deescalation of the Iranian conflict, inflation should see some degree of relief.

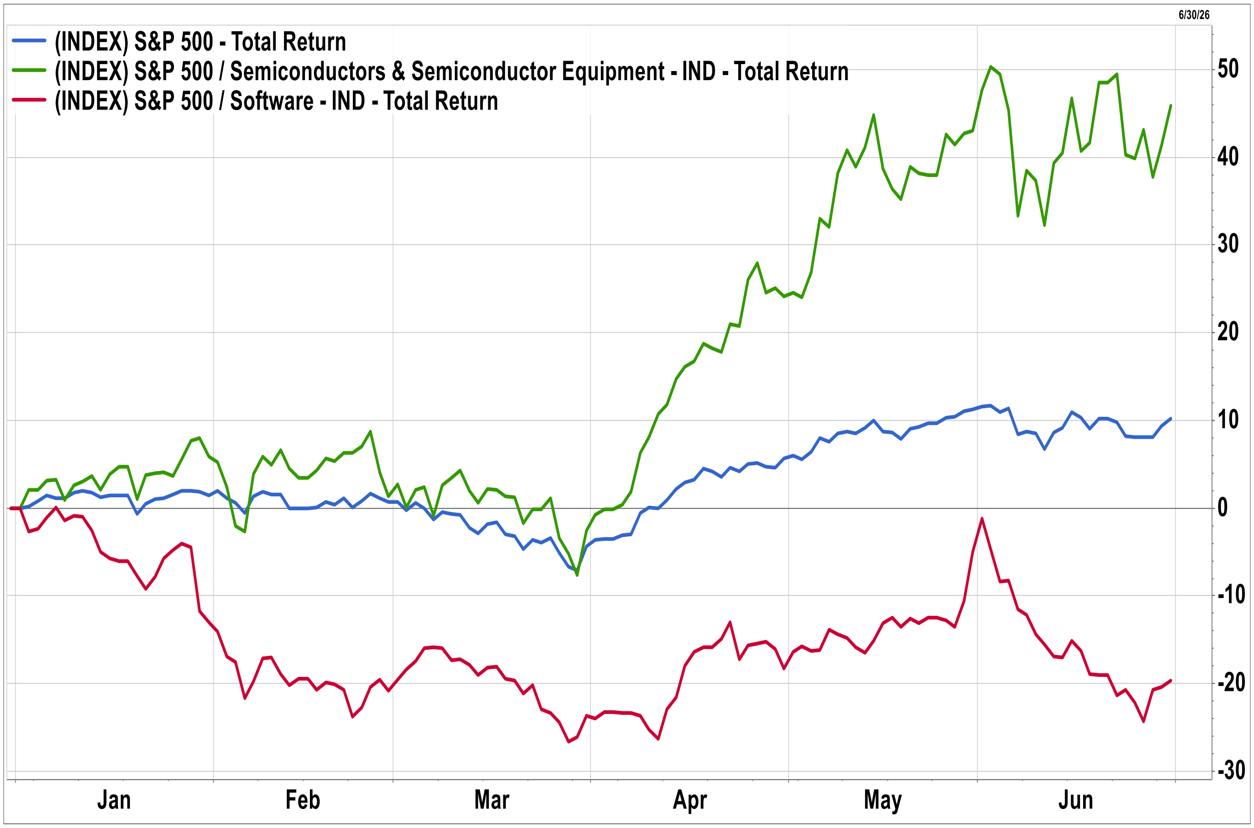
<u>Financial Market Review</u>

In an unexpected and historic rally, given the geopolitical backdrop, the S&P 500 posted its largest quarterly gain in six years with a 15.2% return. As impressive as a double-digit quarterly return seems, the results were pale in comparison to the Nasdaq 100 Index which generated almost a 28% return in the 2nd quarter. The average stock, as measured by the S&P 500 Equal Weight Index returned 11.4%. Even though the average stock generated the "lowest" of these returns, it's important to not overlook the obvious - an 11% quarterly return is far above any reasonable expectation.



Given the distribution of returns amongst the indices, it is not surprising that the Information Technology sector led the stock market higher. However, simply viewing technology stocks as a whole doesn't tell the full story. The real leader in the technology space during the quarter was the semiconductor industry, posting a return of 49.7%! This was the best quarter on record for stocks in the semiconductor industry. Following this run-up, the semiconductor industry is now by far the largest industry group in the S&P 500. It's important to remember that each of the 11 S&P 500 sectors are made up of a number of underlying industry groups. The semiconductor <u>industry</u> is now larger than the second largest <u>sector</u>, Financials, by almost double. To put this into context, the largest banks, brokers, insurance companies and credit card companies in the United States in total are worth about *half* that of the semiconductor industry, which comprises only 20 individual companies.

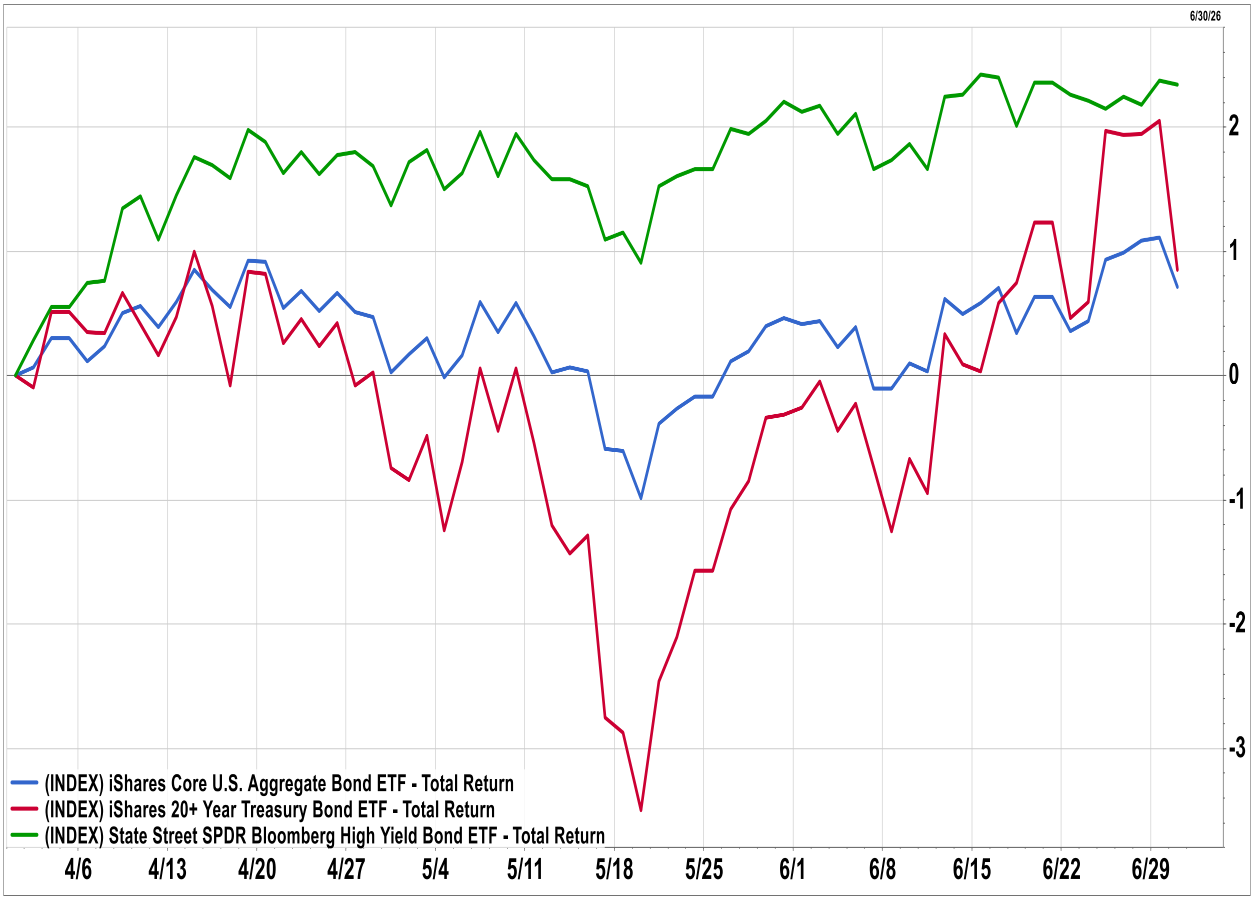
Software companies represented the unfavorable dispersion in the technology sector during the quarter. The software industry group rose 5.4% in three months, returning roughly a third of the headline S&P 500 Index's result. As Artificial Intelligence (AI) optimism continued to build, the prevailing narrative remains that many software companies will become obsolete. Even including the positive quarterly return, the software industry has still declined by almost 20% in the first half of the year. It is hard to fathom that an almost 70% return differential exists between the two industry groups in the same S&P 500 sector.



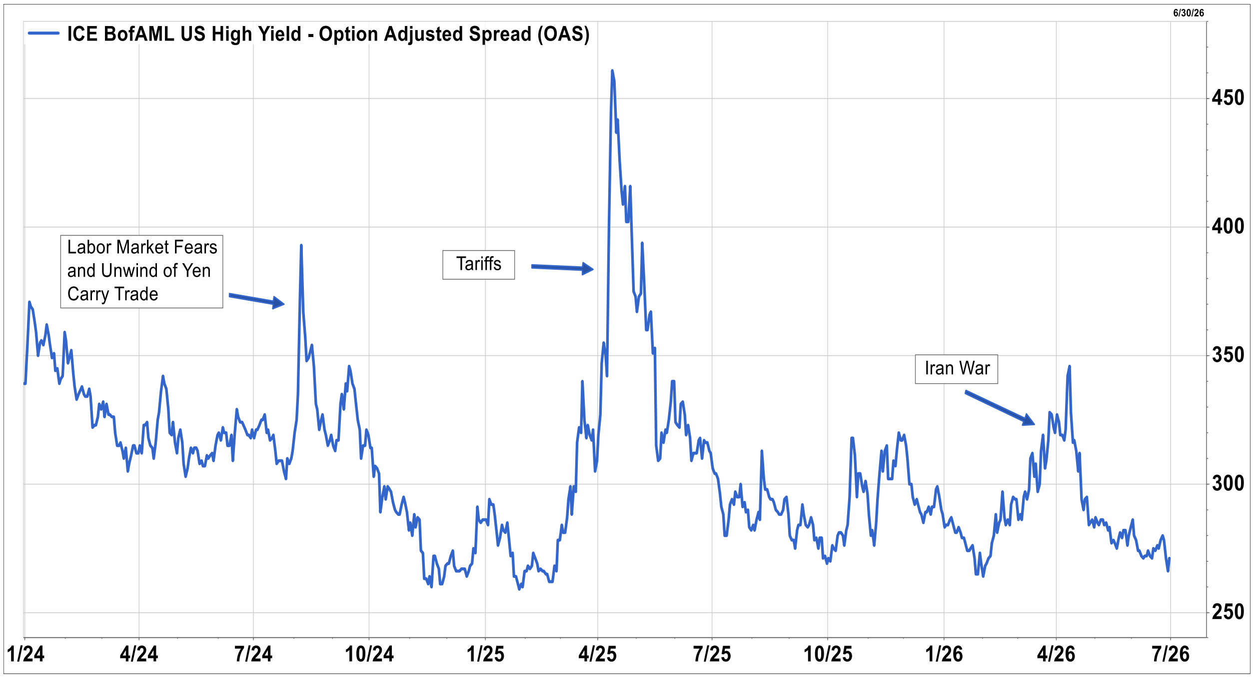
The stocks of the major AI hyperscalers, four of which are components of the Magnificent 7 group, have actually declined by about 5% on a year-to-date basis. In total, the Mag 7 contributed almost no return to the S&P 500 in the first six months of the year. There clearly has been a strong rotation out of the hyperscaler and software names, into the secondary AI industries like semiconductor equipment, hardware, and electrical equipment companies.

Outside of the United States, international equities also had an impressive quarter. Emerging market stocks, in particular, exhibited strong performance, with a quarterly return in excess of 24%. The impressive performance of emerging markets can be explained based on the construction of the index. The top-weighted stocks in the MSCI Emerging Markets Index are generally related to the production and design of semiconductor chips. The largest company in the index, Taiwan Semiconductor Manufacturing Co. (TSM), which is responsible for the actual production of Nvidia's chips, gained more than 40% in the last three months. Many of the same themes that helped buoy the U. S. equity market were also present in emerging markets. The MSCI EAFE Index, comprised of international developed economy stocks, returned less than half of its emerging markets counterpart, and modestly trailed the S&P 500 with a return of 10.8%. It is important to note that the international developed index has far less technology exposure relative to the S&P 500 and emerging markets. The technology sector alone now represents about 38% of the S&P 500 and more than 44% of the MSCI Emerging Market Index, compared to just 14% of the MSCI EAFE.

The fixed income market had a lackluster quarter when compared to the excitement in the equity markets. Core bonds, as measured by the Bloomberg U.S. Aggregate Bond Index, gained about 0.7% on a total return basis. Long-term U.S. Treasury Bonds performed just marginally better with a 0.9% return. The risker area of the fixed income universe, high yield bonds, gained 2.3%, and generally performs better when risk assets are doing well.



After a brief decline in the beginning of April, the policy-sensitive two-year U.S. Treasury yield rose steadily throughout the remainder of the quarter. At the longer end of the yield curve, the 10-year U.S. Treasury yield also increased during the quarter, but peaked on May 19th, and modestly declined toward the end of the quarter. While pinpointing one precise explanation for the rise in yields is difficult, investors generally expected higher inflation and a Federal Reserve that could no longer justify lowering their policy rate given the economic backdrop. Following the widening in the wake of the war, credit spreads declined sharply during the quarter, which provided additional support for bonds on the risker end of the spectrum.



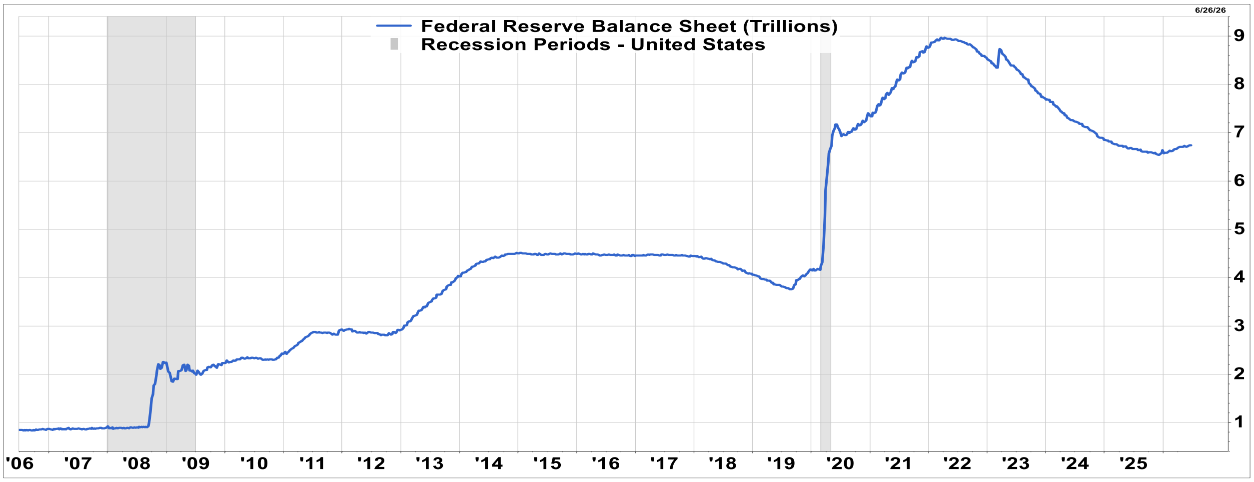
High yield credit spreads are now at a level that is consistent with a floor that has not been breached for almost 20 years, which indicates that bond investors are not terribly concerned with the potential for defaults.

A Kevin Warsh Federal Reserve

With no shortage of theatrics and some delay, Kevin Warsh was officially confirmed by the Senate on May 13th as the next chairman of the Federal Reserve. The path to Warsh's confirmation was rocky, primarily due to the ongoing Department of Justice (DOJ) investigation into then-Fed Chair Jay Powell. Many lawmakers viewed the investigation, related to the cost overruns for the renovations at the Fed's headquarters, as simple political pressure on the Chairman who had differing monetary policy views than President Trump.

Senator Thom Tillis, a Republican from North Carolina on the Senate Banking Committee, was the primary roadblock for advancing Kevin Warsh's nomination. Republicans held a slim majority on the committee and without Tillis's vote, the confirmation process could not continue. Tillis argued that he would not advance Warsh's nomination until the DOJ investigation was resolved, and that is precisely what happened. Following the investigation being dropped, Warsh's nomination passed the Senate in a 54-45 vote.

With the nomination spectacle behind us, market participants can now shift their attention to the changes at the Fed that Warsh has proposed. The phrase "Regime Change" has been used by the now-Chair in describing his intention to alter many of the operations of the Federal Reserve. Rightfully, a substantial overhaul at the world's most important central bank could cause angst in financial markets. One of the areas of focus, based on Warsh's longstanding criticism, will undoubtably be managing the Federal Reserve's balance sheet.



When economic conditions are poor, the Federal Reserve will purchase bonds in the open market in an attempt to support the economy. This practice is referred to as Quantitative Easing (QE) and can be clearly seen with the balance sheet increases during the Great Financial Crisis (GFC) and the Covid-19 recession. While the Fed has been allowing bonds to roll off the balance sheet for the past few years, its size has still increased more than 10-fold compared to the pre-GFC levels. The obvious trend, and concern, is that the Fed never reduces its balance sheet to the pre-crisis level and will continue to expand the balance sheet with each future recession. Chair Warsh has routinely expressed his desire to reduce the balance sheet and thus take a less interventionalist approach to monetary policy.

Another major criticism that Kevin Warsh has levied at the Fed centers on their communication style and frequency. Historically, the Federal Reserve has not always operated in a way that was entirely transparent. The rationale and messaging, if any, surrounding policy decisions were typically cryptic at best. As recently as the early 1990's, the Fed did not explicitly announce its policy decisions or issue any official statements. Market participants were left to infer the policy decisions from other sources. In 1994, under Chairman Alan Greenspan, the Federal Reserve began releasing an official statement following the Federal Open Market Committee (FOMC) meetings if the policy rate was adjusted. Despite the major advancement in transparency, these statements were intentionally vague in an attempt to preserve future monetary policy flexibility.

Chairman Kevin Warsh has frequently expressed his desire to limit the length and the details of the Fed's public statements. Warsh, like Greenspan, believes that too detailed communication and issuing forward guidance will effectively limit the Fed's ability to make objective future policy decisions. In the first FOMC statement under Warsh, the forward guidance in the statement was removed entirely and the economic commentary was greatly reduced. Unsurprisingly, the first Warsh-led FOMC statement was about half as long as previous statements under former Chairman Powell. While a reduction from roughly 300 words to 150 words in the statement may not seem significant, it is a telling sign that we are entering an era in which there will be far less clarity from the world's most important monetary policy authority.

While the notion of change at the central bank may seem concerning, comfort should be taken in knowing that Chair Warsh has previous involvement as a member of the Board of Governors at the Federal Reserve. Warsh served as a Governor from 2006 to 2011 and helped guide the Fed during one of the most turbulent times in history - The Great Financial Crisis. While the new

Chairman may certainly have differing views than the previous officials, different must not instinctively be assigned a negative connotation. Warsh undoubtably possesses the education and experience to serve as an excellent chairman of the Federal Reserve.

Artificial Intelligence Generated Commentary

While numerous *Outlooks* have discussed the concentration and valuations of Artificial Intelligence stocks, no prior *Outlook* has ever demonstrated AI's utility. It seems instructive given the exuberance surrounding these stocks that we exhibit to readers the capabilities (and limitations) of AI. Several questions will be posed to "Claude," Anthropic's AI model, regarding financial outlooks and concerns so readers can get a sense of what this new technology can do.

Question: Provide a three-paragraph outlook for the S&P 500

AI Answer:

The S&P 500 enters the second half of 2026 near record territory, closing in June around 7,500 after rising 7.7% year-to-date as of early June, driven primarily by a massive AI capital spending boom that has overshadowed inflation and tariff concerns. Wall Street has grown more bullish throughout the year: Goldman Sachs recently raised its year-end target to 8,000, up from a prior 7,600, projecting roughly 6% further upside, with earnings-per-share forecasts of $340 for 2026 (24% annual growth). AI investment is expected to drive a large share of that earnings growth, with the biggest cloud computing companies planning roughly $670-905 billion in capex.

The near-term calendar is dominated by two catalysts: Q2 earnings season kicks off July 14th when major banks like JPMorgan, Bank of America, Goldman Sachs, and Citigroup report earnings, with analysts expecting around 22% average earnings growth, and the Federal Reserve's rate decision lands July 28th, with jobs and inflation data in between shaping expectations. Technology and financials are seen as the sectors most likely to lead.

That said, risks are real and increasingly discussed. Market leadership remains narrow, concentrated in AI and energy-related names, and the earnings-growth story is disproportionately driven by a handful of high-momentum stocks — a dynamic some strategists call an "AI earnings circular financing problem." Inflation hit 4.2% in May, its highest in three years, raising the odds the Fed could hold or even raise rates rather than cut, and valuations are historically stretched, with the CAPE ratio near levels last seen during the dot-com era. Net-net, most institutions remain constructively bullish into year-end, but flag narrow breadth, rate uncertainty, and AI-spending durability as the key swing factors.

Question: Since semiconductor companies have rapidly appreciated year-to-date, are they overvalued?

AI Response:

Semiconductor stocks aren't uniformly overvalued, but they're selectively stretched in AI-exposed names — the sector (<u>Human correction: semiconductors are an industry group, not a sector)</u> now makes up a record 19.7% of the S&P 500 (nearly 4x its 2020 weighting) and Bank of America's Bubble Risk Indicator for the group sits at 0.91 on a 0-1 scale, with names like AMD trading near 175x trailing earnings versus Nvidia's 32x despite similar AI exposure. The core debate is whether AI infrastructure spending is a durable multi-year buildout (supported by real earnings growth and booked-out capacity) or a front-loaded arms race pricing in near-flawless corporate execution — bears note current valuations leave little room for even a slowdown, though most see a sharper correction as more likely than a systemic collapse given these companies' real cash flows.

Question: Given that much of the data used in the previous AI generated commentary was sourced from many large sell-side research firms, is it possible that a Claude response would ever differ from the consensus view?

AI Response:

No — that response was consensus by construction, since I only searched mainstream financial media and bank research, which sets the consensus rather than getting ahead of it.

Question: Is there a risk of relying on this AI information if it is formed purely from the consensus opinion?

AI Response:

Yes, this is a real and structural risk, not a hypothetical one. The consensus reflects the crowd's current best guess, not a check on whether the crowd is right, and every major bubble (dot-com, 2008, prior AI hype cycles) had strong consensus support right up until it broke. Aggregating mainstream sources can also create false confirmation - banks, media, and screeners often cite each other's numbers, so five "independent" sources may really be one view echoed five times — while genuinely contrarian calls are hard for me to surface via search precisely because they haven't been validated yet. The fix isn't asking for a different-sounding answer but treating the consensus as one input alongside your own variant view, appropriate position sizing, and specific triggers that would tell you the consensus is breaking down before it becomes obvious to everyone else.

Final Thoughts

Much of the AI generated response that is detailed above provides reasonable and rational explanations of the current factors driving equity market returns. The S&P 500's performance has been narrow, not only by sector, but even by differing industries within the same sector as previously mentioned. Continued narrow performance is generally not a sign of a healthy equity market, yet it's precisely what has happened since the October 2022 market low point.

One contra-point to the lack of market breadth is that the entire S&P 500 gain year-to-date has been supported by extraordinary earnings growth, which have grown at the fastest pace since the economy exited the Covid-19 recession. Incredibly, the S&P 500 has a more favorable valuation level today, based on the forward price-to-earnings (P/E) ratio, compared to the average level experienced over the past three years despite the 70% price-gain in the Index over that time. If the S&P 500 was entering bubble-like conditions, we would expect to see a broad-based increase in the P/E ratio and that has not occurred yet. That doesn't mean that pockets of the market – such as semiconductors - aren't experiencing excessive exuberance, but currently that phenomenon has yet to infiltrate many other market segments.

Even though the absolute valuation level remains elevated compared to historical norms, the fact that the S&P's earnings multiple has not expanded can give investors some sense of comfort.

It seems that the overarching risk at this point in the market cycle is that we could be currently experiencing the peak in corporate earnings and the heavy AI capital expenditures, which are fueling earnings, may begin to fizzle out. Investors need to be realistic that earnings growth in excess of 20% is not sustainable for the S&P 500 on a long-term basis. Companies cannot continue to expand their income at an ever-increasing pace. This is why it is imperative that portfolios are constructed in a way that can participate when the times are good but do not leave investors totally vulnerable when the inevitable slow-down occurs. But for now, as long as this earnings party continues, it seems that the market is more than willing to keep dancing.

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