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MARKET MUSINGS

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**Q1 2026 REVIEW: MARKETS CONFRONT
PRESSURE FROM AI DISRUPTION,
GEOPOLITICS, AND PRIVATE CREDIT**

Rush Zarrabian, CFA®
Corbett Road
Managing Partner, Portfolio Manager



SUMMARY

- The market backdrop has shifted quickly in 2026, with AI disruption, rising oil prices from geopolitical tensions, and growing concerns around private credit replacing earlier optimism. Private credit's rapid growth and lack of stress testing are drawing increased scrutiny as higher rates expose potential vulnerabilities. The key concern is whether these pressures will remain contained or begin to spill over into the broader economy.
- Asset class performance diverged in Q1, with equities under pressure, bonds providing little support, and commodities surging on the back of a sharp rise in oil prices. Weakness in U.S. markets was driven largely by Big Tech. International markets led early in the year but lost momentum as geopolitical risks increased.
- A weak first quarter has historically pointed to a more challenging year, but outcomes have been mixed, with the market finishing higher about half the time. While recent declines have been relatively contained and partially reversed, the overhang of risks suggest a more volatile and uneven path forward.
- Our **microcast**[™] signal was downgraded to neutral over the past month. Taken together, the models remain constructive on equities but reflect a higher degree of uncertainty than at the start of the year.

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See content within for additional information on the summary items discussed above

A TRIO OF WORRIES KEEPS STOCK MARKET IN CHECK

At the start of 2026, the market backdrop was constructive. AI-related investment remained a clear tailwind, last year's tax bill was expected to provide additional stimulus, and the Fed appeared poised to further ease monetary policy under new leadership.

One quarter in, the narrative has shifted. Concerns around AI-driven disruption first hit the software sector, triggering a sharp repricing in companies that had previously been viewed as having durable competitive advantages. That was followed by the escalation in Iran, which pushed oil prices higher, adding renewed pressure to inflation. We spoke at length about both these issues in the two previous Market Musings.

The third major concern involves private credit.

Private credit is lending that happens outside the traditional banking system. Instead of borrowing from a bank or issuing public bonds, companies borrow directly from private funds. These loans typically go to midsize businesses (many of them owned by private equity firms), and they offer investors higher returns in exchange for less liquidity and less transparency than public markets provide.

The asset class grew substantially after 2008, **when tighter post-crisis regulations forced traditional banks to pull back from riskier lending.** Private credit funds stepped in to fill that gap, and years of easy money and strong demand from private equity turned direct lending into a large, mainstream source of corporate financing. Fast forward to today, and it's no longer a niche corner of the investment world.

Howard Marks outlines this evolution well and highlights why it matters in his latest memo to Oaktree clients:

The massive amounts of capital that have been available for investment in direct lending created a goldrush mentality. In the last 15 years, something like \$2 trillion of direct loans has been made. (The whole private credit sector was only about \$150 billion 20 years ago.) Thus, I imagine some direct lending managers accepted too much money and invested it too fast, applying standards that were too low and setting the scene for a correction.

The concern now is one of scale. This is not about a 2008-style collapse—private credit funds are not built on significant leverage—but many funds have operated in a largely stable environment and have yet to be tested through a real downturn. Portfolio stability has also been supported by infrequent valuations and limited price discovery.

That backdrop is starting to shift. Higher rates are pressuring businesses structured for a low-cost environment, making refinancing more difficult and exposing weaker

underwriting standards from the boom years. Scrutiny is rising around borrowers' ability to service debt, sector concentration, and the reliability of liquidity under stress.

In some cases, **funds have already begun limiting investor redemptions**, raising questions about how accessible capital would be if conditions deteriorate. Given private credit's role as a key source of financing, a sustained tightening would likely extend beyond the asset class, weighing on investment, hiring, and overall credit availability. Offsetting that would require stronger bank lending, and potentially support from the Fed.

At the same time, these concerns are not unique. Markets are always searching for the next point of stress (hence the idea that they climb a "wall of worry"). **The key question is whether weakness in one area can be absorbed without spreading.** With geopolitical risks elevated and uncertainty around AI still evolving, that remains an open question.

ASSET CLASS REVIEW: COMMODITIES AND EVERYTHING ELSE

The following table highlights major asset class returns from the first three months of the year (data from Schwab):

	BENCHMARK	Q1 2026
U.S. Large-Cap Stocks	S&P 500® Index	-4.4%
U.S. Small-Cap Stocks	Russell 2000® Index	0.9%
International Developed Stocks	MSCI EAFE Index	-1.1%
Emerging Market Stocks	MSCI Emerging Markets Index	-0.1%
U.S. Bonds	Bloomberg US Aggregate Bond Index	0.0%
Treasury Inflation Protected Securities	Bloomberg US Treasury Inflation Protected Securities (TIPS) Index	0.3%
High Yield Bonds	Bloomberg US Corporate High Yield Bond Index	-0.5%
International Developed Bonds	Bloomberg Global Treasury ex-US Index	-2.7%
Commodities	S&P GSCI Index	40.0%
REITS	Dow Jones U.S. Select REIT Index	4.6%

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Some additional insights from the table:

U.S. large caps struggled, led lower by the Magnificent 7. The S&P 500 finished the quarter down 4.4%, despite a nearly 3% rally on the last day of March. The decline was nearly identical to its Q1 decline last year when tariff concerns weighed on the market. Big Tech accounted for much of the drawdown, reflecting its outsized weight in the index.

Overseas markets started the year strong before fading. Both developed and emerging markets were up double digits through February, but the escalation in the Middle East weighed on risk appetite, with Europe and Asia more directly exposed to the fallout than the U.S. Both asset classes still outperformed the S&P 500 in Q1, though the margin narrowed significantly by quarter-end.

Bonds offered little support. The aggregate bond index was flat in Q1, as renewed inflation concerns—stemming from the rise in commodity prices—led to reduced expectations for Fed rate cuts, pushing yields higher and prices lower.

Commodities moved sharply higher, standing out as one of the few areas of strength. The surge was driven largely by rising oil prices, which ended the quarter up roughly 70%. With energy making up nearly half of the index, performance in other commodities had little impact on the overall result.

DOES Q1'S PERFORMANCE GIVE US ANY INSIGHT INTO WHAT THE REST OF THE YEAR MIGHT LOOK LIKE?

Q1 ended with the worst S&P 500 quarterly return since 2022. It's often the case that a bad first quarter leads to lower returns over the rest of the year. According to SentimenTrader:

- Since 1950, the S&P 500 has shown a first-quarter gain 62% of the time
- Following positive Q1s, the index showed positive "Last 9 months of the year" performance 80% of the time versus **50% following negative Q1s**

Historically, a negative first quarter has tended to signal a more challenging path for the rest of the year. But even in those instances, the market has still finished higher about half the time.

Recent examples highlight that variability. Last year, the S&P 500 fell 4.28% in Q1 but went on to gain 17% for the full year. In 2020, the index dropped nearly 20% during the early stages of the pandemic before finishing up 18%.

In contrast, 2022 followed a weaker path. The combination of the Russia-Ukraine war, the highest inflation in decades, and the most aggressive Fed tightening cycle since the 1980s led to a negative first quarter that was followed by two additional down quarters before a rebound in Q4.

Notably, this year's performance through the first 60 trading days marked the 12th worst start over the past century. At one point near quarter-end, the market was down 7.3% (data from Charlie Bilello):

S&P 500: Worst Performance through First 60 Trading Days (1928 - 2026)				
Rank	Year	Price Return: First 60 Trading Days	Price Return: Day 61 to Year-End	Price Return: Full Calendar Year
1	2020	-21.3%	+47.8%	+16.3%
2	2009	-12.8%	+41.6%	+23.5%
3	2001	-12.6%	-0.5%	-13.0%
4	1938	-12.1%	+41.7%	+24.5%
5	1933	-11.6%	+62.9%	+44.1%
6	1935	-11.1%	+58.9%	+41.4%
7	2008	-10.4%	-32.3%	-39.3%
8	1939	-9.3%	+4.5%	-5.2%
9	1980	-8.6%	+37.1%	+25.4%
10	1982	-8.4%	+25.0%	+14.5%
11	1977	-7.9%	-3.9%	-11.5%
12	2026	-7.3%	?	?
13	1942	-7.2%	+21.2%	+12.4%
14	1968	-7.1%	+15.8%	+7.7%
15	1960	-6.7%	+4.0%	-3.0%
16	1978	-5.7%	+7.2%	+1.1%
17	1957	-5.5%	-9.3%	-14.3%
18	1973	-5.4%	-12.6%	-17.4%
19	1941	-5.4%	-13.2%	-17.9%
20	1932	-4.7%	-10.6%	-14.8%

As of 3/30/26

Historically, outcomes following similar starts have been mixed but end up skewing positive. Among the 20 worst starts, stocks finished the year higher 12 times and lower 7 times.

Despite everything that unfolded, the market never reached correction territory, typically defined as a 10% decline from an all-time high. The S&P 500's drawdown bottomed at 9.1% on March 30th, and since then, stocks have rebounded by roughly 9% (as of this writing).

Still, the underlying pressures have not gone away. Concerns around private credit, elevated oil prices, and AI-driven disruption remain in focus. At the same time, the market has rallied strongly since late 2022, delivering double-digit gains for three consecutive years. In addition, midterm election cycles have historically resulted in more volatility.

In that context, a more uneven and choppy market environment remains the most likely path forward.

In summary, the strong start to 2026 quickly gave way to a more uncertain backdrop, as AI-driven disruption, rising oil prices tied to geopolitical tensions, and growing concerns around private credit all weighed on sentiment. While equity weakness was concentrated in large-cap tech and bonds offered little diversification, commodities—driven by a sharp rise in oil—were a notable outlier. Historically, a weak first quarter has pointed to a more challenging path, though not necessarily a negative full year, leaving outcomes highly dependent on how current risks evolve. With private credit tightening, inflation pressures lingering, and geopolitical uncertainty still elevated, markets are likely to face a more volatile and uneven environment, with the key question being whether these pressures remain contained or begin to spill over more broadly. Our tactical strategies remain positive to neutral and will adjust accordingly as conditions evolve.

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CORBETT ROAD
CAPITAL MANAGEMENT



BARNES DENNIG
Private Wealth Management



THANK YOU

Cincinnati

150 East Fourth Street
Cincinnati, OH
Tel: 513.241.8313

Dayton

40 N Main Street, Ste 2000
Dayton, OH 45423
Tel: 937.223.7272

Kentucky

2617 Legends Way
Crestview Hills, KY 41017
Tel: 859.344.6400

Indianapolis East

8470 Allison Pointe Blvd, Suite 200
Indianapolis, IN 46250
Tel: 317.572.1130

Indianapolis West

5342 W. Vermont Street
Indianapolis, IN 46224
Tel: 317.241.2999

www.barnesdennigprivatewealth.com.com