

## Solid start interrupted, not derailed (so far)

**Resilience** noun: the capacity to withstand or to recover quickly from difficulties; toughness.

– Oxford English Dictionary

The opening quarter of 2026 brought more shocks to the global economy and capital markets, culminating with the conflict in the Middle East – capital markets are being resilient.

Many equity markets remain positive for the year, including Canada (+3.3%) and emerging markets (+0.6%), while international developed (EAFE) markets are down 2.3% and the S&P 500 is off 4.6%.

The threat of higher inflation from higher commodity prices linked to the conflict saw bond yields rise, leaving the year-to-date return of the FTSE Canada Universe Bond Index a tepid, but portfolio-stabilizing 0.23%.

All told, a typical investor with a portfolio of 60% globally diversified equities and 40% Canadian fixed income has roughly flat performance year to date.

While capital markets are oscillating on any new information (credible or not), individual investors should avoid overreacting. To encourage calm, we're providing some insight into what we believe matters most: the strong fundamentals that were present heading into the conflict and underpinned solid, early-year gains in capital markets; key fallout from the Middle East conflict that's affecting markets; and a clear assessment of potential impacts.

### Strong fundamentals heading into the conflict

The global economy is buoyed by many factors: reasonable levels of inflation; supportive financial conditions; decreased trade uncertainty; productivity gains; fiscal stimulus, including tax cuts; capital expenditures in AI, defence and infrastructure; deregulation; and signs that employment, manufacturing and housing activity are attempting to exit their recent soft patch. These underlying constructive fundamentals and the resulting upgrades to corporate earnings outlooks drove most global equity markets upward through February. Attesting to the strength of

these underlying factors are the sharply positive results from some of the most cyclical-growth oriented markets: Japan up 17% and emerging markets up 15% in the first two months.

### Key fallout from the Middle East conflict

The Middle East conflict is a risk-off event that stokes fears of stagflation (inflation and slow/no economic growth), a scenario where oil prices and bond yields rise and the U.S. dollar strengthens.

Suffering the most in March were markets that had gained the most in January and February on prospects for better global growth and lower inflation. Declines ranged between 7% and 11%, reflecting the downshift of the previously solid narratives on economic growth, inflation, earnings, and borrowing costs.

However, the prior gains were large enough to leave some curious net winners for the year thus far. Under a risk-off scenario you wouldn't expect to see small- and mid-cap companies outperform large-cap companies, and emerging markets outperform developed markets. Or European and Japanese markets that have greater exposure to Persian Gulf oil outperforming U.S. equity markets, where the U.S. economy is better insulated.

Gold warrants special mention; tumbling bullion prices in March surprised many. We see this selloff as a cleansing of January's parabolic move, not a repudiation of gold's ability to hedge geopolitical risks. A view supported by the fact that the price for bullion remains up 8% for the year.

### Assessing the potential impacts

The world has navigated oil shocks in the past, most recently caused by Russia's war on Ukraine and last year's 12-day Iran war, but intermittently for much of the past five decades. The majority of these oil shocks occurred when the U.S. was a net

importer of oil and gas versus its current position as a net exporter. Canada is also a net oil exporter; that helps mitigate economic implications.

Inflation-adjusted oil prices remain well below historical highs. While the rate of change matters, the U.S. economy is much less sensitive to oil prices than it was 10, 20, or 30 years ago.

North American reliance on Persian Gulf oil is now minimal. But since the commodity is priced globally, price — not supply — can still be an issue. This is not about a shortage of oil or other commodities: rather it's about the fact that oil is stuck in the Persian Gulf.

Notably, Iran has significant financial incentives to open the Strait of Hormuz. Any resolution or partial détente enabling commodity flows should sharply reverse March's downdrafts. Daily trading action supports this: we've seen sharp gains for stocks and declines for oil on signs of progress.

Physical supply is a problem for Europe, Japan and China, but short-term reserves and other workarounds are buying some time. There are numerous instances where navigation continued through the narrow passageway during periods of kinetic conflict — always at higher risk, but never completely stopped.

Oil futures show near-term oil delivery priced much higher than for future delivery. This is the opposite of the Russia-Ukraine experience, where long-dated oil rose much more than spot oil prices. The takeaway is that oil markets are expecting prices to come back down (oil prices started from low levels heading into this shock).

We do feel enough damage has been done, whether to physical assets or simply to risk appetite, that the world has said goodbye to these ultra-low, sub-US\$60 oil prices and their growth-stoking tailwind to global consumption. That said, the world has regularly witnessed oil prices well above US\$100 per barrel; the peak on an inflation-adjusted basis is over US\$200. The global economy has demonstrated it can function with oil prices in the US\$75 to US\$90 range — 12, 24 and 36-month forward pricings for WTI oil are all below US\$75 and below US\$80 for Brent crude.

## Key implications for capital markets

The commodity shock affects inflation and growth, with implications for earnings, central bank policy and bond yields. At the start of the year, the outlook for inflation, growth, bond yields and central banks was on track to boost the economy and markets in 2026. Clearly, the longer oil remains trapped in the Strait of Hormuz, the worse the damage to the global economy becomes. But what's happening now in the Middle East represents a setback, not a body blow.

Higher oil prices sap household spending and add to costs for businesses. These extra costs dampen growth, which (with the exception of commodity producers) need to be accounted for in earnings growth.

Here again, where we start matters. Estimates of year-over-year corporate earnings growth for 2026 were solid (high-teens growth in North America, low double-digits in international developed markets, and 29% in emerging markets). There is room for estimates to be revised downward yet still forecast positive earnings growth for the full year.

Equity market valuations will need downward adjustment based on three variables. First is the possibility that central banks won't cut rates (especially in the U.S.) and the risk that central banks may need to raise rates to quell inflation. Second is elevated longer-term bond yields, both real and nominal. The third is a dampened growth outlook.

However, stock market declines in March helped lower valuations. The most expensive market, the S&P 500, was already in a better valuation position even before the March decline. The S&P 500 has now traded sideways for eight months while earnings have continued to grow at around 10% over that same period.

For bond investors, yields are seesawing — moving higher on the inflationary impact, but retreating at times, given the growth-sapping nature of higher energy prices. Net-net, the inflation concerns are more acute than the growth concerns, leaving yields elevated.

## Outlook and positioning

We remain constructive on equity markets and continue to support a small equity overweight and a fixed income underweight (see Table 1). We believe damage to the global growth outlook would require significantly more time plus higher energy prices to erase our original base-case upside.

Historically and for structural reasons, stocks are a good inflation hedge: if companies aren't raising prices, there is no inflation.

Being overweight to Canada provides exposure to energy and other commodities as a hedge. Yet, we caution that gains of 30% in Canada and 40% in the S&P 500 for the energy sector year to date are at risk of a pullback if the Middle East conflict eases. Overall well-diversified exposure handles this risk.

Fixed income is becoming more attractive as yields rise, and we think bond yields are ahead of eventual central bank decisions on raising or lowering interest rates. Although rate cuts may be off the table for now in the U.S., we don't see North American central banks raising rates based on this supply shock alone. This is especially true for Canada, where the economy is weaker and trade frictions linger.

Given the rapidly shifting and uncertain nature of the conflict, we are not yet changing our 2026 price target forecasts of 7,400 for the S&P 500 and 34,000 for the S&P/TSX.

Before the conflict, we were leaning toward raising these targets. For Canada, that may still be the case. At this juncture, the forecast would be revised down for the S&P 500 but not enough to drive a negative calendar year.

We will need to revise our outlook if the current situation drags on or if Persian Gulf infrastructure is significantly damaged; either outcome would inevitably lead to higher prices for longer.

The 2026 forecast we made at the start of the year called for a decent upside for equity markets. We were on the cusp of upgrading those calls, so any revisions could still easily result in calendar-year returns that are flat or in the low single-digits.

**Table 1: Asset Allocations**

	Income			Balanced			Growth			Aggressive Growth		
	Recommended Asset Mix	+/-	Benchmark Weights	Recommended Asset Mix	+/-	Benchmark Weights	Recommended Asset Mix	+/-	Benchmark Weights	Recommended Asset Mix	+/-	Benchmark Weights
Cash	3	(-2)	5	5		5	5		5	5		5
Fixed Income	67	(-3)	70	40	(-5)	45	20	(-5)	25	0		0
Equity	30		25	55		50	75		70	95		95
Canadian Equity	18	(+3)	15	28	(+3)	25	38	(+3)	35	40		40
U.S. Equity	7	(+2)	5	17	(+2)	15	22	(+2)	20	35		35
EAFE Equity	5		5	5		5	5		5	10		10
Emerging Equity	0		0	5		5	10		10	10		10

## The last word: Diversification is resilience

A lot of what drives capital markets and the modern world is less reliant on fossil fuel energy than in the past (the declining share of old economy manufacturing and the rising importance of services, plus the move toward a knowledge-based and technology-centric economy).

Significant tailwinds are already in flight (e.g., tax cuts, government spending, capital investment in AI, nation-building projects, electricity and infrastructure buildout). Consumers in the upper 40% of the income spectrum represent the majority of the spending that equity markets focus on; they are much better insulated from higher inflation. All of these factors support continued resilience in equity markets.

Everything that's happened so far in 2026 reinforces the importance of a well-diversified portfolio: exposure to a broad range of global equities and sectors, with bonds providing an important cushion.

As the definition of resilience reminds us, resilience requires a bounceback from a setback. We aren't suggesting all will be calm. A modestly positive year for well-diversified investors remains on the table. Historically, it hasn't paid off to bet against resilience.

Please contact your BMO Nesbitt Burns Investment Advisor if you have any questions or would like to discuss your investments.



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