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EQUITY MARKET ROTATION PUT TO THE TEST BY SECOND-QUARTER RESULTS

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The resumption of hostilities between Iran and the US demonstrates just how fragile the peace process is and that it is likely to remain chaotic, although the markets still appear to be influenced by other, more tangible factors. Indeed, concerns over the persistence of inflation in memory chip prices have led to a significant rotation within equity indices. Sovereign bond yields have also faced a significant resurgence in pressure, particularly in Europe. That said, as was the case in the first quarter, the second-quarter earnings releases, on which investors will be keeping a close eye, are likely to be the real deciding factor.

Following record highs in early June, a sharp rotation across factors and sectors has taken hold

Having hit numerous record highs, global equity markets have edged back slightly since the start of June, despite the memorandum of understanding on peace between Iran and the United States and a still-robust investment cycle in artificial intelligence. Whilst technology stocks contributed significantly to the April–May rally, they have weighed on index performance, particularly in the US, South Korea and China, due to the sector's significant weighting in these markets (nearly 40% for the S&P 500, 60% for the South Korean KOSPI and 32% for the CSI 300). Other Asian markets and Europe, by contrast, have managed to fare well, partly thanks to falling energy prices.

That said, this decline was also heavily concentrated in a small number of stocks, including the US 'Magnificent Seven', which have fallen by around 6% since June despite a rebound of more than 8% since 26 June. This concentration of underperformance is reflected in the performance of the S&P 500 index, which has fallen by around 1% from its highs, whilst the underlying shares have, on average, posted a positive return of around 3%.

At this stage, this correction in the "AI/Semi/Momentum" theme has not led to a major fall in the equity indices, which remain close to their highs. This lack of contagion can be explained by the fact that profit-taking on the indices and shares that have risen the most during the first six months of the year is being offset by gains in sectors that had previously fallen out of favour with investors.

We are therefore witnessing a rotation that is both sectoral – with the technology sector underperforming compared with the financial, industrial and healthcare sectors – and factorial – with the momentum factor underperforming relative to the value factor. Divergences within the same sectors are also very significant.

It should nevertheless be emphasised that this rotation is taking place following an exceptional rally, characterised both by its scale – with returns of over 200%in just a few months for certain semiconductor technology stocks – and by its concentration, as only a small number of stocks delivered such returns. This rally was notably driven by technical factors, including the extremely rapid growth of leveraged ETFs, which amplified movements in the underlying securities.

Despite the recent correction in these shares and questions over the sustainability of the increase in memory chip prices, we do not believe that this rotation calls into question the valuation fundamentals of the sectors currently under pressure. Moreover, even after this rotation, the indices concerned are posting very positive annual returns that outperform the global indices.

New tensions in government bonds

Alongside this rotation in the equity markets, we are seeing mounting tensions in the government bond market, particularly for maturities of more than five years, which, in most regions, have returned to their recent highs. Indeed, since the end of June, the average rise in 10-year sovereign yields has been 18 basis points across the major developed countries. The rise has been more pronounced in Europe, with an average increase of 25 basis points over the month.

This rise can be attributed, on the one hand, to a rebound in the inflation premium, as oil prices have rebounded due to renewed tensions between the United States and Iran, heightening uncertainty regarding the normalisation of traffic through the Strait of Hormuz; and, on the other hand, to questions about the credibility of fiscal policies, particularly in Europe, as projections for public deficits are deteriorating.

We estimate that around 30 per cent of the total rise stems from the adjustment in inflation expectations. Indeed, despite the recent rebound, inflation expectations for the next five years have declined since the signing of the peace memorandum in mid-June between the US and Iran and are now well below their May highs. The remainder stems mainly from political instability, particularly in Europe, as illustrated by the resignation of the British Prime Minister and the narrow majorities held by the governments in France, Germany and Italy, as well as from weak growth, affected by rising oil prices and uncertainty over trade.

The direct consequences are rising government borrowing costs at a time when funding requirements have rarely been so high, as illustrated by the $500 billion in sovereign bond issues – $20 billion more than the previous record set in 2020, when budgets were being used to support growth in the wake of the Covid-19 pandemic. Furthermore, high real long-term interest rates act as a brake on investment for both households and businesses by raising the implied level of profitability required to maintain their repayment capacity. This is why, despite rising yields and historically high absolute levels, we do not believe that sovereign bonds offer attractive performance potential from a tactical perspective.

Expectations for second-quarter corporate earnings are high

Nevertheless, in a period dominated by AI and fears of overheating in the sector, as well as by geopolitical tensions and uncertainties over the direction of monetary policy, investors are likely to refocus their attention on the corporate earnings season, which began this week with the major US banks.

We believe that the second quarter of 2026 should confirm the resilience of US equities, with the S&P 500's earnings per share (EPS) likely to post one of the highest quarterly growth rates seen in recent years. Solid results and, above all, the resilience of EPS – which is one of the main drivers of long-term market performance – could therefore help refocus attention on corporate fundamentals and provide a stronger anchor to support additional share price gains in the second half of the year.

For the second quarter of 2026, the markets are anticipating a year-on-year increase of 23% in the S&P 500 index's EPS. This figure could even reach 26% if the historical earnings beat rate of 3% is taken into account. Although this represents a slight slowdown compared with the first quarter (28%), this rate would still be the second highest since the fourth quarter of 2021 and would confirm the superior earnings growth of the US market.

Once again, the technology sector is expected to post one of the strongest gains for the quarter, at +65 per cent year-on-year, an acceleration from the +56 per cent recorded in the first quarter. This strength continues to be driven by the semiconductor industry, particularly memory chip stocks, which, as before, are benefiting from strong investment demand linked to AI whilst supply remains limited, enabling them to generate record margins. The energy sector is expected to see a marked rebound due to the volatility in oil prices during the quarter following the recent conflict, with profits up by +119 per cent. We therefore believe that the rise in US corporate margins, which remain at record levels, will continue and remain a key driver of the rise in equity indices.

In Europe, earnings expectations for the second quarter remain broadly optimistic at this stage. The consensus forecasts 11% growth in earnings per share (EPS) in Europe, the highest pre-results estimates since 2021. Based on the historical average beat rate, growth could therefore reach +13%.

The Euro Stoxx 600 index is expected to see earnings per share rise by around +11 per cent, which would represent a genuine rebound in the Old Continent's earnings momentum. The energy sector, where EPS is forecast to grow by 88 per cent, is expected to contribute to this momentum, as the sector carries a higher weighting than in the US (5.2% vs. 3.2% for the S&P), thereby offsetting the relatively sluggish growth of the technology sector compared with the US – a sector which, conversely, carries a lower weighting in the Stoxx (only 9.3%). The rebound in earnings in certain more cyclical sectors, such as basic materials, certain parts of the consumer sector and industrials – aided by a weaker euro against the dollar, a rise in inventories in anticipation of a protracted conflict in the Gulf, reduced deflation in Chinese product prices and lower interest rates since June – should also contribute to the index's growth. However, certain sectors such as the automotive and travel sectors are seeing sharp declines in their earnings expectations, for obvious reasons linked to the rise in oil prices in the second quarter.

We remain positive on equities overall, although selectivity is required in a highly volatile environment characterised by very high investor expectations regarding corporate earnings.