

War, Fundamentals, and the Fed

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EXECUTIVE SUMMARY

- After a turbulent start to the year marked by a 4.4% quarterly decline and a 9% peak-to-trough drawdown, the S&P 500 has fully recovered to all-time highs, propelled by resilient consumer spending and strengthening corporate earnings growth.
- However, persistent energy disruptions stemming from the Middle East conflict continue to pose meaningful risks, with the potential to suppress consumer spending, tighten financial conditions, compress corporate margins, and ultimately weaken the labor market if prolonged.
- As long as inflation expectations remain anchored—with market-based measures holding near 2.2%—the Federal Reserve can afford to be patient on energy price spillovers and shift its focus toward labor market conditions, potentially opening the door to further easing later this year.
- As energy market volatility, consumer resilience, labor market stability, and inflation expectations remain in flux amid shifting geopolitical forces, staying anchored in economic fundamentals is essential to navigating the uncertainty ahead.



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The Iran-U.S. ceasefire has helped calm markets, giving investors room to refocus on economic fundamentals. For now at least, those fundamentals remain on solid footing. The S&P 500 has climbed back to all-time-high levels following a rough start to the year, recovering from a 4.4% decline in Q1 and a 9% peak-to-trough drop between January and March. That rebound has been driven by resilient consumer spending and strengthening corporate earnings growth.



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Nevertheless, risks remain. Persistent energy disruptions—a lingering consequence of the Middle East conflict—could weigh on consumer spending. They could also tighten financial conditions, compress corporate profit margins, and if sustained, soften the labor market.

In this edition of CIO Perspectives, we take stock of what is keeping the economy on track, examine the risks worth watching, and explore how the Federal Reserve (Fed)—itself in flux—may approach monetary policy during this period of geopolitical uncertainty.

War and its impacts

The emergence of a ceasefire between the U.S. and Iran represents a meaningful near-term de-escalation. Despite ongoing headline volatility, there appears to be a willingness to negotiate on both sides. While the ceasefire remains fragile, financial markets have responded with surprising resilience. Both the S&P 500 and Nasdaq indexes have recovered since the onset of the conflict and currently sit near all-time highs,¹ while credit spreads and volatility measures have also calmed.

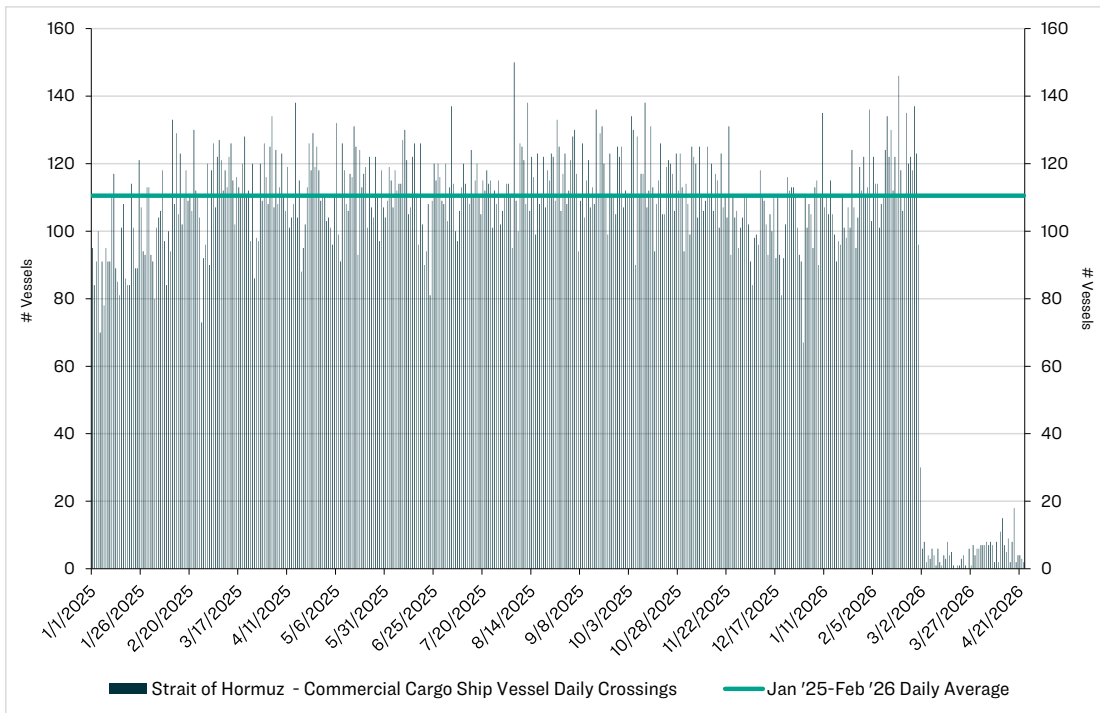
The more consequential risk, however, lies in the duration of the Strait of Hormuz closure. The strait remains effectively shut to commercial transit, with ~15% of global oil trade being impacted as a result (Figure 1). The longer energy disruptions persist, the more visible the structural damage to the global economy will become. The consequences are wide-ranging, including severe disruptions to global air travel, higher food prices and potential food scarcity, disruptions in technology manufacturing and artificial intelligence (AI) semiconductor production, and factory slowdowns across Europe and Asia.

The destruction of energy infrastructure across Gulf nations compounds these concerns. Repair timelines for oil refineries are measured in months to years, and Qatar’s damaged liquefied natural gas (LNG) production capacity may require three to five years to fully restore. Damage to aluminum facilities in the UAE and Bahrain further underscores the breadth of industrial impact. The reverberations across the global economy are likely to persist for some time—a dynamic that may explain why interest rates and commodity markets have not shared the same level of optimism currently being reflected in equity markets. Bond yields and oil prices remain elevated relative to pre-conflict levels, signaling persistent geopolitical risk premia and residual inflation concerns.

The political calculus in Washington is also a relevant factor. The Trump administration is keenly aware that the conflict is unpopular domestically. It also understands that sustained elevated gasoline prices carry real electoral consequences heading into the midterms. This political incentive reinforces the base case that the ceasefire will hold and that the Strait of Hormuz could reopen sooner rather than later, even if negotiations yield a deal that falls short of a sustainable long-term agreement on key issues such as uranium enrichment and ballistic missile programs.

FIGURE 1

The Strait of Hormuz remains largely blockaded.



Source: Bloomberg, TIAA Wealth Chief Investment Office.

Economic and corporate fundamentals remain supportive

With geopolitical tensions showing signs of containment, investors have begun to refocus on underlying economic fundamentals. By most measures, those fundamentals remain healthy. Thus far, the Iran conflict appears to be affecting economic sentiment more than actual economic activity.

Consumer spending—a primary indicator of economic health as it accounts for roughly two-thirds of U.S. gross domestic product (GDP)—has remained resilient. March retail sales grew above consensus expectations, with February data revised upward as well. There is little evidence yet that higher gasoline prices have prompted households to pull back in other areas of spending. A meaningful offset to higher gas prices has come in the form of elevated tax refunds, which are running ~15% above 2025 levels as of April 22, according to U.S. Treasury data. Consistent with this picture, commentary from the banking sector continues to point to steady consumer credit conditions.

That said, there are emerging areas of potential vulnerability.

- First, financial market conditions shape economic activity in two key ways: through changes in household wealth and through the cost of inputs like labor and raw materials. This dynamic is especially significant today, as higher-income households—buoyed by strong asset values—continue to drive consumer spending, while lower-income households face mounting financial pressure. While recent market volatility has been limited and the S&P 500's swift recovery to new highs likely preserves the confidence of the affluent consumer, this transmission channel warrants close monitoring. Rising redemptions and default rates within the private credit market also pose a challenge to financial conditions, especially for smaller businesses that have increasingly relied on private lending as a source of financing over the past decade.
- Second, the labor market, while still broadly resilient, is softening beneath the surface. Wage growth is moderating, and hiring rates remain subdued, reinforcing a fragile low-hire/low-fire equilibrium. The influence of AI on employment remains marginal for now, with firms opting to delay or reduce hiring rather than cut payrolls outright. Still, extended energy disruptions—if they translate into persistent inflation and incremental growth headwinds—could shift this dynamic and lead to a more pronounced softening of labor market conditions.

For investors, AI-related capital expenditures continue to be a source of strength. Hyperscalers are projected to deploy approximately \$650 billion in capital expenditures this year, providing direct support to GDP growth as well as longer-term productivity benefits. Technology stocks have been a primary driver of the equity market's recovery, gaining approximately 23% since the S&P 500 trough on March 30 and outperforming the broader index by roughly 10% over that period.

A significant test for the technology sector comes later this year, with a wave of anticipated large-scale initial public offerings (IPOs), including SpaceX targeting an estimated \$1.7 trillion valuation, OpenAI targeting approximately \$1 trillion, and Anthropic in a comparable range. These listings have the potential to be defining events for both the broader technology ecosystem as well as investors' appetite for AI-related assets.

The public listing of these mega cap companies could also have important implications for index-based investing. While the timing and eligibility for inclusion in the S&P 500 remain uncertain, eventual addition would require index tracking funds to absorb incremental technology exposure, further concentrating ownership among a small group of dominant market leaders. This dynamic is worth monitoring and could contribute to periods of elevated volatility around index inclusion events.

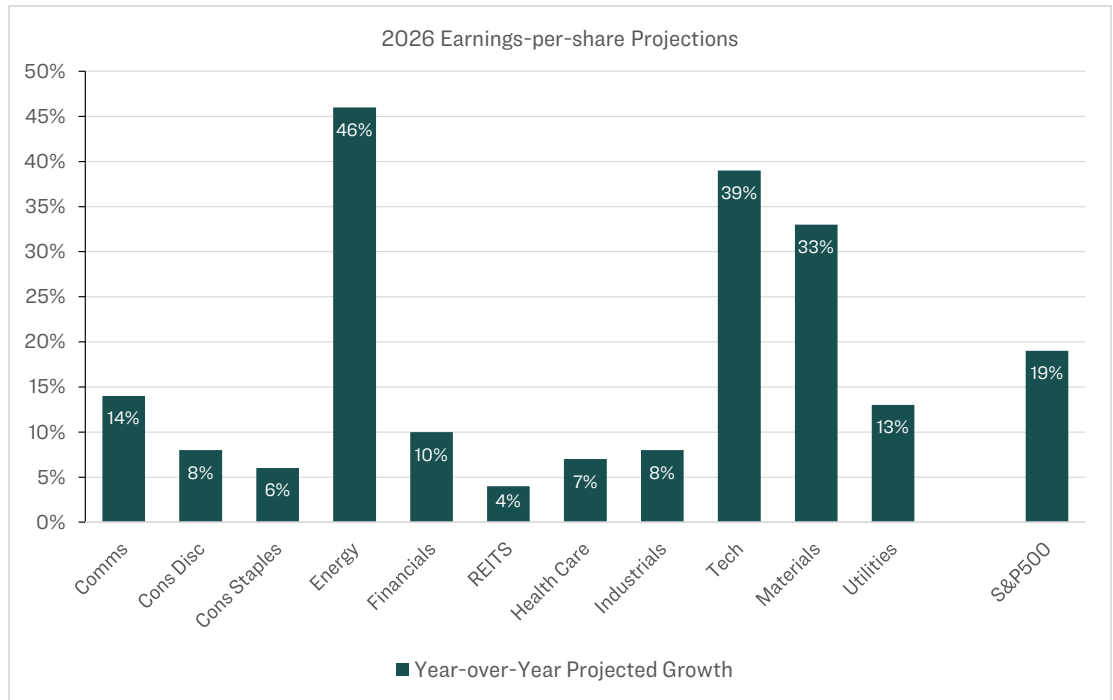
Corporate earnings provide additional reasons for optimism. Full-year 2026 earnings-per-share (EPS) growth projections for the S&P 500 have been revised upward from approximately 16% year-over-year (YoY) in February to roughly 19% YoY today.² Some of this is related to rising

earnings for energy stocks, but the positive trend extends to other sectors too—materials, technology, financials, and utilities sectors are all seeing constructive estimate revisions (Figure 2). At a sector level, approximately half of the total 2026 EPS growth is expected to originate from technology, though earnings momentum is broadly healthy across sectors.

In aggregate, the U.S. fundamental backdrop remains resilient, but headwinds could progressively intensify should energy disruptions persist and market volatility remain sustained. Economists have begun modestly trimming U.S. GDP growth forecasts, though growth is still projected to exceed 2% for the full year.

FIGURE 2

Corporate earnings growth is expected to be solid in 2026.



Source: FactSet, TIAA Wealth Chief Investment Office

The Fed outlook: Navigating elevated uncertainty

Prior to the conflict, the inflation outlook was relatively benign, with moderation in the rate of change of service prices offsetting the residual tariff-driven upward pressure on some goods prices. A combination of moderating wage growth, productivity improvements, and housing disinflation portended a gradual decline in the annualized rate of inflation—albeit to levels still above the Fed’s 2% target.

Against this backdrop, the Fed had been waiting for more evidence that tariff-related price increases were peaking before delivering additional rate cuts. Within the monetary policy committee (FOMC), views appeared divided between those anticipating one further rate cut in 2026 and those expecting two or potentially more.

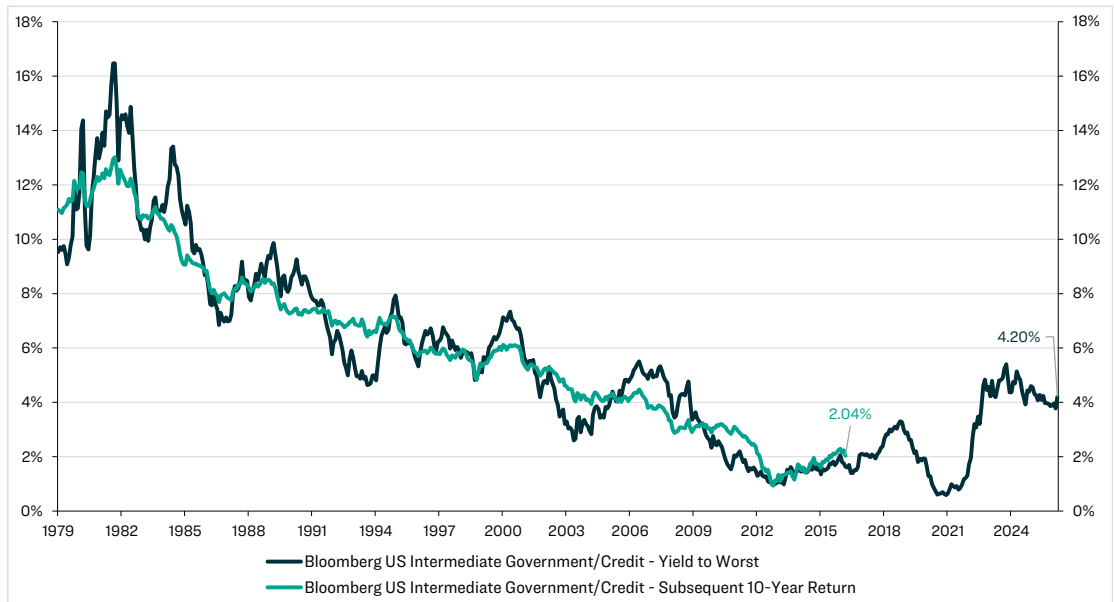
The Middle East conflict has added meaningful complexity to the Fed’s calculus, creating simultaneous upside risks to inflation and downside risks to household consumption and labor market conditions. The monetary policy outlook is further complicated by the leadership transition from Chair Powell to President Trump’s nominee Kevin Warsh. While Warsh’s hearing before the Senate Banking Committee on April 21 was relatively light on details, comments about the need to reform the current monetary policy framework and models suggest that the Fed’s reaction function could change in the second half of the year.

In weighing the path for monetary policy, labor market concerns are likely to be the more decisive factor over time, provided the Fed gains confidence that the energy price shock is not embedding itself into longer-term inflation expectations. Encouragingly, market-based measures of inflation expectations have remained relatively stable—around 2.2%—while survey-based measures have ticked up but remain within the range observed over the past few years, and well below 2022 levels. Contained inflation expectations would allow policymakers to be more patient in assessing the potential spillover effects of the ongoing spike in energy prices and could pave the way for further easing later this year.

With respect to the Treasury market, absent further escalation in the Middle East, 10-year yields are likely to remain in the 4.0% to 4.5% range for the next several quarters, consistent with an economy sustaining roughly 2% growth and resurging inflationary pressures. Yields could then begin to drift lower toward year-end, assuming a moderation in energy prices and the labor market. At current levels, our view is that bonds provide attractive value within diversified portfolios. Positive inflation-adjusted yields in the vicinity of 2% boost fixed income’s diversification potential in a scenario where volatility is driven by economic growth concerns, rather than inflation concerns (Figure 3).

FIGURE 3

More attractive yields boost the long-term total return potential for bonds.



Source: FactSet, TIAA Wealth Chief Investment Office

Conclusion

Despite elevated geopolitical risks, resilient economic conditions and improving earnings trends continue to provide a healthy foundation for markets. In the near term, we are watching several key developments closely: how long energy market disruptions persist, whether consumer spending and the labor market hold up, and whether inflation expectations stay under control. The Fed now faces a delicate balancing act, namely keeping inflation in check while remaining responsive to shifting economic conditions. How it navigates that challenge will be a major driver of the market outlook—and of market conditions—in the months ahead. In an environment where both economic and geopolitical forces are in flux, staying grounded in economic fundamentals is more important than ever.

Endnotes:¹ FactSet data as of April 22, 2026.² FactSet data as of April 24, 2026.**IMPORTANT DISCLOSURES**

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