FIDELITY PRIVATE WEALTH

Quarterly market commentary

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Testing the Narrative: Recession Recedes, AI Succeeds

Capital markets entered the second quarter on shaky footing. Conflict in the Middle East, recession headlines in Canada, inflation concerns and polarized views on technological innovation gave investors plenty of reasons for caution. Yet uncertainty has become a familiar feature of this market cycle. Equity markets once again climbed the wall of worry, navigating through first-quarter volatility and ending the first half of 2026 at new all-time highs.

Recession or not? A *technical* recession is typically defined as two consecutive quarters of negative GDP growth. Canadian GDP declined by 0.2% in Q4 2025 and edged slightly lower again in Q1 2026 (-0.03%). By that measure, Canada briefly entered a recession, but the broader evidence is less convincing.

While economic growth has clearly softened, recessions are usually deeper and more self-reinforcing: production falls, unemployment rises, incomes weaken and consumers pull back spending. Instead, unemployment fell to 6.5% in June, wages increased by 3.0% year over year and consumer spending remained resilient.

Part of the explanation lies in slower population growth and a decline in the number of temporary residents. While total economic output was marginally lower, **output per person increased**, with per-capita GDP rising 0.2%.

Encouragingly, Q2 economic data has been more constructive, with the first two months of the quarter showing positive GDP growth, suggesting the slowdown may prove temporary rather than the start of a more pronounced downturn.

AI's next test: Proving useful at scale. AI remained the dominant market theme during the quarter, but the narrative continued to evolve. In 2025, markets rewarded a narrow group of companies driving the buildout of AI infrastructure and capabilities. By early 2026, however, investors wanted evidence that this spending could translate into earnings growth, productivity gains and durable demand.

The first corporate earnings season of 2026 delivered exactly that. More than 80% of companies in the S&P 500 reported earnings above expectations, reinforcing confidence that AI-related spending is generating tangible business benefits. Market leadership broadened during the quarter, with industrials, financials and other cyclical sectors contributing meaningfully to returns rather than gains being driven by a handful of large technology companies.

At the enterprise level, the conversation is increasingly a balancing act between innovation and practicality. Companies are not only searching for the most powerful AI models but also for the most cost-effective tools for specific tasks. Token usage, energy consumption and infrastructure costs have become more significant operating considerations. This shift has kept demand strong for key AI inputs such as memory, semiconductors and data center capacity, while pushing model developers to compete on efficiency as much as performance.

KEY TAKEAWAYS

Capital markets posted another strong quarter, led by a broadening AI trade.

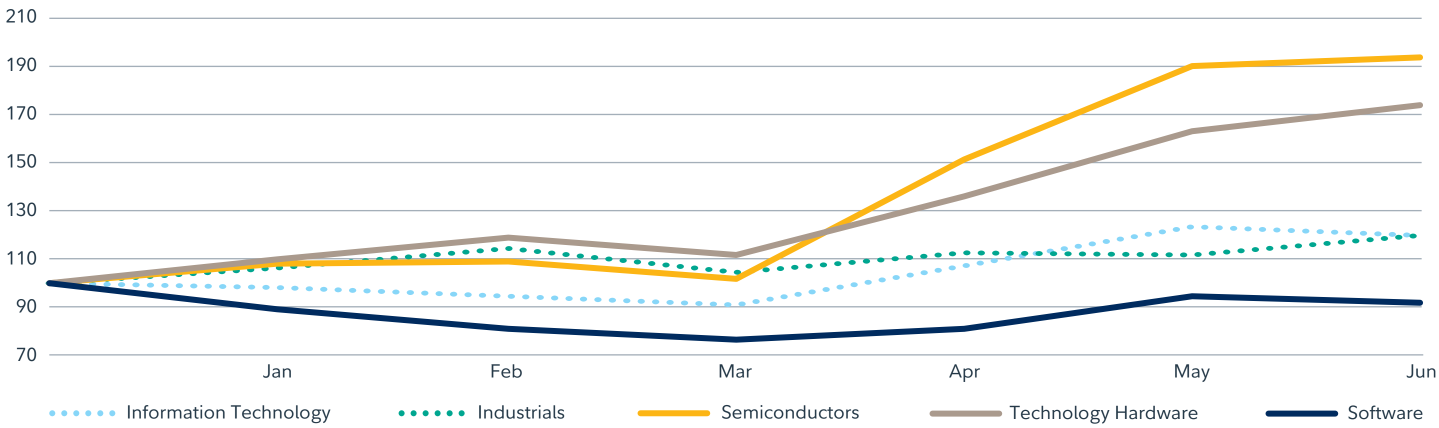
Widespread recession fears in Canada lacked broader economic confirmation.

The AI theme continued to evolve with a focus on scale, efficiency and supply constraints.

Diversification remains key in an increasingly complex and fast paced market.

The chart below highlights this trend: Technology and Industrials rallied and ended the period at similar year-to-date levels, reinforcing that AI leadership has extended beyond traditional technology to include physical infrastructure. However, beneath the surface, dispersion was significant: Semiconductors and Technology Hardware led the trend, while Software lagged, as investors became more selective toward companies still proving monetization and efficiency. Looking ahead, the next phase of innovation may be defined less by the flashiest AI model and more by the tools that can deliver useful outcomes at the lowest practical cost.

Investors Favour AI Infrastructure (S&P 500 - Year To Date 2026)



Source: S&P Dow Jones Indices LLC, as of June 30, 2026. Returns are total returns in USD and indexed to 100 as of December 31, 2025. For illustrative purposes only.
Past performance is not a guarantee of future results.

Canadian equities

Canadian equities, as measured by the S&P/TSX Capped Composite Index, rose 7.0% in Q2, marking a reversal in trends from last quarter. Financials led performance, posting a stellar return of 25.6%, as strong earnings, resilient balance sheets and stable credit conditions reinforced confidence in the sector. Canadian banks are closely watched since domestic and foreign investors often use them as a proxy for the Canadian economy.

Their outperformance could indicate that investors may be less convinced by the recession narrative than recent headlines imply. In contrast, Materials and Energy, the top performing sectors in Q1, lagged in Q2, declining by 11.5% and 5.0%, respectively. While commodity prices initially rose amid Middle East tensions, they retraced sharply later in the quarter as geopolitical risks eased, weighing on sector returns.

Inflation, however, reflected the earlier rise in energy prices. Headline CPI climbed to 3.2% in May versus 2.4% at the end of last quarter, driven largely by higher gasoline prices. Excluding energy, inflation was 2.2% in May, which is much closer to the Bank of Canada's 2.0% target. With underlying inflation pressures still anchored and economic growth still soft, the Bank of Canada held its policy rate unchanged at 2.25%, viewing the rise in headline inflation as largely energy-driven and likely temporary, unless geopolitical tensions keep energy prices elevated.

U.S. equities

U.S. equities, as measured by the S&P 500 index, staged an even stronger comeback in Q2, returning 15.2% in USD terms (17.3% in CAD terms). Information Technology led performance, rallying 31.6%, followed by Industrials at 14.5% (both returns in USD). In line with Canadian equities, Energy was the weakest-performing sector as easing tensions in the Middle East contributed to a pullback in oil prices.

The U.S. economy also remained resilient. GDP grew by 2.1% in Q1 while unemployment stayed relatively stable at 4.3%. Inflation, however, rose to 4.2% in May, driven primarily by energy prices, but core CPI (excluding energy and food) also remained elevated. This combination of resilient growth and sticky inflation has created a growing debate within the Federal Reserve.

Echoing the broader discussion around AI and productivity, Chairman Kevin Warsh and some policymakers appear to believe that stronger productivity gains can help offset inflationary pressures and support faster economic growth. Others remain concerned that the economy risks running too hot, allowing inflation to become more entrenched. Against this backdrop, the Federal Reserve held its policy rate unchanged at 3.50%–3.75%.

International equities

Investors have increasingly looked beyond the U.S. for opportunities tied to AI, broadening participation in the theme after several years of highly concentrated market leadership. Emerging markets have been the biggest beneficiaries. Taiwan and South Korea, home to several of the world's leading semiconductor and memory-chip manufacturers, continued to attract capital as demand for AI infrastructure remained strong. In contrast, commodity-oriented regions such as Latin America and parts of the Middle East saw more muted returns as oil and commodity prices pulled back later in the quarter. Overall, the MSCI Emerging Markets Index led regional equity performance with a standout return of 26.1% in CAD terms.

In the developed markets, the MSCI EAFE Index gained 12.7% in CAD terms. Japan remained a standout, supported by ongoing corporate governance reforms, improved capital discipline and a favourable economic backdrop. European markets also participated in the rally, benefiting from improved risk sentiment as geopolitical tensions eased, with returns strongest in technology-heavy markets and more varied elsewhere.

Fixed income

Bond markets also had mixed results in our key regions this past quarter. In Canada, softer economic data reduced interest rate expectations and supported bond prices, with the FTSE Canada Universe Bond Index gaining 2.0% in CAD terms. U.S. bonds had a more muted quarter, as higher inflation expectations, large fiscal deficits and elevated government borrowing kept upward pressure on longer-term yields. As a result, the Bloomberg U.S. Aggregate Bond Index (CAD-hedged), posted a modest gain of 0.3% in CAD terms. Meanwhile, some international markets faced increased inflationary pressures and expansionary fiscal policies, leading certain central banks to adopt a more cautious policy stance.

Corporate issuance also remained active, including new borrowing from large cash-generating companies such as Alphabet and Amazon. Their use of debt financing highlights management's conviction that AI-related spending represents a long-term strategic investment, even as capital requirements continue to rise. As these borrowing programs expand, markets will remain focused on whether future earnings growth can outpace these associated financing costs.

Outlook

Our expectations for the second half of the year remain **cautiously optimistic**. The recent easing of geopolitical tensions has helped moderate energy-driven inflation pressures, while renewed confidence in AI-related innovation backed by rising corporate profits continues to support structural growth. The confluence of these factors could be constructive for risk assets and their ability to continue generating positive returns for the rest of the year.

That said, risks remain. One of the biggest is whether AI-related investments can deliver returns that justify the market's elevated expectations. Any evidence that returns on investment are falling short of expectations could lead to a meaningful reassessment. Such a reassessment could lead to lower corporate investment, weaker earnings expectations and a reduction in equity valuations. The combination of these could elevate recession risks, particularly in the U.S.

Inflation and long-term interest rates remain important variables. Persistently higher price pressures could limit the scope for central bank easing and challenge current valuation levels.

At the same time, as expectations continue to rise, companies may find it increasingly difficult to exceed already elevated earnings forecasts. If earnings growth begins to moderate, markets may face periods where optimism has already been reflected in asset prices, resulting in more muted returns. This dynamic may also contribute to greater volatility, as investors now react more sharply to new information and changing expectations, as illustrated by the sharp decline in technology stocks earlier this year, followed by an equally rapid recovery in the second quarter.

In this environment, we continue to favour diversification across both themes and geography. Canada provides access to large, defensive businesses and natural resource companies that can perform well even when domestic economic growth is modest. The U.S. remains at the forefront of AI-related innovation, while international markets provide exposure to complementary parts of the AI supply chain, including areas such as memory chips. As market leadership continues to evolve, maintaining a disciplined, long-term approach remains more important than reacting to short-term noise.

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