

The rotation underway



Executive summary

- The U.S.-Israeli attack on Iran that began on February 28 has disrupted global markets and economies but beyond the initial impacts of the conflict, the improvement in economic fundamentals that was in place prior to the attack remains in place.
- The “growth-at-any-cost” era is facing an inflection point. Market leadership has shifted from the narrow concentration of mega-cap technology stocks to a broader swath of the market. Information technology and communication services—the heavyweight champions of 2024 and early 2025—are now lagging, while capital rotates into value-oriented and defensive sectors.
- What’s driving this latest market rotation? It begins with a shift in how investors are thinking about artificial intelligence (AI) as the focus has shifted within the last four months. The excitement about AI hasn’t disappeared, but investors are now demanding more concrete evidence of returns on AI investments.
- The bond market has been the standout performer in recent weeks as yields have declined since January. Inflation appears to be headed in the right direction and bonds have also benefited from flight-to-safety, with investors seeking safe havens amid turbulence in AI-related equities.
- Despite market rotation and flight-to-safety, the underlying fundamentals of the U.S. economy remain healthy. Investor sentiment is fragile right now, which makes it vulnerable to sudden shifts in market narratives. AI fatigue is palpable. However, this does not necessarily signal the peak or end of the bull market.
- Diversification remains paramount. By combining secular growth exposure with defensive and value-oriented sectors, alongside core fixed income positions, investors can protect portfolios from the disruption risks concentrated in AI segments of the market. Importantly, bonds are once again serving their traditional role as portfolio stabilizers during times of equity turbulence.



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Markets react to the initial phase of the conflict in the Middle East

Over the weekend of February 28–March 1, the [U.S. and Israel launched joint operations conducting major strikes across Iran](#) that targeted leadership and military sites. Iran responded with drone and missile launches toward Israel, U.S. military targets in the region, and, importantly, several Gulf countries. After a week, there are few signs that either side is willing to halt hostilities.



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Renewed geopolitical instability is weighing on investors’ sentiment already strained by shifting narratives around artificial intelligence (AI) disruption, potential AI overspending, and U.S. policy uncertainty. If oil prices continue to extend their gains, current economic and earnings projections would be undermined, which would likely drive market volatility higher and risk prompting a more material pullback in equity prices. Interest rates are being pulled between safe-haven demand and the inflationary impulse from higher oil prices. So far, the latter dynamic has prevailed, with the U.S. 10-year Treasury yield up 20 basis points (bps) last week. Finally, gold may continue to benefit in this environment. As investors continue to price in a larger risk premium in traditional asset classes due to spreading geopolitical and policy uncertainty, a prolonged conflict in the Middle East could extend this dynamic and drive sustained demand for gold.

The situation in the Middle East remains highly fluid and—as of this writing—we see four potential scenarios unfolding:

1. Swift removal of the regime (including the IRGC) by the U.S. or a popular uprising. This could lead to outcomes ranging from a transition to democracy, to chaos and the breakdown of the Iranian state into several factions. Markets would struggle to price such uncertainty, and oil prices would likely continue to embed a geopolitical risk premium. That said, this scenario could also lead to some stabilization in oil prices, after the 39% rise year-to-date (YTD).¹

2. Diplomacy returns to the table. The scale of the joint operation could push remaining senior Iranian regime figures to negotiate on nuclear and security issues. This would mirror the Venezuelan dynamic, where new leadership accepted U.S. terms to avoid deeper intervention. This is the most market-friendly scenario, with oil prices likely moderating in this case. However, senior IRGC officials have so far signaled no willingness to negotiate and have stated Iran is prepared for a prolonged conflict.

3. Maximum pressure retaliation by the IRGC, including targeting regional oil supply and the Strait of Hormuz. A full blockade of the Strait would be difficult given the U.S. military presence in the region, but Iran could engineer persistent disruption via drones or small boats, deterring insurers and shippers from using the waterway. Tanker traffic has already declined in recent days. This scenario would have the most direct and immediate impact on global oil supply, and could cause the sharpest short-term spike in oil prices.

4. Regional conflict involving Iranian proxies and Gulf states. This scenario would carry the risk of more long-lasting ramifications for global markets than Scenario 3. Strikes on Dubai, Abu Dhabi, Bahrain, Saudi Arabia, Qatar, and even Oman—alongside attacks on Israel and U.S. military bases—underscore the plausibility of this path. A prolonged regional conflict would force investors to price in the risk of sustained oil supply disruption, keeping the oil risk premium elevated as a result.

The rotation underway

While rising geopolitical uncertainty is likely to remain a key driver of market sentiment over the next few weeks, the wide divergence in performance across sectors and geographies that prevailed over the first two months of the year is exposing a fundamental shift in investor preferences—one of the most significant rotations we've seen in a decade.

The “growth-at-any-cost” era is facing an inflection point. Market leadership has shifted from the narrow concentration of mega-cap technology stocks to a broader swath of the market. Information technology and communication services—the heavyweight champions of 2024 and early 2025—are now lagging, while capital rotates into value-oriented and defensive sectors.

Prior to the late February escalation in the U.S.-Israel conflict with Iran, markets were already showing clear signs of broadening participation. The S&P 500 energy sector had surged 20%, the materials sector (lumber, industrial chemicals, metals, etc.) had gained 15%, and the industrials sector had advanced 13%. Defensive sectors

were participating as well, with consumer staples up 14% and utilities climbing 9%. For the first time in nearly three years, the equal-weighted S&P 500 outperformed its market-cap-weighted counterpart (the official S&P 500 benchmark) by 5% YTD.² This breadth expansion signaled a more sustainable bull market—though it may pose near-term headwinds for portfolios should the geopolitical unrest drag on.

The AI thesis matures: From intent to ROI

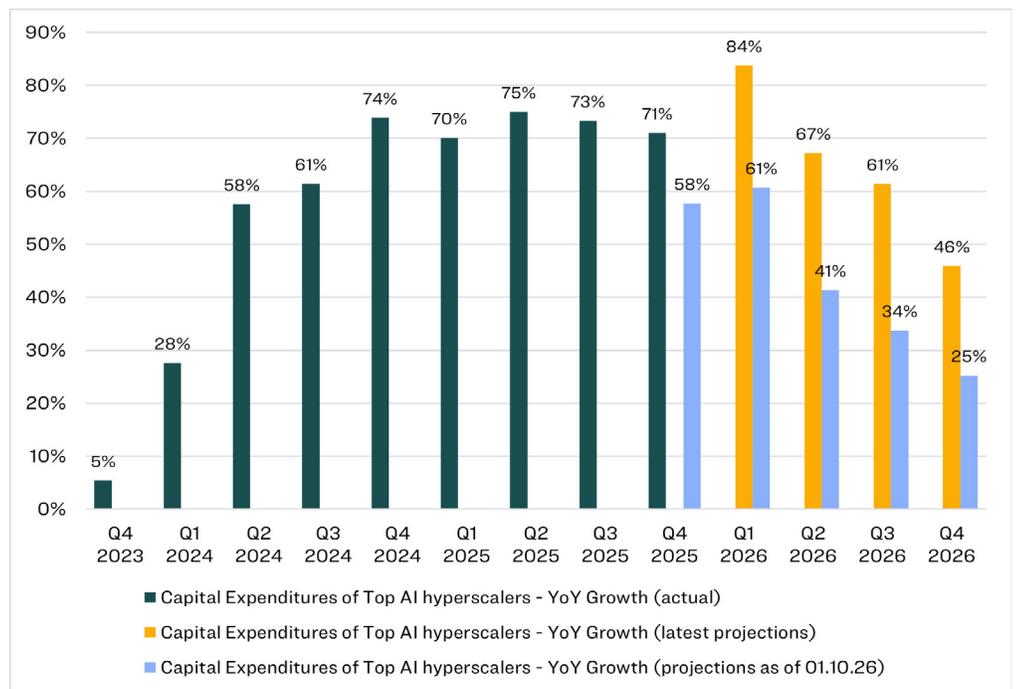
What's driving this rotation? It begins with a shift in how investors are thinking about artificial intelligence (AI). Throughout 2024 and early 2025, markets rewarded companies based on AI's promise—the potential for transformative technology down the road. Over the past four months, that focus has shifted. Investors are now asking harder questions: Will these massive AI investments actually generate profits? Which businesses might be disrupted by AI, and how quickly will companies and consumers actually adopt (and pay for) these technologies? The excitement about AI hasn't disappeared, but investors are now demanding more concrete evidence of returns on AI investments.

Hyperscalers (i.e., cloud computing giants) are projected to deploy over \$650 billion in AI capital expenditures (capex) this year, a significant step-up from 2025. With so much money pouring in, investors are increasingly focused on the sustainability of capex, the impact on balance sheet quality and cash flow generation, and future monetization (Figure 1). Beyond these financial considerations, two additional dynamics are reshaping the investment landscape:

- **AI-fueled disruption:** The rollout of new products featuring agentic³ AI—autonomous systems that can complete complex tasks independently—had disrupted multiple industries, from software to logistics to financial services. Investors are becoming increasingly more selective when picking perceived winners and losers across both large and small cap stocks. The companies most vulnerable to being replaced or bypassed by AI (“AI disintermediation”⁴) have been penalized by equity investors YTD. Volatility has been particularly acute in the software-as-a-service (SaaS) industry, where AI agents threaten to automate and replicate tasks that have historically commanded premium valuations.
- **On the flip side,** AI adoption is also driving significant opportunities. While companies vulnerable to AI-driven automation and disruption are experiencing heightened equity volatility, investors are rewarding businesses that demonstrate tangible benefits from adopting AI, such as improved productivity and rising profit margins. Meanwhile, the massive infrastructure buildout required to power AI represents a boon for industrial and infrastructure businesses that are seeing a significant rise in production orders.

FIGURE 1

AI Capex projections have been revised significantly higher.



Source: Bloomberg, TIAA Wealth Chief Investment Office.

Fixed income: Safety and yield converge

The bond market has been the standout performer from mid-January through the end of February. The 10-year Treasury yield⁵ declined from 4.30% in January to as low as 3.92% prior to the onset of the military action against Iran. However, the conflict in Iran has led to renewed fears over higher inflation (via higher energy and shipping costs) and pushed the 10-year yield back to 4.15% (as of March 5, 2026).

Meanwhile, market-implied expectations for future rate cuts by the Fed have been pared back to reflect the risk of higher inflation. As of March 5, the market is now pricing in less than 2 rate cuts for 2026, compared to nearly 3 cuts as of Friday, February 27.

Even before the start of the Iran conflict, the sizeable move lower in yields appeared somewhat at odds with fundamental factors including robust GDP growth, large fiscal deficits, and higher-than-expected inflation data. Importantly, the rise in oil prices, the persistent stickiness of service prices, and the return of supply-chain shortages within the semiconductor industry pose upside risks to inflation that may have been underestimated by investors. Additionally, the 10-year U.S. Treasury term premium could come under renewed pressure should investors' concerns around Fed independence and tariff revenue—following the [Supreme Court decision](#) two weeks ago—escalate again.

The corporate bond market remains resilient, but historically tight credit spreads are now facing mounting headwinds from souring investor sentiment following the escalation of geopolitical tensions in the Middle East.

Finally, investors have had to grapple with mounting concerns about heavy debt issuance from major technology companies financing their AI infrastructure buildouts. In addition, the AI disruption affecting software stocks is also affecting software company bonds. This poses risks for private credit and leveraged loan

sponsors, which have a larger exposure to software than the high yield corporate bond index. We are carefully monitoring these dynamics for potential ripple effects across the broader credit market.

Macro fundamentals: Resilience beneath the rotation

The underlying fundamentals of the U.S. economy remain healthy.

Consensus GDP growth expectations for 2026 have been revised higher—from 2.0% at the beginning of the year to approximately 2.4% today. While AI-related capital spending continues to exceed expectations, we're also seeing early signs of a broader recovery in manufacturing—both at home and abroad—that extends beyond AI.

The latest Institute for Supply Management (ISM) surveys for the manufacturing and services sectors showed remarkable strength in business orders, a trend consistent with improved orders reflected in Q4 earnings within industrial and other cyclical sectors. Global manufacturing activity, as measured by Global Purchasing Managers' Indexes (PMI), has also improved. Rising net exports from Asia—a reliable signal of global manufacturing momentum given the region's central role in global supply chains—provide further confirmation (Figure 2).

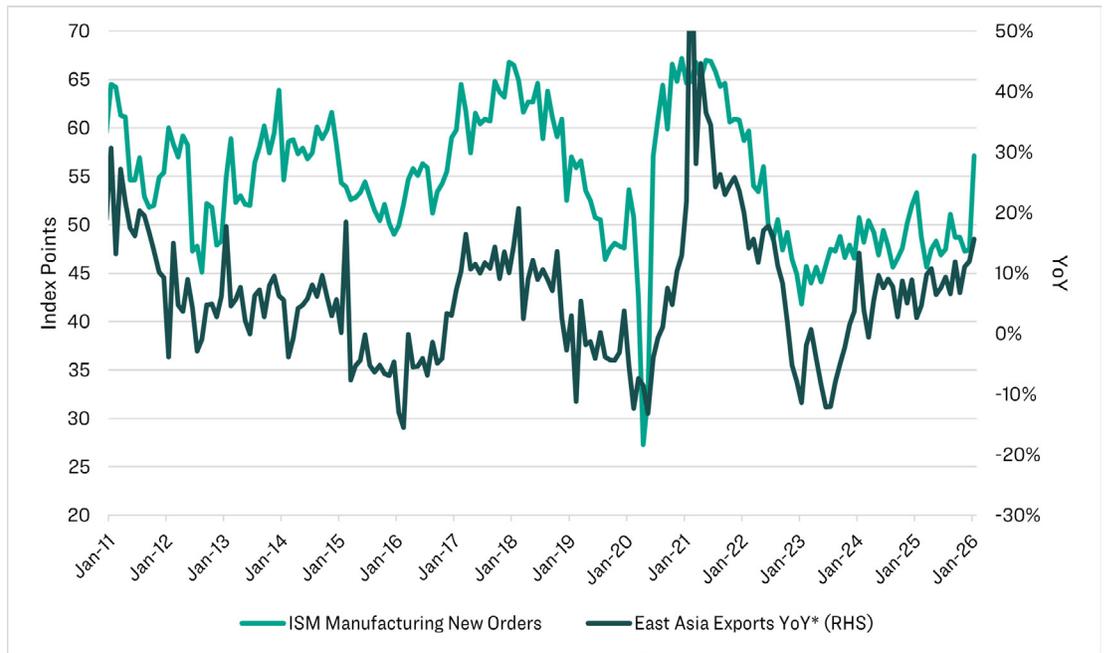
All this is contributing to broadening earnings growth, with notable improvements in Europe (10% projected earnings per share [EPS] growth in 2026, compared to -4% in 2025), Japan (6% projected EPS growth in 2026, compared to 2% in 2025), emerging markets (29% projected EPS growth in 2026, compared to 18% in 2025), and across cyclical sectors here at home. U.S. industrials and materials, for example, are expected to deliver 11% and 23% EPS growth, respectively, in 2026, compared to 7% and 6% in 2025.

At the same time, the U.S. consumer remains healthy in aggregate. The gap between high-income and low-income consumers persists, as wealthier households spend more and lower-income households remain cautious. However, so long as layoffs remain contained and inflation-adjusted wage growth remains positive, our view is that aggregate household spending capacity should remain resilient.

We see several U.S. stimulative factors—including retroactive tax cuts expected to boost refunds by ~\$100 billion, business tax breaks encouraging capital spending, sequentially lower tariff rates, large AI capital expenditures, administration efforts to boost household affordability and reduce mortgage rates, and accommodative financial conditions from rising equity prices and lower rates. In addition, productivity growth picked up significantly in the second half of 2025, rising at an annualized 4% pace between June and December. These dynamics should continue to provide support to cyclical economic momentum over the coming months.

FIGURE 2

The global manufacturing cycle appears to be improving.



Source: Bloomberg, ISM, TIAA Wealth CIO.

* East Asia Exports are calculated as the trade-weighted average of YoY Exports Growth for the top 10 exporting countries in Asia.

Policy backdrop: Fiscal, monetary, and trade

Fiscal, trade, and monetary policy are likely to remain key drivers of market sentiment in 2026.

On the fiscal front, tax refunds are expected to exceed last year's levels by approximately \$100 billion. How consumers use these refunds—whether they'll spend them, save them, or use them to pay down credit card debt—remains uncertain. Personal savings rates have moved lower in recent months, and credit card balances are at all-time highs. However, history suggests U.S. consumers tend to spend incremental cash. As a result, it is reasonable to expect a combination of spending, savings and debt payments following the disbursement of larger refunds.

On the trade policy front, the Supreme Court ruling against International Economic Emergency Powers Act (IEEPA) tariffs carries two crucial implications:

- The ruling further supports the recent downtrend in the U.S. effective tariff rate, already underway due to a combination of broader product exemptions and country-specific trade agreements.
- However, the Trump administration quickly reimposed a 15% global tariff rate using Section 122 of the Trade Act of 1974 and signaled its intention to pursue additional, more permanent tariff categories through formal trade procedures. This has reintroduced trade uncertainty for businesses that were beginning to adjust to the previous tariff framework.

On monetary policy, the Fed has cut interest rates by 175 bps since mid-2024, keeping financial conditions accommodative. But signs of a stabilization in labor market conditions and evidence that inflation risks may be perking up again could

keep the Fed on hold at least through the [change in leadership](#) scheduled for May, and possibly longer.

Potential risks should be carefully monitored

We are noticing mounting tension between cyclical tailwinds and shifting investor sentiment. We think equities remain supported by robust fundamentals—including strong expected EPS growth in 2026 (~14% year-over-year [YoY] for the S&P 500)—but risks could emerge from a sudden sentiment shift related to key themes such as AI (monetization, balance sheet quality, AI-led disruptions, or another DeepSeek moment challenging U.S. AI dominance), widespread expectations for tamed inflation, geopolitics—with some Iran-related scenarios carrying the potential of altering current economic projections—or private credit. These risks could be exacerbated and amplified by the large increase in margin debt within retail accounts that has occurred since early last year. Given that U.S. households hold around one-third of their wealth in equities (almost 40% for the top 20% of households by income), exogenous market shocks should be monitored as a potential threat to the consumption and earnings outlook.

Portfolio considerations: Navigating the rotation

Our core investment principles remain unchanged: stay invested and maintain diversification.

Investor sentiment is fragile right now, which makes it vulnerable to sudden shifts in market narratives. AI fatigue is palpable. However, this does not necessarily signal the peak or end of the bull market. Historically, the broadening of earnings and stock gains across more sectors—exactly what we’re seeing now—have been encouraging developments. In this environment, we expect more economically sensitive segments of the equity market like value and international stocks to outperform, whereas growth stocks could be more prone to volatility as the AI market cycle matures.

Diversification remains paramount. By combining secular growth exposure with defensive and value-oriented sectors, alongside core fixed income positions, investors can protect portfolios from the disruption risks concentrated in AI segments of the market. Importantly, bonds are once again serving their traditional role as portfolio stabilizers during times of equity turbulence.

Finally, one of the key themes in our [2026 Outlook](#) was the expectation for higher volatility this year. We maintain this view, and we’ve positioned for it by being moderately underweight corporate bonds within diversified portfolios as a form of risk hedging. This reflects historically stretched spread valuations, the potential for rising concerns about credit quality—particularly within the private credit industry—dwindling cash flow buffers, and issuer exposure to AI-driven business disruption.

Endnotes:

¹ As of this writing, March 6, 2026.

² Market performance data referenced in this publication as of February 25, 2026.

³ Agentic AI refers to an artificial intelligence system designed to achieve specific goals with minimal human supervision. Unlike traditional AI models that operate within predefined constraints and require human intervention, agentic AI exhibits autonomy, goal-driven behavior, and adaptability.

⁴ AI disintermediation refers to the elimination or compression of traditional intermediaries by artificial intelligence, enabling direct connections between producers and consumers or automating middle-layer tasks.

⁵ Bond prices are inversely correlated to yields, and when yields fall, prices move higher.

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