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Q1 2026: What's driving volatility?

TIAA Wealth Management

CIO FOCUSPOINT

Executive summary

- While market consensus remains relatively bullish, with equity strategists on average expecting a roughly 12% price gain for the S&P 500 in 2026, investor sentiment appears fragile and potentially vulnerable to sudden shifts in fundamentals and market narrative.
- Since the turn of the year, the sense of uneasiness has been stirred by the sequencing and overlapping of a few unfavorable dynamics, including geopolitical turmoil, policy uncertainty, AI disruption, private credit jitters, and market rotation out of the largest sectors.
- Looking ahead, our view is that the succession of prevailing market drivers may continue to be unusually rapid, and at, times chaotic. On one hand, fundamental dynamics remain supportive of risk assets. But on the other, we see a range of potential catalysts that could keep single-stock volatility elevated, with risks of broader, index-level volatility as well.
- In this environment, broad asset and geographic diversification represents the first line of defense against fluctuations in market performance. Tactically, we have a preference for value stocks over growth stocks, which are more sensitive to the wide dispersion within the AI theme. In addition, we retain an underweight tactical exposure to investment grade and high yield credit to hedge against the risk of recurring volatility.

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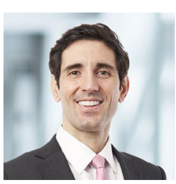

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The first two months of 2026 have forced investors to reckon with a more volatile market backdrop, characterized by significant dispersion across sectors of the equities market and single stocks. As we anticipated in our 2026 Outlook, volatility would emerge as a recurring theme this year, as the artificial intelligence (AI) cycle matures and policy uncertainty persists. Interestingly, the S&P 500 remains within ~4% of its all-time highs,[1] signaling investors' caution but not distress. However, a notable shift is occurring beneath the surface: The average stock within the index is nearly three times as volatile as the index itself, and there is a wide performance dispersion across and within equity sectors.

While market consensus remains relatively bullish, with equity strategists on average expecting a roughly 12% price gain for the S&P 500 in 2026 (from current levels), investor sentiment appears fragile and potentially vulnerable to sudden shifts in fundamentals and market narrative.

Since the turn of the year, the sense of uneasiness has been stirred by the sequencing and overlapping of a few unfavorable dynamics:

- **Geopolitics.** While relatively inconsequential for global markets, the capture of Venezuela's President Maduro by the U.S. on January 3, 2026, was an indication that risks associated with a return of geopolitical uncertainty had risen. As the Trump administration signaled the willingness for a more interventionist foreign policy strategy, investors have been grappling with potential ramifications across asset classes and geographies. The ongoing conflict in the Middle East reinforces our view that geopolitics will remain a key source of market volatility in 2026.

- **Policy uncertainty.** The run-up to the November midterm election in the U.S. provides a strong incentive for the Trump administration to do two things: 1) frontload the implementation of key policy priorities ahead of a possible loss of the majority in Congress; and 2) focus on improving household affordability—a top-of-mind issue for voters. This also means that the rapid rollout of policies and policy proposals creates uncertainty about potential impacts on the economy and markets. At different times since the start of the year, proposals like interest rate caps on credit cards, or prohibiting residential real estate purchases by institutional investors, has led to intense bouts of volatility across sectors viewed as more vulnerable, such as banks and alternative asset managers. Investors have also faced concerns about Federal Reserve (Fed) independence, while the recent Supreme Court (SCOTUS) ruling on reciprocal tariffs and swift reimposition of a Section 122 global tariff rate caused a renewed spike in trade policy uncertainty in late February.

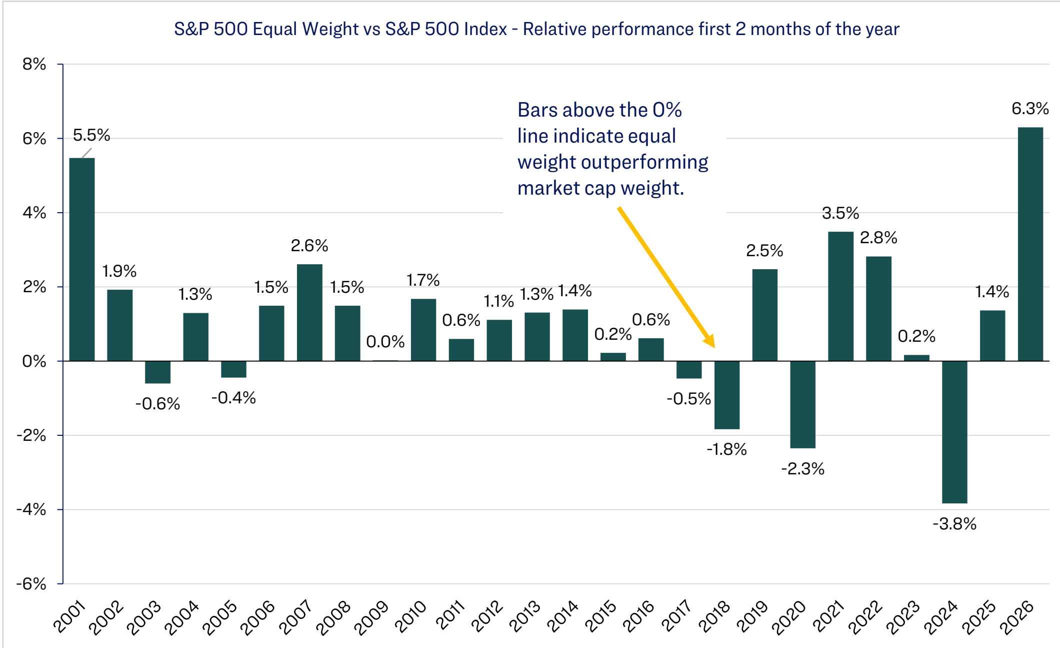
- **AI disruption.** The narrative around AI has shifted since the turn of the year, and investors have been much more focused on distinguishing between potential winners and losers. This has fueled a significant performance dispersion across the AI equity ecosystem. The rapid evolution of AI agents and the threat of "disintermediation"—as AI systems get better at performing repetitive and routine tasks—have taken a toll on several industries year-to-date (YTD), from legal and insurance, to freight logistics and property managers, and most notably software stocks.

- **Private credit.** Significant thematic rotations within markets rarely remain isolated. The large sell-off in software stocks—important drivers of the strong equity bull market of the past decade, and beneficiaries of large public and private investment demand—has raised awareness about exposure to the sector by less liquid and transparent credit investors. Business development companies (BDCs)—a widely used investment vehicle in the private credit and private equity industries—are estimated to have a ~22% exposure to the software industry. Jitters about a possible rise in default rates across leveraged loans and direct lending products have been exacerbated by the proliferation of retail products that are characterized by a mismatch between the illiquid nature of the underlying asset class and the limited risk tolerance of individual investors.

- **Market rotation out of the largest sectors.** The three best-performing sectors within the S&P 500 YTD—energy, materials and consumer staples—only account for 9% of the index's market capitalization. The three worst-performing sectors—tech, consumer discretionary and financials—account for nearly 60% of the index's market capitalization. As a result, even against the backdrop of relatively contained index-level volatility, the sell-off in stocks that are more heavily owned by institutional and individual investors underpins a sense of heightened caution among investors. Market concentration has not been rewarded YTD, a notable change relative to the past few years; the equal-weighted S&P 500 index outperformed the cap-weighted S&P 500 index[2] by more than 6% over the first two months of the year, the largest gap this century (Figure 1).

FIGURE 1

The equal-weight S&P 500 has significantly outperformed YTD.



Source: Bloomberg, TIAA Wealth CIO.

Looking ahead

Our view is that the succession of prevailing market drivers may continue to be unusually rapid and, at times, chaotic. On one hand, fundamental dynamics remain supportive of risk assets:

- The manufacturing cycle is experiencing a revival, with global Purchasing Managers' Index (PMI) indicators showing a rise in orders for intermediate goods, Asian exports—a central element of global manufacturing supply chains—rising significantly YTD, strong trucking orders in the U.S., and Q4 25 earnings season pointing to accelerating momentum for business activity in 2026.

- While the continued increase in AI-related capital expenditure projections is raising concerns about overspending and the outlook for return on invested capital, the near-term impact on the economy is positive, and we expect the contribution of AI-related investments to gross domestic product (GDP) growth to be as high, or higher, than in 2025.

- Productivity growth picked up significantly in the second half of 2025—rising at an annualized 4% pace between June and December. The acceleration in AI adoption and integration across the economy bodes well for a continuation of above-trend productivity growth, which lifts GDP growth potential and boosts corporate profit margins.

- Earnings growth is broadening beyond the largest companies in the U.S., with mid- and small-sized companies expected to deliver stronger profits in 2026 and finally seeing upward revisions to forward-looking earnings projections. Importantly, consensus estimates for S&P 500 earnings growth over the next 12 months continue to climb even in the face of significant macroeconomic disruptions like the spike in oil prices, representing a key source of support to stocks.

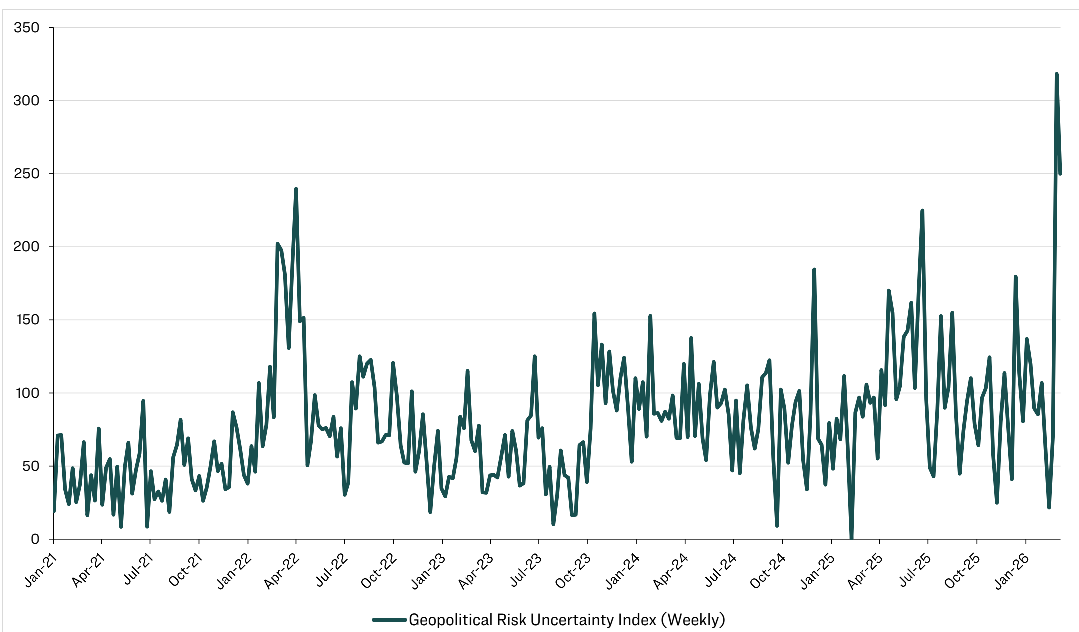
- While the recent spike in oil prices represents a negative development that threatens an otherwise resilient fundamental backdrop, we see several dynamics that could provide at least a partial buffer over the next few months, including retroactive One Big Beautiful Bill Act (OBBBA) tax cuts expected to boost individual refunds by ~$100 billion, OBBBA business tax breaks encouraging capital spending, sequentially lower tariff rates, administration efforts to boost household affordability and reduce mortgage rates, and accommodative financial conditions stemming from the rise in equity prices and drop in interest rates of the past year.

But on the other hand, we see a range of potential catalysts that could keep single-stock volatility elevated—with risks of broader, index-level volatility as well—and sustain the dispersion across and within sectors.

- The conflict in the Middle East has caused geopolitical uncertainty to reach levels comparable to those seen in February 2022, following the Russian invasion of Ukraine, and in April 2025, following the announcement of reciprocal tariffs (Figure 2). Shortly after the onset of the war, we outlined four scenarios that we thought could emerge from the initial tensions. Unfortunately, at the time of this writing, the scenario involving a material oil supply disruption and broadening conflict—with at least 15 countries involved so far—appears to be prevailing. Gulf countries are gradually shutting down oil production facilities as storage and shipping capacity runs out, a development that could create supply shortages even following any kind of de-escalation, as it would take time to restart production and absorb the shipping backlog. Additionally, the lack of a clear off-ramp for either U.S./Israel or Iran makes a scenario of further escalation plausible, and the involvement of Iran's Yemen-based Houthi allies could imperil the alternative routes and pipelines used by Gulf countries to divert oil shipping from the high-risk Strait of Hormuz.[3] While a temporary spike in oil and gas prices could end up being manageable for the U.S. and global economies—and may allow central banks to look through the rise in headline inflation likely to occur over the next few months—a more durable rise above $100/barrel would pose serious headwinds to household consumption, corporate earnings growth, inflation expectations, and monetary policy.

FIGURE 2

Geopolitical uncertainty* has climbed again.



Source: Bloomberg, TIAA Wealth Chief Investment Office. *The Geopolitical Risk Index measures the frequency of news articles on adverse geopolitical events and associated risks.

- The rule of thumb is that a 10% rise in oil prices might add approximately 0.30%/0.35% to U.S. headline inflation over the subsequent few months. Since February 27, and as of March 12, Brent oil prices have increased by more than 40%, with wide day-to-day fluctuations up and down likely to continue. As discussed above, the persistence of higher oil prices as well as their impact on consumers' inflation expectations will matter greatly for how the Fed reacts to these developments. Our base-case scenario is that, for the time being, geopolitics should add to the list of factors keeping the Fed on hold. But the risk is that a sudden rise in inflation expectations could force the Fed to entertain the possibility of rate hikes. This doesn't seem likely in the near term, but we think that markets will become increasingly sensitive to different measures of inflation expectations as a barometer of this risk. Notably, the European Central Bank (ECB) and the Reserve Bank of Australia are now projected by markets to hike cash rates by 0.25% and 0.5%, respectively, by the end of 2026. This could be an overreaction to geopolitical events, but it exposes the risk of a shift in monetary policy expectations nonetheless.

- We saw risks to the market consensus expecting ongoing disinflation in 2026 even before the spike in oil prices. Service prices excluding housing have reaccelerated since last summer, commodity prices[4] were 11% higher through the first two months of the year, ballooning AI-related capital expenditures are causing shortages of computer and electronic inputs, the combination of fiscal stimulus and immigration crackdowns may be creating a supply/demand mismatch in the economy, and surveys still point to the risk that tariff-induced price hikes by businesses might still be coming. While disinflationary forces—most importantly, a moderation in housing prices—exist as well, recent dynamics suggest that the path forward for inflation may not be smooth.

- The AI hyperscalers[5] are projected to spend ~$675 billion to continue building out the AI infrastructure in 2026. This represents a ~65% year-over-year (YoY) increase in spending relative to 2025. Such large deployment of capital bears crucial ramifications for investors:

  » ~90% of operating cash flow will be allocated to capital expenditures by hyperscalers in 2026, up from ~70% in 2025 and ~50% in 2024. This will come at the expense of shareholder buybacks (a key source of support for these stocks over the past decade), which are projected to represent between 10% and 15% of operating cash flow in 2026, down from 50%/60% levels that investors were accustomed to.

  » In addition to the immediate tangible impact on shareholder returns, heavy spending is also raising the bar for these businesses to start showing signs of a compelling return on invested capital.

  » While these companies remain highly profitable, with strong balance sheets, falling free cash flow yields and shrinking buybacks reduce the valuation premium that investors are willing to attribute to these stocks—with important repercussions for the broader equity market, given their almost 20% cumulative weight within the S&P 500.

- The AI market cycle is evolving fast. As Figure 3 shows, the distribution of winners and losers within the AI ecosystem has been very broad since last summer. Rising AI-related capital expenditures have penalized hyperscalers but benefited infrastructure/data-centers stocks and AI-exposed semiconductors stocks. Rising AI adoption has threatened software stocks (and other stocks of companies whose revenue was expected to be augmented by the advent of AI) but lifted businesses that could see productivity gains. These trends have flipped over the past couple of weeks, with a rebound in software stocks and a drop in semiconductor stocks. Our view is that dispersion within the AI theme may persist. This technological advancement is unique in two important ways: speed of adoption and speed of progress. Adoption is ramping up quickly, and the ramifications across employment, productivity, and business use cases could materialize faster than in previous technological cycles. And AI models are being upgraded and improved rapidly, as widespread adoption boosts the incentive of being fast and being first. Against this backdrop, investors' expectations may continue to fluctuate, which may lead to a recipe for volatility.

- Jitters within the private credit market should be monitored carefully. The industry is facing a confluence of headwinds: 1) the exposure to software loans; 2) a range of defaults across subprime lending products without appropriate collateral coverage, as private credit investors have acted as lenders of last resort to riskier businesses; and 3) the fading perception of stability usually associated with private credit, as more loans are suddenly marked down to zero from 100. These headwinds face an industry that has grown exponentially and matured over the past decade, and one that is more connected to the broader financial system. In fact, since the end of 2020, commercial banks have lent more than $1 trillion to non-depository financial institutions, a category that includes private equity and private credit funds.

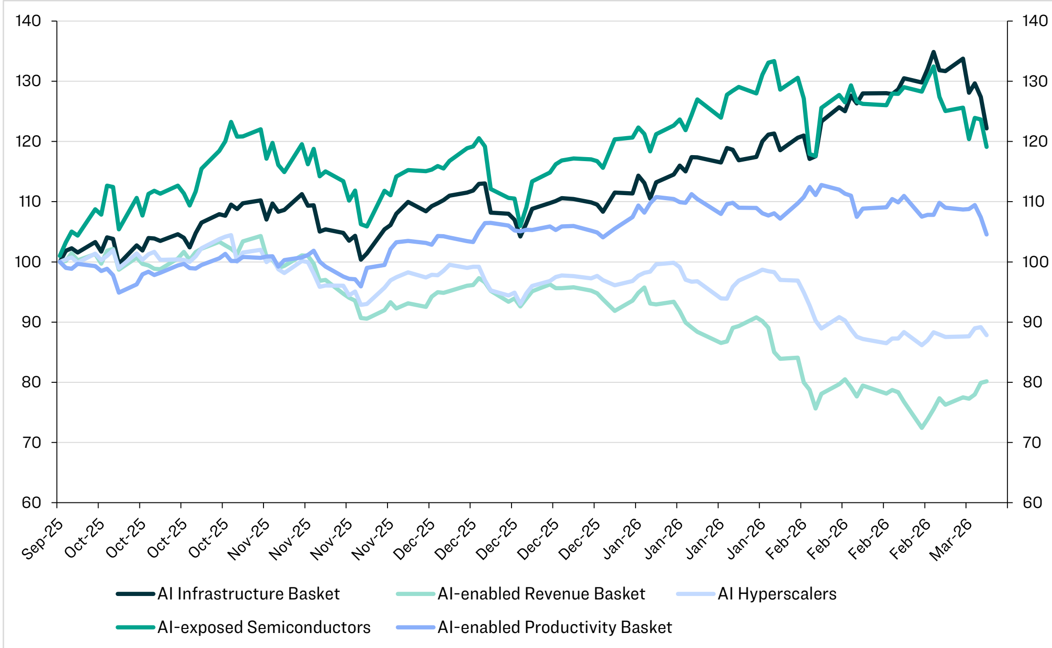
- Policy uncertainty is unlikely to fade anytime soon, especially with the midterm elections looming large. We are watching two areas in particular:

  » The SCOTUS decision on whether President Trump can legally fire Fed Governor Lisa Cook. A ruling in favor of the administration could jolt markets and cause a rise in the Treasury term premium,[6] with broader cross-asset implications likely as well.

  » The rollout of more policy proposals by the Trump administration, with a focus on household affordability. Urgency on this front could be heightened by the rise in oil prices.

FIGURE 3

Wide dispersion within the AI market theme.



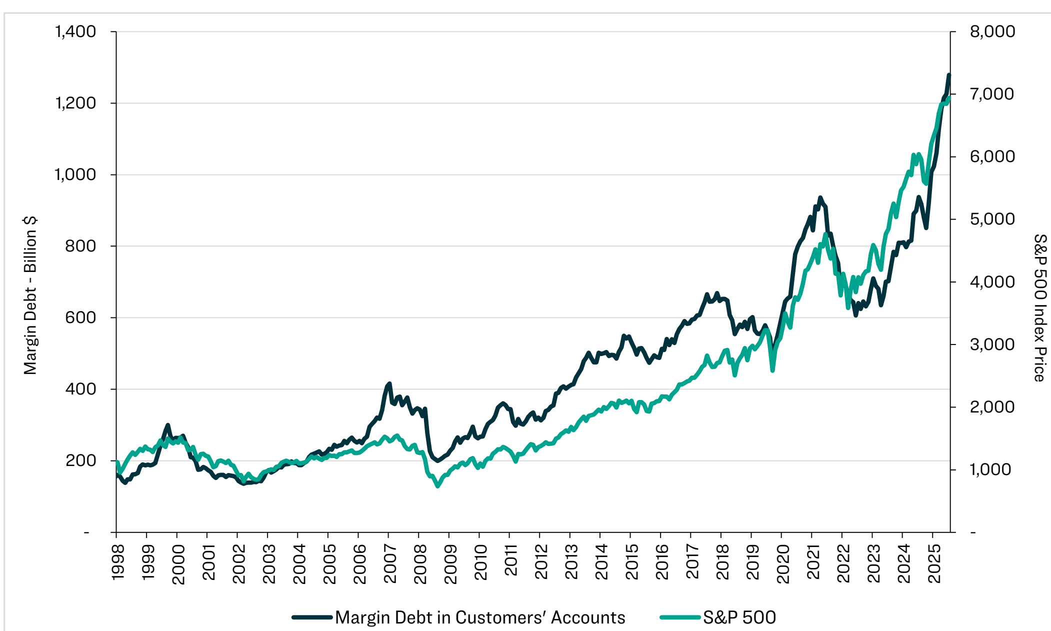
Source: Goldman Sachs, Bloomberg, TIAA Wealth CIO.

In addition to these catalysts, we have been monitoring the market exposure and leverage of retail investors as a dynamic that could exacerbate volatility and economic sensitivity to sustained market pullbacks. In particular, margin debt within retail accounts has swelled by $428 billion since April 2025 (Figure 4).[7] Historically, when margin debt has increased as much as it has since April (22% after adjusting for the rise in the S&P 500) over any 12-month period over the past 30 years, the risk of higher volatility over the next 12 months has been greater than normal.

Finally, U.S. households hold 31% of their net worth in equities, up from an average of 23% between 2010 and 2019. Households in the top 20% of the income distribution hold 37% of their net worth in equities, up from an average of 28% between 2010 and 2019. Given how important the "wealth effect"[8] has been in supporting household consumption over the past few years, with an outsized contribution from the more equity-exposed high-income cohort, a steep fall in equity prices could negatively impact household consumption and therefore feed into added economic and market uncertainty.

FIGURE 4

Retail margin debt has swollen significantly since April 2025.



Source: FINRA, Bloomberg, TIAA Wealth CIO.

What does this mean for investors?

While the market environment so far in 2026 has been unsettling, it is important to keep perspective: the S&P 500 remains ~21% higher than one year ago, corporate earnings continue to grow, and broader economic fundamentals remain constructive. That said, the list of potential catalysts for further market volatility has expanded, and the alternation of market narratives driving market sentiment is likely to remain rapid, in our view.

In this environment, broad asset and geographic diversification represents the first line of defense against fluctuations in market performance. Tactically, we have a preference for value stocks—a group with a higher exposure to oil-sensitive energy stocks and more defensive sectors like healthcare and utilities, and that could benefit should geopolitical tensions abate and should investors once again shift their focus back to supportive fundamentals—over growth stocks, which are more sensitive to the wide dispersion within the AI theme. In addition, we retain an underweight tactical exposure to investment grade and high yield credit to hedge against the risk of recurring volatility.

Finally, we highlight the following considerations for investors:

- Remain anchored to up-to-date financial plans. Ensure investments are appropriately diversified across equities, bonds, and cash holdings as per risk profiles, as well as diversified income solutions that can help to support spending.

- Risk-averse investors, in consultation with their advisors, can discuss raising some cash if needed for immediate purposes. However, consider balancing the need to remain invested in equities for growth of capital during retirement years.

- Maintain a long-term perspective. Equities are a volatile asset class and have a history of bouncing back quickly from drawdowns.

- If currently not in place, consider having an emergency fund for unforeseen costs like medical emergencies, home repairs, etc. This lowers the possibility of dipping into retirement assets during a market downturn.

Endnotes:
1 As of March 12, 2026
2 In the equal-weight index, each stock is weighted equally, whereas in the market-cap-weighted index each stock carries a weight proportional to its market capitalization. The top 10 stocks represent ~40% of the cap-weighted index.
3 Other ways to partially replace some of the lost oil supply would be: 1) the release of global oil reserves; 2) the increase in oil production in the U.S., which however could be slow to materialize given the low number of active oil rigs.
4 Bloomberg commodity index.
5 Microsoft, Meta, Alphabet, Amazon and Oracle.
6 The extra compensation required by investors for holding long-maturity bonds rather than continuously rolling over short-maturity bills.
7 As of January 2026.
8 As the value of assets rises in relation to the value of liabilities, households feel more comfortable about their financial situation and about spending money.

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