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"Persistent Uncertainty"

Dear Clients and Friends: January 15, 2026

Markets were beset by an abundance of disruptive forces last year. Yet investors were rewarded for doing nothing. If you owned U.S. stocks, you made good money. If you owned foreign stocks, you did even better. If you held Treasuries, you did just fine. Even cash maintained an ample yield.

Except doing nothing was hard. Between DOGE, DeepSeek, "Liberation Day," and turmoil in the Middle East, the S&P 500 swooned nearly 19% from its February high, including a decline of 12% in a single four-day period. Then, starting in early April, a dramatic recovery ensued as tariffs were softened and DOGE started to fade into the background. The economy and corporate earnings remained strong, Congress passed the "One Big Beautiful Bill," and the Federal Reserve resumed interest rate cuts. All the while, AI was in the background fueling massive capital expenditures and stoking investor excitement. Oh, and the holiday season was marred by the longest government shutdown in history. It's truly difficult to believe we fit all of this into one year!

When the dust settled, the S&P 500 was up nearly +18% for the year, adding +2.6% during the quarter. While the Magnificent 7 and AI trade were responsible for much of these gains, the market rally broadened out as the year progressed. International stocks had a banner year, up +4% for the quarter and +31% for the year. A third of these gains were attributable to the -10% decline in the value of the dollar as tariffs spurred uncertainty on global trade. Small-cap stocks had a more difficult year, up +1.5% for the quarter and only +6% for 2025. The equal-weighted index, a better measure of how the average stock performed, was up +10% for the year. Have we mentioned investors preferred the narrative of the mega-cap stocks in the AI trade?

Bond investors had reasons to cheer as well. Bonds have struggled to generate much return since pandemic-driven rate cuts pushed yields to near zero in 2020. Subsequent rate hikes kept pressure on bond returns but normalized yields. Entering 2025, the 10-year Treasury yield sat at 4.6%. That yield provided a nice base return, while soft jobs, steady inflation, and three rate cuts helped bond prices edge higher. For the year, the Bloomberg Aggregate Bond Index returned +7.3%.

K-Shaped Economy

As we turn the page to 2026, the forces that supported last year's market returns remain in play. However, a risk is building beneath the surface: a widening gulf between the economic haves and have nots. Economist Peter Atwater has dubbed this divergence the "K-Shaped Economy." The sustainability of this "K-Shaped" economy is likely to become more important in the coming years. From a stock market standpoint, the upper slope of the K is represented by technology and other companies exposed to AI innovation and its deployment. They appear poised for continued near-term growth. Conversely, on the lower arm of the K, more cyclical industries like autos, housing, transports and consumer discretionary are exiting a year of anemic growth with an outlook of continued near-term weakness.

This analogy can also be extended to the extraordinary divergence between Wall Street and Main Street. While the stock market hit 39 new all-time highs in 2025, consumer confidence, as recorded by the University of Michigan Consumer Sentiment Survey, is hitting all-time lows. When asked, most people are pretty gloomy.

How can it be so good and so bad at the same time? Back to the K. On the upper arm you have the wealthiest 10% of Americans. They are doing just fine. They have stable, well-paying jobs that allow them to keep up with inflation. They also have 401(k)s and other investments that continue to swell as the stock market hits new highs, instilling a wealth-effect that promotes continued confidence. After a strong 2025, consumer spending data shows this cohort is now responsible for nearly half of all spending in the U.S.

On the lower arm, you have the other 90% of America. Their lives are very different. Many live paycheck-to-paycheck and have seen inflation eat away at take-home pay. Their retirement plans are much smaller, if they have one, and definitely not swelling. Job security is becoming more of an issue. They don't have confidence; they have anxiety. Consumer Confidence surveys are like the equal weighted stock market index; every person gets one vote. With such a higher percentage of people struggling in the current economy, it is easy to understand how the surveys are plumbing lows.

Essentially, wealthy Americans' spending and the AI buildout have been keeping the U.S. economy elevated. GDP growth looks to have been 1.9% last year, slightly below average compared to the last 30 years. So, there's been a disconnect between the average person's lived experience and the data. Our conclusion is the low reading of consumer confidence is <u>understating</u> the strength of the economy, and the stock market trading at all-time highs is <u>overstating</u> the strength of the economy.

Recent News

Given how fast things are changing, it is remarkable how stable and resilient the economy and stock market have been. Since slowing down doesn't appear in the cards, we wanted to briefly address several of the topics where we are most focused. Warning, this list updates constantly!

The job market spent much of 2025 in a kind of dead calm. We saw the unemployment rate slowly creep up from 4.0% to 4.4% throughout the year. The most recent data show unemployment and layoffs near historic lows but hiring also at its lowest level in decades. Economists have dubbed it a "no hire, no fire" situation. Recent corporate commentary has been remarkably consistent in stating that automation and AI are being increasingly deployed to reduce headcount and raise productivity, central levers in cost management and earnings growth. This trend, balanced by net negative immigration for the first time in 50 years, should lead to a relatively stable unemployment rate for the foreseeable future.

"Affordability" has become the new central focus of the Trump administration. The President seemed to dismiss Americans' concerns originally but has started to address it lately. Trump has long believed that inflation mostly stems from two sources: interest rates and oil prices. These two factors have entered the news recently in some noteworthy ways.

On the interest rate front, Trump has been hammering Fed Chair Powell, since before the election, to bring them down faster than the Federal Reserve has felt comfortable. Lower borrowing costs would make monthly notes for large ticket items, like cars and houses, more affordable. The Fed's hesitation centers on its belief that much of recent experienced inflation has been due to the extended period of ultra-low interest rates. Heated rhetoric turned into a criminal investigation focused on Powell's testimony involving renovations of the Federal Reserve building. These actions are seen as intimidation and attacks on the Fed's independence, attempting to affect policy decisions. One common characteristic of nearly all historical failed nations is a central bank that loses its independence and becomes directly controlled by the Head of State. Ironically for Trump, there was a global political backlash of this charge that may have effectively lengthened the time Powell stays in place.

Turning to oil… the U.S. just executed a military operation capturing Venezuelan leader Nicolas Maduro. The stated objective was to help the Venezuelan people and to bring a drug cartel leader to justice. However, since his capture, most every action has prioritized taking control of the world's largest proven oil reserves. President Trump has reportedly homed in on $50 a barrel oil, currently around $60, to alleviate energy costs for U.S. households and bring down other inflation. However, this could backfire as well. U.S. oil companies, which are expected to spend the necessary billions to increase Venezuelan production, are pushing back because of past experiences in the country and recognition that the lower target price will affect their own profitability. According to the Dallas Fed, breakeven prices for America's premier shale oil plays hover between $62 and $64 a barrel.

Lastly, the cornerstone of Trump's second term has been his tariffs. He issued the "reciprocal" tariffs using the International Emergency Economic Powers Act of 1977. No President has ever used this law to impose tariffs. On November 5th, the Supreme Court held hearings on the legality of Trump's use of this act after lower courts found he had exceeded his authority. A decision is expected sometime in January. During arguments, the Court seemed to lean in the lower courts' favor but acknowledged striking down the tariffs and forcing refunds of hundreds of billions of dollars would be terribly problematic. If he loses, the President has promised to reissue tariffs under different laws, likely resetting the clock on new challenges and inviting uncertainty all over again on global trade.

Outlook

Space, and our readers attention, prevent us from expounding on other news items such as Greenland, another government shutdown, or the mid-term elections. We instead reiterate our statement earlier that it is remarkable how stable and resilient the economy and stock market have been with all the "noise." We do see economic momentum staying positive on the backs of the wealth effect, AI buildout, and an accommodative Fed. The tax benefits from last year's OBBB should start to help consumer and business confidence in the second quarter. While valuations for U.S. stocks remain high, corporate earnings growth is set to continue and expand. Margins for business remain exceptionally healthy. We also have confidence there will be plenty more things to grab our attention.

Thank you again for your continued confidence and trust as we work through these extraordinary times. We welcome your comments, questions, and referrals. Please don't hesitate to contact us. Stay safe and well.

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