Equities strengthen, returns moderate

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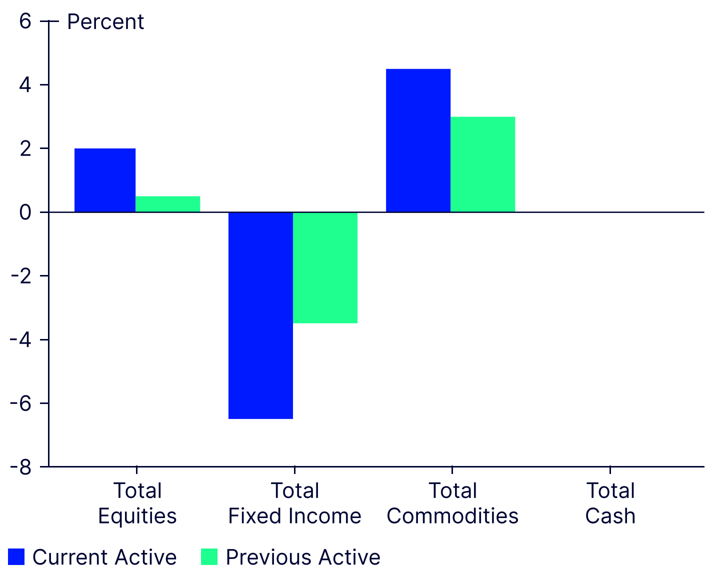
Each month, the State Street Investment Management Investment Solutions Group (ISG) meets to debate and ultimately determine a Tactical Asset Allocation (TAA) to guide near-term investment decisions for client portfolios. Here we report on the team's most recent discussion.

Macro backdrop

Economic activity remains resilient, supported by a stable labor market, healthy corporate fundamentals, and continued business investment. Labor market conditions have generally improved in recent months, with hiring becoming more broad-based across industries, as reflected in the Bureau of Labor Statistics (BLS) labor diffusion index. Small business hiring intentions remain consistent with a solid employment environment, while measures of unemployment and underemployment have continued to decline. New business formation has accelerated, and broader indicators, including layoffs and unemployment claims, suggest labor market conditions are neither excessively tight nor materially weakening.

Together with robust corporate profits, ongoing capital expenditures, and supportive wealth effects, these trends continue to underpin consumer spending and overall economic growth. Meanwhile, manufacturing and service sector activity remain firmly in expansion territory, reinforcing our view that the economy continues to demonstrate resilience despite a higher interest rate environment.

Figure 1: Model portfolio tactical positions for the US



Note: The benchmark allocation is equities: 57%, fixed income: 40%, commodities: 3%, and cash: 0%. The tactical positioning chart shows the active positioning of these asset classes relative to their respective benenmarks (represented as 0%), comparing the current and previous month.

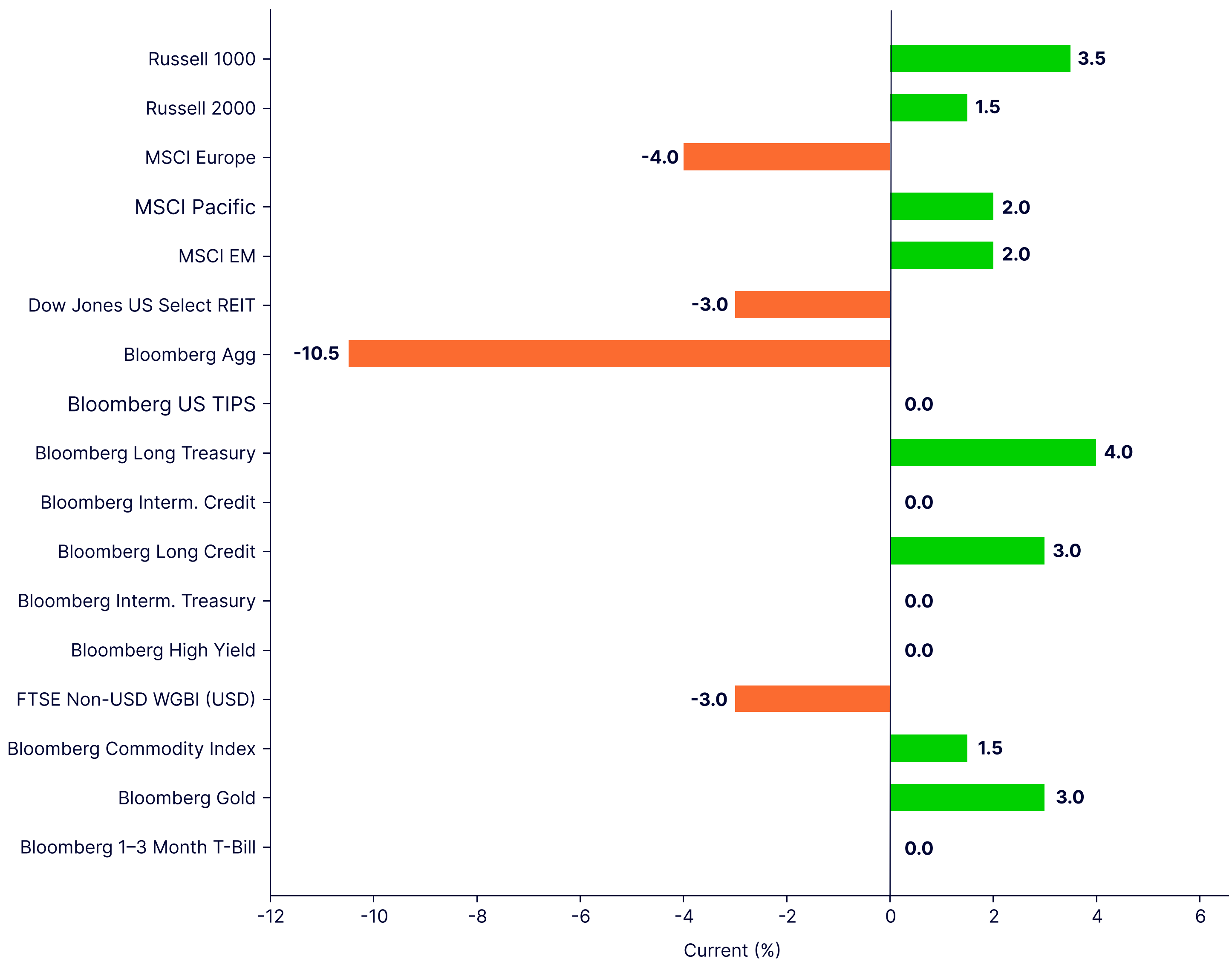
Source: State Street Investment Management, as of August 7, 2026. The model portfolio positions presented above are representative of ISGs market views and our positioning for our tactical portfolios as of the date given. The results shown were achieved by means of a mathematical formula and are not indicative of actual future results which could differ substantially. This information should not be considered a recommendation to invest in a particular sector or to buy or sell any security shown. It is not known whether the sectors or securities shown will be profitable in the future.

While economic growth remains constructive, inflation pressures continue to warrant close attention. Although producer and import prices have moderated from recent highs, both remain elevated relative to historical norms and have generally trended higher since mid-2023. Survey-based measures of prices paid in both the manufacturing and services sectors also continue to indicate above-target inflation pressures.

Housing-related inflation remains an important longer-term consideration, as measures of asking rents and new lease rates appear to be stabilizing and moving higher following a period of decline. While these developments may take time to filter through to official inflation data, they represent a growing risk to the disinflation narrative. Offsetting some of these pressures is the continued moderation in wage growth, although stabilization in hiring activity suggests labor cost pressures could eventually reach a floor. Overall, we expect inflation to remain sticky and only gradually move toward target.

Against this backdrop, the Federal Reserve faces an increasingly challenging policy environment. While Chair Warsh has provided limited forward guidance, several Federal Open Market Committee (FOMC) members

Figure 2: Benchmark asset classes and their weightage



Source: State Street Investment Management, as of August 7, 2026. Investment grade bonds consist of investment grade credit, Treasuries and aggregate bonds.

have expressed a willingness to tighten policy further should recent inflation improvements stall. The latest employment report, which includes upward revisions to prior months, has reinforced expectations among some policymakers for additional rate hikes. We continue to view labor market conditions as broadly stable rather than overheating and believe inflation remains the Federal Reserve's primary concern.

While we do not believe higher interest rates would be particularly effective in addressing supply-driven inflation pressures, we acknowledge that the balance of risks has shifted toward additional tightening. As a result, if upcoming inflation data fail to show meaningful progress, the Federal Reserve is likely to raise rates.

Directional trades and risk positioning

Our quantitative outlook remains most constructive on real assets, with expected returns for commodities and gold continuing to stand out amid a more muted outlook for equities and fixed income. While the equity outlook improved this month, the signal remains only moderately positive, though we continue to see support from strong market sentiment. Fixed income expectations weakened, with our model forecasting only a modest decline in yields. Against this backdrop, we modestly increased our overweight to equities and gold, funding the change by reducing duration through a sale of aggregate bonds.

Despite ongoing geopolitical tensions, elevated energy prices, and hawkish signals from the Federal Reserve, investor sentiment has remained resilient, supported by softer inflation readings and generally favorable economic data. Reflecting this backdrop, risk aversion, as measured by our Market Regime Indicator (MRI), improved modestly and now sits at its lowest level since the start of 2024. Support within the model was broad-based, though the strongest signal came from tighter credit spreads and lower implied equity volatility. Together, these indicators point to improving investor confidence and reduced demand for downside protection.

Sentiment measures also strengthened, moving from slightly risk-off to neutral, while trend and risk-support indicators remained supportive of continued risk-taking. Taken together, these signals suggest a favorable environment for risk-taking and continue to justify an overweight allocation to equities.

Our global equity forecast improved modestly during the month, but overall return expectations remain relatively subdued. The improvement was driven by a stronger short-term signal, reflecting supportive market fundamentals and investor sentiment. However, the model's longer-term component continues to act as a significant headwind, as risk-adjusted equity returns remain less attractive relative to high-quality bonds.

At the factor level, sentiment and quality remain the strongest contributors, supported by robust sales and earnings trends, while momentum, although still positive, has moderated from the exceptionally strong levels seen earlier this year. Valuations continue to detract from the outlook, and macroeconomic factors, while improved, remain slightly negative. Taken together, the balance of signals continues to point to modestly positive equity returns from current levels.

Our fixed income model continues to forecast positive returns across bond markets, although expectations have shifted modestly beneath the surface. Return forecasts for high yield improved, while expectations for investment-grade bonds moderated as our model reduced the magnitude of its expected decline in Treasury yields. This shift reflects a combination of weaker support from growth-sensitive factors and a more constructive backdrop for risk assets.

Our equity momentum signal, which evaluates the year-over-year change in market performance, continues to point to slowing growth momentum, although the degree of weakness has moderated. Together with our mean reversion factor, these signals continue to support lower yields. Offsetting this, improving risk appetite suggests stronger demand for risk assets and modest upward pressure on yields. On balance, the model now anticipates only a modest decline in rates. Within credit, the more constructive outlook was driven by improved momentum and a more favorable risk environment, which more than offset the challenges posed by higher interest rates, leading the model to anticipate tighter credit spreads.

Relative value trades and positioning

Within equities, regional forecasts shifted meaningfully this month. Expectations for Europe and emerging markets weakened, although we still anticipate solid returns from emerging markets. Pacific equities saw the largest improvement, rising in our regional rankings. While our outlook for US equities remains constructive, expected returns are less compelling relative to Pacific and emerging markets, and our model continues to favor US small caps over large caps. Overall, the gap between US and non-US equity return expectations has narrowed, resulting in a more balanced regional outlook.

Our outlook for non-US developed equities remains positive, supported by a notable improvement in the Pacific region. Pacific equities now screen favorably across all major factors we evaluate, with the largest contribution coming from stronger sentiment and improving macroeconomic conditions. After softening last month, analysts' sales and earnings expectations improved meaningfully, enhancing the region's relative attractiveness.

In Europe, the weaker forecast was driven primarily by a deterioration in sentiment indicators. While earnings and sales expectations remain constructive, Europe has become less compelling on a relative basis. In addition, weak price momentum continues to weigh on the outlook, offsetting the benefit of still-attractive valuations.

Our outlook for US equities remains constructive, although the region's advantage over other markets has narrowed. Rich valuations and softer price momentum continue to temper expected returns. However, several underlying factors remain supportive. Quality metrics, which assess corporate balance sheet strength and profitability, continue to score well, while favorable macroeconomic conditions and constructive earnings and sales expectations support the outlook. Within the US, we continue to favor small caps, reflecting more attractive valuations and stronger macroeconomic signals.

Emerging markets weakened modestly this month as price momentum softened, although the factor remains supportive overall. Combined with still strong sentiment indicators, these signals continue to support a positive, albeit more moderate, outlook for the region.

Against this backdrop, we made several notable adjustments to our regional equity positioning. We reduced overall exposure to US equities, shifted our US allocation from large caps to small caps, and further trimmed exposure to Europe. The proceeds were reallocated to Pacific equities, reflecting the region's improved outlook and resulting in a renewed overweight position.

Within equity sectors, Communication Services and Health Care remain our preferred sectors, while Energy replaces Industrials in the top tier of our rankings. Although our outlook for Industrials remains positive, the sector moved lower due to weaker relative price momentum and a less supportive macroeconomic backdrop. In contrast, Energy benefited from improving sentiment and stronger momentum, supported by elevated energy prices, while attractive valuations continue to provide an additional tailwind.

Communication Services remains highly ranked across most factors we evaluate, with only a recent moderation in price momentum detracting from an otherwise favorable outlook. Health Care does not lead any single factor but continues to score well across several areas, including valuations, macroeconomic conditions, and price momentum.

To see sample Tactical Asset Allocations (TAA) and learn more about how TAA is used in portfolio construction, please contact your State Street relationship manager.

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Illiquid risk/Asset investments may have difficulty in liquidating an investment position without taking a significant discount from current market value, which can be a significant problem with certain lightly traded securities.

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