

Quarterly economic outlook: Change is the only constant.



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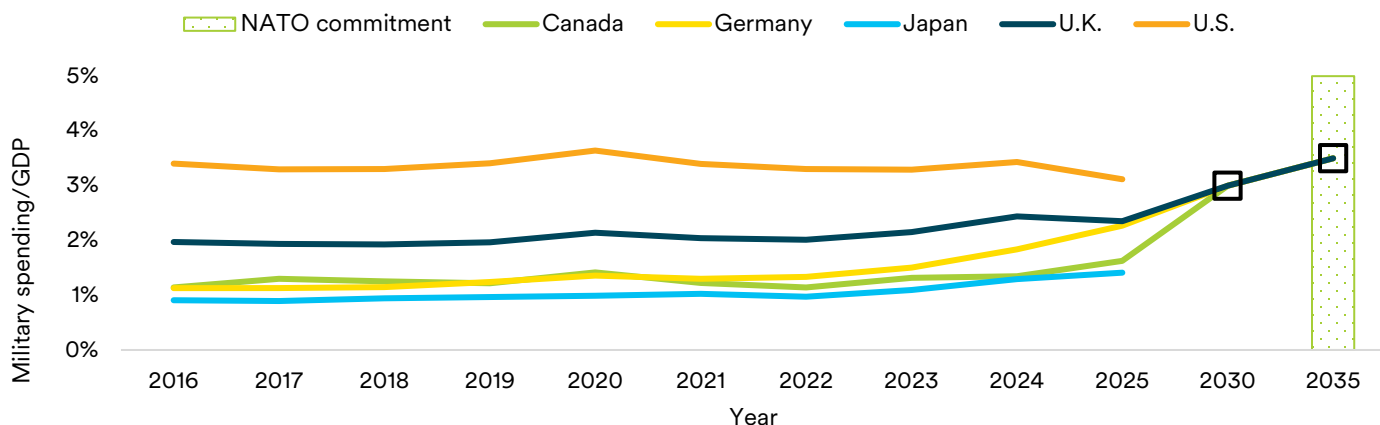
Sometimes, it seems, the only constant in this world is change. It would certainly be understandable for investors to feel that way at the midpoint of 2026. The halting progress toward a diplomatic resolution between Iran and the U.S. (which would allow shipping traffic through the Strait of Hormuz to fully recover) has occupied front-page headlines, as have the eye-watering levels of corporate investment in artificial intelligence (AI).

Headlines have also focused on consequential shifts in areas such as military spending, central bank dynamics, exchange rates, capital markets, inflation, supply chains, weather patterns, and demographics. These shifts have unfolded at different speeds along a variety of timeframes. Some have brought us to historically unusual places and upended status quos, while others have allowed for continuity. Ultimately, the sum of these conditions may mean a variety of things for economies and markets—and inform how investors should engage with the current environment.

Not our grandparents' post-war era

While dramatic developments related to the Persian Gulf and AI have dominated the news cycle, global military spending is also an area that has experienced meaningful breaks with longstanding status quos. The Trump administration's pressure campaign on fellow NATO members to increase defense spending, while often abrasive, appears to have had the desired effect; the alliance has now committed to increase military spending to 5% of GDP by 2035. While most NATO countries are likely to fall short of the 5% commitment, it's clear that several countries have been ramping up military expenditures and will likely continue to do so in the years ahead. Japan, one of NATO's close global partners, has also begun to expand military spending (Exhibit 1) on top of loosening longstanding constraints on its defensive capabilities.

Exhibit 1: Rising military expenditures, shifting spending patterns



Source: SIPRI Military Expenditure Database, NATO, Oxford Economics, SEI. Annual military spending as a percent of gross domestic product in U.S. dollars. 2035 bar represents NATO agreement to spend 5% of GDP on defense, squares represent Oxford Economics' estimates of actual 2030 and 2035 spending levels. Data as of 6/29/2026.

A U.S. presidential administration encouraging higher military spending by both Germany and Japan is a clear break with the post-WWII era. And publicly airing NATO's longstanding internal frictions over national defense budgets is a clear break with the Cold War era. For investors, the implications are clear. Expanded defense budgets, along with increasing social support for the elderly, infrastructure spending, and investments in supply-chain resilience should keep nations' government budget positions in deficit for the foreseeable future. While this may provide some support for economic activity, it is also expected to aggravate ongoing material- and labor-supply bottlenecks and keep upward pressure on prices and interest rates. We are in a nebulously bipolar world that's loosely organized around the China-U.S. rivalry; this marks a notable difference from the post-WWII and post-Cold War decades, and geopolitical risks could unfold in unpredictable ways.

Notable shifts in central bank outlooks

Since the closure of the Strait of Hormuz and the installation of a new chairman at the U.S. Federal Reserve (Fed), central bank dynamics have shifted notably. Prevailing expectations at the start of the year were for most central banks to hold interest rates steady or lower rates further in 2026. Those expectations were turned on their heads as the Strait of Hormuz closure unleashed inflation pressures. While most developed central bankers indicated that they would hike rates in response to sharply higher commodity and shipping prices, only the Bank of Japan, the European Central Bank, and the Reserve Bank of Australia raised their interest-rate targets during the second quarter. Whether other central banks will follow suit is a subject of intense debate, with markets currently pricing in a small number of interest-rate hikes for many of them. We view current global economic activity as resilient enough to withstand a modest amount of monetary tightening, and we believe that inflation and longer-term rates will remain stubbornly elevated.

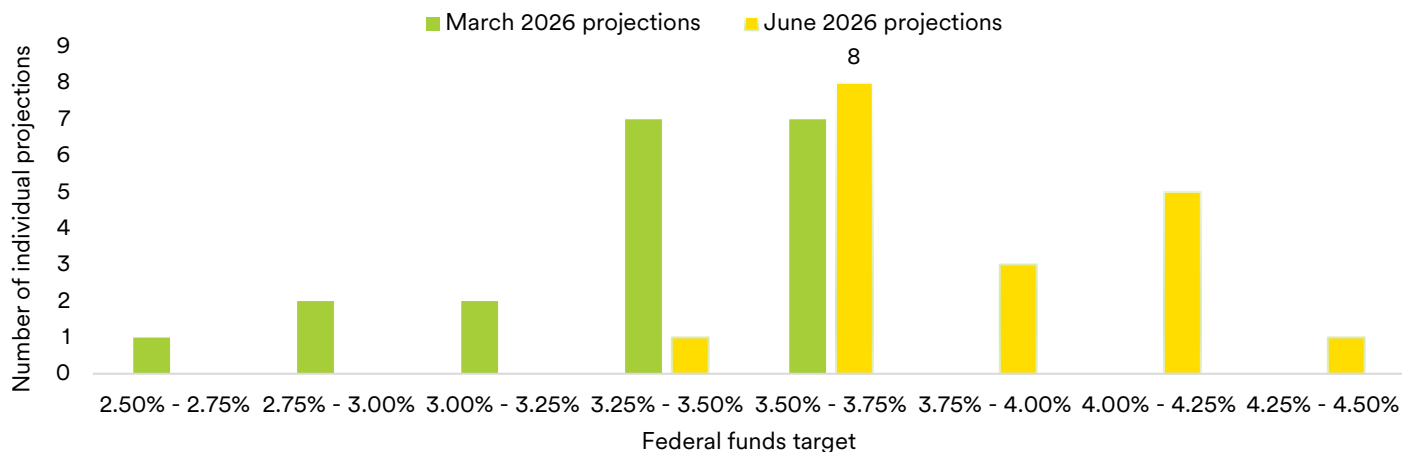
Things have become especially interesting in the U.S., where newly appointed Fed Chair Kevin Warsh presided over his first policy meeting in mid-June and articulated his desire for a "top-to-bottom review of monetary policy operations" in five areas: Fed communications, balance-sheet and reserve management, economic data, productivity and labor, and inflation measurement. Warsh promised to assemble task forces to study each of those areas and recommend reforms, hopefully by the end of 2026. While these five domains are ripe for reform to varying degrees, we view Fed communications as the most relevant for the near term. In something of a "back-to-the-future" dynamic—after a decades-long evolution to provide the public with stronger policy guidance and greater transparency into its deliberations over last 15 to 20 years—the Fed chair is now someone who has historically argued that monetary policy would be better served by less frequent communication and less explicit forward guidance. Such a reversal in communication efforts would effectively require market participants to rely even more heavily on interpreting economic data to form interest-rate expectations, as they did in the last two decades of the 20th century and first few years of the 2000s. This adds further importance to concerns about economic data quality, and it's encouraging that the Fed (along with statistical agencies in a number of countries) is giving this area a close look.

Chair Warsh has also expressed a desire to shrink the Fed's balance sheet (the amount of financial assets it holds). Today's large balance sheet arose out of policy responses to the 2008 Global Financial Crisis (including Fed market operations and

tighter financial regulations under the 2010 Dodd-Frank Act). It's widely agreed that balance-sheet reduction would require meaningful regulatory and operating changes in order to avoid money-market disruption. Therefore, we expect Fed balance-sheet policy changes to be a much slower-developing story than that of communication behaviors.

While the market's attention has been primarily focused on the new Fed chair's plan, we believe it's just as important to pay attention to the Federal Open Market Committee's (FOMC) marked shift in expectations for 2026. In the span of only three months, the 18-member policy-setting committee went from a majority expecting a lower interest-rate target to just one member expecting a lower target rate—with nine members expecting an increase of 0.25% or more over the rest of this year (Exhibit 2). That's quite a swing. We should also note that, true to his views on overcommunication, Chair Warsh abstained from contributing to the FOMC's June Summary of Economic Projections.

Exhibit 2: A hawkish shift at the Fed



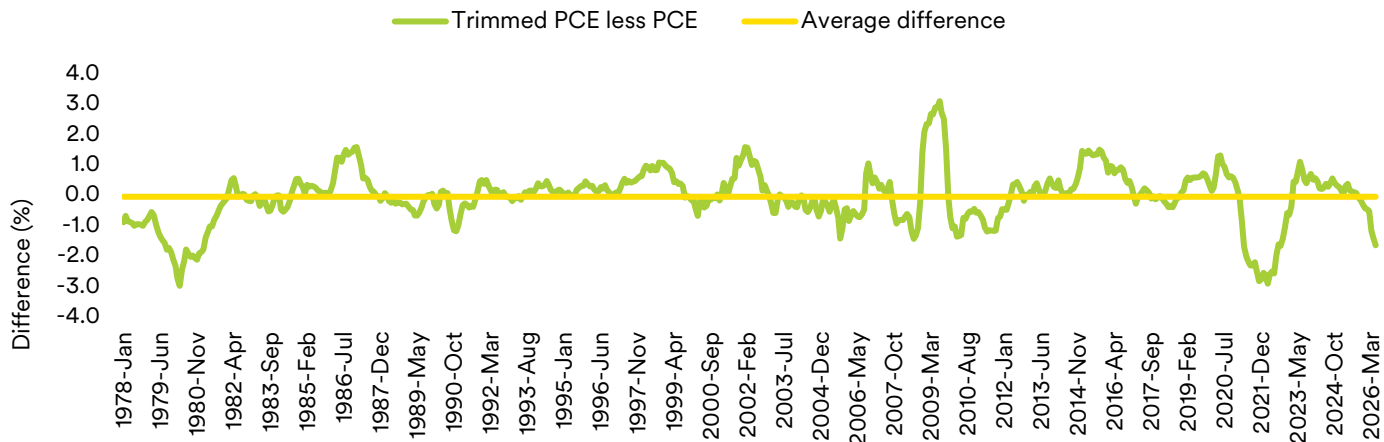
Source: Board of Governors of the Federal Reserve System, SEI. Federal Open Market Committee (FOMC)-member projections for interest-rate changes in 2026 as of March and June 2026 meetings.

Shifting inflation targets?

For several years now, many observers—central bankers among them—have expected inflation to return to more desirable levels. Clearly, this hasn't happened, and we remain skeptical that at-target or below-target inflation lies just around the corner in many countries. Strengthening labor market, heavy AI-related investment demands, sustained government budget deficits, increased military expenditures, and further investments in supply-chain resilience (spurred by multiple rounds of U.S. tariffs, COVID-19, and, most recently, Hormuz-driven price shocks) may continue to exert upward pressure on prices. If lackluster housing markets start to recover in a meaningful number of countries, this would only enhance the dynamic.

While Warsh has long held himself out as an inflation fighter—a profile his first press conference largely reinforced—many have speculated that he'll eventually lower the Fed's interest-rate target to satisfy President Trump, who appointed him to the post. The new Fed chair has kept those cards close to the vest but has also mentioned a greater focus on "trimmed" median measures of inflation that strip out the most significant contributors to price movements in any given period. Shifting to an alternative inflation measure would likely be better received by markets than explicitly abandoning the 2% inflation target in favor of something higher. It remains to be seen just how hawkish or dovish the Warsh Fed will be, but it's worth noting that the Dallas Federal Reserve's trimmed version of the Fed's long-preferred personal-consumption expenditures (PCE) price index is one of the few well-behaved measures of U.S. inflation at the moment; it has been running well below PCE since late 2025, as shown in Exhibit 3.

Exhibit 3: Trimmed mean inflation attracting the doves



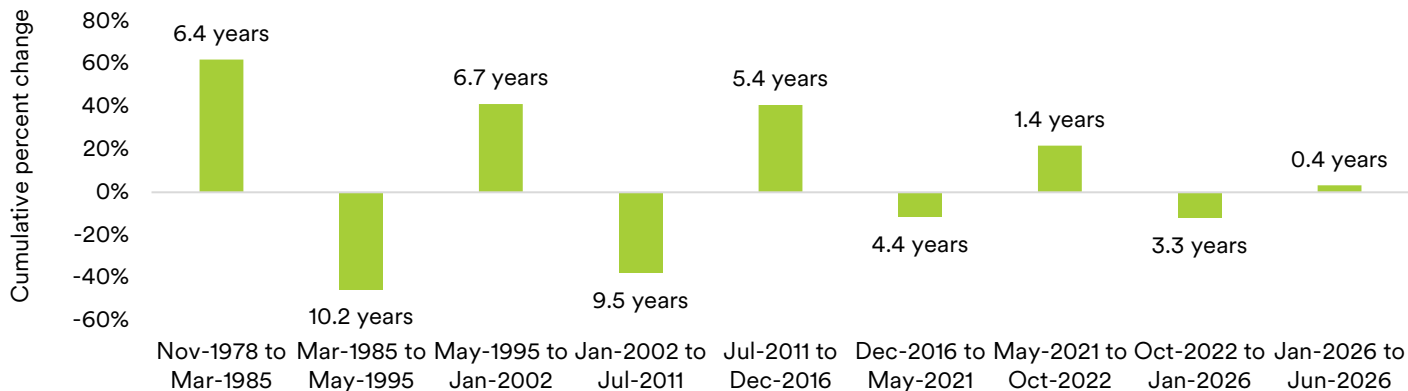
Source: U.S. Bureau of Economic Analysis, Federal Reserve Bank of Dallas, Federal Reserve Bank of St. Louis, SEI. Difference between the year-over-year percent changes in monthly trimmed-mean PCE inflation rate and Personal Consumption Expenditures chain-type price index. Monthly data from January 1978 through May 2026, as of 29 June 2026.

As we often remind clients, inflation is one of the most pernicious risks to investment portfolios as it eats into nominal returns and real wealth over time. Although it is important to note that inflation-sensitive assets can provide diversification during periods when higher-than-expected inflation drives both stocks and nominal bonds lower. We shouldn't be surprised if the Fed (and, perhaps, other central banks) switched to friendlier measures of inflation at some point. It wouldn't be the first time that a central bank transitioned toward purportedly cleaner signals of underlying inflation trends (although cynics might describe it as moving the goal posts!).

Change of direction for the U.S. dollar

This shifting outlook for U.S. monetary policy along with the country's prominence in the global AI buildout has put a bid under the dollar against most other currencies. Over the last four decades, U.S. dollar bull and bear cycles have produced similar annualized magnitudes—but have recently been compressed into much shorter timeframes, as shown in Exhibit 4 (although it's important to acknowledge that determination of cycle peaks and troughs involves some subjective judgment).

Exhibit 4: USD cycles since 1978



Source: Board of Governors of the Federal Reserve System, St. Louis Federal Reserve, SEI. Goods-trade-weighted U.S. dollar index versus major currencies, from January 1973 through December 2005, and U.S. dollar index versus advanced foreign economies from January 2006 through June 18, 2026. Weekly data, not seasonally adjusted, indexed to 100 at the start of 2006. Data as of 29 June 2026.

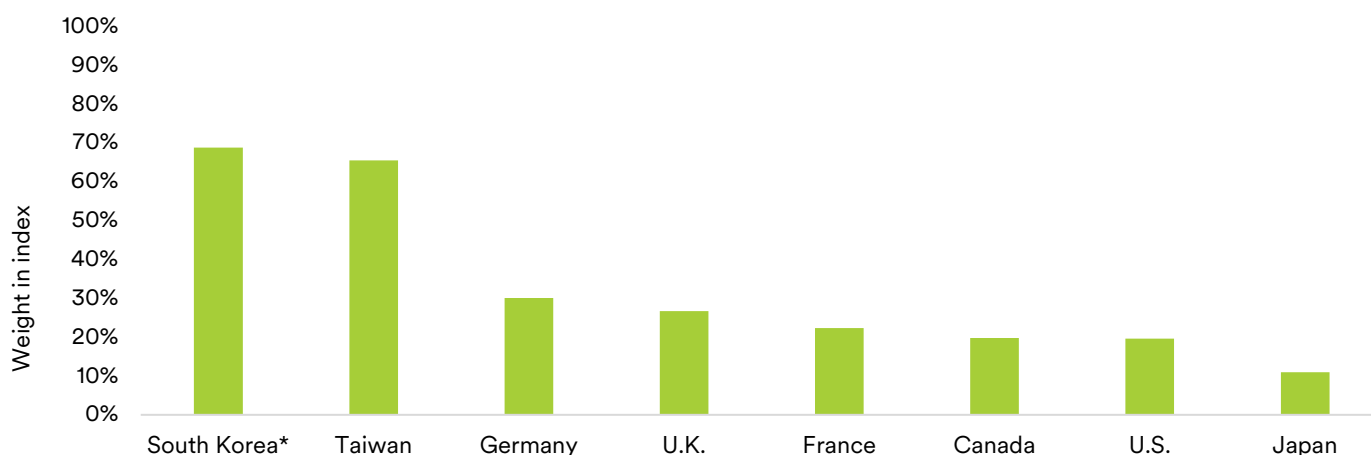
While the current uptrend only started in January, it comes at the tail of a three-plus-year downtrend. Therefore, a durable reversal seems plausible; it certainly has some fundamental supporting arguments.

Market indigestion, meme stocks, churning commodity prices

Credit markets have been quite interesting. AI-focused companies, which previously exhibited massive free-cash-flow generation, are now pouring operating and financing cash flows into physical investments in chips, data centers, and other infrastructure. Meanwhile, demands for upgraded energy grids continue to grow (with the exception of China, which has already invested heavily in modernizing its energy infrastructure). Compared to similar-quality credits, spreads for many of these companies widened as markets were forced to digest the heavy demands for financial capital—not just those arising from the AI buildout, but from investment-grade issuers generally.

One of the more notable stories in global equity markets during the second quarter was the elevated volatility in concentrated, AI-heavy national stock market indexes, especially South Korea and Taiwan (Exhibit 5). Investors may expect AI-related stocks to continue providing a wild ride—thanks to the segment’s massive capital expenditures, its still-cloudy long-term prospects (capex financing, costs and margins, enterprise and individual rates of adoption, intensifying competition, future regulations), and the recent availability of levered, single-AI stock products. These factors were evident in the extreme second quarter volatility of many AI-related securities.

Exhibit 5: Some tech-heavy markets are also top heavy



Source: MSCI. Data as of 29 June 2026. Total weight of three largest constituents in the MSCI Canada, MSCI France, MSCI Germany, MSCI Japan, MSCI Korea, MSCI Taiwan, MSCI United Kingdom and MSCI USA Indexes. *South Korea may be understated given chaebol structures.

Commodity markets have been whipsawed by the closure and halting reopening of the Strait of Hormuz (energy commodities and downstream and residual products), and by the AI buildout (industrial metals and certain other commodities). Global energy-price pressures and negative flows into gold exchange-traded funds have contributed to the shiny metal’s declining price. However, this could reverse course; with much-lower energy price, and with the U.S. dollar-based financial system, the diversification of foreign-currency reserves into gold by some central banks could very well likely reassert itself. Some agricultural commodities could prove volatile in the coming quarters given the loss of Persian Gulf-produced fertilizer inputs, and numerous weather-related risks arising from an especially strong “El Nino” pattern in the Pacific Ocean.

The AI-buildout story and commodity-price volatility are expected to persist in the years ahead. Therefore, it’s important for investors to be mindful of the subsequent heightened volatility that could ensue across markets more broadly—and to remain especially wary of concentration risks and aware of underappreciated opportunities related to (or are independent of) the AI narrative.

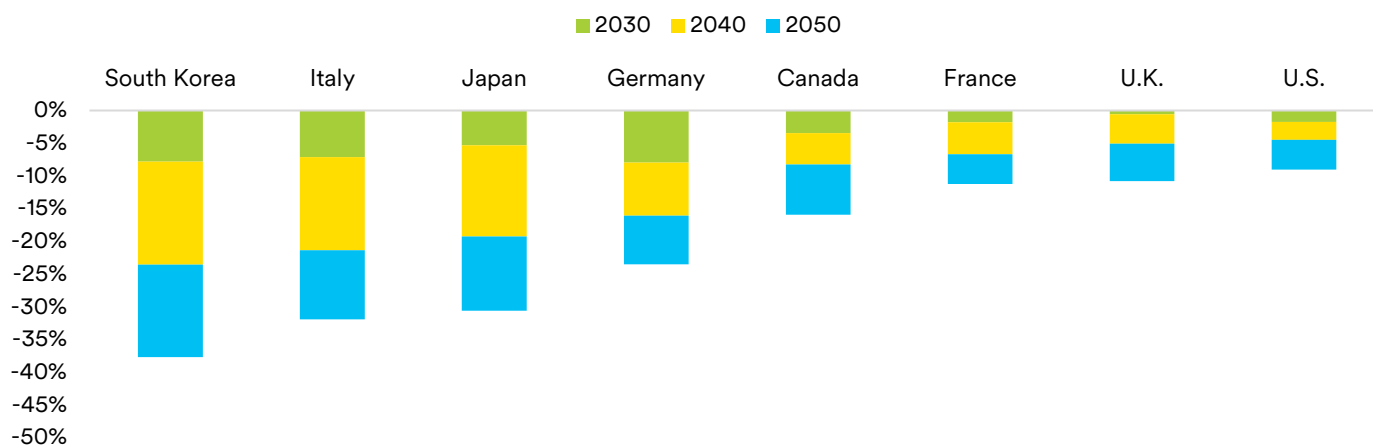
The great demographic turnaround

The market outlook for demographics in coming decades indicates that a massive break with the global experience of recent centuries is underway. For thousands of years, the world’s total human population grew at a snail’s pace as high fertility rates (number of children per woman) barely kept ahead of mortality rates and as shocks to population growth tended to involve

large declines due to events like pandemics and large-scale famines. Until the 1700s, high rates of mortality meant low rates of old-age dependence. However, the world’s population has exploded since the sixteenth century—from an estimated 600 million to over eight billion today—as improvements in sanitation, food availability, and public health have sharply lowered mortality rates. While the world’s population has continued to increase, fertility rates have steadily declined since the 1970s. Fertility rates in several countries—including South Korea, China, Italy, Japan, Canada, Germany, the U.K. France, the U.S., and, most recently, India—have already fallen below replacement levels, according to the United Nations’ most recent estimates.

While likely to continue unfolding gradually, this might be the largest trend break with economic and capital markets’ history of the last two centuries. It is important to be aware of the implications of such a disruption on labor forces and old-age dependency. A greater share of elderly and retired people relative to working-aged people implies a greater demand for goods and services relative to the amount that can be produced—all else being equal. The qualifier “all else being equal” speaks to the reason economists and policymakers typically invoke the critical importance of productivity growth; if more of those goods and services can be produced with the same or fewer inputs (such as labor), the inflationary consequences should be manageable (albeit likely higher than those of recent decades). AI and robotics, as well as organizational learning and human skill development, will be critical determinants of how this plays out in the decades ahead.

Exhibit 6: Rapidly shrinking workforces ahead



Source: United Nations World Population Prospects 2024. Forecasted, cumulative, percentage net flows into national workforces as of 2030, 2040 and 2050. Data as of 26 June 2026.

Shifting demographics also raise questions about future consumer spending, often framed in terms of labor income and saving preferences. For instance, if shrinking workforces were to result in falling total labor income—a worst-case outcome—this would undermine consumer-spending growth. However, a more-complete framing also takes wealth effects into account: The impressive population growth of the last two centuries has occurred alongside a substantial increase in financial holdings and other assets, thanks to factors such as productivity gains, institutional development, globalization, and capital-market deepening. In the years ahead, this accumulated stock of wealth will become an increasingly important source of household consumption. Of course, distributional, behavioral, and asset-price dynamics will matter, but the bottom line is that household assets may remain a meaningful source of support for consumption.

For investors, the demographic outlook underlines the importance of productivity growth in the years ahead. That growth is likely to come from a combination of further development and broader adoption of labor-saving technologies (AI and robotics, for example), investments in human capital, and improvements in organizational efficiency.

There are continuities; not all are comforting

In a world of constant change, it can be reassuring to find constants. Unfortunately, not all of today’s constants are comforting, and some are likely to continue creating economic and market uncertainty. Persistent government fiscal deficits and the human, material, and logistical bottlenecks mentioned earlier have been with us for some time now; as already noted, these are likely to exert upward pressure on prices and interest rates, all else equal. Residential real estate continues to struggle in numerous advanced economies, with high mortgage rates, stubbornly wide mortgage spreads, and historically low

affordability. That may eventually shift (at different speeds based on the characteristics of each country's mortgage market) as the aggregate rates on existing mortgages converge with the marginal rates on new mortgages. Finally, to the detriment of multiple economies, especially those of continental Europe, China remains an intensely competitive exporter on the world stage and it is now bringing its low-cost model to bear in the AI arena.

The shifting dynamics and small number of constants may not create an especially comforting environment for risk taking. Fortunately, when it comes to navigating economic and financial market volatility, there are some historically reliable strategies: implement a carefully thought-out investment strategy; work with professional asset managers who are committed to meeting and, whenever possible, exceeding investment objectives; and stay disciplined, even when change seems to be the only constant.

Key takeaways:

- Investors should be aware of shifting diplomatic relationships, spending patterns, and risks in the geopolitical landscape. Large government budget deficits are likely to persist.
- Multiple central banks have indicated that they plan to raise interest rates, and a small number have already done so. If all central banks follow suit, the global economy appears to have enough momentum to withstand a modest increase in interest rates. However, a meaningful increase in longer-term interest rates could set the stage for worsening market volatility.
- The new Fed chair has given mixed signals, but we think there's a meaningful risk of the Fed tightening policy by more than currently anticipated. This could support USD strength and foster continued market volatility, which may have additional relevance for portfolios with currency exposure.
- Massive corporate spending is fueling the AI buildout and spurring strong demand for real and financial resources. This has resulted in some market indigestion and market volatility, especially in top-heavy, tech-dominated equity markets.
- Significant demographic shifts are expected to put ever-increasing pressure on government budgets, labor markets, and some prices. This highlights the importance of productivity growth in the coming years.
- As economic and market constants become less certain, investors' focus on historically reliable strategies and partnership with trusted investment professionals should remain constant.

GLOSSARY AND INDEX DEFINITIONS

For financial term and index definitions, please see: <https://www.sei.com/ent/imu-communications-financial-glossary>

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