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The Big Questions on Our 250th Anniversary

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By:

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The Big Questions on Our 250th Anniversary

By Steven Wieting and David Bailin

As the US celebrates its 250th Birthday, we assess the state of markets and the economy through Abraham Lincoln's eyes.

Think Lincoln

Consumer sentiment has never been lower than it is today. This is not a function of economic conditions. Last month, 57,000 new jobs were reported with 552,000 created in the first half of 2026. With energy costs falling, inflation will soon be comfortably below 3%. Rate hikes appear unlikely. So what's depressing people?

President Abraham Lincoln wrote this 23 years before the US Civil War:

"Shall we expect some transatlantic military giant, to step the Ocean, and crush us at a blow? Never! All the armies of Europe, Asia and Africa combined ... could not by force, take a drink from the Ohio ... in a thousand years.

At what point then is the approach of danger to be expected? I answer, if it ever reach us, it must spring up amongst us. It cannot come from abroad. If destruction be our lot, we must ourselves be its author ..." January 27, 1838

Consider "disunity". Today's fractured information environment, state-sponsored AI-powered disinformation, and severe US partisan discord are psychological elements of a malaise sweeping across America.

Four Questions for Investors on July 4

With US wealth and employment measures at record highs, we consider key questions for wealth:

- 1) US equities have more than a decade of above-average returns behind them. Profit margins are at a record high. What should one do or prepare for if circumstances change?
- 2) Will the boom in tech shares come to an end before the boom in AI infrastructure spending does?
- 3) What will be the impact of a new Fed Chair who was skeptical of government action during the crises of recent years?
- 4) Now that markets have "relaxed" over energy shock concerns, is it unwise to hedge for downside risk?



Profits, Profits Everywhere...

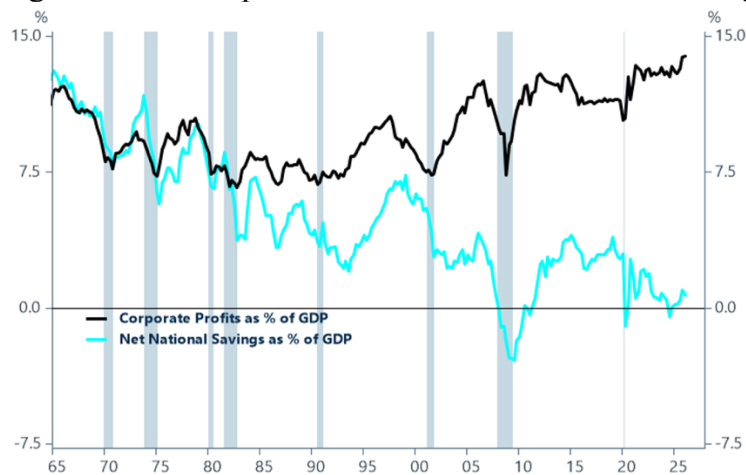
Even with temporary shocks and disruptions such as COVID, US corporate profit margins have been climbing as a share of national income, helping power strong US equity returns (Figure 1). Surprisingly, this occurred even as tariffs drove increased business costs.

A critical element driving profits are accelerating borrow and spend policies across all sectors of the economy, not just the Federal Government.

Today, a small group of tech companies is borrowing large sums to build out AI infrastructure to deliver AI services. This helps generate escalating profits for tech hardware makers at higher prices. While AI infrastructure borrowing is not driving an unusually large rise in overall corporate borrowing, the link between the borrowing and tech hardware margins is clear.

For the Federal government, borrowing boosts profit margins in a macroeconomic context. Budget deficits finance demand in excess of supply, boosting corporate profits of domestic and foreign companies. While those deficits can be offset by higher savings of consumers and businesses, the present trend has seen lower savings rates overall (see Figure 1).

Figure 1 - US Corporate Profits and Net National Savings as % of GDP



Source: CIO Group, Haver Analytics

As we've discussed before, we don't see a US federal debt crisis looming. New Fed Chair Kevin Warsh may even lend greater credibility to the US as a borrower by reinforcing the commitment to price stability. However, there is a high likelihood that future Federal borrowing will "crowd out" other borrowers, raising hurdles for more productive uses of savings.

Most practically, we see a cyclical drop in US profit margins at some point with a modestly reduced scope for fiscal/monetary intervention to cushion it. However, that cyclical decline doesn't seem likely in the coming year.



When a decline in profits of significant magnitude does come, we believe shifting asset allocation levels is important. Having assets that are negatively correlated to falling equities is critical for risk managers (Figure 2).

Figure 2 - Asset Allocation tools to Hedge Equity Declines and Volatility

Peak-to-trough total return	2000-2002	2007-2009	Last 30 years
S&P 500	-46.4%	-45.2%	1,800%
IT	-81.9	-45.2	4,810
Healthcare	-10.2	-25.7	1,696
30-Year Treasury	31.5	28.4	294
2-Year Treasury	21.9	9.5	130
Gold	11.6	22.7	1056

Source: CIO Group, Haver Analytics

Boom, Boom, Booms Don't Last

This is what's on everyone's mind: Will the boom in tech shares come to an end before the boom in AI infrastructure spending does?

In our view, the concentration risk of tech hardware is the key cyclical risk for the world's equity markets (Figure 3). The extraordinary gains of commodity memory chip producers – some as much as 700% in the year-to-date – has heightened that risk even as it has enhanced portfolio returns this year.

It is completely normal for semiconductor EPS to rise and fall sharply every few years. Share prices anticipate these turning points with about a three-month lead time. Therefore, earnings estimates might not fall before shares do.

While we may not be the “first” to know if a key spender in AI infrastructure changes its plans, an important check on earnings estimates is the capex spending plans of hyperscalers. When their forward budgets pull back, we would lean heavily against today's semi-conductor shares. This is even as AI maintenance and other demand sources remain strong.

Current indications suggest it is possible for semiconductor EPS to rise another 60% through 2028. While we know what to look for, we are not reducing exposures further in the US and Asia after our recent recalibration ([see recent Point](#)).

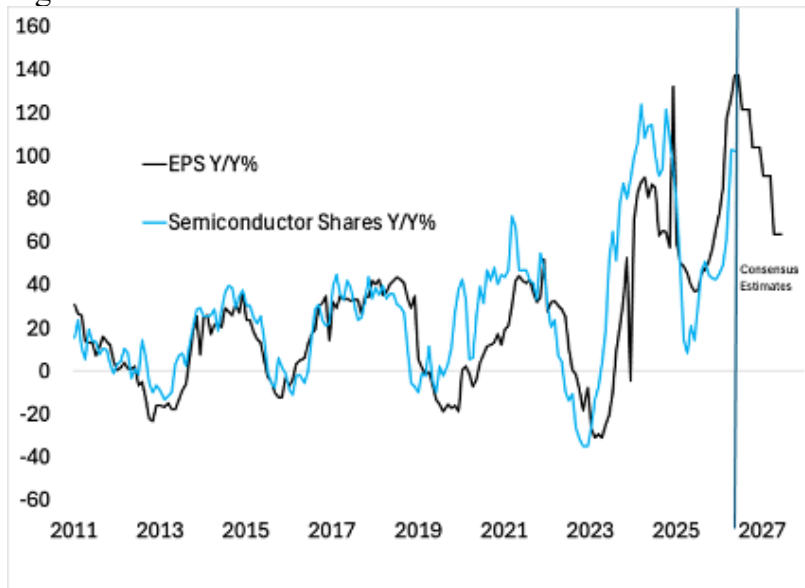


Figure 3 - Semiconductors and Comm Equipment Group Market Caps as % of S&P 500



Source: CIO Group, Haver Analytics

Figure 4 - S&P Semiconductors vs EPS and Estimates Y/Y%



Source: CIO Group, Haver Analytics



Warsh May Not be Your Friend

What impact be the impact of a new Fed Chair who was skeptical of government action during the crises of recent years?

Last week we discussed Fed Chair Kevin Warsh's skepticism of market intervention and activist monetary policy in significant detail.

Regulators and policymakers were sadly out of step in managing systemic risks prior to the crisis of 2008. After the crisis, they added elements of unusual restraint to housing finance after the risks had already dwindled. This has contributed somewhat to housing shortages that persist to this day.

We are not certain how well Kevin Warsh has absorbed all the lessons of the economic preconditions and monetary responses associated with the 2008 Crisis and Covid periods. While market forces are the best drivers of the economy, that doesn't relieve regulators and central bankers of their responsibilities. Therefore, we think there is some modest higher level of risk to consider with a new Fed Chairman.

While monetary easing is not a cost-free exercise, Warsh largely confirmed his view that activist Fed actions are not his preference. So, in the event of a self-reinforcing collapse – which we have experienced before - Warsh may be slower to act.

To Hedge or Not Hedge, That is a Question

With the energy shock behind us, is it wise to hedge portfolios for downside risk?

As US drivers and vacationers hit the road for the summer travel season beginning with the July 4 holiday, they will feel some relief from the recent energy shock (Figure 5). A wide range of transportation fuels including diesel are likely to fall at least another 10% in price in the coming month. And this should result in near-zero headline CPI readings over the next two months.

For investors, not only are gas prices falling, but the headwinds of energy spikes are too. The sharp negative correlation between events in the Iran conflict, the price of oil, and equities of every sort is diminishing (please see our [Point of two weeks ago](#)). The usual relationship between oil and global equities hovers near zero over long periods. The day/day correlation rose to -65% from March-May, and is now normalizing.

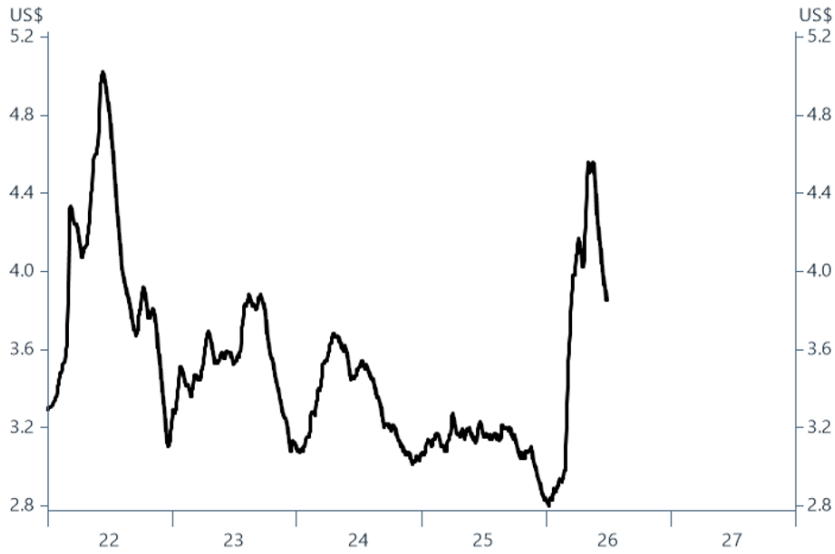
We continue to hold a modest position in income-oriented US energy export partnerships and pipelines. There are residual effects from the US Iran War that will reshape how energy is delivered benefiting the US for a time.

More generally, we believe investors face much bigger questions than the near-term price of oil. Yet as US investors take a moment to celebrate July 4, they can look forward to rising both profits and risks as we enter 2027 and beyond.



"If destruction be our lot, we must ourselves be its author and finisher. As a nation of freemen, we must live through all time, or die by suicide."

Figure 5 - US Retail Gasoline Price – Another 10% Drop Likely in Coming Weeks



Source: CIO Group, Haver Analytics



Contact us for more information

info@ciogroup.com

Stay subscribed

New York

41 Madison Ave, Floor
31, New York, NY

New Jersey

45 W. River Road, Suite 202
Rumson, New Jersey, NJ

Phone

+1 (212) 516-4000