Under the Radar for the Second Half

JULY 2026

QUARTERLY LETTER FROM THE DIRECTOR OF RESEARCH

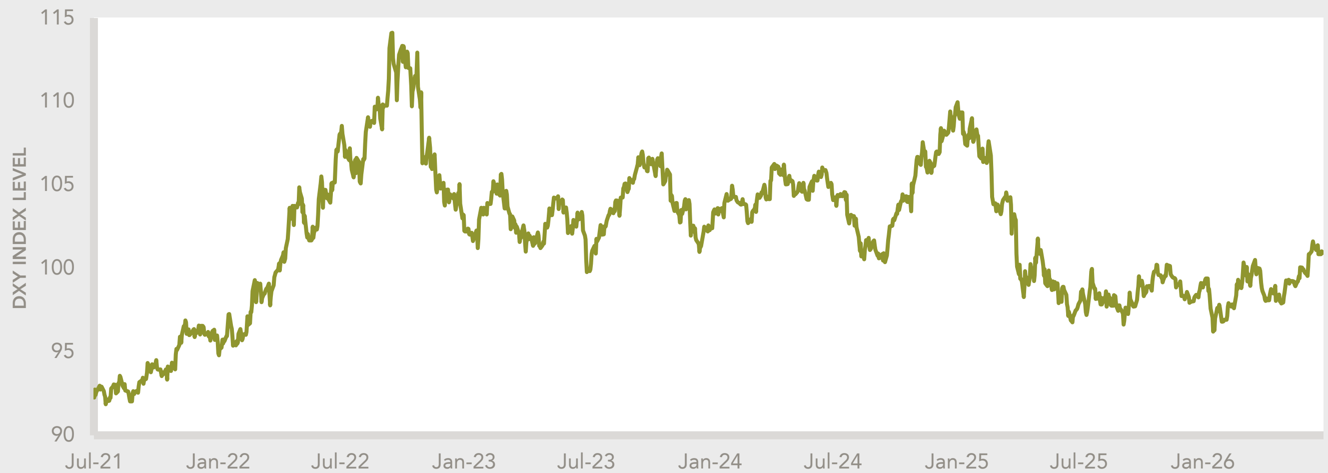
The usual midyear version of these letters has touched on year-to-date performance as well as the most influential macroeconomic and market-specific variables to monitor over the last six months of the year. This time, however, I enlisted the help of some colleagues — Frank Valle, Evan Frazier, Fred Huang, and Weston Whalen — to identify more subtle yet materially influential factors to watch across the economy and capital markets. Make no mistake: the headline topics of Fed policy, interest rates, geopolitics, earnings, and overall diversification remain paramount to long-term investment success, but the following metrics will likely determine if the positive performance of 2026 continues for the second half of the year.

The dollar is back…or did it ever go anywhere? After weakening versus developed and emerging currencies in 2025, the dollar is back in vogue. It has strengthened in 2026 on the combination of geopolitical safe-haven flows, hawkish Fed repricing, and U.S. growth outperformance.

The largest catalyst of dollar strength in 2026 has been the U.S.–Iran conflict, which increased demand for dollar-denominated assets. From late February to early April, the dollar strengthened 2.5%, bolstering it as the world's safe-haven asset. New chair Kevin Warsh reinforced the Fed's commitment to higher-for-longer rates which are generally positive for currencies. This will keep the interest rate differentials high versus most major currencies that make up the basket of currencies represented by the dollar index shown below: the euro, yen, Swiss franc, and Canadian dollar. Finally, concerns of U.S. fiscal sustainability have subsided as U.S. exceptionalism has continued. Overall, the modest unwind of the de-dollarization trades shows a renewed confidence in U.S. assets and conveys an optimistic outlook on U.S. growth for the second half of the year.

However, an announcement on July 1 introduced some uncertainty for longer-term trade agreements in North America.

EXHIBIT 1: THE DOLLAR REBOUNDS IN 2026



Source: Bloomberg as of July 9, 2026

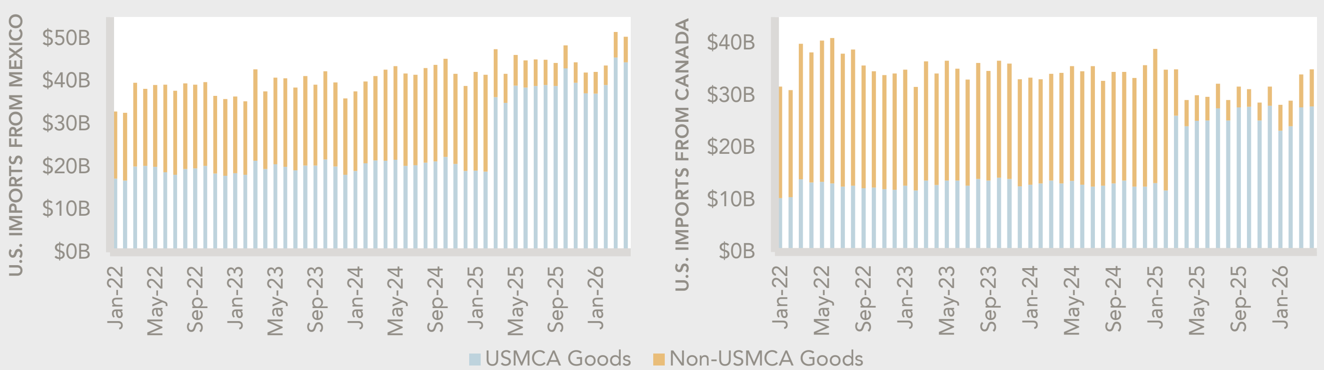
The U.S. decides not to renew the United States-Mexico-Canada Agreement ("USMCA")

On July 1, the U.S. announced it would not renew the pact in its current form and while it is still legally binding until its expiration date of July 1, 2036, this introduces longer-term policy uncertainty. Current zero-tariff rules, supply chains, and market access remain active, but markets may begin pricing greater policy risk into cyclical sectors that depend heavily on cross-border trade. Admittedly this is more of a longer-term risk rather than the second half of 2026, but markets react quickly to news, typically to the downside when uncertainty is introduced. Mexico may be particularly vulnerable given its growing importance in U.S. manufacturing, while Canadian exporters could also face headwinds. In terms of industries most at risk, manufacturers with integrated North American supply chains (autos, industrials, machinery, electronics, agriculture) could face higher costs and supply chain disruptions.

Tight spreads, record supply…should we be worried about the credit markets?

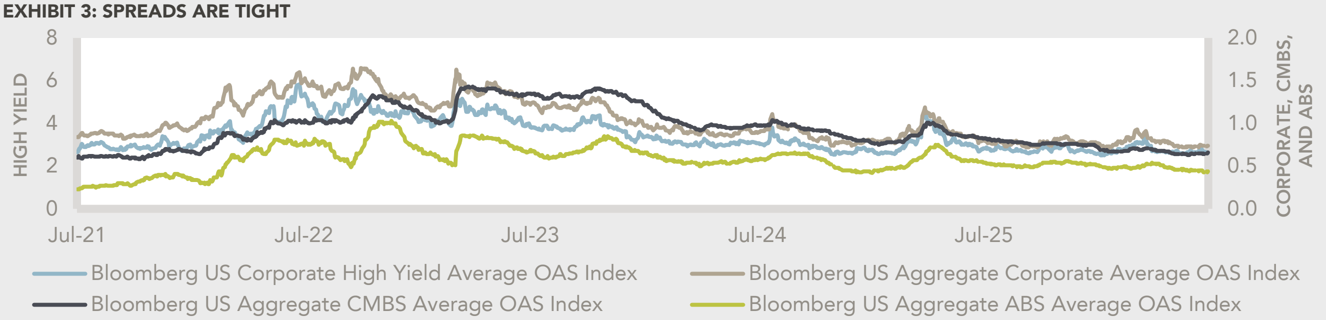
Corporate spreads are very tight. Historically, 100 basis points ("bps") was considered tight but other than the Unemployment Flash, Tariff Tantrum, and the Iranian Strike, the market has traded inside of 100 for the last 2.5 years. It currently sits at 73 bps, 2 bps wider than the multi-decade low. High yield has moved in lockstep with investment grade ("IG") and is currently at 260 bps. Compounding the issue is record supply. Normally, high issuance would lead to wider spreads. However, the market has easily digested $1.14 trillion in IG corporate bond issuance. The theme of 2026 has been jumbo deals with transactions from Amazon, SpaceX, NVIDIA, Meta, Salesforce, and Oracle, but the market is starting to reach its limit. Amazon went to the market for the second time this year for another $25 billion (first was $37 billion), but it was only 1.6x oversubscribed (a steep drop from four months ago and well below average).

EXHIBIT 2: U.S. DECIDES AGAINST RENEWING USMCA TRADE DEAL



Source: U.S. Census Bureau data compiled by Bloomberg Economics as of April 30, 2026 (most recently available). Customs value of goods imported for consumption.

EXHIBIT 3: SPREADS ARE TIGHT



Source: Bloomberg as of July 8, 2026

Increased discretion is warranted in tight spread environments. Generic aggregate managers are duration neutral and overweight corporates. Over time this should lead to outperformance, but the tight level of spreads is limiting the excess performance opportunities. To date, the record volume of issuance has not been disruptive to spreads and fixed income performance, but the dynamic bears watching. Not only for the impact to fixed income, but for the historically positive correlation between credit spreads and equities, which offer several trends we are following.

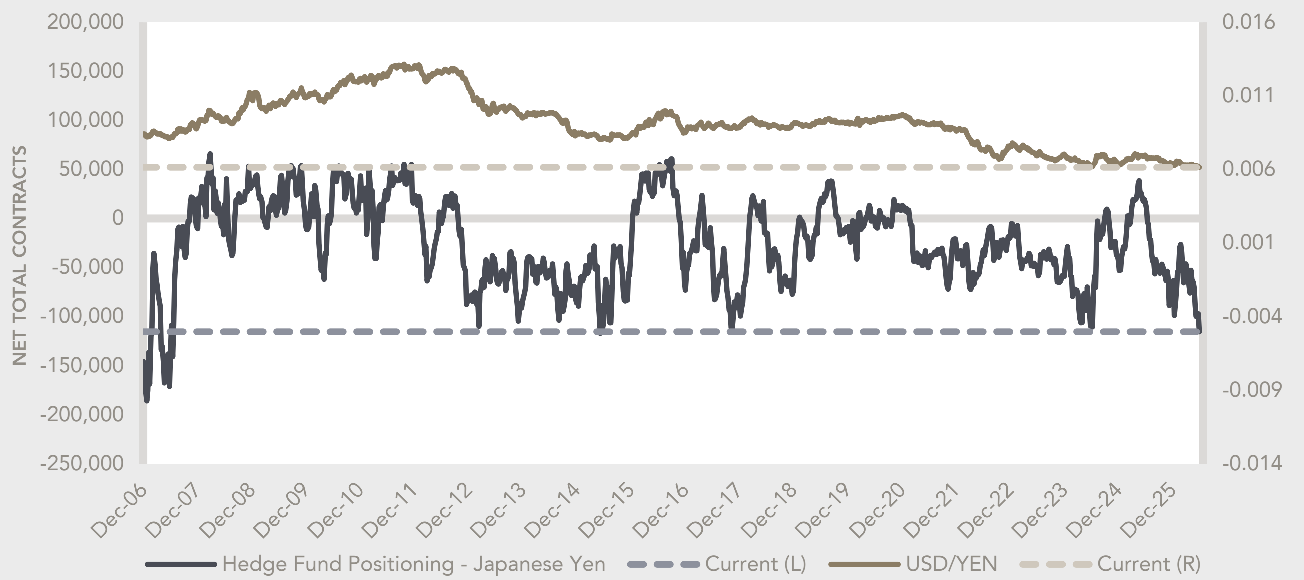
Keep your eye on the Japanese yen

Investors continue to fund investments by borrowing cheaply in yen (at multi-decade lows vs. the U.S. dollar) and investing in higher-yielding assets elsewhere (known more commonly as the yen carry trade). At this point there is no indication that the yen will unexpectedly appreciate, but current crowded positioning around this strategy creates the possibility of a disorderly unwind should the trade abruptly reverse. Past unwind episodes have historically produced sharp increases in market volatility and broad risk-off behavior as leveraged investors were forced to rapidly reduce positions across global equities, credit, and emerging markets to repay yen borrowings. Markets most exposed to leverage and momentum — particularly large-cap technology stocks — could face the most pressure during an unwind. Japanese monetary policy normalization or declining U.S.–Japan interest rate differentials could act as catalysts for a stronger yen. Recent hedge fund positioning *(see Exhibit 4)* suggests that markets are at least recognizing the crowded dynamic of the trade and although the unwind of the yen carry trade is not the base case, investors should recognize that seemingly isolated currency moves can quickly become global liquidity events.

AI market rotation

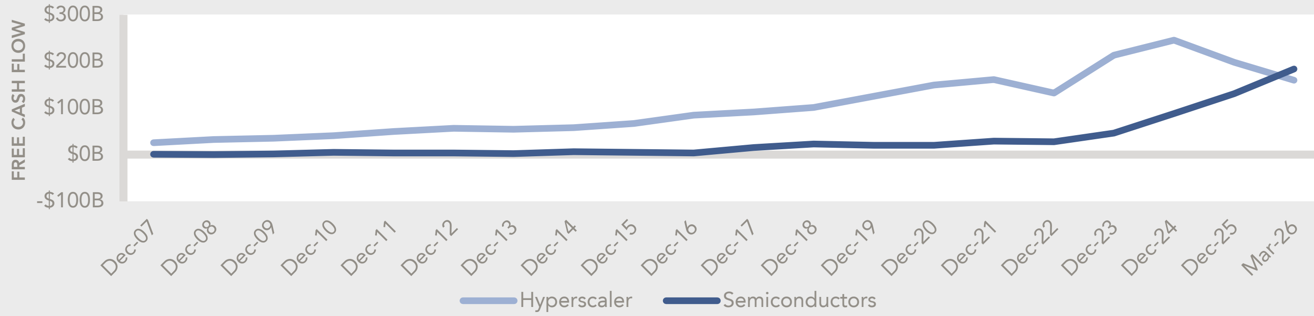
Hyperscalers are projected to spend over $600 billion on AI infrastructure in 2026, with some forecasts putting 2027 spending as high as $1.1 trillion. This level of spending has been a massive tailwind for the chip, memory, and networking suppliers on the other side of those contracts. Not surprisingly, semiconductor stocks have dramatically outperformed hyperscaler stocks, with AI chip and memory makers outperforming almost continuously since last September.

EXHIBIT 4: HEDGE FUNDS INCREASE SHORT YEN POSITIONS



Source: Bloomberg, CFTC as of June 30, 2026

EXHIBIT 5: THE RECENT AI MARKET ROTATION



Source: FactSet as of March 31, 2026. Hyperscalers: AMZN, GOOGLE, META, MSFT, ORCL. Semiconductors: NVDA, MU, AVGO, AMAT.

Both groups carry heavy weight in the S&P 500 so this back-and-forth rotation may produce more sideways churn than a clean broad rally, since gains in one group partly offset losses in the other. Over the long-run, however, this performance gap between AI chipmakers and hyperscalers is unsustainable. Hyperscalers are the ultimate demand source for chips, and if the chip layer keeps extracting an ever-growing share of the value being created, it erodes the profitability of its own biggest customer base. This dynamic will not persist without either the downstream players catching up or the upstream players eventually feeling the pullback. There appears to be two possible outcomes that close the gap:

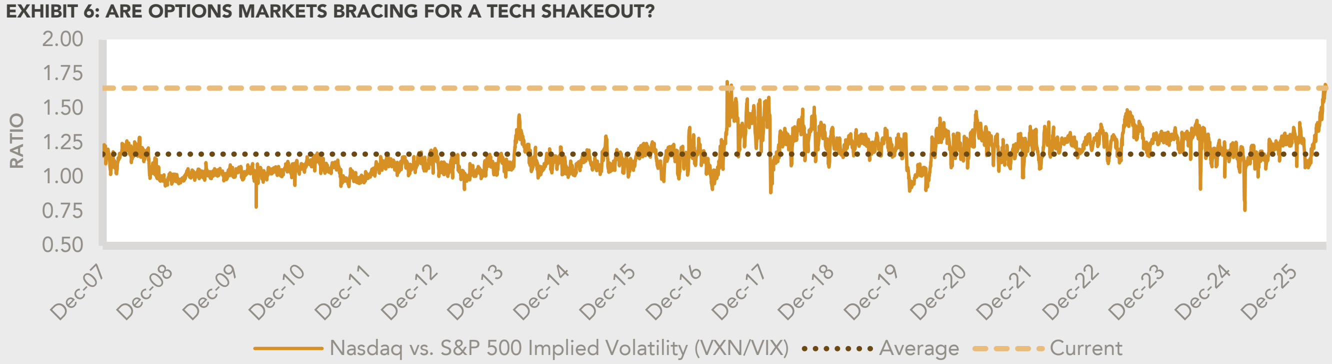
- Hyperscalers improve AI monetization and catch up;
- Continued semiconductor outperformance depresses hyperscaler capex intentions and eventually becomes a headwind for chip demand itself.

These dynamics undoubtedly contribute to the next trend we are watching:

Pricing on tech options

The relative implied volatility on Nasdaq options has risen to multi-year highs as the market is pricing greater uncertainty around AI-related earnings expectations and valuations. This concern was further manifested by the outperformance of value stocks over their growth counterparts in the first half of the year. As discussed ad nauseam in prior letters, technology leadership has become increasingly concentrated, making broad market indices more vulnerable if a few large AI companies disappoint. A correction in AI leaders could spread beyond technology given their large index weights and influence on investor sentiment. The divergence between strong market performance and expensive downside protection suggests investors remain invested but are increasingly concerned about tail risks rather than expecting an immediate bear market.

EXHIBIT 6: ARE OPTIONS MARKETS BRACING FOR A TECH SHAKEOUT?



Source: Bloomberg, Apollo as of June 30, 2026

However, this is not the only evidence of growing concern around current market sentiment.

Margin debt levels continue to climb

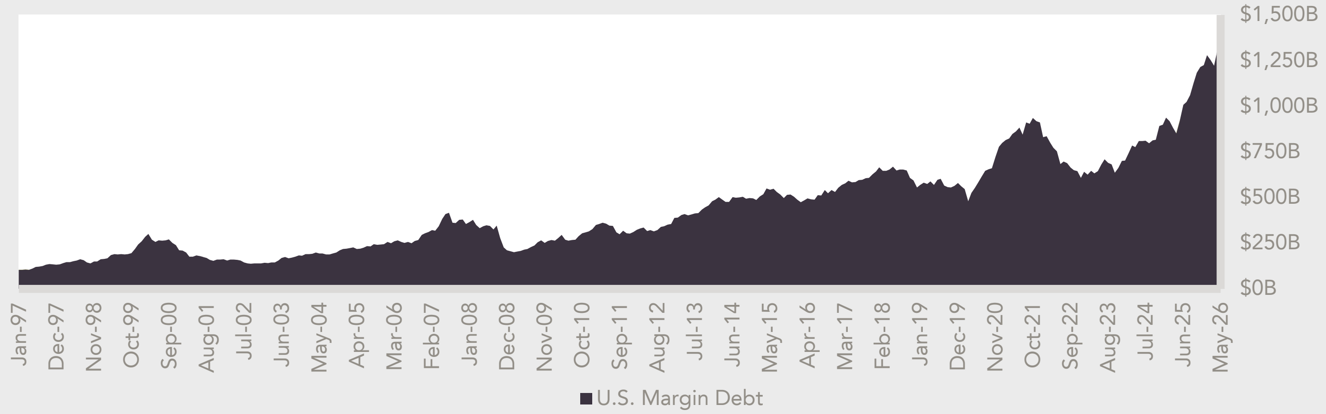
Margin debt rose for a second straight month in May, reaching a new record high of $1.42 trillion, an 8.5% increase from April and a 54% rise compared to the previous year. Generally regarded as a measure of investor sentiment and risk appetite, high levels can signal confidence but extreme spikes may also indicate excessive speculation, increasing the risk of market instability.

Leverage magnifies downward price movements just as it accelerates gains, and if account equity falls below maintenance requirements, brokers issue margin calls that force investors to sell stocks to cover them. Historically, this is a lagging indicator that shows the market is turning and rising margin debt usually just tracks bullish sentiment and rising markets. But the rate of increase and the level relative to current market performance is worth monitoring should we see an uptick in margin calls.

Don’t forget about China and India

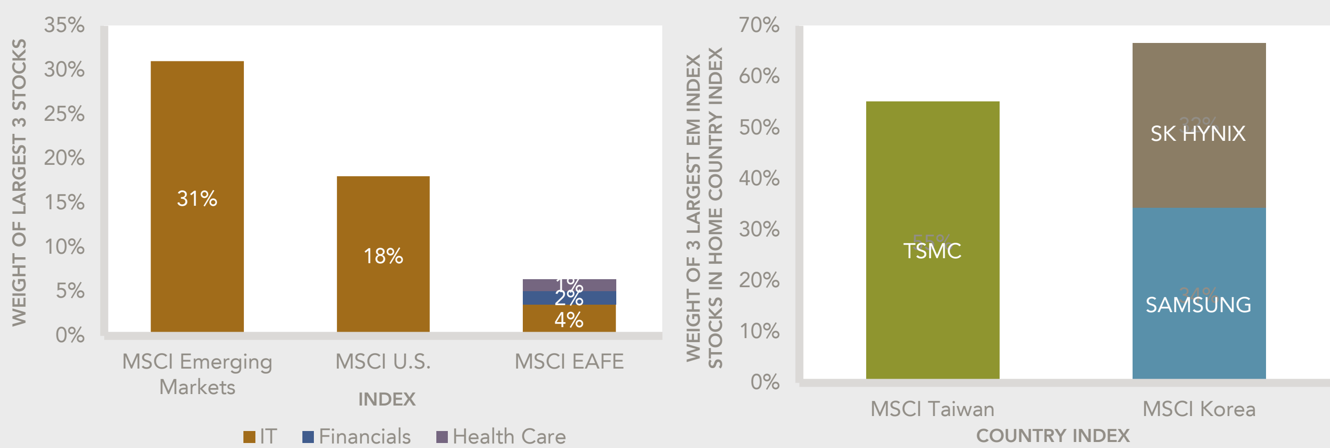
Emerging market (“EM”) returns are undeniably strong but have been driven by Taiwan and South Korea. The index is becoming less diversified as the largest tech names dominate the index, but there are differentiated sectors in other EM countries that offer diversification from the AI and semiconductor giants.

EXHIBIT 7: MARGIN DEBT AT AN ALL-TIME HIGH



Source: FINRA as of June 30, 2026

EXHIBIT 8: CONCENTRATION IN EM EQUITIES



Source: MSCI as of June 30, 2026

China continues to battle some pervasive macro issues but is a hub for technological innovation (think factory automation, electrification, biotechnology). India offers domestic opportunities in infrastructure buildout and economic growth (especially demographically when looking at the growth of middle class consumers). Though less impactful today on index performance, these two countries are still meaningful weights and positive performance from these countries is good for the overall asset class, particularly if there is a rollover in the AI and semi space.

No need to panic

None of these data patterns are meant to scare our readers, but the overly impressive returns we have seen out of equities since 2022 will not continue in perpetuity. Whether it be vacillations in dollar strength or elevated short yen positions, the topics discussed here — particularly movements to the downside — offer insight into the direction of markets. We all know it is impossible to predict what markets will do, but the trajectory of these variables coupled with the usual headline items mentioned in the introduction should give investors sufficient insight into portfolio performance for the rest of the year.

Until next time,

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