Weekly Market Commentary

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Jeffrey Buchbinder, CFA, Chief Equity Strategist, LPL Financial

Brian Booe, Associate Analyst, Research

LPL Financial

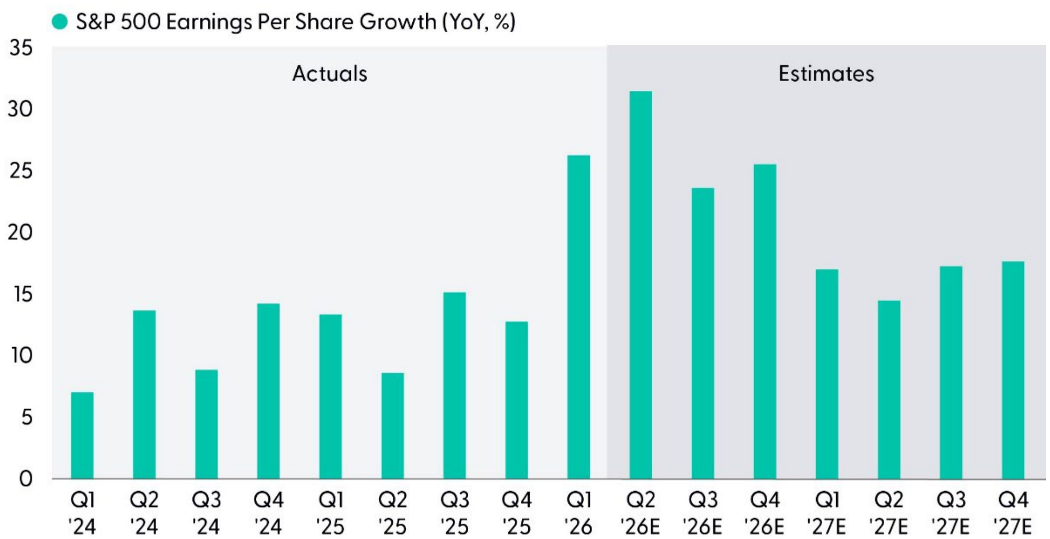
Stock Market Tug of War: Earnings vs. Rates

As we wrote earlier this month, earnings have provided a strong foundation for stocks this year. With second quarter earnings growth for the S&P 500 on track to exceed 30% (excluding private investment mark-ups) and analysts continuing to raise estimates, it's safe to say this season strengthened the fundamental case for equities. So, while geopolitics, election-related risks, and rising interest rates may drive volatility in the coming months, improving and broadening earnings growth is likely to raise the floor for stocks, and the S&P 500's recent technical breakout to new highs probably raises the ceiling. Here are some of our takeaways from this earnings season and some quick thoughts on the tug of war between stocks and interest rates.

Strong Earnings Season Raises the Floor

Second quarter earnings results — and it seems fair to call them a blowout — have increased our confidence that the earnings outlook can support stocks over the balance of 2026. Not only has the pace of earnings growth surprised us (we expected a percentage increase in the high 20s), but the guidance was good enough for analysts to raise estimates for the second half and 2027. As shown in "Earnings Growth on Track for Four Straight Quarters Over 20%," not only have earnings grown at over a 20% pace during each of the last two quarters, but they will likely do so in the third and fourth quarters as well — even without the "other income" from mark-ups on private investment holdings that boosted "all-in" S&P 500 earnings growth to over 50% in the second quarter. Further, S&P 500 profit margins are at record highs and are expected to go higher — with or without the technology sector. Despite high oil prices and rising borrowing costs, non-technology operating margins have reached record highs and are expected to inch higher over the next few quarters.

Earnings Growth on Track for Four Straight Quarters Over 20%



Source: LPL Research, Bloomberg 08/20/26

Disclosures: All indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results. Estimates may not materialize as predicted and are subject to change. Earnings exclude investment mark-ups from Alphabet (GOOG/L) and Amazon (AMZN).

That higher potential floor for earnings and stock prices doesn't mean we don't have to watch out for volatility. Geopolitics, the midterm elections, the Federal Reserve (Fed), and fluctuations in long-term rates (more on that below) may cause swings in stocks this fall. Meanwhile, questions about overspending on artificial intelligence (AI) capabilities will probably be with us well beyond 2026. But the spectacular second quarter results from corporate America probably raise the floor for stocks, while at the same time, the recent technical breakout in the S&P 500 is likely to raise the ceiling.

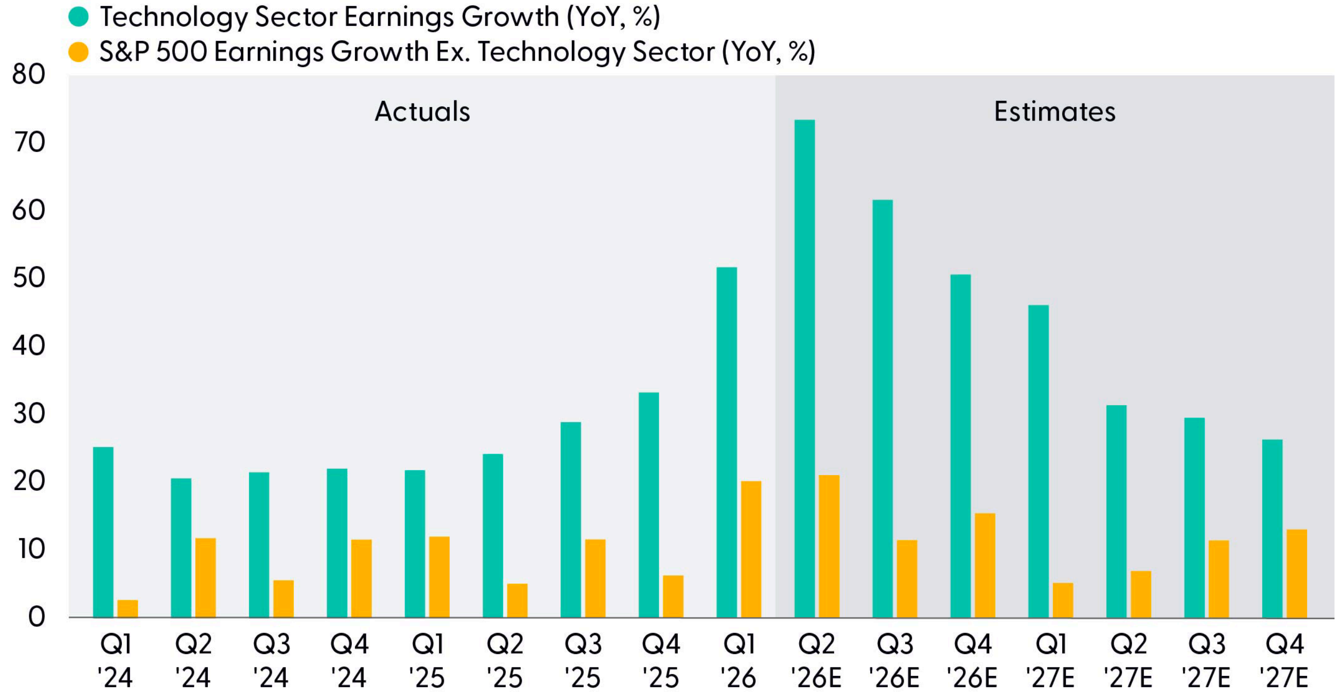
Earnings Season Highlights Must Start With AI

The primary driver of the strong earnings growth will not surprise you — it's technology and the massive AI investment. We estimate that about three-quarters of the 50% headline S&P 500 EPS growth number was AI-driven. That includes some tech companies not classified as tech, such as Alphabet (GOOG/L) and Amazon (AMZN), and valuation mark-ups of private AI holdings.

If instead we isolate just the technology sector, the contribution to S&P 500 earnings in the second quarter is more like 35%. But that doesn't mean the sector's earnings aren't booming. The "Technology Remains by Far the Most Powerful Earnings Driver" chart illustrates just how strong the sector's earnings growth has been — over 50% in the first quarter and over 70% in the second.

Also impressive is the pace of earnings growth excluding technology, which is tracking to 21% in the second quarter. Excluding AI stocks, as defined by Bloomberg, the earnings growth rate is an even more impressive 23.9%. And excluding the Magnificent Seven, earnings are growing 31%. Bottom line, while tech and AI are leading the charge, the stock market would not be where it is if it wasn't for help from the rest of the market.

Technology Remains by Far the Most Powerful Earnings Driver



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What Did We Learn About the Hyperscalers’ Ability to Monetize Capital Investment Plans?

Our biggest question coming into earnings season was not so much about capital investment guidance from the hyperscalers; it was widely anticipated that those numbers would go higher (and they did). The top five are likely to spend nearly $800 billion this year and well over $1 trillion next year. Our biggest question was whether the hyperscalers would be able to monetize that massive investment. (Tom Shipp and Tucker Beale discussed this topic in their latest *Beyond the Numbers* report on July 22.)

Alphabet, Amazon, and Microsoft provided solid responses to that question, growing cloud computing revenue strongly. Let’s take them one by one before we get to the nuanced story around Meta:

- Alphabet grew its cloud/AI revenue 82% in the quarter, the fastest in the group. Add to that a backlog of $514 billion, and it looks like the company is monetizing its investment at a reasonable level. However, negative free cash flow in the quarter and the need for outside funding to add more compute capacity caused investors to sell the news after second quarter results.
- For Amazon, revenue jumped 37% to $42.2 billion at its Amazon Web Services (AWS) unit, the fastest pace of growth since the fourth quarter of 2021. Profit margins held up, but capital expenditures drained all of the company’s free cash flow.
- Microsoft was the cleanest story. Revenue for Microsoft’s cloud offering, Azure, accelerated to 43%. Perhaps more impressive, $19.6 billion of free cash flow was generated in the quarter, the best of this select group. The software giant also told Wall Street that compute capacity added to the backlog was monetized quickly during the quarter and that they expect positive free cash flow in 2027.

Turning to Meta, where its AI investment to date is being used internally and not to support an external cloud business, the story is complicated. Meta was one of the earliest winners in the race to show improved results in its core advertising business by implementing AI. Ad revenue grew a solid 27% in the second quarter, suggesting that trend continued.

But Meta does not have cloud revenue to help justify its investment, leading to worries among some analysts that this cycle will be a repeat of the metaverse debacle back in 2022, when the stock fell 26.4% in a single trading session on February 3, 2022, on fears of wasteful spending. Another similar 24.6% one-day drop on October 27, 2022, sent the stock below $100 for the first time since 2016.

Meta’s capital expenditures guidance this quarter was too open ended for the market’s liking, and progress toward monetization has lagged its hyperscaler peers, even though founder and CEO Mark Zuckerberg has indicated that selling excess computing capacity is being considered.

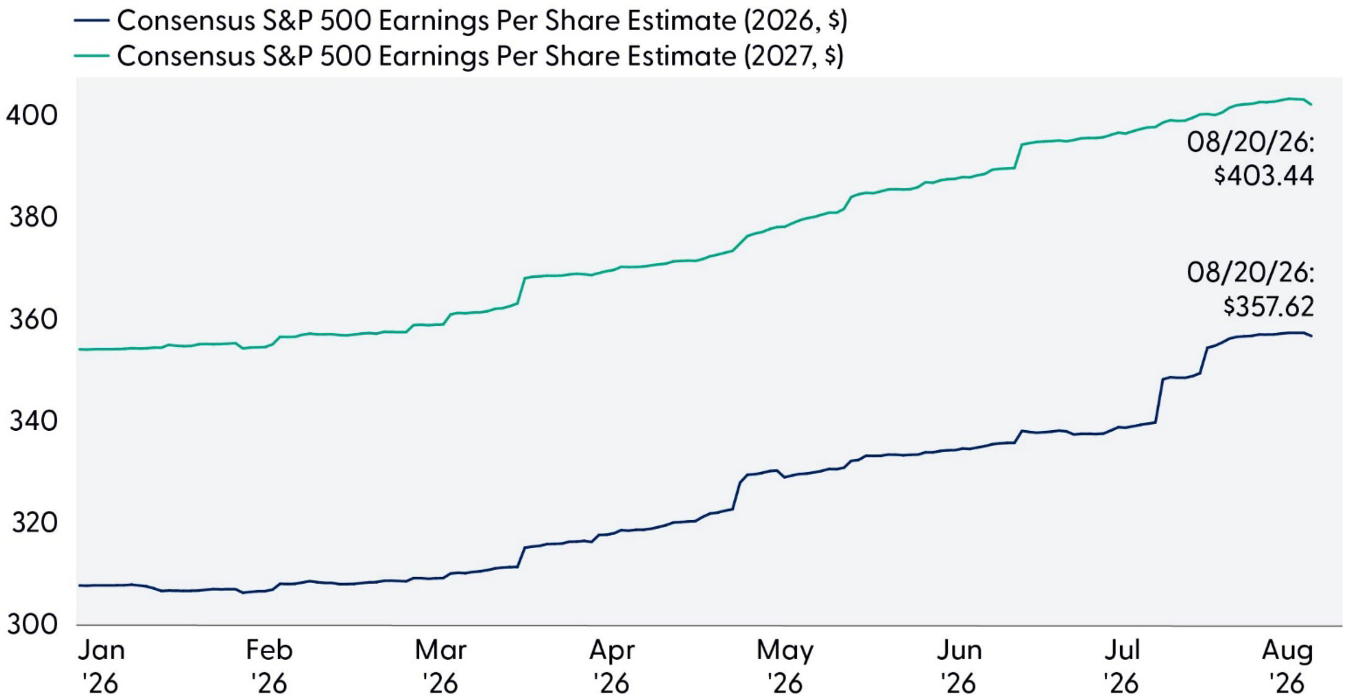
Bottom line, as a group, the hyperscalers have made progress convincing markets that the massive AI investment will pay off. Total order backlog has surpassed $2.5 trillion after increasing 18% quarter over quarter (source: Bloomberg). At the company level, Alphabet, Amazon, and Microsoft have made some good strides, Amazon’s and Microsoft’s cloud revenue growth impressed, while Meta still has some convincing to do.

Other Earnings Takeaways

Moving beyond mega cap technology, here are some other takeaways from earnings season that suggest the floor for stocks has likely been raised.

- **Estimates have risen.** Broadly speaking, one of the best ways to judge earnings season is by analyzing guidance to assess how confident management teams are about the future. We can do this by monitoring trends in consensus estimates, illustrated in the “S&P 500 Earnings Estimates Continue to March Higher” chart. Actual earnings usually fall short of where estimates stood at the start of that year, but not this year. The bottom-up consensus S&P 500 EPS estimate for 2026 has increased 15% year to date, while the estimate for 2027 is up 13%. During the earnings reporting period over the past six weeks, estimates for 2026 and 2027 have increased by 5.6% and 1.8%, respectively, suggesting earnings momentum has not slowed down. This is very unusual, as estimate increases like this typically only occur during recoveries from recessions.

S&P 500 Earnings Estimates Continue to March Higher



Source: LPL Research, Bloomberg 08/20/26
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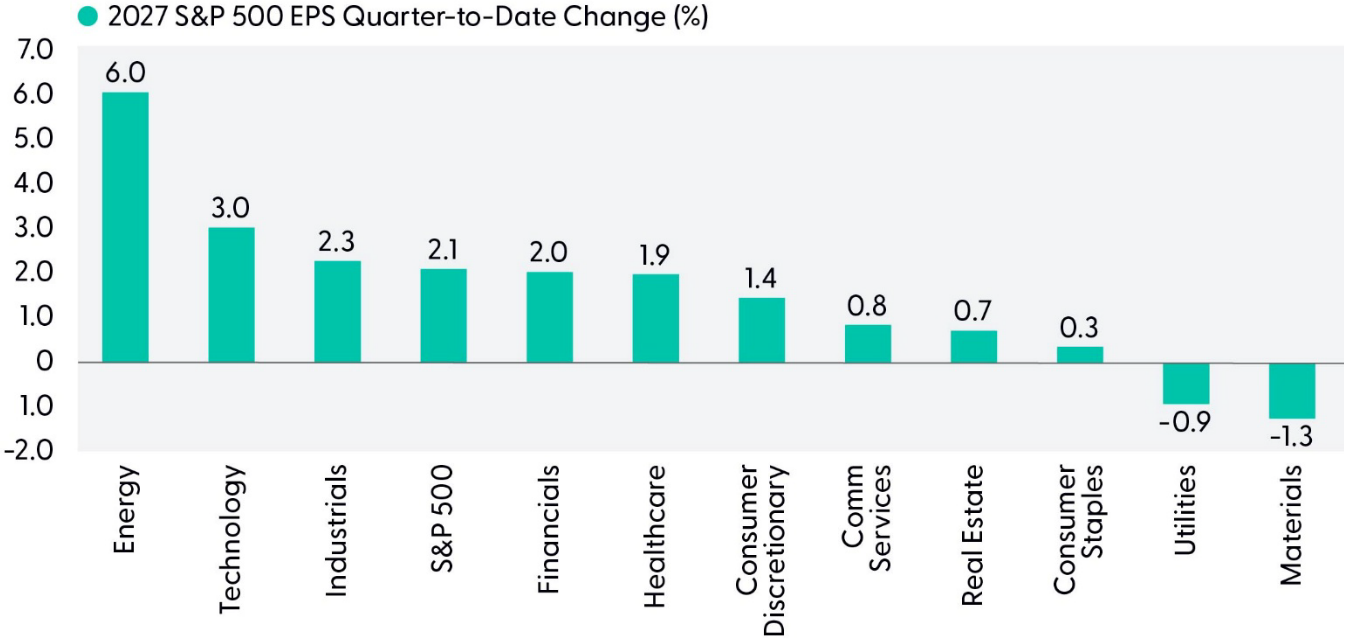
- **Impressive breadth of earnings momentum.** An overview of earnings season, of course, starts with AI and technology. But, as noted above, S&P 500 companies grew earnings over 20% excluding AI-levered companies. If one-time charges for Gilead (GILD) and Merck (MRK) are excluded, all 11 S&P sectors grew earnings by at least 8% in the second quarter (healthcare earnings excluding one-time items rose 19%). So, it wasn't just AI. Perhaps even more impressive is that 2027 estimates have increased for nine of the 11 sectors since quarter-end, as shown in "2027 Earnings Estimates Lifted for All but Two Sectors."

2027 Earnings Estimates Lifted for All but Two Sectors



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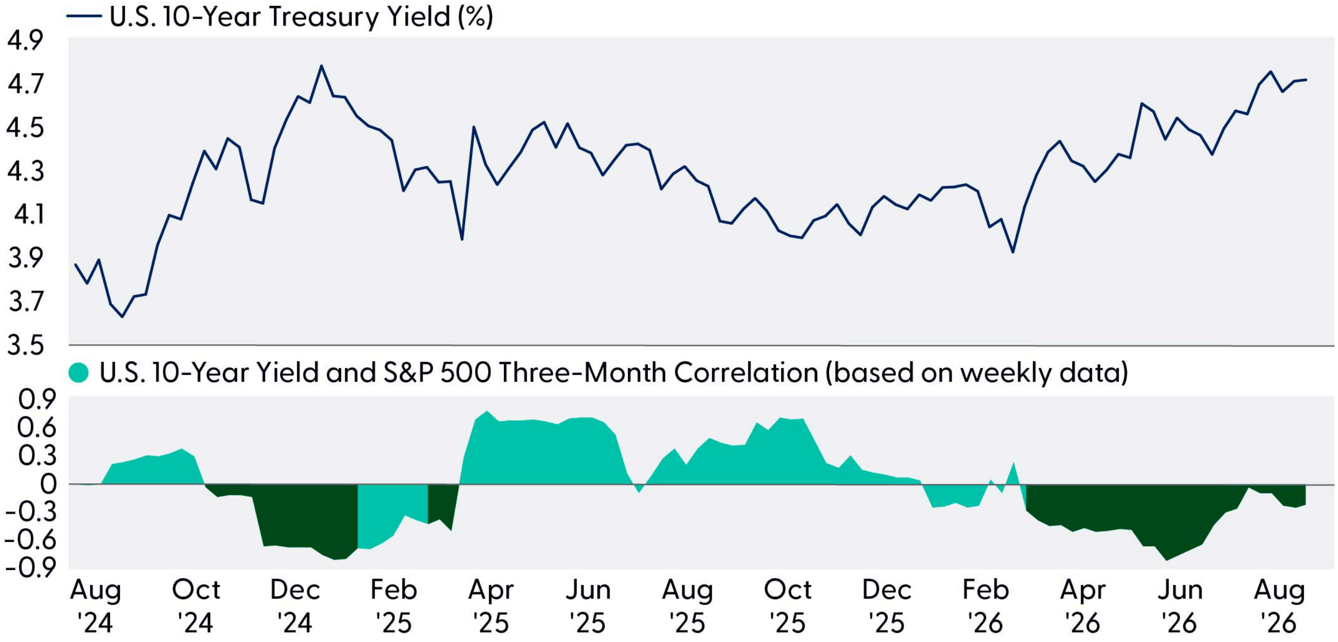
- **Stocks Have Actually Gotten Cheaper.** As earnings expectations have impressively risen, stocks have gotten cheaper. The price-to-earnings ratio (P/E) for the S&P 500, based on consensus earnings per share (EPS) estimates for the next 12 months, has fallen 11% this year even though the index's price has appreciated 12% (through August 21, 2026). In other words, the "E" has risen faster than the "P" in the P/E calculation. (At the same time, we acknowledge that valuations based on free cash flow have not gotten cheaper as the hyperscalers have effectively spent their free cash on building out data centers.)

Yields on the Rise

As a blockbuster earnings season helped propel stocks to new heights, higher Treasury yields have been pushing in the other direction. Historically, a rise in yields driven by economic growth is fine for stocks, but elevated yields caused by inflation worries can at a point put pressure on stock prices — especially when rates rise rapidly to multi-year highs as they did in July.

As shown below, when the 10-year Treasury yield sustains gains above the 4.3% range, correlation with the S&P 500 turns negative, suggesting that stocks have struggled above this level. When the 10-year yield has entered this range, market concerns of higher rates potentially hurting the economy via higher borrowing costs, impairing demand for big-ticket purchases begin to dampen risk appetite. In addition, higher interest rates tend to weigh on stock valuations by increasing the cost of capital. LPL Research's house view is that the 10-year yield edges lower to the 4% to 4.5% range by year end but we wouldn't be surprised if yields edged a bit higher from current levels in the short term given resilient economic growth, high oil prices, and heavy corporate issuance.

Correlation Between Treasury Yields and Stocks Has Tended to Flip When Yields Exceed 4.3%



Source: LPL Research, Bloomberg 08/20/26
Disclosures: All indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results. Shaded areas illustrate periods during which the U.S. 10-Year Treasury yield exceeded 4.3%. Dark green shaded areas represent periods when the 10-year Treasury yield sustained levels above 4.3%.

Conclusion

Second quarter reporting season reinforced our view that earnings can support further gains for stocks over the balance of 2026. While AI investment continues to drive a substantial share of earnings growth, the breadth of improvement across sectors is encouraging. Stronger profits have brought down valuations as stock prices have moved higher. So, while volatility tied to geopolitics, monetary policy, the midterm elections, or rising interest rates may come in the months ahead, a supportive fundamental backdrop raises the floor. At the same time, from a technical analysis perspective the recent breakout by the S&P 500 to new highs raises the ceiling (our near-term technical-based target for the index is 7,950). While the tug-of-war between interest rates and stocks may continue, we expect lower oil prices and ebbing inflation to help bring interest rates down over the next several months and prevent interest rates from becoming a bigger headwind for stocks.

Asset Allocation Insights

LPL's Strategic and Tactical Asset Allocation Committee (STAAC) maintains its recommendation for a tactical equity overweight and fixed income underweight. We believe an improving macro backdrop and sustained AI-driven earnings growth will continue to support the broader equity market through the remainder of 2026. The Committee recently shifted the implementation of the equity overweight from low-volatility strategies to a quality-factor tilt to enable greater upside participation. Within fixed income, we continue to emphasize high-quality bonds, take a cautious stance toward rate-sensitive sectors, and maintain exposure to diversifying alternative strategies. Within bond sectors, we remain underweight investment grade corporates and mortgage-backed securities (MBS) as spreads remain tight relative to historical standards, diminishing the risk/reward profile of the sectors.

Important Disclosures

This material is for general information only and is not intended to provide specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors or will yield positive outcomes. Investing involves risks including possible loss of principal. Any economic forecasts set forth may not develop as predicted and are subject to change.

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All investing involves risk, including possible loss of principal.

Alternative investments may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

US Treasuries may be considered "safe haven" investments but do carry some degree of risk including interest rate, credit, and market risk. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet or Bloomberg.

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