Shearwater Creek Investment Matters

Market Update: May 2026

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Over the past month, the markets have shown some serious resilience. Despite facing plenty of headwinds and uncertainty, they've recovered well from the sell-off we saw after the conflict in Iran broke out, and overall investor sentiment has stayed remarkably constructive. Equity markets have kept climbing even with inflation concerns creeping back into the picture—mostly driven by higher energy prices stemming from the geopolitical tension. While rising interest rates and uncertainty around the Federal Reserve continue to be a bit of a drag, the sheer strength of corporate earnings, fueled by the massive wave of spending on Artificial Intelligence, has outweighed those worries for now.

Inflation and the Fed

The Federal Reserve is still front and center in every market conversation. Kevin Warsh has officially taken the helm as the 17th Fed Chair, and he's stepping into leadership of a pretty divided central bank. Remember back at the start of the year when everyone expected a fairly aggressive string of rate cuts throughout 2026? Those expectations have shifted big time over the last few months. Inflation has proven to be stickier than expected, and economic activity is holding up better than anticipated. In fact, if you look at the Fed Fund futures market today, there's actually a higher probability priced in for a rate hike over the next year than any more cuts.

Rising energy costs, ongoing geopolitical tensions, and broader price pressures have pushed inflation readings back up—especially in transportation, housing, and services. While inflation is still way below the peak numbers we saw a couple of years ago, this latest pickup reminds us that the "last mile" of getting inflation fully under control is going to be a bumpy ride. That said, our view is that the Fed will likely look through this temporary bump if energy prices, particularly oil, start settling back down toward pre-conflict levels. For now, we expect the Fed to keep rates right where they are until the timing is right for their next move, which we still believe will eventually be a cut.

Earnings and the AI Divide

First-quarter earnings for the S&P 500 came in strong, and expectations for the rest of the year are hovering in the high teens. Honestly, that's a pretty remarkable growth forecast for 2026. A massive driver behind these numbers is the sheer amount of capital being poured into the market by the massive AI "hyperscalers". Most industry forecasts don't see this capital expenditure cycle peaking until 2027 or 2028, meaning the money is going to keep flowing for a while.

However, we are beginning to see a clear "AI Divide" take shape across the broader market. It's no longer a rising tide that lifts all boats. Investors are becoming incredibly selective, looking closely at sectors that can actually convert this technology into real profitability, cash flow, and sustainable growth. On the flip side, the market is starting to heavily penalize those sectors and business models that are being disrupted or left behind by AI. It's becoming a game of the haves versus the have-nots, making sector selection more critical than ever.

Looking Ahead

As we head deeper into the second quarter, there are four key themes we are watching closely:

1. Inflation & Fed Policy: Markets will stay hypersensitive to inflation data and Fed commentary. The big question is whether this recent inflation bump is a temporary blip or something more permanent. The answer will dictate how much flexibility the Fed has to ease policy later this year.

2. Economic Growth & the Consumer: The American consumer has been the backbone of this economy. The focus now is on whether consumer spending and hiring are just normalizing, or if they're starting to crack under the weight of higher prices and prolonged high interest rates.

Looking Ahead *Continued*

3. Valuations: After the incredible run we've had, valuations in certain pockets of the market are looking pretty stretched. We have some caution around specific areas of the AI trade. A lot of sectors are riding high on the coattails of that hyperscaler spending, pushing valuations to levels we just don't think are sustainable long-term—especially once we move past peak investment spend in a few years. Momentum can certainly keep pushing things higher in the short term, but we prefer a more cautious, measured view here.

4. The Mega-IPO Pipeline: We're looking at the potential for three historic companies to go public this year at valuations north of $1 trillion: SpaceX, OpenAI, and Anthropic. While we aren't commenting on the specific investment merits of these listings, there's no doubt demand will be massive. This could actually create some short-term volatility in the broader AI sector as investors shuffle money out of current positions to reallocate into these new offerings.

Our Perspective

May really emphasized what has become the defining story of 2026: an economy and a market that are incredibly tough, but running on a track lined with growing risks. Growth is positive, people are spending, and corporate earnings are healthy. But at the same time, inflation is sticky, the Fed is cautious, and policy uncertainty is high.

While markets could absolutely keep grinding higher if growth stays stable and inflation cools down again, we expect volatility to stick around. This kind of environment rewards balance, diversification, and discipline rather than aggressively chasing the latest hot momentum trend. Moving forward, we expect the market to become even more selective, drawing a sharper line between the sectors that can truly sustain growth and those that might struggle in a slower, more uncertain environment.

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WEALTH ADVISORS LLC