The ADVISOR

Focus on Community Banking Issues

Third Quarter 2026

ECONOMIC ENVIRONMENT

What to Watch Outside of the "Noise?"

Leading and lagging economic indicators remain important in establishing an objective baseline for the likely trajectory of the economy, even amid the current geopolitical environment and its near-term impact on inflation. Breaking the data into key measures helps distinguish longer-term trends from temporary pressures related to Iran, higher energy costs, tariffs, and elevated AI-related spending. Several gauges should remain at the forefront:

The Labor Market

The labor market continues to show resilience, with layoffs remaining the exception rather than the rule. For the week ending July 18, initial jobless claims fell to a multi-decade low of 187,000. This reflects continued stability in the business climate and supports a healthy level of consumer spending.

At the same time, payroll growth has gradually slowed. Together, these trends point toward an economy that is unlikely to experience either a boom or a bust, but instead continues to moderate at a measured pace. This balance should allow the Federal Reserve to remain patient rather than responding prematurely in either direction.

The Consumer Price Index

The Consumer Price Index continues to demonstrate how sensitive inflation can be to immediate pressures such as gasoline and other energy costs affected by geopolitical conflicts. The latest June reading of 3.5% was down from 4.2% in May, but core inflation remains elevated and stubborn.

Unless there is a near term resolution to the war, the Investment Committee does not see any material relief from price pressures through the remainder of 2026. However, provided inflation does not meaningfully reaccelerate, the current environment also

EPG RATE OUTLOOK

July 2026

MARKET RATE	Actual (%) 6/30/2026	Projected (%) 6/30/2027	Yr1 Δ	Projected (%) 6/30/2028	Yr2 Δ
FedFunds	3.75	3.75	0.00	3.50	-0.25
Prime	6.75	6.75	0.00	6.50	-0.25
3mthTsy	3.81	3.75	-0.06	3.60	-0.15
6mthTsy	3.97	3.80	-0.17	3.70	-0.10
1yrTsy	3.98	3.85	-0.13	3.75	-0.10
2yrTsy	4.17	3.90	-0.27	3.80	-0.10
3yrTsy	4.18	3.95	-0.23	3.90	-0.05
5yrTsy	4.23	4.00	-0.23	3.95	-0.05
10yrTsy	4.47	4.25	-0.22	4.15	-0.10
30yrTsy	4.95	4.75	-0.20	4.60	-0.15

RATE OUTLOOK DESCRIPTION:

This represents EPG's current view of interest rates.
Depending on the actual timing of the ALM meeting, the outlook may be altered and/or updated.
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Features

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ECONOMIC ENVIRONMENT

does not necessarily require monetary tightening. Instead, we believe it supports an extended "wait-and-see" approach by the Fed.

Gross Domestic Product

GDP growth has been trending slightly above 2% based on first-quarter data. This is an improvement from the anemic, flat-to-below-1% growth that characterized the end of 2025. Government spending is likely to continue, while business investment, particularly spending related to AI infrastructure, is unlikely to materially abate in the near term. This improvement reinforces the view that the economy is unlikely to shrink.

EPG Rate Outlook

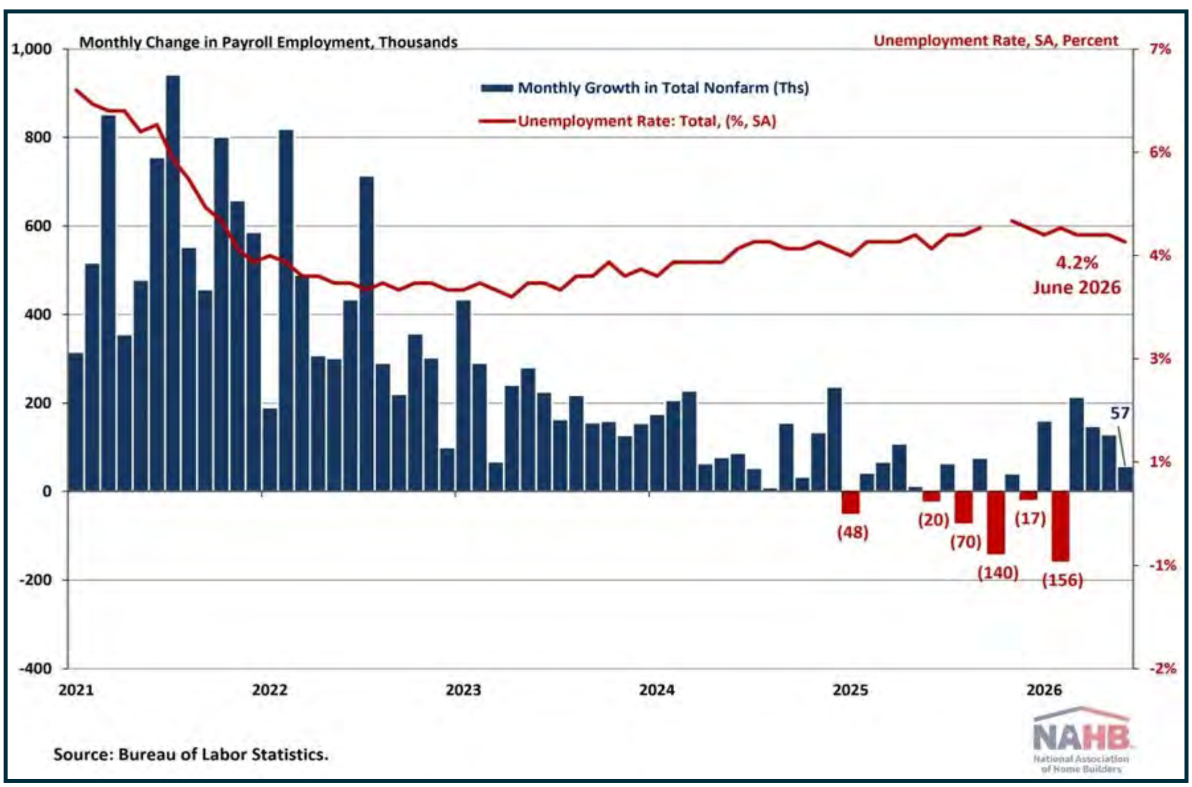
Our base-case outlook calls for no Fed rate action during the remainder of 2026. While inflation remains above target, stable labor conditions and moderate economic growth should allow policymakers to maintain the current Federal funds rate as they evaluate whether recent price pressures are temporary or more persistent.

Looking further ahead, we project one 25 basis point rate cut during the second half of 2027. This reflects an expectation that inflation will gradually improve and economic growth will slow modestly, but not enough to justify a rapid or sustained easing cycle. In our view, policy rates are likely to remain higher for longer, with any eventual adjustment occurring cautiously and incrementally.

In the Short Term, Event Risk Matters

The threat of additional tariffs, unrestrained AI spending, and uncertainty surrounding the duration of the Iran conflict remain potential pressure points for inflation and monetary policy. These factors could delay the eventual normalization of interest rates, particularly if they contribute to renewed price increases or stronger economic activity. This is evidenced by volatile and wide-ranging views of potential Fed action with 60% of market participants expecting no rate hike while 40% expect a 25 basis point hike.

However, we believe temporary inflation caused by energy costs or geopolitical developments is unlikely, by itself, to prompt the Fed to raise rates. Policymakers will



Source: Bureau of Labor Statistics.

likely require evidence of broader and more persistent inflation before considering tightening. Similarly, the Fed is unlikely to cut rates while inflation remains elevated and the economy continues to expand at a healthy pace.

If Not Now, When?

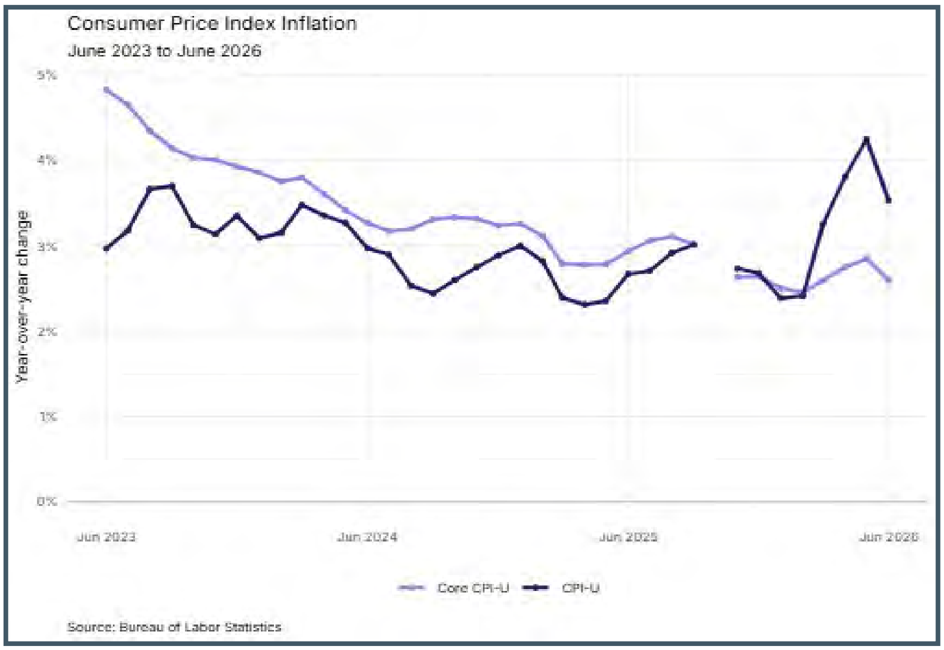
With the Fed's 2% average inflation objective becoming increasingly difficult to achieve, at least based on current data and geopolitical conditions, policymakers have little incentive to begin easing monetary policy this year. The Fed's continued emphasis on price stability over near-term support for economic growth reinforces the case for keeping rates unchanged. A reduction in tariff pressures, moderation in AI-related investment, resolution of the Iran conflict, and sustained improvement in core inflation could eventually create room for the Fed to act.

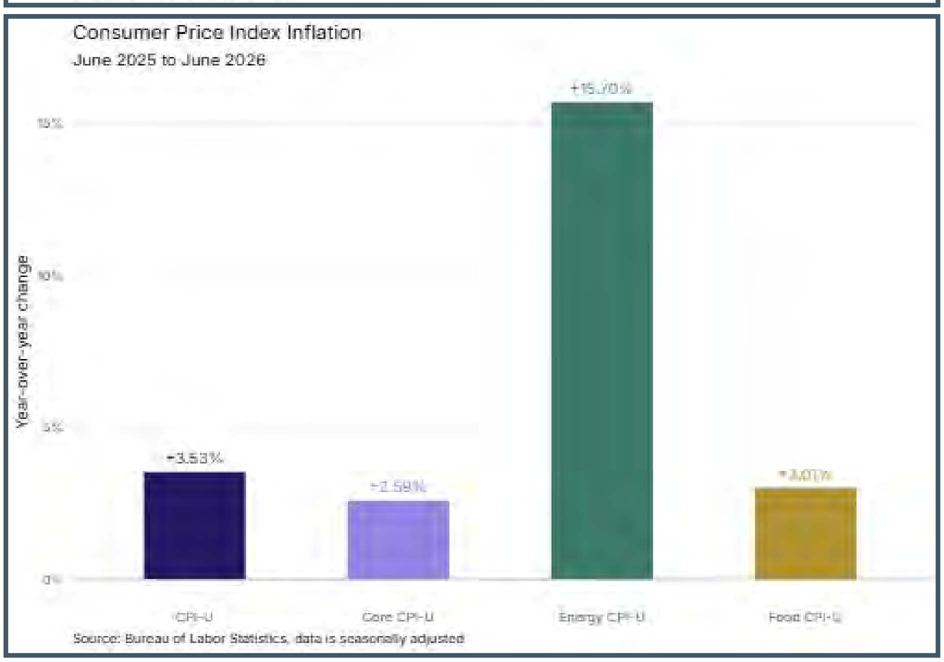
Do Politics Come Into Play?

Going back to 2024, when the Fed cut interest rates by 50 basis points, there were contentious arguments and accusations that the timing of the decision benefited a presidential candidate. While the vast majority of experts and analysts continue to view the Fed as an independent institution rather than a politically driven one, the optics surrounding monetary policy and election timelines can still be problematic.

Combined Together

Thus, integrating key economic data, geopolitical factors, elevated inflation measures, and a stable but gradually moderating labor market supports an outlook for continued economic strength in the short term, followed by a limited slowdown over the next 12 to 18 months. The practical conclusion is to look beyond short-term headlines and plan for a durable but more selective operating environment in which disciplined financial management will be increasingly important. ◆





FIXED INCOME STRATEGY

Financial Markets Uncertainty Accompanied by Changes at the FOMC

Entering 2026, the Federal Reserve's dot plot and Fed funds futures contracts were both implying interest rate cuts later in the year. Then, in late February, the Middle East tension began, triggering widespread volatility across the capital markets spectrum. While equity valuations initially weakened, bond yields climbed higher as the price of crude oil surged above $100 per barrel. The sharp rise in energy costs reignited inflation concerns and prompted investors to reassess their expectations for monetary policy.

Throughout 2025, inflation trended lower, bringing the economy closer to the Fed's objective of price stability. However, inflationary pressures reemerged this year. The Consumer Price Index (CPI), which was 2.4% in January, now stands at 3.5%. Although the CPI declined by 0.4% on a monthly basis in June, inflation still remains elevated on an annual basis, driven largely by higher energy prices. Inflationary pressures also intensified at the producer level, as the Producer Price Index (PPI) increased by 1.1% on a monthly basis in both April and May. Similar to consumer prices, producer prices then also fell sharply in June as crude oil prices declined by nearly 20%. However, crude prices have rebounded by more than 10% in July due to the continuation of war-related disruptions. It is likely that the deflationary effects observed in June could be short lived and that inflationary pressures will reignite in the coming months.

As a result, financial markets have largely abandoned expectations for near-term rate cuts. Instead, investors have increasingly priced in a "higher-for-longer" interest-rate environment, with some voting participants even considering the possibility of renewed Federal Reserve tightening if inflation remains persistently above target level. Elevated inflation, stronger-than-expected employment results, and energy-driven price shocks have complicated the Fed's path towards monetary policy easing.

A New Fed Chair: How Will Markets React?

Kevin Warsh kicked off his second stint at the Federal Reserve by making a statement, or shall we say lack thereof, regarding current economic conditions and the Fed's policy implementation. More importantly, it was a wake-up call for financial markets, signaling that the Federal Reserve would no longer spoon feed investors information they had become accustomed to hearing from former Fed Chairs'. Although it may be disruptive and could lead to more market volatility in the short term, it will likely be a good thing for both markets and the central bank over the long term. Warsh commented that "financial markets perform best when they react to incoming data, not when they try to game how the Fed will react to that data."

Based on the June FOMC statement, the Investment Committee expects the Warsh-led Fed to continue providing investors with limited forward guidance. However, he was clear with his commitment to bringing inflation back down to the 2.0% targeted level, a goal that has not been consistently achieved over the past five years. The Investment Committee views the Fed's commitment to containing inflation as good news for the U.S. economy and consumers. After signaling a more accommodative stance prior to the war, members of the policy committee have indicated they are prepared to raise interest rates, if necessary, to achieve their inflation objective.

FIXED INCOME STRATEGY

Due to the apparent pivot from previous Fed leadership, markets may need to adapt to a new regime characterized by a different approach to monetary policy with less forward guidance. With persistently elevated inflation and the ongoing effects of the war impacting energy markets and oil prices, this environment is likely to contribute to greater interest rate volatility. Although the economy and labor market remain more resilient than many economists had anticipated, increased policy uncertainty may lead to increased short-term volatility across broader capital markets.

Investment Landscape

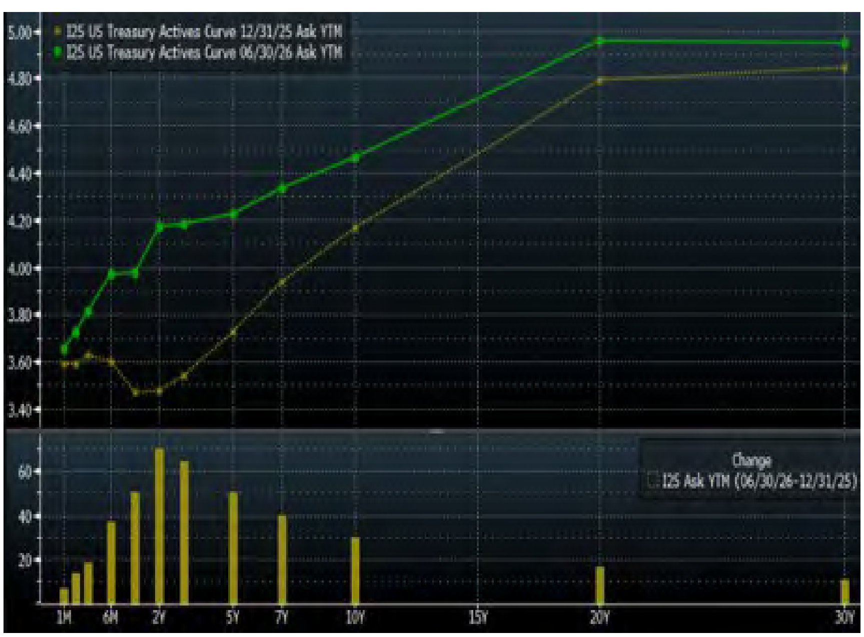
With the yield curve flattening for the first six months of 2026 and policy signals remaining mixed, the Investment Committee believes that minimizing duration risk while maintaining accretive book yields remains an attractive strategy. Investment yields in excess of 5.0% on high-quality assets provide an opportunity to enhance portfolio income while preserving a disciplined approach to duration and risk management.

Hybrid ARMs and 20-year Agency MBS remain effective investments for managing interest rate risk while generating attractive spreads above short term funding costs. This positioning seeks to balance income generation with prudent risk management in an evolving interest rate environment.

While Corporate and Municipal bonds have experienced some price volatility, credit spreads in both sectors still remain near the lower end of their historical ranges. At the same time, issuance remains elevated, as corporate borrowers continue to take advantage of favorable financing conditions driven by tight spreads.

With the 10-year U.S. Treasury yield above 4.5%, even modest deployment of excess liquidity into investment securities as a substitute for slower loan growth can be accretive to balance sheets, enhance net interest income, and support improved earnings potential. ◆

Yield Curve 12/31/25-6/30/26



Source: Bloomberg

Yield Curve Changes Year to Date

Term	12/31/2025	6/30/2026	Change
2 Year	3.47	4.17	0.70
3 Year	3.54	4.18	0.64
5 Year	3.73	4.23	0.51
7 Year	3.94	4.34	0.40
10 Year	4.17	4.47	0.30
20 Year	4.79	4.96	0.17
30 Year	4.84	4.95	0.11

EQUITY STRATEGY

A Strong Foundation, But a High Bar

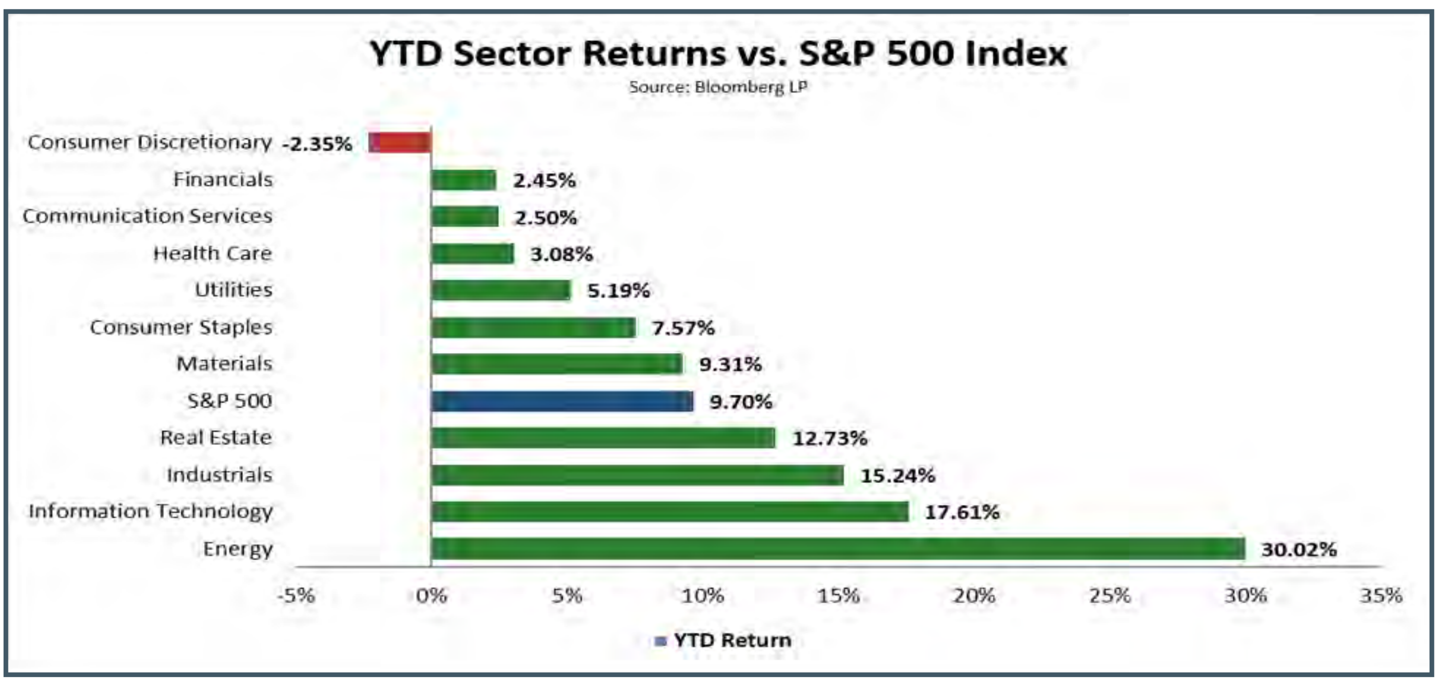
Equity markets have continued to move higher despite uncertainty surrounding inflation, monetary policy, and the conflict in Iran. While these issues have created periods of volatility, investors remain focused on a healthy economic backdrop and corporate results that continue to exceed expectations.

In the medium to long-term, we are positive on domestic equities. While valuations remain elevated and interest rates may stay higher for longer, the market is increasingly supported by broad earnings growth rather than multiple expansion alone. Profitability remains strong, business investment continues to expand, and the economy has thus far absorbed elevated interest rates without significant deterioration in employment or consumer spending. However, ambitious projections leave less margin for disappointment.

Earnings Take the Lead

Corporate earnings have provided the clearest support for the market this year. First-quarter results were well above expectations, leading analysts to raise estimates for the remainder of 2026. According to FactSet, second-quarter S&P 500 earnings are projected to grow more than 23% from the prior year, while full-year growth is expected to approach 24%. Tech and Energy will look to deliver some of the strongest gains, though earnings strength is extending across the market. Healthy consumption, AI-related spending, and continued cost discipline have allowed companies to expand profits despite elevated interest and input expenses.

These projections are encouraging, but they also create a more demanding setup. Companies must now deliver strong results simply to meet expectations, and recent market reactions show that earnings beats may not be enough to offset soft guidance or underlying demand trends.



The AI Opportunity Expands

Artificial intelligence remains the defining investment theme of the current cycle, but the opportunity has evolved. The initial phase was concentrated in semiconductor companies and hyperscale cloud providers that supplied the computing capacity needed to train increasingly complex models. While these companies remain central to the buildout, the physical requirements of AI are broadening the opportunity into Industrials, Utilities, Energy, and other infrastructure-related areas.

Data centers require power generation, electrical equipment, cooling systems, networking capacity, and large-scale construction. These needs are creating visible demand for companies that historically have little connection to the Tech sector. Simultaneously, rising electricity demand is accelerating investment in the grid and natural gas infrastructure. We believe the next phase will focus on AI adoption. Investors are beginning to look for evidence that AI can improve productivity, reduce expenses, or generate new revenue streams. Over time, we anticipate the market will reward businesses that can successfully apply AI within their existing operations (customer service, software development, research, logistics, etc.)

Spending Must Translate to ROI

The market's focus is shifting from the amount being spent on AI to the returns generated by that spending. Large capital commitments weigh on free cash flow in the near term, and investors will increasingly expect stronger cloud revenue, improved operating efficiency, or greater customer adoption to justify these investments. Large companies are issuing debt and equity to fund this investment without exhausting cash reserves, which creates significant long-term growth potential but also increases risk due to leverage, dilution, and implementation challenges if returns fail to justify the spending. It is becoming clear that companies demonstrating a clear path toward monetization should continue to be rewarded, while those investing aggressively without visible returns face greater scrutiny.

We do not believe this shift undermines the broader AI thesis. Rather, it reflects the natural progression of a capital investment cycle. The transition is likely to produce volatility as expectations adjust, but it should also create opportunities to invest in high-quality businesses when short-term concerns overshadow long-term advantages. Therefore, we continue to favor companies with strong competitive advantages and demonstrated abilities to convert growing backlogs into cash flow, especially within the Tech and Industrials sectors.

A More Selective Market

Market participation has expanded beyond mega-cap Tech, but recent performance has not represented a uniform rotation. As shown in the chart below, Tech, Industrials, Energy, and select Consumer companies have performed well, while defensive areas such as Health Care have lagged as investors favor stronger growth and earnings momentum.

This reflects a market that is broadening while remaining focused on quality. Companies with healthy cash flow, manageable debt, and visible earnings growth have been rewarded, while businesses dependent on lower rates or distant profitability remain more vulnerable.

Can the Consumer Continue to Hold Up?

Consumers are still supporting economic expansion, although spending patterns remain uneven. Aggregate consumption has proven resilient, backed by wage

EQUITY STRATEGY

growth, relatively stable employment, and continued strength among higher-income households. Companies serving affluent consumers have generally maintained healthy demand, while less differentiated businesses face a greater need for promotions and discounting. The labor market remains the key variable. A slower pace of hiring has not yet translated into a significant increase in layoffs, allowing income and spending to remain sturdy. For now, we believe moderation is more likely than contraction, though the consumer warrants close monitoring if the cumulative effects of higher prices and interest rates continue to build.

Implications for the Community Bank Equity Portfolio

For Community Bank portfolios, we believe the current environment supports maintaining measured equity exposure while continuing to emphasize capital preservation and portfolio quality. The long-term outlook remains positive, supported by healthy earnings growth, continued business investment, and expanding opportunities related to AI, infrastructure, and productivity. However, current valuations, restrictive monetary policy, and geopolitical uncertainty may produce periods of volatility that create an immediate impact on capital through mark-to-market movements.

A key development to monitor is the idea that portfolios may have more Tech exposure than sector weights suggest, as traditionally defensive areas are increasingly tied to AI-related spending. This has generated strong returns but raised the risk of unintended concentration across companies benefiting from the same investment cycle. Portfolio construction should therefore focus on underlying revenue drivers and diversification rather than sector labels alone. Especially in this environment, portfolios should be sized relative to earnings/capital comfort levels and overall balance-sheet risk. ◆

Dow Jones

Source: Moneycontrol

Nasdaq

Source: Moneycontrol

ALM STRATEGY

Don't Overthink It - The Current Environment May Not Be As Uncertain As It Seems

Although it may feel like the operating environment is in constant flux, driven by the war in Iran, a new Fed Chair and fluctuating inflation, it may actually be much less volatile than you think. If we separate the headlines from the real impact on the business, the constant on-again, off-again nature of the activities in the Middle East may be far less unsettling.

Potential Impact on the Business of a Community-Based Financial Institution

Let's examine the impact of three separate scenarios, and for sake of argument, let's call them the best-case scenario, the worst-case scenario, and the most likely scenario.

Best-Case Scenario

Let's start with the best-case scenario, as this one is relatively easy to evaluate. This assumes that the war is over in short order, in the next month or so, and as a result, crude oil prices decline while dragging inflation expectations with it. Gas prices will come down, but it will take a bit of time to wring the inflationary pressures from the system, but the worst has been avoided. Market expectations for Fed activity, which based on recent Fed Fund Futures contracts was two hikes of 25 basis points by early 2027, switch to potential cuts down the road. In this scenario, it could be argued that the operating environment could revert back to the pre-war period in early 2026, when the market expected a cut in 2026.

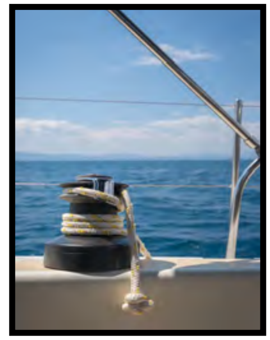
If this were to play out, the decline in inflation expectations would likely remove upward pressure on deposit costs, leading to a decline in deposit rates, including CDs, high savings and money market accounts, and Brokered CDs. Once again, if we go back to early 2026, the expectation of a Fed cut applied downward pressure to funding costs, but once that flipped due to the rise in oil prices, the pressure was applied in the opposite direction. That would be reversed.

In addition, and perhaps possibly the most important outcome of a quick end to the war, sentiment would improve dramatically. The overhang of concern would decline significantly, and borrowing activity would likely improve. The big negative may be tighter liquidity as depositors withdraw money to invest in the stock market, which would likely get a boost.

Worst-Case Scenario

For this exercise, this will be our worst-cast scenario, although we all know that things can always get worse. The expectation here is that the war will rage on for an extended period, leading to significantly higher oil prices that pressure inflation, and eventually, Fed rate hikes. Under this scenario, let's assume the Fed must hike 100 basis points over the next year to combat inflation. This would impact deposit and borrowing costs, with CDs potentially rising to over 5% while overnight borrowing moves to nearly 5%. This would pinch margins, as while loan rates would climb, demand would fall as business owners could be reluctant to take on newer debt at levels approaching 8%.

Under this operating environment, would business grind to a halt? Would you cease all lending activity and hunker down for the next year? Of course not! Even under this scenario, business continues but certainly gets a bit tougher. Demand will be lower, margins will tighten, and credit may become a much bigger concern, but liquidity may improve. The stock market would likely become more volatile, leading some people to bring money back to federally insured depositories.



The outcome here would be significantly more challenging than the previous scenario, but the show must go on, as they say.

Most Likely Scenario

This one may be obvious, but the outcome falls in the middle of the two discussed above; the war ends in the medium term, before the Fed needs to act to control inflation, but not so quickly that we avoid additional short-term disruptions. In this case, rates may continue to be volatile, but in a relatively tight range, before declining once the war ends. With the 5-year FHLB near 4.50% and the 10-year Treasury near 4.70%, loan rates appear attractive even with marginal funding costs above 4%. Overall loan demand remains decent-strong, although it varies by region.

Margins may tighten as we near the end of 2026, driven by upward repricing of the majority of maturing CDs, but overall business conditions remain solid, even with the constant ups and downs of the war.

What Are The Takeaways From This Exercise?

The key point to consider is that whether the operating environment improves significantly or moves in the opposite direction, business fundamentals should remain similar in each of the scenarios.

- Even in the worst-case scenario, with rising deposit costs and likely only slightly impacted credit conditions, increasing loan yields will offset a portion of the impact, so although we may face tighter margins, many financial institutions have built some cushion to buffer against this.
- Loan pipelines appear strong currently, which should also provide some cushion, at least for the next quarter or so.
- None of the scenarios are bad enough that lending would cease; rates may move against you, but unless the operating environment deteriorates significantly more than expected, activity will continue.

All scenarios indicate a continuation of business activities as you ignore the noise to the extent possible. Depositors will continue to roll CDs, borrowers will continue to pay their debts, and while operating conditions may deteriorate at bit, business will move forward.

Ultimately, while the range of potential outcomes may be wide, the practical implications are more manageable than the headlines suggest. Community financial institutions should continue to remain flexible, stay focused on fundamentals, and avoid overreacting to short-term uncertainty. ◆

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The ADVISOR is a publication of EPG Incorporated

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