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April 1, 2026

World Class Roadblock

While the conflicts in the Middle East and Iran plod along at an excruciatingly slow pace, we are maintaining our projection of a rise in inflation and a diminution in profits indefinitely, roiling the markets, if it hasn't happened already. Consumer sentiment makes it clear that an elevation in costs, combined with a slowdown in the energy supply lines, are at the heart of a pullback in discretionary spending and GDP output. Already, several government spending initiatives have been throttled back or eliminated entirely (see Agriculture, Energy, Education, Transportation etc.). Tariffs and taxes are eroding hard earned increases in wages and portfolios. Just taking the cost of food and fuel alone, the rate of inflation could top out several percentage points higher than today within months.

This is cause for alarm for the monetary authorities that are now digesting the bad news, regressive to the gains already made after the Covid pandemic. Perhaps forced to raise rates to stem nascent inflation pressures, central banks are poised with one foot on the accelerator and one foot on the brake... not an ideal situation. By their own admission, bankers are rethinking their growth projections for the global economy. Everyone remains in perpetual limbo waiting to see which side of the military conflict blinks first, and to what degree it really matters at this juncture. Any rise in interest rates will tighten the collar on an already unsteady recovery.

Recall how only 18 months ago we were talking about an economic renaissance in a post-pandemic marketplace. Once again, the words "New Paradigm" were all the rage driven by technology and a balance sheet flush with cash. Despite a profusion of euphoria and demand, the real data was muted somewhat by a cautious Federal Reserve. Nevertheless, investors forged on, producing one of the most expansive market recoveries of the last century. In doing so, however, they laid the groundwork for a capitulation off of the highs that only exposed the "emperor's clothes": *you can't build a functioning stock market and economy on hyperbole, greed, and cheap money alone.*

Though some might argue that the recovery was monumental, let's remember that *profitability and demand* are the real core drivers of economic growth. Build a better mousetrap and they will come. Today, we see a reduction in demand and equivocation about all the hype laid on us by the government's cheerleaders. Instead, core consumer prices have become profit killers and a most glaring example of how to stall a rally in mid-stream. Leadership out of this morass will not come from AI or new paradigm technology but, rather, from core businesses in the Industrial, Consumer, and Energy sectors. We are paying a heavy price for the exhilaration of the "tech-bros" who seem to believe that you can click and program your way out of any problem.

Investors are scared and burned by the wealth effect that rewards the war profiteers while at the same time starving the underclass out of home, health, and job security. Until purchasing demand returns, the combination of unemployment, high interest rates, and eroding supply chains will be a triple-edge sword that mutes capital expenditures in the home and corporate boardroom. Real economic growth rates will be subordinated to global warfare and years hence of unsubstantiated or unprovoked territorial incursions. Consider this: free and unabated global trade is, at the very least, a significant indicator for later-years' Gross Domestic Product (GDP). While these data, alone, have no unique quantitative impact, their relationship to future consumer demands is unquestioned. In that context, prognosticating about the future is much more difficult today than 6 months ago.

Markets

One of the strategic fallacies that so often ruins investor's likelihood for portfolio success is being short-sighted regarding goals and/or performance analysis. Broadly speaking, most investors look at their monthly statement (or their annual return) and extrapolate about the success, or failure, of their investment strategy/methodology and their money manager. While instructive, these short-term metrics can be misleading as they only account for a snapshot in time of the data.

More importantly, however, is the consideration and quantification of *trendline data*...more specifically, what we call stochastic integers. These numbers provide the analyst with time-series quotations as to the magnitude and amplitude (duration) of the direction in which a security, sector, or economic phenomenon is moving. Typically, these mathematical secular evaluations take time to unfold and, in so doing, allow the observer to smooth out any anomalies within the overall economic cycle.

By comparing the ratios of these time series to others in an historical context the investor can more easily understand, and navigate, intermittent volatility without distortion from one-off events.

Just one month ago, the Dow Jones was nearly ten percent higher than today. We had been in a period of unusually high stochastic valuations across most asset classes and sectors. In fact, the last time I witnessed (trend) valuations that high was in the mid-to-late 1990's, just prior to the real estate and dot.com bubbles. The Iran war effectively wiped out those hard-won gains, and more. This is not to suggest that we are on the cusp of another colossal capitulation, only to acknowledge the historical significance of where we are in today's market thinking.

Because of those elevated relative strength numbers 30 days ago, and the disastrous reaction to the war afterwards, we can make several assertions about why and what caused the demand for valuations to rise to such an extraordinary level, and why today those reasons might be suspect... First, the post-Covid buying surge in equities, combined with the inordinate amounts of balance sheet cash (corporate and household) built up during the time of lockdown, scaled up the demand for product. Corporations coming out of the lockdown were looking to make strategic productivity investments, while consumers were just looking to make up for lost time spent isolated at home. The “next generation” of wealth, created by innovation and demand, ramped up stock market activity in the last five years like none in any five-year period prior.

These innovation advancements fueled the rise in stock valuations. It also, unfortunately, laid the groundwork for unrealistic short-term expectations about earnings growth. But how likely is/was it to expect the growth in stock earnings to generate a commensurate rate of price acceleration, widening P/E ratios beyond sustainable norms, particularly during a time of war and global uncertainty? There’s only so much capital to go around, and only so many persons to feed those expectations.

Strategy

If you look at these figures in isolation you might be convinced that this is, in fact, the tipping point. But, here again, short-term time series assessment is misguided. Many of the largest corporations in the world are just getting started on their AI technology investments for the future. In context, their price-to-earnings ratios are historically modest. One might conclude therefore that there are profits and expenditures not yet realized in certain segments of the economy. This, then, is where prudent asset allocation becomes most important.

Diversifying amongst sectors by overweighting durable businesses and underweighting the laggards is a way to mute unrealistic expectations and to insulate against exogenous noise that weighs down the “*24-hour here and now*” perspective that too many investors cling to.

The underlying resiliency of the global economy is something we believe in. On the surface, things look extraordinarily bleak right now. Tariffs and geopolitical tensions weigh heavily on the mind...and wallet. Inflation risks are punctuating almost every discussion about earnings growth and product demand. We know that the underlying fundamentals had been quite strong up until the Iran conflict, but the margin for error is quite slim. As a result, there is widespread apprehension about where this all ends and how the next few years might remediate this bump in the road.

We expect that global growth will recede before it gets better. Inflation will wreak havoc on consumer’s pocketbooks, particularly in foodstuffs, housing, and energy. The peril of uncertainty is pervasive, and clouds one’s ability to plan for the long-term. All these things, taken in sum, weave an uncomfortable tapestry of stress-related reactions. But just like bull markets, bears have a timeline too and will reverse course in due time. Of that we can be certain.

Conclusion

Vulnerability is a costly thing for the markets. Because there is no real measurement for “distress”, we can only surmise what things might put the genie back in the bottle. What we do know is that concentrated wealth in the hands of a few is not a homogenous way of rekindling broad-based confidence in wealth building. We’re either all in this together or we’re not.

The outlook for the next quarter, and beyond, is not *strategic*...it is *survival*. It is critical that we as portfolio managers allocate investment resources based upon earnings sustainability and capital preservation. Our core sectors for this quarter include **Basic Materials, Technology, Energy, and Consumer Durables**... a large blending of recognizable trends and consistent performers, good times and bad. Nevertheless, it is a defensive assessment that dominates our near-term trend analysis.

Trying to be *innovative* or *unique* in a market absorbed by current events and uncertainty is not worth the effort or risk of being wrong and having to make up for valuation misjudgments later. In due time, every trend, good or bad, expires and reverses course. History tells us so.

Suggested Balanced Account Asset Allocation, Q2, 2026

Equities: 55%
Fixed Income: 28%
Cash: 17%

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