

## QUARTERLY REVIEW

December 31, 2025

# Q4 Economic and Market Commentary

We will remember 2025 as a year in which the market added another nearly 20% return, making it three consecutive years of outsized returns for investors, and the 7th best 3 years run on record. Since the market lows in October of 2022, the S&P has gained approximately 90%. It's almost hard to remember that we had a 19% pullback from mid-February to early April on tariff concerns, most of which failed to materialize or were minimal compared to initial fears. The fourth quarter saw the S&P add another 2.6% as the market exhibited its normal seasonal patterns, except for the lack of a Santa Claus rally as the market weakened in the last week of the year. The Q4 gain brought the full year return for the S&P to 17.8%. The market in Q4 experienced some volatility as it suffered from a lack of government data due to the shutdown and saw a drop of 5% from the end of October through November 20th as worries over circular AI funding, and a weaker jobs market took center stage. Most of these concerns were alleviated by strong earnings reports from the major AI themed stocks allowing the market to recover and reach a new high on Christmas Eve. Earnings for Q3 were exceptionally strong, helping to underpin the market, as earnings grew 13.8% year over year, well above the initial expectations of 7.9% at the end of September, and marked the fourth consecutive quarter of double-digit growth. The driving forces in 2025 were a resilient consumer and relentless AI capex spending. Global AI capex for 2025 was estimated to have been between \$375 - \$423 Billion (roughly equal to the Manhattan Project), with 2026 forecasted spending expected to increase to \$500 Billion plus. And while the consumer has felt more glum in 2025, that sentiment did not manifest itself in spending. The University of Michigan Consumer Sentiment Index has declined from 74 in December 2024 to 52.9, yet spending rose over 4%. The Fed cut rates another 50 basis points in Q4 as expected, but in a break with recent history we did see some dissent among voting members.

# The Economy

Q3 GDP came in at the strongest rate of the last two years at 4.3%, improving from a solid Q2 of 3.8%. While the government shutdown should negatively impact Q4 to some degree, the Atlanta Fed is currently estimating Q4 GDP to be a robust 5.4%. We would expect the economy to remain solid in 2026 as the fiscal impacts of the “Big Beautiful Bill” fully engage. Increasing tax refunds should help consumers who are currently stretched, and we would expect the bulk of those refunds to be spent. The combination of individual and business provisions in the bill should add 0.9% to GDP (\$350 - \$400 billion). AI capital spending will continue in 2026 and has contributed 40 – 45% of US GDP growth over the last three quarters, up from less than 5% in the first three quarters of 2023. Any hints of a slowdown in AI capex will face scrutiny. The unemployment picture bears watching as continued weakness would argue for further Fed rate cuts, but the Fed will be in a tough position as the stimulative effects of fiscal spending could put continued pressure on inflation. Core PCE is at 2.8% year over year, and shelter costs should continue to move lower, while cost pressures continue to persist in other areas such as healthcare costs rising north of 4%. It seems the Fed’s focus is shifting more toward unemployment, as hiring has weakened and the unemployment rate has risen to 4.4%. Oil has experienced its biggest annual drop since 2020, falling almost 18%, and while consumers have benefited at the pump, other energy prices such as electricity have increased by over 6%, driven by AI data center demand. We expect inflation to remain between 2.5% - 3% in 2026, and the Fed’s own projections don’t show inflation reaching the 2% target until late 2027. Retail sales are up roughly 4% nominally year over year, and according to Visa, holiday spending rose 4.2%. Spending has also become bifurcated, with the top 10% of income earners responsible for 50% of consumer spending, while the lower income cohorts have cut back and have felt the “affordability” issue more acutely. The market gains have increased the wealth of the top income cohorts, leading to the “K shaped” economy that economists now reference with one segment doing well while another struggles. Retail spending will be a key metric in 2026 given the pressure on the lower end consumer, worries over a tighter labor market, potential worker displacement due to AI, and lack of immigration.

# Market Review **Fourth Quarter Market Recap:**

While the market closed the year below its all-time high, it was yet another solid quarter and strong year. In Q4 the S&P gained 2.6%, but only Healthcare (+11.7%) and Communication Services (+7.3%) had gains above the index. Life Sciences and Tools saw nice gains in healthcare with Thermo Fisher and Danaher gaining 19.5% and 15.6% respectively. The market saw some rotation away from Technology in November on valuation concerns and this benefited Healthcare, which had been a lagging sector YTD. Communications Services once again had solid gains with a strong performance contribution from Google (+28.9% in Q4) with positive news on its Gemini AI models and indications of strong cloud backlogs. Financials were up 2% in Q4 benefiting from a steepening yield curve, expectation of merger activity, and anticipated relaxation of regulatory requirements which should continue to benefit the sector into 2026. Mid November saw an almost 5% market decline as investors reassessed the odds of a December rate cut as the delayed September jobs report showed payroll gains of 119,000 and were stronger than expected. December was roughly flat for the market with some profit taking and year-end repositioning. The rotation was evident with Large Value beating both the S&P 500 and Large Growth in Q4 at +3.8%. Sectors exhibiting the weakest performance in Q4 were Real Estate (-2.9%), Utilities (-1.4%), Consumer Staples (flat), and Consumer Discretionary (+0.7%). A common theme within the underperforming areas was sensitivity to rising interest rates (Real Estate and Utilities), as both are interest sensitive, and growth rates within the Consumer Staples area which are generally uninspiring. There were only 3 sectors that beat the S&P in 2025, Communications Services (+33.6%), Technology (+24%), and Industrials (+19.4%). Both precious and industrial metals were strong in 2025 and especially in Q4 with silver rising 52%. The strong performance of gold and silver is probably indicative of concerns of monetary debasement and rising global debt levels.

## Stock Market Indexes

Market/Index	2024 Close	2025 Close	Quarter Change Total Return	YTD Change Total Return
DJIA	42544.22	48063.29	4.03%	14.92%
Nasdaq	19310.79	23241.99	2.72%	21.17%
S&P 500	5881.63	6845.50	2.65%	17.86%
Russell 2000	2230.16	2481.91	2.19%	12.79%
IEFA	70.28	89.46	4.45%	32.08%

## What to Expect Going Forward:

It's difficult to expect another strong year of returns given the past three years, but fundamentals still look attractive for the market. Since 1926 there have been three times when the S&P had 3 consecutive years of better than 15% returns. Only once did the fourth year produce a negative return. We are also entering a mid-term election year, and mid-term years tend to be the most volatile with an average 19.4% drawdown. Earnings are expected to increase 8.3% for Q4 (10th consecutive quarter of growth), and by another 15% in 2026. Profit margins are expected to move higher (forecasted margin of 19%), and markets normally don't get into trouble if margins are expanding. The Fed is likely to cut rates further in 2026 under a new Fed chair (Fed Funds futures expect 2 cuts), and fiscal stimulus is coming. While valuations are lofty at 22X earnings, the multiple excluding the top 10 names in the market is 19.2X, still high historically, but more reasonable given the magnitude of earnings growth. The forward P/E of the market only rose by 3% in 2025, with the rest of the market's almost 15% gain being attributable to earnings growth. Perhaps in a world of deteriorating fiscal health higher valuations are justified for companies that are improving productivity and growing earnings faster than the broader market. We are bothered by the increasing concentration of market cap as the "Mag 8" (add Broadcom), is now 40% of the S&P, whereas a decade ago the top 8 names were just 15% of the index. A broadening of market returns would be welcome, and we expect that to happen in 2026 as other sectors' earnings growth rates close the gap with the Tech sector, and by Q4 2026 should exceed the growth rate of the Mag 7. Even with solid fundamentals there are plenty of issues that will keep us vigilant. First, clients ask if we are in an AI bubble? It's hard to deny the impact AI related spending has had on the economy and the market. A combination of 42 AI related companies has generated 65-75% of S&P earnings and capex since ChatGPT launched in late 2022. Impressive! The differences between today's tech companies and the dot-com bubble era of 2000 are substantial. Our belief is that we are not in a bubble, but valuations and slowing rate of change in AI capex growth metrics bear scrutiny. Will we have an independent Fed? We view Fed independence as central to a strong economy and markets, and hope that the next Fed chair shares those sentiments. Will unemployment continue to rise? Hiring was slower in 2025 due to tariff uncertainty, and with the worst-case scenario off the table, we would expect the job market to remain stable. Affordability and inflation remain problematic, and while we expect some improvement in inflation, the jump in price levels since Covid are still an issue. The lag between growth in disposable income and price increases is what has led to weak consumer confidence readings. Geopolitical events will also be part of the plot in 2026 as we have already started the new year with Maduro's ouster in Venezuela. As always, we will monitor these issues and use our best judgment in adapting your portfolios to changing events.

# Fixed Income Recap and Outlook

In the final quarter of 2025, the US economy continued to show resilience, facing a historical 43-day government shutdown as well as a weakening job market. Following the post-reopening rebound in Federal spending, strong personal consumption and increase in net exports, the Atlanta Fed Now GDP forecast for Q4 now stands at 5.4%. Even with incomplete data, the Fed lowered overnight rates 3 times during the quarter to 3.5-3.75%. Job growth deteriorated over the 3rd quarter with the unemployment rate moving up to 4.4% from 4% at the beginning of the year. With regards to inflation, the Fed's preferred measure remained well above the Fed's target of 2% at 2.8%, slightly higher than the beginning of the year. In their December statement, the Fed believed the risks to further downside in the labor market were greater than persistent higher inflation. A few of the Fed's participants who favored lower rates at the December meeting felt that the decision to lower rates was a close call and finally balanced. The path forward for the Fed is unclear with a wide range of expectations for fed funds into 2026 ranging 175bps (2.125%-3.875%) and an increase in dissents at the meetings. The market continues to see the Fed lowering overnight rates 2 more times in 2026 to 3%. Even with the lack of economic data for most of the quarter, periodic elevated equity volatility and a more divided Fed, interest rates traded within a relatively tight range. The 2 Year US Treasury bounced between 3.45% to 3.61% and the 10-year US Treasury traded between 3.95% and 4.19%. The long bond however, drifted higher during the later half of the quarter ending the year at 4.85%. With interest rates and risk spreads stable over the quarter, returns were driven mostly by yield and sector returns generally returned around 1% to 1.2% for the quarter. No sector had superior excess returns during the quarter in comparison with prior quarters when risk spreads and yields moved steadily lower post April "Liberation Day." As we enter 2026, risk spreads across the spectrum and quality remain at historically tight levels. The market is obviously pricing in a favorable environment in the near term and not discounting any substantial volatility going forward. Some of this is justified by continued inflows into the fixed income space, healthy corporate and personal balance sheets and a stable interest rate environment. Going into 2026 with positive momentum is a good contrast from earlier this year when heightened risk aversion and economic uncertainty were more dominant. While the year ends with more positive momentum than in began, the primary question for 2026 is whether higher GDP growth will eventually translate into a stronger labor market.