LPL Financial

Equity Strategy Insights

Keys to Additional Stock Market Gains in the Second Half

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Executive Summary

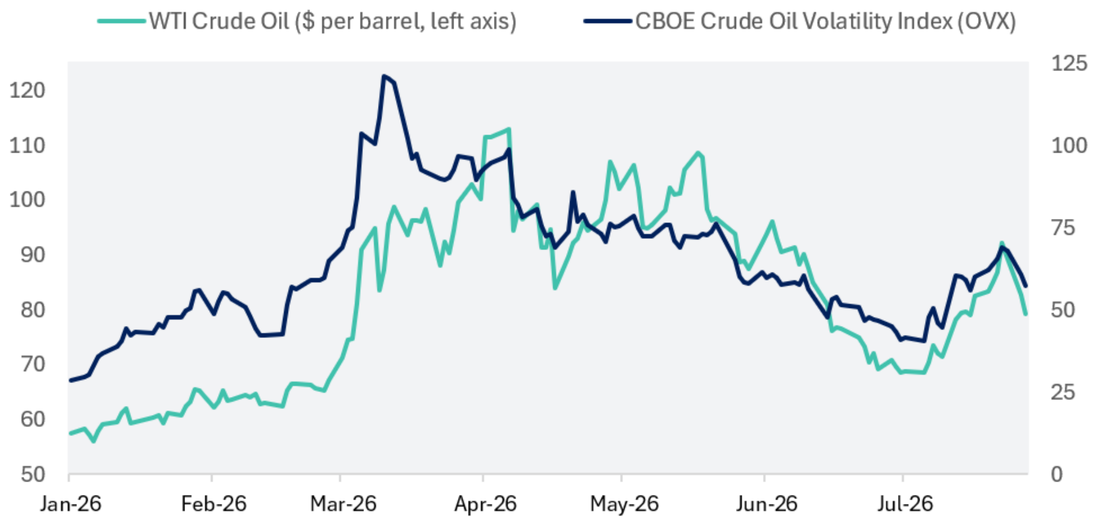
- LPL Research continues to expect a supportive backdrop for stocks during the second half of 2026 despite ongoing geopolitical uncertainty, oil market volatility, and increasing AI skepticism.
- Low recession risk suggests this bull market may continue through its fifth year, consistent with historical patterns.
- Strong earnings growth remains the primary driver of stock market gains. AI-related investments and healthy fundamentals across several sectors outside of technology should continue to underpin corporate profits.
- Investors should remain mindful of risks, including Middle East developments and other potential geopolitical flareups, inflation pressures, AI monetization challenges, and midterm elections.

Macro Backdrop Remains Challenging

As we wrote in *Midyear Outlook 2026: Policy, Buildouts, & Bottlenecks*, part of our expectations for positive second half returns hinged on improvement in the macro backdrop. Well, shortly after the LPL Research team published that view, disruptions to the Strait of Hormuz intensified and the Houthis opened a new front in the battle to restore tanker flows in the Persian Gulf by attacking Saudi tankers in the Red Sea. So, after oil dipped below $70 in early July, the relief provided was short-lived as the U.S. conducted strikes on Iran over the past two weeks and oil prices shot back up over $90 a barrel. After the attacks were paused over the weekend of July 24 amid reports of another round of mediated talks, oil prices pulled back to around $80.

At a high level, these developments do not change our stock market outlook for the second half. Our forecasts are slightly below consensus in part because of the geopolitical uncertainty — on top of the uncertainty surrounding the monetization of the massive AI investments. As we've seen before, the Trump administration will likely find an offramp soon, because $100 oil and $5 gasoline are sure-fire ways to lose votes in the upcoming midterm elections, now just over three months away.

Oil's Bumpy Ride Has Continued



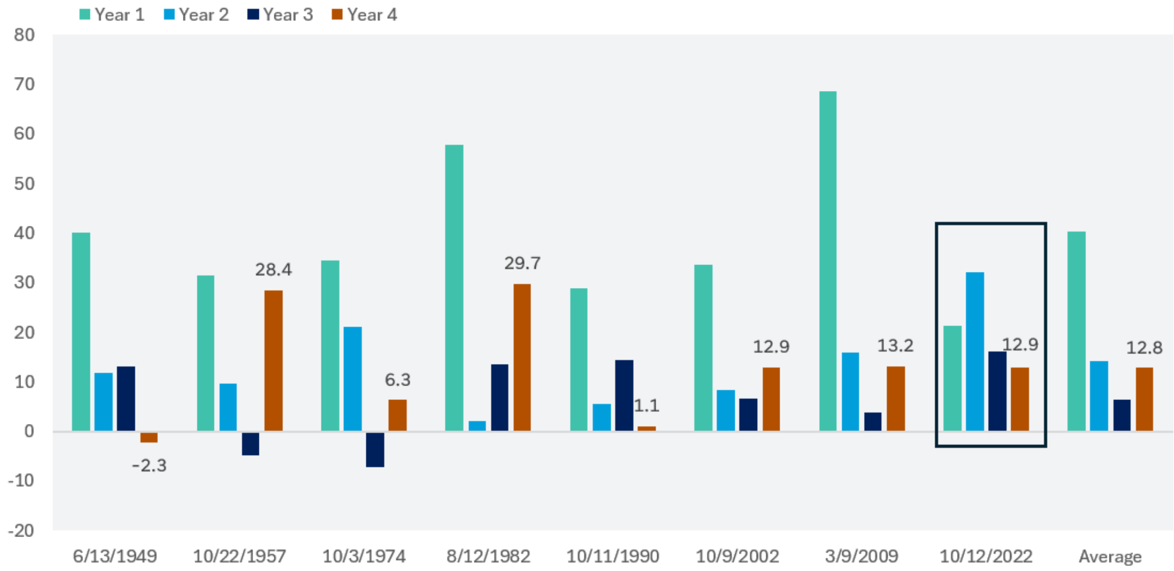
Source: LPL Research, Bloomberg 07/28/26
Disclosures: All indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

Supportive Economic Cycle

In last year's Outlook 2026, we made the case for the bull market to make it through year four. With that anniversary date coming in October, we believe that forecast is looking good (a 20% decline from the S&P 500 peak would end the bull market). We expect potential for new highs for stocks this summer or early fall. Some historical perspective to consider, though past performance does not guarantee future results:

- Bull markets that make it to year four usually generate strong gains that year. The last negative year four for the S&P 500 came during the first bull market after WWII more than 70 years ago, and five out of the last seven bull markets have experienced double-digit gains in their fourth year, including the current one, which is up 13% with 11 weeks to go until this bull market turns four on October 12, 2026.
- Of the seven bull markets that made it through four years, six made it through year five — although the 1982 and 2002 bull markets ended during the month they turned five.
- Bull markets don't die of old age; something kills them. They generally end due to the following: 1) a recession, such as the pandemic or Great Financial Crisis; 2) the Federal Reserve (Fed) slams on the brakes to conquer inflation; or 3) built-up excesses, such as in 2000 when the dotcom bubble burst. If this bull market is going to end, the last option is probably most likely, in our view, but given the core business strength of the hyperscalers, we do not expect wasteful AI investment to end this bull market before the next all-time high above 7,620 is reached.
- Support from the substantial technology spending and fiscal stimulus likely takes recession off the table for 2026 and probably 2027 as well. We do not believe there is enough potential inflation in the system to drive the Fed to embark on a series of rate hikes. We acknowledge one hike could come this fall, but high oil prices and sticky inflation are unlikely to be sustained long enough for the Fed to do much more than that.

Bull Market Follows the Playbook With a Strong Fourth Year



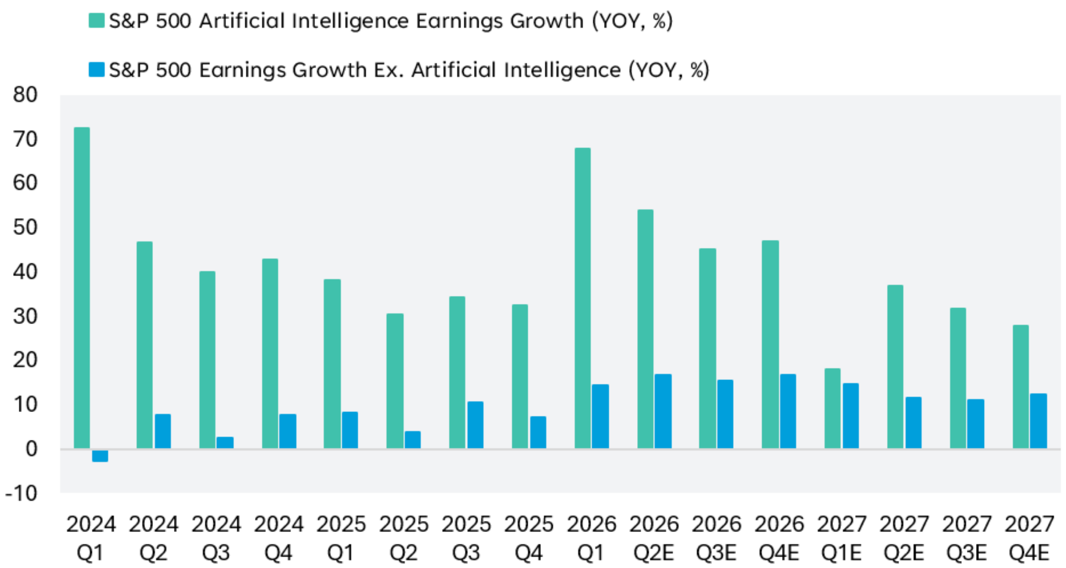
Source: LPL Research, Bloomberg 07/27/26

Disclosures: All indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results. Only bull markets that made it through a fourth year are shown, in addition to the current bull market. The current bull market that started on 10/12/22 is boxed and remains in progress.

Earnings Offer a Solid Foundation for Stocks in the Second Half

Stock market gains so far this year have been driven by earnings, not by higher valuations. In fact, based on the next 12 months price-to-earnings ratio (P/E), the S&P 500 is about 11% cheaper today than it was at the start of 2026 — the index P/E has fallen from 22.2 to 19.7 (source: FactSet). We expect that earnings strength will continue to provide a solid floor for stocks in the second half, and potentially some upside as well, driven largely by AI investment. The debates around how much capital investment is too much and whether the hyperscalers will be able to generate acceptable returns will continue (as we wrote about in our latest Weekly Market Commentary). At the same time, a resilient economy will provide support for non-AI earnings, which could experience growth over the next six quarters.

Artificial Intelligence Investment is Providing a Strong Earnings Tailwind



Source: LPL Research, Bloomberg 07/27/26
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Earnings growth so far in 2026 has been very strong at well over 20% even if the mark-ups on private equity stakes are excluded — including holdings of SpaceX (SPCX). Based on the initial batch of second quarter results, with less than half of reports in the books, second quarter earnings are tracking to an impressive 26% excluding those mark-ups. An impressive 86% of S&P 500 companies have exceeded consensus earnings targets, about 10% above the long-term average. And putting the AI earnings boom aside, the average positive earnings surprises for financials, healthcare, and energy so far are +17.0%, +13.1%, and +12.2%, respectively. Bottom line, LPL Research expects stocks to move higher in the second half on the back of strong earnings and an improving geopolitical and macroeconomic backdrop, even if the markets remain skeptical of AI investment and trading in hyperscalers remains choppy.

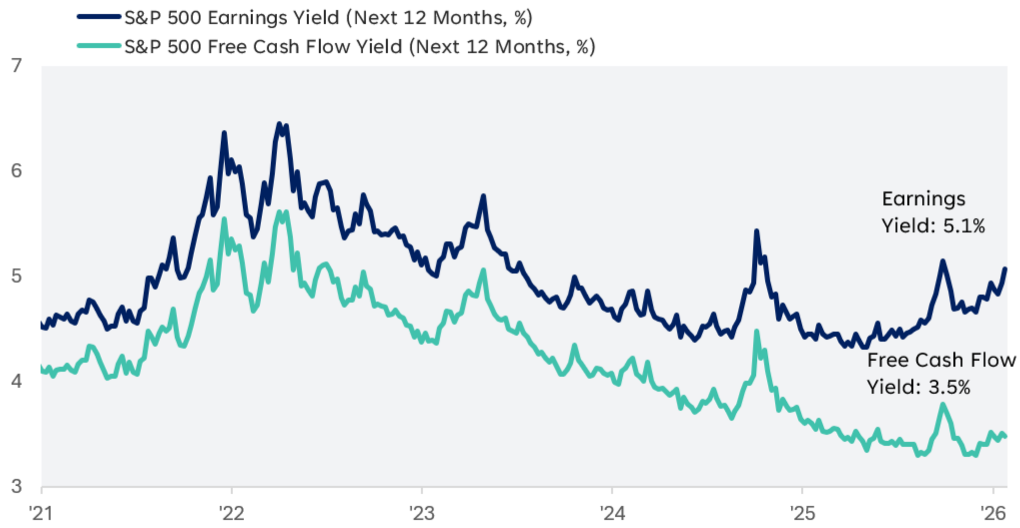
Valuation Discussion Requires Nuance

The valuation discussion isn't binary. It requires nuance. At a high level, stock valuations are a function of several factors that we believe are supportive of a slightly higher P/E in six months, including: 1) above-average earnings growth; 2) below-average recession risk, bolstered by stimulus and the AI spend; 3) margin expansion opportunities by the AI adopters; and 4) the potential for an improving macro backdrop, primarily easing inflation.

Factoring in LPL Research's views of these valuation factors, we would not argue stocks are expensive here. But it's also difficult to make the case that they are attractively valued. What we have is a market that is reasonably priced on earnings but overvalued on cash flows. The P/E on next 12-month earnings estimates has actually dipped below 20, putting the earnings yield (earnings divided by price) above 5%, which we find very reasonable. However, taking that one level deeper, on a cash flow basis, stocks are expensive — the S&P 500's free cash flow yield is 3.5%. Massive capital investments by the hyperscalers have depressed cash flows, thereby inflating cash flow-based valuations. Over the long term, cash flows matter.

Looking ahead, one of two things must happen. Either hyperscalers will support cash flows by pulling back on investments or by generating attractive returns on those investments. We'll see over the next couple of years which way this goes, but we expect more of the latter than the former, with plenty of ups and downs along the way.

Stock Valuations on Earnings Are Reasonable; On Free Cash Flow, Not So Much



Source: LPL Research, Bloomberg 07/28/26
Disclosures: All indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results. Estimates may not materialize as predicted and are subject to change. Free cash flow is operating cash flow minus capital expenditures. Earnings yield is earnings divided by price. Free cash flow yield is free cash flow divided by price. Higher yields represent more attractive valuations and vice versa.

Risks That Could Hold This Market Back

We maintain our year-end fair value S&P 500 target range of 7,650 to 7,750, based on a P/E of 22 and our 2027 S&P 500 earnings per share forecast of $350. However, we fully recognize several risks that investors should keep in mind. First, the Iran conflict may not be over. Although the latest ceasefire has brought West Texas Intermediate (WTI) crude oil back down below $80, there is no guarantee that it will stay there or go lower. The shipping disruptions in the Persian Gulf are affecting more than just oil, introducing lingering inflation risks, and increasing the possibility of Fed rate hikes — although we do not expect one this week.

Beyond the Middle East, the risk that AI disappoints is a key risk for markets in the second half and beyond. We've seen several flavors of this risk bubble up in just the past week alone, including Chinese competition in large language models (LLMs) and inference, as well as circular financing with NVIDIA's (NVDA) deal to back $250 billion of a datacenter buildout.

Other risks to consider include the potential for elevated market volatility around the midterm election and a possible flareup of China-Taiwan tensions.

Conclusion

The combination of resilient economic growth, strong corporate earnings, ongoing AI-driven investment, and supportive fiscal policy continues to provide a favorable backdrop for equities. While investors are right to scrutinize elevated capital spending by hyperscalers and monitor developments in the Middle East, we believe these risks will be offset by the powerful earnings tailwind that continues to support stock prices.

The ongoing bull market continues to follow a historical path that has typically led to additional gains, and valuations on earnings remain reasonable given the strong profit outlook. That said, expectations should remain measured. Periods of volatility tied to geopolitics, monetary policy, the AI debate, or the upcoming midterm elections are likely. We expect the market's path higher to be volatile amid skepticism around AI investments. That skepticism is reflected in our cautious earnings forecast for next year. Nevertheless, absent a recession, a significant policy mistake, or a material deterioration in earnings trends, we believe stocks are well positioned to deliver additional gains and reach new highs over the balance of 2026.

Important Disclosures

This material is for general information only and is not intended to provide specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors or will yield positive outcomes. Investing involves risks including possible loss of principal. Any economic forecasts set forth may not develop as predicted and are subject to change.

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Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet.

This research material has been prepared by LPL Financial LLC.