

What is the most important issue to monitor in 2026? Geopolitical Risks

As we entered 2025, our focus was on the new administration. That's nothing new as we have managed through numerous leadership changes in our government during the 20 years since our investment management team was formed. Typically, these matters focus on domestic economic topics. This year, and perhaps for some time moving forward, we are focused on potential disruptions and their negative impacts on global businesses, economics, and markets. Everything from political events, regime conflicts, and international tensions, ranging from war and terrorism to trade disputes and policy shifts, has the potential to effect global stability, supply chains, and investment. It's a broad concept encompassing military actions, political instability, shifts in power, cybersecurity threats and economic sanctions creating uncertainty and volatility for global operations and finance. While both equity and fixed income markets performed well during 2025, we suspect geopolitical risks will move to the center stage. In these times, fixed income portfolios have typically outperformed equity markets. Our diversified and well-balanced portfolios have weathered these storms in the past, delivering clients with the stability they expect from our investment process.

Our 2026 Economic and Fixed Income Outlook

We expect steady, healthy economic activity in 2026 with modest improvement in inflation and an easing Fed. This should bode well for rates and risk assets, such as credit. While credit spreads are at the low end of historical ranges, Treasury yields have reset significantly higher compared to the post-GFC to pandemic era and all-in yields are attractive. Corporate and household balance sheets are healthy, as are corporate profit and labor income growth trends. Credit risk should remain low, keeping spreads relatively tight. We expect increased net corporate credit issuance driven by AI investment and a faster pace of merger and acquisition activity to present a modest supply headwind. In year two of Trump's second term, we expect big policy surprises, such as Liberation Day, are mostly behind us and uncertainty fades while confidence grows.

Corporate Earnings and Capital Expenditures: We are forecasting steady profit growth in S&P 500 corporate earnings from 10.7% estimated growth for 2025 to 11-13% growth for 2026. We expect solid, but moderating growth in business investment during 2026 driven by still very robust, but slowing growth in AI and data center investment, tax incentives from the One Big Beautiful Bill Act (OBBBA), a fading tariff drag, and lower short-term interest rates.

The ISM Manufacturing Index: In 2025, we saw the persistence of flat to modestly positive real growth in the manufacturing sector. The

survey-based ISM Manufacturing Index has signaled contraction, with readings significantly below 50 throughout most of 2025. Manufacturing activity in Europe improved slightly, but stayed weak in 2025. China's manufacturing activity showed a modest acceleration versus 2024. The U.S. ISM Services Index was relatively weak, but positive, throughout most of 2025 and strengthened in the fourth quarter of 2025. For 2026, we expect improved growth.

The ISM Manufacturing Index is a monthly indicator of U.S. economic activity based on a survey of purchasing managers at more than 300 manufacturing firms. It is considered to be a key indicator of the state of the U.S. economy.

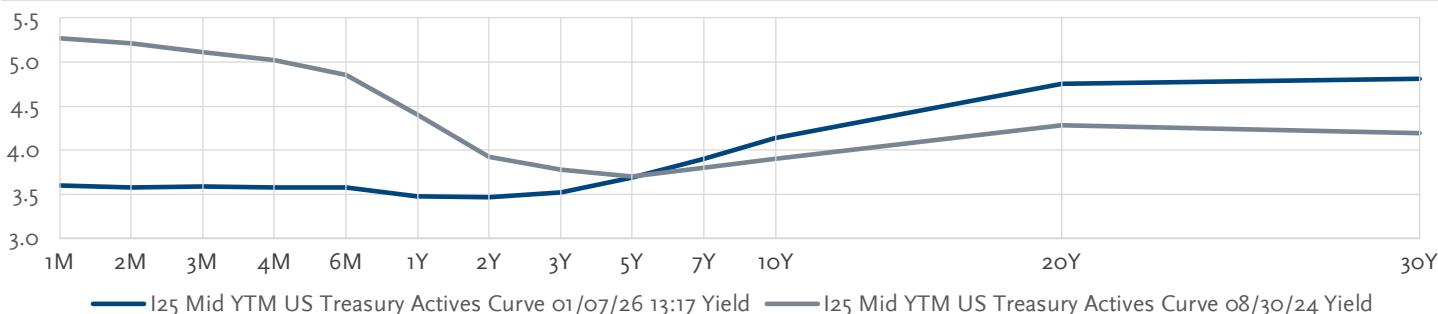
Gross Domestic Product: For 2026, we believe the U.S. economy will slow from the current 2.3% rate (as of 3Q), falling more in-line with its long-run potential of 1.8-2.0%. Currently, our expectations are in-line with the Bloomberg consensus for 2026 GDP of 2.0%. We think a more cautious Fed, cracking labor market, and normalized productivity gains will serve as headwinds to GDP growth during 2026; however, we note risks appear skewed to the upside due to the fiscal stimulus baked into recent legislation.

Unemployment: We anticipate the unemployment rate will be more or less stable in 2026 and remain consistent with the 4.6% as of November 2025. We expect weakening consumer trends and AI/tech driven layoffs to be offset by slowing population growth amid immigration controls and a stable participation rate. Wage growth, currently around 4%, will trend modestly lower as the labor market continues to soften.

Inflation: We expect inflation to continue to trend modestly lower during 2026. We expect Core PCE (Personal Consumption Expenditures excluding food & energy; the Fed's preferred measuring gauge) will finish 2026 at approximately 2.6% driven by housing disinflation and the impact of tariffs anniversary. We believe the Fed will remain focused on attaining their 2% Core PCE target, but during 2026, they will patiently allow the rate to decelerate.

Monetary Policy: The Fed has now cut the overnight rate by 175 basis points (bps), beginning in September 2024, and has signaled that it expects to cut this rate by another 25 bps in 2026. However, in May 2026, a new Fed Chairman will be installed. President Trump has been clear that he would like much lower rates and that he will nominate someone with similar views. Fed interest rate decisions are made by a majority vote of the FOMC which is currently deeply divided. While a new dovish Fed Chairman cannot by himself dictate interest rate policy, he is the most influential member of the committee. This, combined with our expectations of modest improvement on inflation and a somewhat weak labor market, leads us to believe we could see 50-75 bps of cuts in 2026.

In a highly unusual move, longer-term interest rates have risen while the Fed has cut short-term rates. See the chart below. This is contrary to the historical experience.



Source: Bloomberg; Retrieved as of 1/7/26.

We can think of four reasons for this unusual development, all of which point to a higher terminal rate when the Fed is done cutting:

1. The Administration's policies, including higher tariffs, lower immigration and, thus, lower labor supply, and stimulative tax policy, which traders worry could be inflationary.
2. Slow progress against inflation. Year-on-year rates are going sideways.
3. The Fed cutting rates against the backdrop of above target inflation and a likely more dovish Fed in 2026.
4. Eventual increased long maturity Treasury supply.

Why would market interest rates rise when the Fed cuts rates? There's an assumption the Fed cuts only when it is appropriate. That policy is always optimized to achieve results. But to the extent the Fed is cutting rates when inflation is too high and stuck, or worse, when inflation is too high and may rise again, long yields will drift upwards.

As for supply, the U.S. budget deficit remains historically elevated and the Treasury has increased the proportion of debt funded in T-bills from the usual 15-20% range to 22.0% (10/31/2025) due to insufficient demand for duration and deficit concerns. Funding the Treasury with a greater proportion of short-term bills reduces interest costs, but results in higher cash flow volatility. Ultimately, the Treasury Department will want to term out bills into longer-term coupon securities, adding duration supply and potentially leading to higher long-term rates. The market may be already pricing this additional supply into long-term interest rates.

Interest Rates: The Fed cut rates 3 times in 2025 starting in September, but we think the Fed will take a more cautious path to begin 2026 due to a lack of clarity on current labor market conditions as a result of the government shutdown and inflation that remains stubbornly above their 2% target. It is our view that the Fed will likely cut rates 2-3 times in 2026, with our base case calling for the first cut in March. Further cuts on the front end combined with persistently high inflation means we continue to believe the yield curve will steepen as the long end stays "higher for longer". We expect the 10-year Treasury yield to end the year between 4.00% - 4.25%.

Investment Grade Corporate Bond Outlook: We remain positive on credit in 2026 given corporate fundamentals, coupled with persistent institutional demand and limited net new supply anchoring credit spreads and performance. Corporate spreads are tight versus comparable U.S. Treasury but we expect fundamentals, technical factors, and demand to remain supportive on the back of attractive all-in yields. We continue to believe credit selection will be paramount if the focus shifts toward the ability of corporates to navigate macro uncertainty. In addition, while we do not rule out some idiosyncratic risks, we see the overall financial system as healthy and recent bank earnings have been robust both on the capital markets and investment banking side.

High Yield Bond Outlook: Spreads began the year at 267 bps, within shouting distance of all-time tights, leaving little room for them to tighten meaningfully. The default rate for cash paying bonds during 2025 was 2.4% compared to the 30-year average high yield bond default rate of 3.2%. Amid

a softer growth backdrop, we expect modest increase in the default rate and spreads during 2026, but an accommodative Fed, fiscal stimulus, and a disinflationary environment should still be supportive of valuations.

Investment Grade Corporate Bond Fourth Quarter Performance: In 2025, fixed-income had its best performance since 2020 with the Bloomberg Aggregate Index returning 7.30% for the year and 1.10% in the fourth quarter. Three Fed cuts in the last half of the year overwhelmed deficit and inflation fears. U.S. investment-grade bonds returned 0.87% during the quarter per the Bloomberg U.S. Credit Index and outperformed U.S. Treasury securities. The Bloomberg U.S. Credit Index measures the investment grade, U.S. dollar denominated, fixed-rate, taxable corporate and government-related bond markets. In our opinion, there are no positions in the portfolios with any credit or sustainability concerns through the market cycle.

High Yield Bond Sector Fourth Quarter Performance: High yield fixed income bonds had a strong fourth quarter with a positive return of 1.23%. High yield spreads were unchanged during the quarter, starting and ending at 267 bps as accommodative monetary policy was supportive of economic growth prospects. For the full year 2025, high yield returned 8.6%, comprised of 6.9% from coupon and 1.7% price return. From a quality perspective, all ratings categories performed well, with BBs outperforming the others at 9.0%, single-Bs returning 8.4% and CCCs the worst performer at 6.5%. High yield bond data is representative of the U.S. High Yield Corporate Bond Index which is designed to track the performance of U.S. dollar-denominated, high-yield corporate bonds issued by companies whose country of risk use official G-10 currencies, excluding those countries that are members of the United Nations Eastern European Group (EEG).

Thank You

For the past 20 years, our fixed income strategies have won numerous awards from Zephyr PSN for our consistent performance in some of the best and worst market conditions. The most important vote of confidence comes from you, our clients. We greatly appreciate your compliments and referrals. Many of you have been clients of ours this entire time. We want to thank you and all our clients for your business and introductions to new relationships during the past decades. We look forward to serving you in 2026 and helping to successfully navigate the ever-changing fixed income landscape.

If you have any questions on strategy, performance or business development, please do not hesitate to contact us.

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Past performance is not a guarantee of future results. Adtrax 8713480.1