Market Commentary

Fourth Quarter 2025

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US equity markets continued to move higher during the final quarter of 2025, although persistent volatility made the rise far from a straight line. The 2.7% rise in the benchmark S&P 500 index during the fourth quarter brought the YTD increase to 17.9%. The S&P 500 rose in each of the last eight months of 2025 after bottoming during the April tariff turmoil.

The same themes that have been evident all year continued to be factors driving stock prices. In addition to tariffs, inflationary pressures, and a very weak jobs market, the longest Government shutdown in history also affected financial markets. Payroll growth has been uneven at best, and there are concerns that job growth has been overstated, meaning there may actually be negligible job growth in 2025.

The Federal Reserve continued reducing the Fed Funds rate with two 25 basis point cuts at meetings during the quarter. The current Fed Funds rate of 3 5/8% is close to the neutral rate that neither spurs nor retards growth. Looking at Fed forecasts, they project 25 basis points of cuts in each of 2026 and 2027. A combined 50 basis points of cuts over the next two years will do little to spur growth. The employment situation continues to deteriorate, while inflation expectations remain above the 2% Fed goal. Further rate cuts could modestly help the labor market, but at the possible cost of inflationary consequences. We must point out that since the Fed first began cutting rates in the Fall of 2024, the Fed Funds rate has been cut by 175 basis points (1.75%), yet the 10-year Treasury rate has risen slightly. This is due to inflation expectations remaining higher than over the past 15-20 years.

Economic and Market Outlook

Interest rates were stable across most of the maturity spectrum as the Fed cut rates in line with market expectations. This combined with a relatively benign inflation outlook to keep interest rates steady. The 1-year Treasury bill yield declined to 3.48% from 3.63% on September 30. The 2-year Treasury note began the quarter yielding 3.60% and declined to 3.48% at the end of September. The benchmark 10-year US Treasury note ended the quarter with a yield of 4.16%, basically unchanged from the 4.15% yield on June 30. S&P 500 earnings in 2025 should come in somewhere around $270, with early estimates for 2026 in the $310 area. This estimated growth of more than 14% relies upon interest rates not rising much from current levels, no recession, and profit margins continuing to increase from the current record levels. However, with stocks having risen faster than earnings for the third consecutive year, the market is valued at more than 22x 2026 earnings estimates. We continue to believe that earnings estimates may be too optimistic which puts stocks at risk of a pullback.

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As they tend to do annually, market strategists are predicting a gain of approximately 10% in the S&P 500 in 2026. We find it oddly disconcerting that strategists predict returns of high single digits nearly every year, and yet the S&P 500 has returned between 5% and 10% only twice in the past 30 years. An added concern heading into 2026 is that every major Wall Street strategist is predicting a higher market in 2026. After an 86% return over the past three years, the few bearish prognosticators have been persuaded and cajoled into predicting a fourth strong year for US stocks. Groupthink is dangerous and when everybody believes in a certain way, risks increase.

As we write this, the US has just arrested Nicolas Maduro of Venezuela. While there is little we can say definitively at this time, we believe the ramifications will play out over months and years. A friendlier government in Venezuela could help spur investment growth in a country that has been hollowed out after decades of democratic socialism. Countries that rely on Venezuela for financial support – namely Iran and Cuba – could become more isolated and face significant financial crises which could spur populist uprisings in those nations.

Portfolio Positioning

Based on the sharp rise in US equities over the past three years, we remain concerned about valuations. Bulls posit that continued strong earnings growth justifies the current P/E multiples on stocks. If earnings continue to grow at 12-15% per year, we might agree. From experience we know there are unknown variables that could cause a pullback at any time. On the geopolitical front, current issues are the Ukraine-Russia war, the new situation in Venezuela, China's increasing belligerence towards Taiwan, and the recent uprisings in Iran. On the economic side, we are concerned about negligible job growth over the past six months, stubborn inflationary pressures, an increasingly strapped consumer, and the ongoing tariff concerns. As your risk manager, we must remain aware of potential headwinds that could affect portfolio values.

We believe international stocks should continue to outperform US stocks in 2026 and have been methodically increasing our positions in international stocks. If a downturn comes, companies with relatively stable earnings and dividends should help cushion the decline. We are not counseling broadly selling equities, but rather to be diligent about valuations after markets have nearly doubled in the past 38 months.

Conclusion

The longest government shutdown in US history marked the first half of the recent quarter. While little legislative change occurred to end the shutdown, there was a modest hit to US economic growth during the just ended quarter.

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We believe the next several months could set the tone for the remainder of the decade. There will be significant changes at the Federal Reserve, budget battles are well underway, and the midterm elections will begin dominating the news in early 2026.

As we enter 2026, we remind you to review your portfolio asset allocation and contact us if there are any significant changes in your financial situation, risk tolerance or if you have any specific questions or concerns about your investments.

We hope you and your families have a safe, healthy, and prosperous New Year.

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