

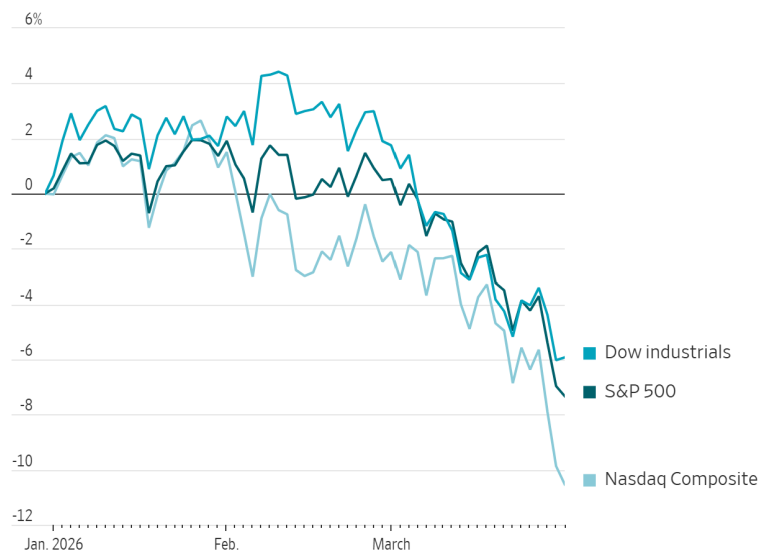
War Tax

“America has no permanent friends or enemies, only interests” –Henry Kissinger

US stocks just completed their worst quarter in four years. Outlooks were rosy to start the year, with growth accelerating, the Federal Reserve poised to reduce rates, and markets shaking off tariff uncertainty. Seemingly out of nowhere came the war with Iran, which caused oil prices to rise 63% and a corresponding drop in most risk assets. For the quarter, the S&P 500 dropped by nearly 5% and the Nasdaq 100 declined by 7%.

The first quarter also saw major dispersion amongst individual stock returns because of a new autonomous AI release from leading AI company Anthropic. Investors rotated out of software stocks in favor of blue chips and many well-known software companies suffered significant losses. This bled over into the Private Credit space on fears that loans made to private software companies would also soon be in trouble.

Index performance year-to-date



Source: FactSet

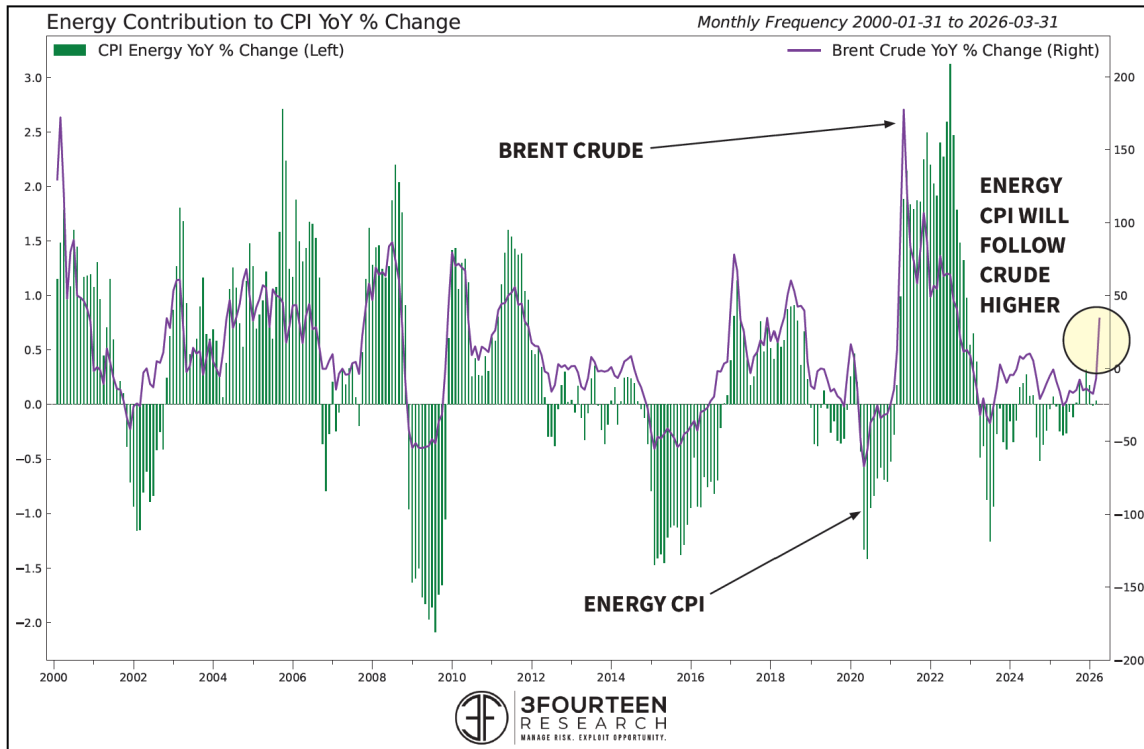
At the beginning of the year, there was nearly an 80% chance of two rate decreases, but by the end of the quarter those odds had dropped to just 5%. Bonds rallied to start the year but eventually ended the quarter flat as Treasury rates increased on inflation fears.

Below we provide an overview of the current investing environment and our thoughts for the rest of the year.

Current Situation: Iran

As we write this letter, markets are being driven by the war in Iran and the blockade of the Strait of Hormuz. Deadlines, ceasefires, and threats have all failed to get oil flowing again. Nearly 20% of the world’s oil flows through the Strait, so there will be a resolution; the question is when. Even if the strait opens quickly, many experts believe oil prices will remain in the \$80s for some time. On the other hand, if the situation worsens, we could see oil in the \$140s. Thus far, when the market seems at its shakiest, TACO (*Trump Always Chickens Out*), seems to go into play and markets have massive rallies. This time probably won’t be any different as the administration doesn’t want high oil prices or stock declines heading into the mid-terms.

Nevertheless, there has probably been enough damage done to energy prices to cause a spike in inflation. Below is a chart showing the energy price impact on overall inflation (CPI). Historically, when energy prices rise by almost 50%, there is a corresponding 1% rise in overall inflation rates. If this plays out, the Fed will be in a precarious position. The new Fed Governor, Kevin Warsh, will have a difficult time convincing his fellow Fed governors to drop rates at the risk of losing credibility.



Hopefully higher energy prices and inflation will prove to be transitory, but that is anyone’s guess. The question is, can rates stay higher and stocks still perform, which has certainly been the case over the past 3 years. Although the Fed has lowered rates, the 10-year Treasury has maintained a range between 3.6% and 4.8% and stocks have performed, indicating that structurally higher rates may be the norm now.

Current Situation: AI & Software

The first quarter was defined by a dramatic shift in the market’s relationship with artificial intelligence going from euphoria to existential fear. As we mentioned in our 2026 Outlook, the central debate around AI was if, and when, the massive spending would translate into returns. Over the last three months, the narrative has changed to “What if it actually works too well?” Fears hit software companies the hardest, as the sector has declined by nearly 30% since October. Many fear that autonomous AI tools could erode per-seat pricing models of companies such as Salesforce and replicate existing software products at scale. Investors have been looking at all companies through the lens of AI immunity or vulnerability. 185 of the 500 stocks in the S&P 500 moved by 15% or more, which resulted in the dramatic dispersion in stock returns as mentioned earlier. This level of dispersion has only been seen twice in the last 30 years, the dotcom bust and the global financial crisis.

AI fears then spread into private credit, where 25-35% of all underlying loans are exposed to AI disruption risk. The software sector represents about 20% of all loans outstanding. Although default rates have increased over the past 18 months, they are far more prevalent in smaller companies, those with earnings of less than \$25 million as those companies tend to be more fragile borrowers. As fears have grown, redemption rates across funds have also grown, putting more pressure on the sector. However, the best managers typically have several characteristics that allow them to navigate volatile markets: they originate their own loans, which are diversified across sectors and time frames, and they have genuine workout capabilities if a loan does have issues. Over the quarter, we spoke to all our managers and have made adjustments as needed. We will continue to monitor the positions closely and remain proactive.

Moving Forward

Outside of the Fed's pause on rate cuts, our original themes for the year remain largely intact. According to S&P Global, \$335 billion in tax refunds will be paid in the first half of the year, which is 11% higher than in 2025. This increase is a result of the tax bill implemented last year and was always projected to be front-loaded. In addition to the refunds, tax withholdings also decreased in January due to updated IRS withholding tables, resulting in another boost to net wages for workers. In addition, incentives for companies to invest and write off many of their expenditures in year one through bonus depreciation should lead to increased consumption. However, the war will take some of this windfall away in the form of higher gas and energy prices. It also has the potential to change the consumer mindset from spending their extra cash to saving their extra cash, if their view of the future is too dim. We do believe there will be an eventual resolution in Iran, and the tax windfall will be positive for the economy.

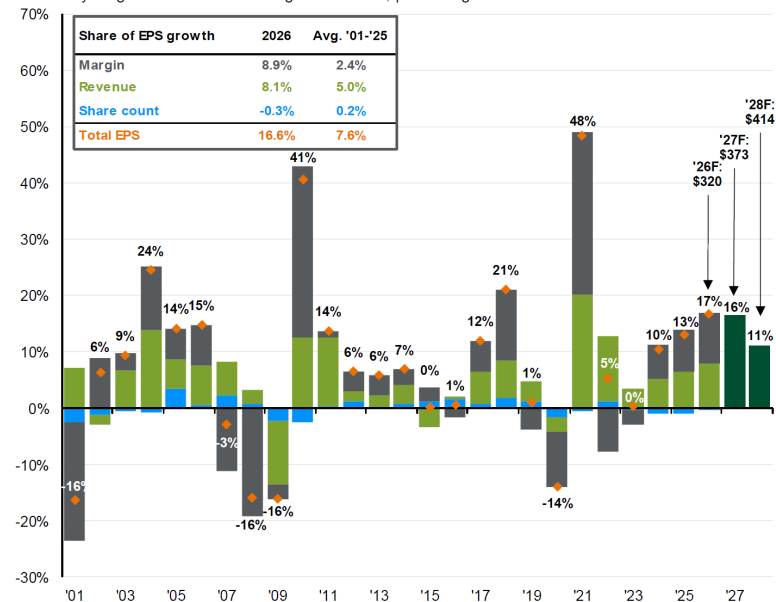
Our other main theme for the remainder of 2026 is related to earnings growth, which is also on target as we enter earnings season.

Growth estimates for the year are now at 17%, which is up from 15% at year end.

Importantly, the next two years are also seeing estimates continue to move higher. It is anticipated that much of this growth will come from higher margins, which makes sense as AI should make many businesses more efficient in their operations. When earnings estimates are at all-time highs, they tend to bode well for stocks. This occurs about 57% of the time

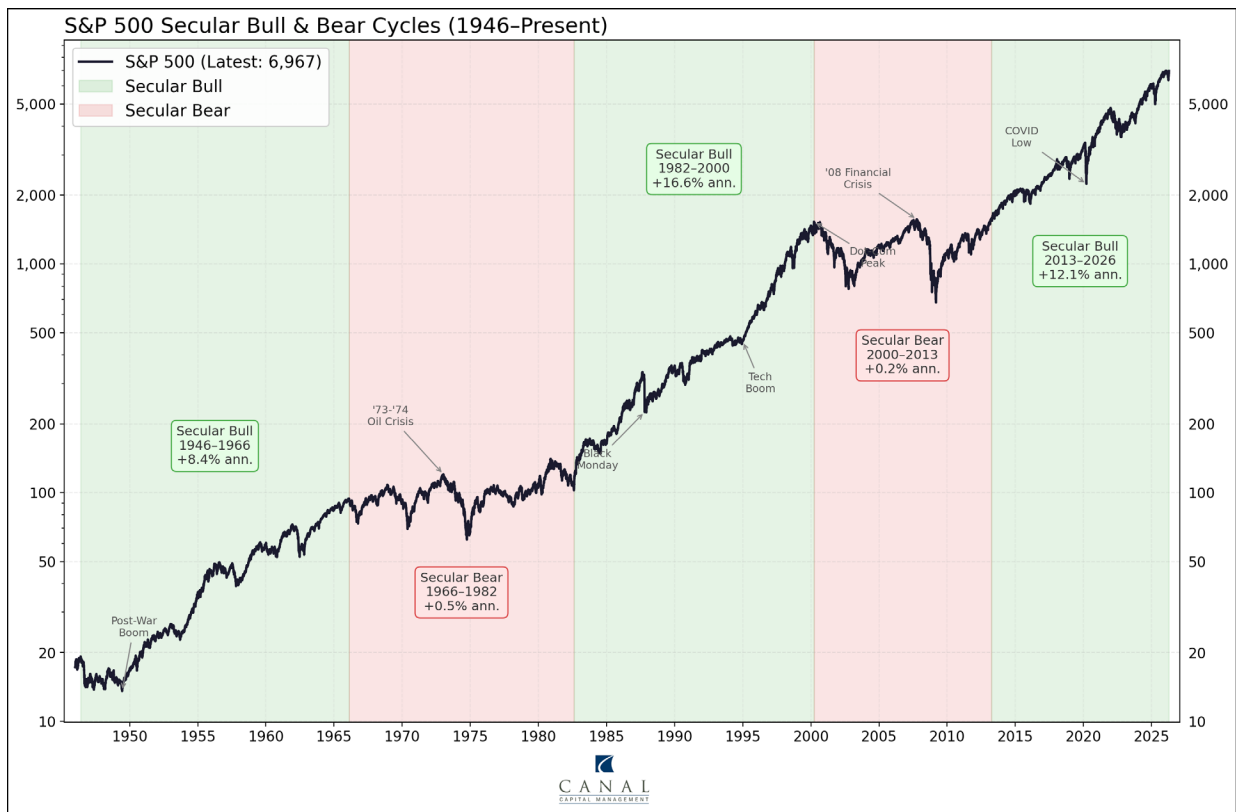
S&P 500 EPS growth

Year-over-year growth broken into changes in revenue, profit margin and share count



and stocks return 12.5% annually. When earnings estimates are not at all-time highs (43% of the time) returns move down to 3.9% annually. This is why earnings growth is so important.

Although it is easy to get caught up in the news of the day in the short term, it is most important that we focus on the long term. Trying to time the next 10% drop or the next crisis is nearly impossible. We prefer to think about markets in terms of secular cycles, which can be defined as *a long-term, multi-decade trend in asset prices that persists across multiple shorter business cycles, recessions, and recoveries*. Below we show the secular cycles going back to the end of World War II.



Secular bull markets tend to last 16-20 years and secular bear markets tend to last 1/2 to 2/3 the length of the bulls. As can be seen from the chart, bulls have great returns and bears are very long time periods of going nowhere. Typically, some sort of innovation serves as a catalyst for the bull cycles. 1946-1966 was the age of the baby boomers, which yielded highways, suburbs, TVs, and the consumer economy. 1982-2000 saw boomers hit peak earnings and the innovation of computers, the internet, and telecom. We are in year 13 of the current bull market and while boomers are leaving the workforce, the millennials are replacing them. This cycle's innovation has included fracking in the energy industry, as well as cloud and mobile computing. The final stage of this cycle will be defined by AI innovation, which is arguably in its early innings. In summary, we will continue to have geopolitical issues, economic uncertainty and even recessions, but the key is to realize that we are still in a great cycle for stocks, which could have many years to run.

Resources

What We Are Reading:

[Is It a Bubble?](#) Howard Marks' most recent memo discusses the AI Bubble.

[Smothering Heights?](#) Michael Cembalest 2026 Outlook

[Why Real Estate in 2026?](#) Apollo memo outlining the favorable market setup for Real Estate

Canal Update & Conclusion

Thank you for taking the time to read this letter. As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall plan or risk tolerance. Post-tax time is a great time of year to set up a review meeting.

Sincerely,

Canal Capital Management

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