

Re: The Fog of War

*Warmer
to Your Team!*

Having begun the year with the economy on relatively strong footing, the unexpected attack on Iran by the United States and Israel on February 28th sent shock waves around the globe. Less than one week before the attacks the U.S. and Iran had already completed two rounds of indirect talks in Geneva and were preparing for a third when the Iranian Foreign Minister, Abbas Arachchi, announced that Iran and the U.S. had a “historic opportunity to strike an unprecedented agreement that addresses mutual concerns and achieves mutual interests.” So much for diplomacy. A few days later the U.S. and Israel began a military campaign referred to as Operation Epic Fury. While there were conflicting statements about goals of the campaign at its onset, the objectives now appear to be: (1) ensuring that Iran never acquires a nuclear weapon, (2) destroying Iran’s missile infrastructure, (3) degrading the Iranian navy and air capabilities, (4) ensuring that Iran could no longer arm and fund proxy armies in the region, and (5) creating regime change. At the time the fragile ceasefire was announced on April 7th, the President and Defense Secretary both declared that all of the goals were achieved. However, any objective assessment would suggest that only a few of the five objectives were achieved, and instead of regime change, we may end up having to deal with an even more hardline and ideological set of leaders within the same regime led by the very son of the Supreme Leader the U.S. and Israel killed in a joint operation at the beginning of the war.

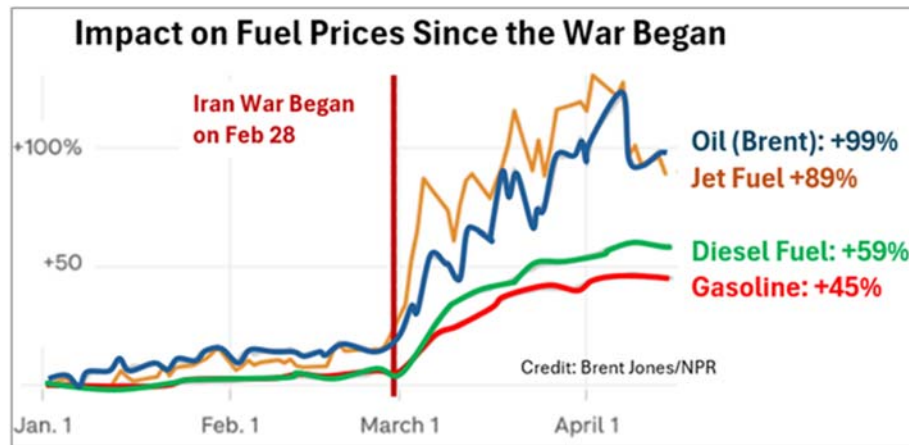
While the outcome of the war remains in doubt, what we do know is that the Middle East has been cast into turmoil with uncertain long-term implications. We also know that the global economic outlook has deteriorated significantly given the energy price shock due to the virtual closure of the Strait of Hormuz which we have now become all too familiar with. As we have learned, the Strait is a



critical chokepoint between Iran and Oman through which about 20% of the world’s oil and liquified natural gas transits through originating from Iran, Iraq, Kuwait, Qatar, Saudi Arabia, and the UAE. In addition, about one-third of the world’s fertilizer passes through the Strait. Roughly 3,000 ships transit through the

Strait each month. The closure not only impacts U.S. gasoline and oil prices but also impacts fertilizer supplies for U.S. farmers which may lead to higher food costs for U.S. consumers. (March’s inflation report from the Bureau of Labor Statistics indicated that inflation jumped to an annualized rate of 3.3%, driven largely by a 21% spike in gasoline prices and a 40% surge in diesel fuel as a result of the war. The impact on food prices has yet to be measured.)

At the time of this writing, despite a brief reopening, Iran reimposed control over the Strait in retaliation for the U.S. Navy’s blockade on Iran’s ports. The U.S. seized an Iranian ship on April 20th which attempted to pass through the blockade. All of this puts the fragile ceasefire and scheduled negotiations into question. In any event, passage through the waterway will remain treacherous until a broader agreement between the U.S. and Iran is reached (stay tuned). So far, the closure is considered the largest oil supply shock in history even surpassing the severe 1973 Arab oil embargo. While the impact on fuel prices including gasoline and diesel fuel has been steep, the cost of jet fuel has risen even more dramatically. Even if a peace deal is struck and the Strait is reopened immediately, it is estimated that it may be as many as six months for global supply chains and energy supplies to return to normal.



Consumer Sentiment Hits a 45 Year Low

The humanitarian cost of the Iran war and related fighting in Lebanon has been devastating for the civilian population across much of the Middle East. Thousands of lives have been lost, millions of people have been displaced, and the estimated property damage may exceed \$20 billion. For the U.S., 13 service members have

lost their lives and the war's cost to taxpayers is estimated to be \$50 billion so far (the Pentagon asked for \$200 billion in supplemental funding in late March). For U.S. consumers, the war's repercussions have only made life more difficult. The most recent Consumer Sentiment Index published by LSEG Data and Analytics indicates that consumer sentiment reached a 45-year low given widespread concern about inflated prices, affordability factors, employment security, and confidence in the future. The chart below indicates that consumer sentiment had almost fully recovered back to normal levels following the Great Recession (green line) but took a sharp downward plunge during the Covid pandemic when inflation soared to 9% and consumers were suddenly faced with higher costs for consumer goods, energy, and housing. While the rate of inflation subsided considerably between June of 2022 and early 2025, consumer prices began rising once again given the impact of tariffs, and most recently due to the sudden spike in gasoline and energy prices resulting from the war. Consumer sentiment has essentially been on a downward trend for the past six years. There are three lines in the graph below which measure the following:

- Consumer Sentiment: How confident people feel about their personal financial situation and the broader economy.

- Current Conditions: How consumers feel about their current finances and confidence in making major purchases or investments.
- Expectations: Consumers' six-month outlook measuring their confidence in the economy, their personal finances, and employment prospects.

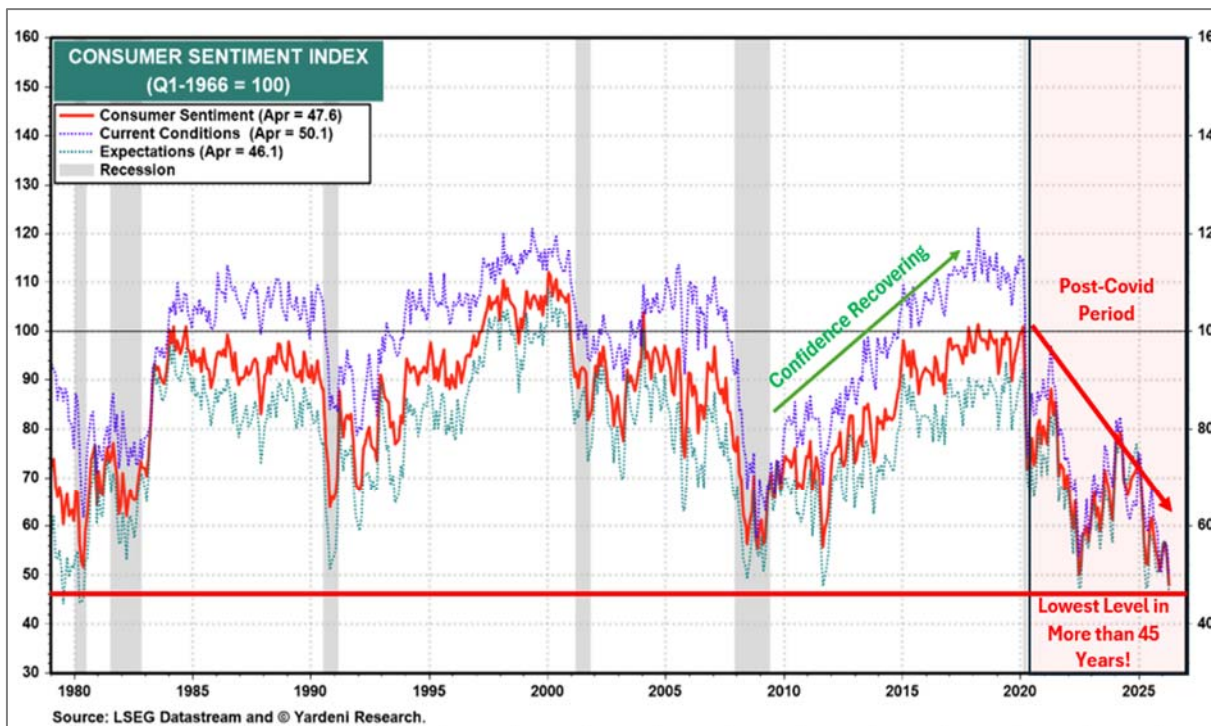
The bottom line is that consumers appear to be exhausted and discouraged by economic anxieties resulting from persistently high prices and reduced purchasing power (the political divide in the U.S. is surely a contributor to the consumer's angst).

Recession Risks Rising

Consumer spending accounts for approximately 70% of the United States' Gross Domestic Product (GDP), and about 60% of global economic growth. Given the pessimistic outlook by consumers, the odds of an economic recession have increased markedly since the war broke out. Bear in mind that recessions have been relatively common events throughout history occurring about once every 6 or 7 years. The most recent recession was the very brief Covid pandemic downturn in 2020, and before that the 2007-09 Great Recession which was the most severe economic downturn since the Great Depression. In the past,

recessions were triggered by various causes including sudden supply shocks (e.g., oil price spikes), aggressive interest rate hikes by the Federal Reserve, banking crises, the bursting of stock market bubbles, and sharp drops in consumer confidence. Several of these triggers appear to be risks the economy is presently facing.

Note on the Consumer Sentiment Index graph to the left that falling levels of sentiment often precede or at least accompany recessions which are indicated by the gray shaded columns. On the other hand, there are glass half full indicators, including strong corporate earnings, a steady labor market, and a surprisingly strong stock market. Ironically, while consumer sentiment is at an historic low, overall consumer spending appears relatively strong which might be attributable to the stock market's wealth effect which disproportionately benefits high income earners (the top 10% of earners account for approximately 50% of U.S. consumer spending). It is doubtful that the economy will remain healthy if just the top 10% are doing well while the other 90% are feeling the pain of high consumer prices and affordability.



Outlook for Global Economic Growth

The outlook for the global economy over the next twelve months appears to hinge upon the duration of the conflict, how long the Strait of Hormuz remains closed, and the future price of oil and gas. The International Monetary Fund (IMF) published its latest economic outlook report entitled, “War Darkens Global Economic Outlook and Reshapes Policy Priorities.” The IMF ran three scenarios: “reference,” “adverse” and “severe.” The “reference” being a quick end to the Middle East hostilities, the “adverse” being an end within a few months with oil prices nonetheless remaining at or above \$100 per barrel for the remainder of the year, and the “severe” being one in which the war lasts until early 2027. Even in the best-case reference scenario inflation would be expected to climb above 4%, causing slower global growth, but avoiding a recession. The “adverse” scenario sees inflation rising above 5% which might suggest a mild recession, while the “severe” scenario sees inflation rising closer to 6% with an even deeper economic downturn. Several economists we follow would take issue with the IMF’s gloomy scenarios, but as financial planners and investment advisors for our clients, our role is to consider both the pessimistic and optimistic outlooks.

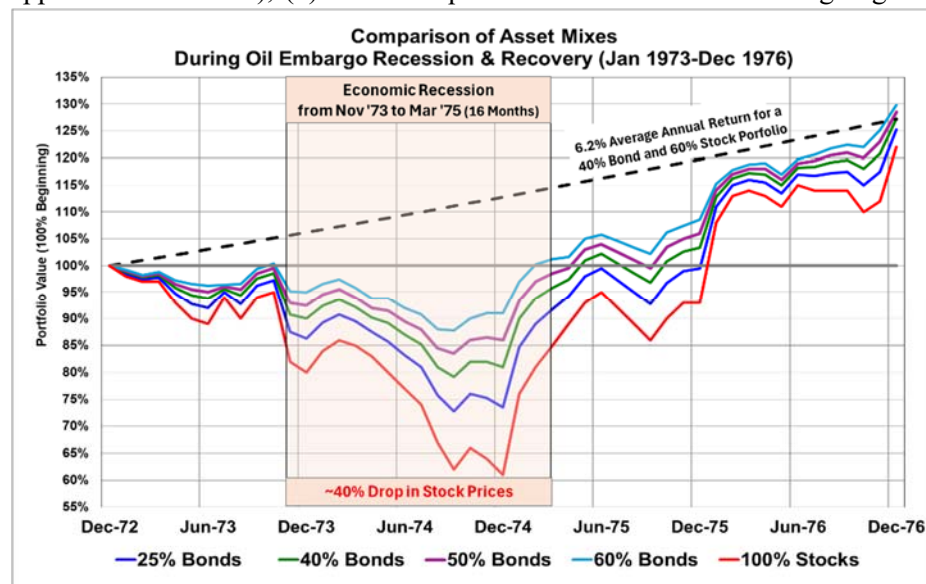
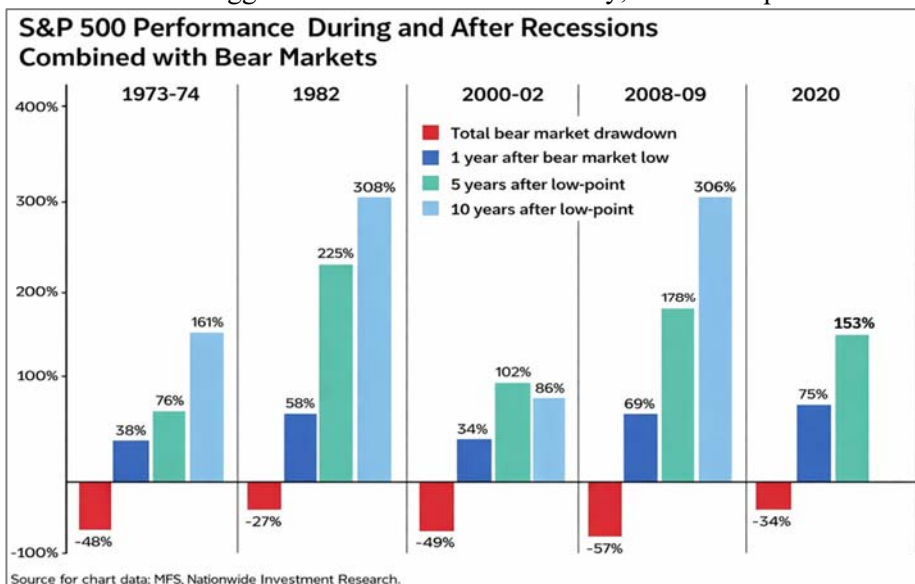
Odds of a Recession?

In late January, the odds of a recession were quite low (about 20%) according to several economists we follow and the prediction markets. After the war broke out, the odds spiked to 35% by late March. Given the recent ceasefire and ongoing negotiations (hopefully), the odds have settled back down to just above 25%. While these odds suggest that a recession is unlikely, the full impact of the oil

price shock has yet to materialize beyond the immediate spike in energy costs. The broader economic impact on inflation and consumer demand may take several more months to develop. (Economists had hoped that the April tax refunds for the average consumer would boost economic growth, but it now appears that those refunds might be needed to offset higher energy costs.)

What If We Have a Recession and Bear Market?

Probably the worst-case scenario for investors would be if the economy falls into a recession and stocks end up in a bear market which is defined as a price decline of 20% or more (some pundits were warning of a bear market even before the Iran war broke out). The bar graph at the bottom left indicates the 5 instances over the past 53 years when a recession occurred in combination with a bear market. The red bars measure the stock market’s decline from peak to trough, with the next three bars indicating the subsequent 1, 5 and 10-year cumulative returns after the low points. The bad news is that it was extremely painful for investors to see their stocks drop by an average of 43%, but the good news is that stocks recovered much of the loss within the subsequent year, and in 4 out of 5 instances their stock values fully recovered after 5 years. Even better news is that balanced portfolios, i.e., a combination of bonds and stocks, experienced significantly better performance during all 5 instances. A good example of how diversification helps mitigate stock market downturns is illustrated in the graph below which indicates how stocks and balanced portfolios fared during the 1973-74 Oil Embargo recession and bear market which was triggered by several eerily familiar sounding catalysts: (1) the 1973 Arab-Israeli War in the Middle East (a.k.a., the Yom Kippur/Ramadan War), (2) the subsequent 1973-74 Arab Oil Embargo against



the U.S. and other nations who supported Israel, (3) a spike in energy prices and rising inflation, and (4) extremely high stock market valuations, especially for the concentrated group of Nifty Fifty stocks within the S&P 500. (These 50 stocks, which included names such as IBM and Xerox, were highly regarded large-cap growth stocks which investors became enamored with given their historic earnings growth and price appreciation. During the recession and bear market of 1973-74 the prices of these highflyers plunged much further than the broader stock market, comparable in many respects to how internet-based stocks suffered during the recession and bear market of 2000-02.)

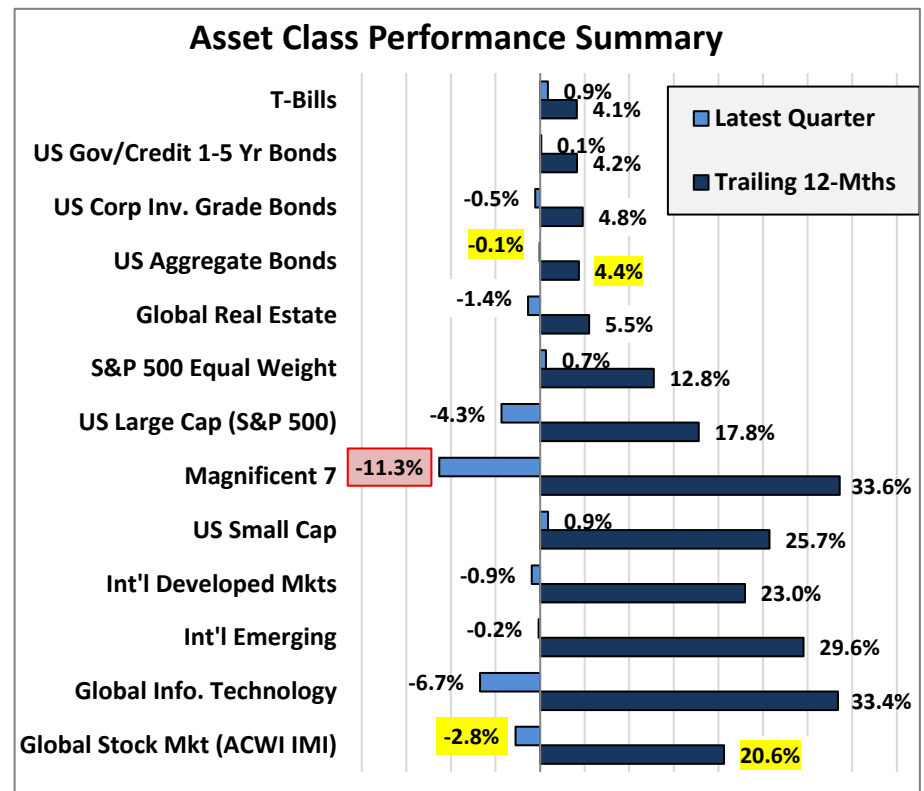
Of course, there are numerous differences between 1973 and today, but our message is that even in such a severe bear market, highly diversified balanced portfolios lessened the downside and recovered much more quickly. For instance, a 100% stock portfolio (the red line in the graph on the previous page) which underweighted the Nifty-Fifty stocks and diversified more broadly across an array of asset classes fell by 38% rather than the 48% drop in the S&P 500 between January of 1973 and September 1974. And even more impressive, a 50% bond and 50% stock portfolio (purple line) fell by a relatively modest 17% and fully recovered by March of 1975 (just six months from the low point). In contrast, a 100% stock portfolio did not fully recover until January of 1976 (28 months from its low point). The major lesson learned was that investing in an appropriately balanced mix of bonds and stocks significantly reduced downside portfolio risk. And by underweighting the most expensive stocks (i.e., the Nifty Fifty) and diversifying across a wide array of global asset classes with tilts toward smaller companies and value stocks, investors recovered from the 1973-74 bear market much more quickly. These same strategies also worked well for investors in the four other combined recessions and bear markets over the past 53 years, including the two most severe downturns (the 2000-02 Internet Bubble Burst and the 2008-09 Great Recession). We believe these time-proven strategies will continue serving investors well in the future.

Asset Class Performance (Stocks Have Been Climbing a Wall of Worry)

Despite all of the aforementioned concerns and risks, the global stock market has nonetheless been “climbing a wall of worry” and posting surprisingly strong returns. Perhaps investors are assuming the war will end quickly, consumer confidence will improve, and corporate earnings will continue on a positive trajectory. For the trailing twelve months, every major asset class and sector included in the Asset Class Performance Summary to the right generated extraordinary returns. The U.S. Aggregate Bond Index was up by 4.4% while the Global Stock Market gained 20.6% (in contrast, looking forward over the next 10 years, the expected annualized return for a globally diversified stocks based upon

current valuations is a comparatively meager 6.1%). The returns for the other stock asset classes ranged from 5.5% (Global Real Estate) to 33.6% (the Magnificent 7), with Global Information Technology stocks close behind (33.4%). International Developed and Emerging Markets stocks gained 23% to 29.6% respectively. U.S. Small Cap stocks gained 25.7%, the S&P 500 Index gained 17.8% and the S&P 500 Equal Weight Index gained 12.8%. Within Fixed Assets, U.S. T-Bills gained 4.1%, U.S. 1-5 Year Gov’t/Credit Bonds gained 4.2%, and U.S. Investment Grade Bonds gained 4.8%.

For the latest quarter, the returns across the board were largely flat with the exception of the Magnificent 7 stocks which declined by 11.3%. The two indices which include the Magnificent 7 were also down, i.e., the Global Information Technology Index was down by 6.7%, and the S&P 500 Index fell by 4.3% (Magnificent 7 stocks comprise about 45% and 35% of the market capitalization of these two indices respectively). Perhaps we are beginning to see some weakness in the Magnificent 7 whose valuations remain elevated relative to the broader stock market. For example, the Forward P/E Ratio of the Mag 7 stocks is now about 26x earnings compared to 20.6x for the S&P 500, 16.8x for the S&P 500 Equal Weight Index, 14.4x for U.S. Small Cap stocks, 13.8x for non-U.S. stocks, and 12.2x for U.S. Small Cap Value stocks.



10-Year Return Expectations Update

We have updated the 10-Year Future Rate of Return Forecasts for many of the major asset classes as well as various mixes of bonds and stocks (the returns are calculated by Research Affiliates with the returns for Equities based upon the Nobel Prize winning research of Robert Shiller). The estimates for Diversified Bonds and Inflation reflect various economic assumptions, including the Fed’s monetary policy goals. The Magnificent 7 stocks are contained within the overlapping US Large Cap (S&P 500) and US Large Cap Growth sections of the market which largely explains their low expected returns of 3.5% and 1.9% respectively. These returns assume that the current U.S. Large and Large Growth stock valuations are unsustainable and will revert, or correct, to their lower historical average Price-to-Earnings levels. At the opposite end of the size

spectrum are U.S. Small Cap Value stocks which are tied with Non-U.S. Developed Markets stocks with the highest expected returns of 7.7%. Global Equities aligned with our model portfolio’s weights have an expected average annual return of 6.1%. Balanced Portfolios of various asset mixes have expected returns of between 5.6% and 6%. We continue to believe that underweighting the most expensive stocks, in this case the Magnificent 7, and tilting the portfolio toward stocks with lower prices will provide much broader diversification and the potential for higher long-term returns.

10-Year Future Annual Rate of Return Forecasts as of 03/31/2026		
	10 Year "Expected" Return	Risk Level (Standard Deviation)
Equities		
US Small Cap Value	7.7%	19.1%
Non-US Developed Markets	7.7%	16.2%
Emerging Markets	7.3%	19.7%
Global Equities Mix	6.1%	15.8%
US Small Cap Growth	5.8%	22.1%
US Large Cap Value	4.2%	15.0%
US Large Cap (S&P 500)	3.5%	14.9%
US Large Cap Growth	1.9%	17.1%
Fixed Assets		
Diversified Bonds	4.8%	2.6%
Cash (Money Market Funds)	3.5%	0.7%
Balanced Portfolios		
20% Fixed - 80% Equities	6.0%	12.8%
40% Fixed - 60% Equities	5.8%	9.9%
50% Fixed - 50% Equities	5.7%	8.4%
60% Fixed - 40% Equities	5.6%	7.0%
Inflation	2.6%	NA

In Closing - The Imperative of Hope

Given the world’s rather foggy and gloomy state of affairs, and particularly the seemingly never-ending conflict in the Middle East, it was encouraging to learn of the work of two ambassadors of hope, Aziz Abu Sarah and Maoz Inon who lead the non-profit organization InterAct. Before the Hamas-led attack on Israel on October 7, 2023, Aziz, a Palestinian, and Maoz, an Israeli, had been involved

in the tourism industry in their respective homelands operating agencies which aimed at fostering intercultural understanding. They had a business connection previously, but the Hamas-led attack changed everything. Inon’s parents were among the more than 1,100 people killed in the attack. His Palestinian acquaintance, Aziz, who lost his brother at the hands of the Israeli military several years before, immediately reached out to Maoz to offer his condolences and support. In an interview with NPR, Maoz said, “I lost my parents on Oct. 7, but I won a brother.” Aziz and Inon put aside ideas of anger and revenge in dealing with their trauma and losses and, instead, decided to set an ambitious goal of creating Israel-Palestinian peace within the next five years. (They recently published a highly acclaimed book entitled; *The Future is Peace: A Shared Journey Across the Holy Land.*)

From their website (www.iinteract.org), “Under the leadership of Aziz Abu Sarah and Maoz Inon— both carrying the weight of personal tragedies inflicted by the Israeli-Palestinian conflict - they have turned personal loss into a powerful commitment to unity. Rather than succumbing to hate, both Aziz and Maoz transformed their pain into a commitment to peace and activism. Their bond is an example of what is possible. Through InterAct, they have amplified efforts to promote dialogue, empathy, and mutual understanding, working toward a future where Israelis and Palestinians can coexist in peace and dignity.”

Last May, Aziz Abu and Inon met with Pope Leo XIV during the 2025 Arena of Peace initiative which focuses on building peace from the ground up through local institutions, education, and social networks. Their discussion with the Pope focused on their five-year goal of creating Israel-Palestinian peace.

We will close with an excerpt from Pope Leo XIV’s recent prayer for peace entitled, *Enough of War!* “War divides; hope unites. Arrogance tramples upon others; love lifts up. Idolatry blinds us; the living God enlightens. My dearest friends, all it takes is a little faith, a mere ‘crumb’ of faith, in order to face this dramatic hour in history together—as humanity and alongside humanity.” Amen.

