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Building Wealth Wisely

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The Glass is Half Full

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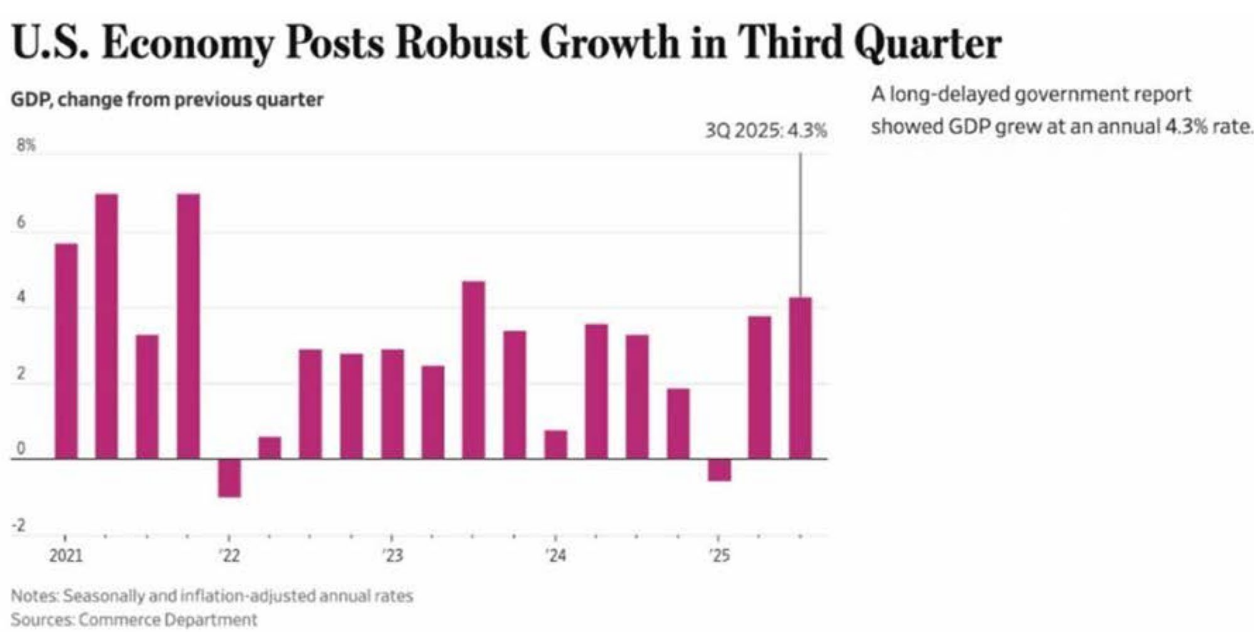
Despite an eventful and uneven ride, most markets delivered strong results in 2025. After falling more than 15% in the first four months of the year, the S&P 500 finished 2025 with a gain of 17%. International stocks gained over 25% and bonds performed well, faithfully delivering nice coupon payments in the 4-5% range.

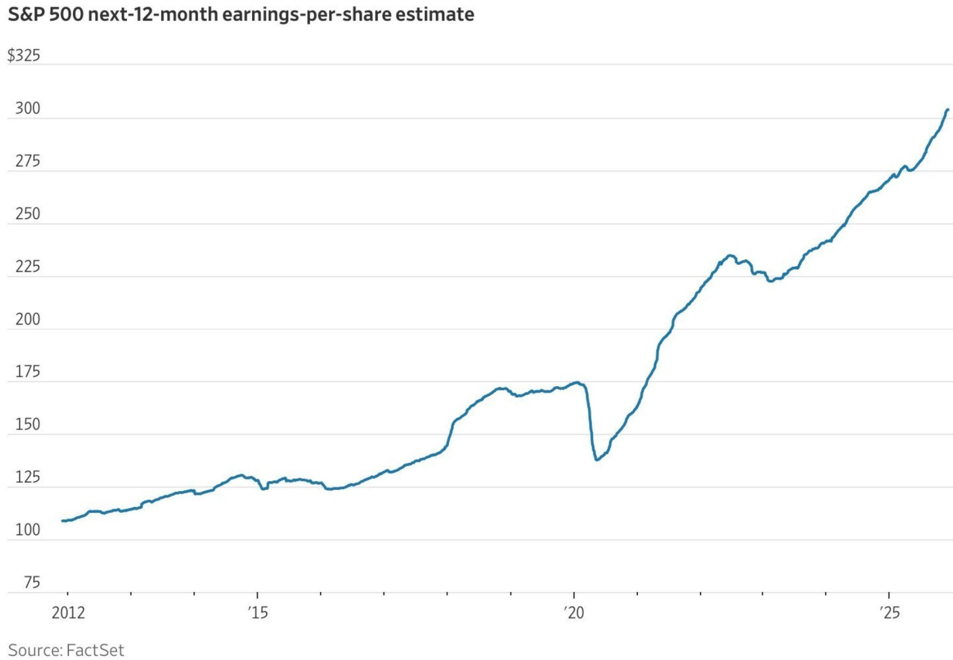
Despite solid equity returns, below the surface the results were extraordinarily unequal. Just 31% of S&P 500 stocks outperformed the index. The S&P 500 Growth index performed nearly twice as well as the S&P 500 Value index (22% versus 12%). The average stock in the S&P gained a lesser 14% return. But we're not complaining.

Maybe of most importance, the majority of stock market gains last year were driven by higher earnings rather than fueled by valuation expansion or sentiment. The economy also held up relatively well and even gained ground during the year despite the adverse pressures of higher tariffs, weaker consumer sentiment, and head-spinning uncertainty.



Adding to the positives for the economy, household debt levels are manageable, and the overall inflation rate of 3% is close to the long-term average level of the last 50 years. The cost of some items like healthcare and electricity are higher, while others like gasoline and rents are lower.

Most businesses in the USA are doing well. Corporate profits delivered strong results in 2025, hitting record levels to GDP. The trade deficit is down. U.S. productivity remains the envy of the world. The forecast for profits is the strongest in years.



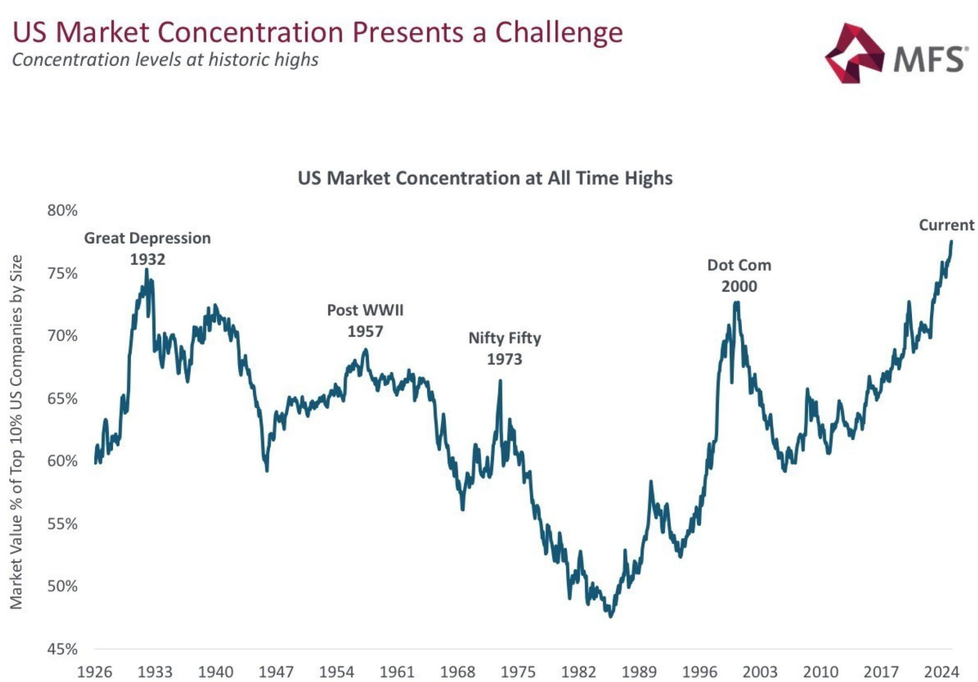
However, there are some signs of potential trouble in the economy. Some areas of private credit and subprime lending are under pressure. Car lenders are stretching out payment time periods, and delinquencies for many types of loans have been rising. The U.S. has a significantly bifurcated economy, with high income households benefiting from rising asset values and the wealth effect, while lower income households have been hammered by inflation.

There are also mixed signals in the labor market. Manufacturing remains subpar, with the number of manufacturing jobs declining in each quarter last year. Some of the lower job growth is related to a reduced need for new jobs since the number of new potential workers entering the country is much less than in past years. The unemployment rate is actually low by historic standards. Companies are hiring less but firing less. Part of this is due to productivity gains and the increasing use of Artificial Intelligence. Nevertheless, job growth is stagnant.

High and rising government debt and deficits throughout the developed world are a growing concern and could negatively impact markets and investors' portfolios in the coming years. In the U.S., high debt levels could strain the Fed's ability to make independent policy decisions, limit the government's ability to respond to future crises, create volatility in the Treasury market, and sow the seeds of higher long-term inflation.

Some parts of the market look overvalued, especially technology stocks and investments focused on Artificial Intelligence. These sectors are arguably approaching bubble territory.

The narrowness of the current stock market is approaching extreme levels. The largest seven U.S. stocks – Apple, Nvidia, Microsoft, Amazon, Broadcom, Alphabet, and Meta – combine for a massive 47% weighting of the S&P 500 Index. When stocks have reached such extreme levels in the past (think Nifty Fifty), there has been a disruptive shuffling of the deck.



Only 188 stocks in the S&P 500 today were also in the index at the end of 1999. Six of the largest 25 index members at the end of 1999 are no longer in the index at all today, and only six – Microsoft, Walmart, Exxon Mobil, Oracle, Home Depot, and Johnson & Johnson – still rank in the top 25.

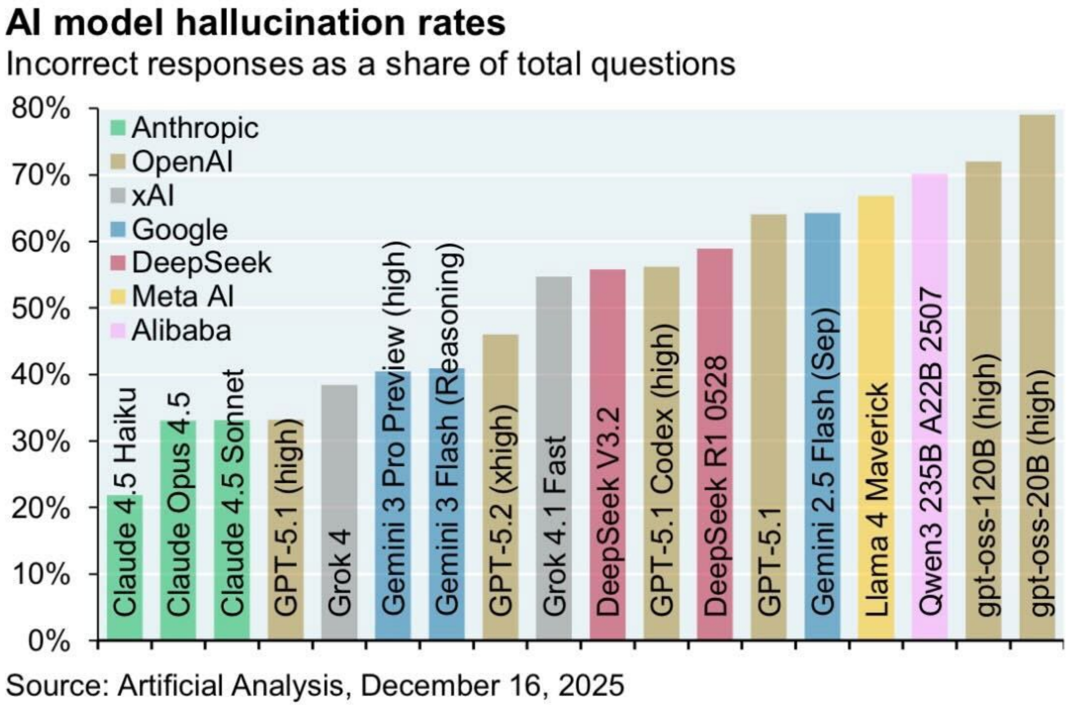
Top 10 companies by decade

This is no time for investment complacency. It is increasingly important to maintain a disciplined and diversified stance instead of chasing overly expensive or speculative stocks. Too many investors today are taking on too much risk in concentrated portfolios. In times of growing exuberance, it is easy to forget that valuation plays a significant role in long-term investment performance.

It is hard to determine just how overvalued large tech companies have become in the rush to embrace Artificial Intelligence. While the current tech capital spending surge as a share of GDP has now exceeded the dot-com era, technology valuations are roughly half of the levels seen at the dot-com peak, with U.S. tech PEG ratios (Price-to-Earnings / Growth) at about 1x-3x in recent years compared to 4x-8x in the dot-com era.

Whereas many dot-com companies were start-ups that relied on speculative funding for their endeavors, the current tech behemoths are funding their A.I. research and products with their own company earnings.

Expectations for the impact of A.I. are certainly exuberant given current A.I. capabilities. Artificial Intelligence will change the world, but the near-term projections seem overrated. The chart below shows the results of a recent study by Artificial Analytics of the accuracy of existing A.I. models, defined as the share of incorrect responses (hallucinations) out of all questions asked. Some of these hallucination rates are shockingly high. Artificial Intelligence is prone to a garbage-in, garbage-out syndrome.



There is little doubt that some companies are going to be losers in the competition to exploit Artificial Intelligence. Today's most darling stock is probably Nvidia. Cisco Systems was the most valuable company at the peak of the dot-com bubble. Cisco's stock dropped 80% in value when the previous tech stock bubble burst. It took until recently – more than 25 years later – for its stock price to recover to its previous level.

Given high valuations, we are growing somewhat cautious in our outlook for certain sectors of the stock market, and we are overdue for a market correction (which tends to happen at least once a year). At current valuations for popular stocks, it would not be surprising if investors got spooked by any negative news this year. As a reminder, market downturns are a normal and regular occurrence.

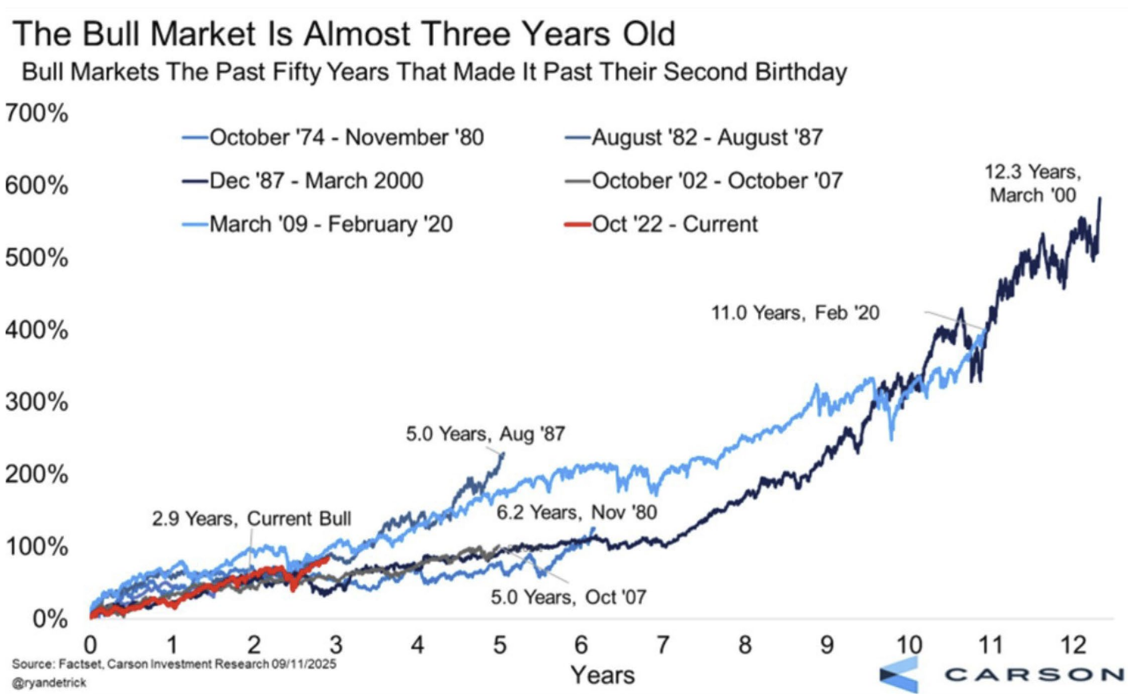
Furthermore, the second year of the presidential cycle is often challenging for financial markets. And for many investors, President Trump adds a level of uncertainty to financial markets. President Trump's actions can be both a blessing and a curse for markets. On the plus side, he has secured our country's borders, lowered taxes for many, and reduced bureaucracy and government regulations.

However, President Trump also tends to act in an arbitrary and unproductive manner. We don't approve of his use of tariffs nor his effort to interfere with the independence of the Federal Reserve. We also find it counterproductive when he threatens to annex an ally like Greenland against their wishes or orders banks to arbitrarily reduce interest rates on credit cards to unreasonable levels.

For all the positive pro-business steps he has taken, President Trump can be an unpredictable loose cannon. Financial markets don't like surprises and uncertainty. It makes it difficult for businesses and families to make long-term plans.

Looking past the challenges in the immediate term – and the prospects for a correction – there is reason to believe both the economy and investment markets can avoid a significant downturn in 2026. By historical standards, the current bull market is still relatively young.

Also, since World War II, the only other years that the S&P 500 finished the year up more than 15% after trading down as much as 15% – as it did in 2025 – were in 2009 and 2020. In 2010, the index added another 12.8%, and in 2021, it rallied 26.9%.



There are still a lot of investment categories that are reasonably priced, like value stocks, energy companies, and income-producing real estate, all of which have lagged meaningfully in performance recently. Moreover, many parts of the stock market, including financials, industrials, materials, and healthcare, have gained momentum in recent months. Small-caps and mid-caps are now hitting new highs.

Rotation is often a healthy sign for a bull market. It indicates the market is broadening and is less driven by a narrow group of stocks. We would welcome new leadership in segments of the market that are less expensive than large tech companies. Mid-caps represent one example of potential opportunity.

Supported by economic growth, moderating inflation, and a dovish Federal Reserve, our longer-term outlook for investment markets is positive. This doesn't rule out an unexpected shock or unpredictable events. We anticipate the long-term positive effects of lower taxes, lower interest rates, higher productivity, less bureaucracy, and less regulations will continue to outweigh the negative effects of lingering trade disputes, geopolitical instability, burgeoning debt, and dysfunction emanating from Washington. Overall, the glass looks half full to us.

Economists who we follow are projecting inflation and GDP growth to be in the range of 2-3% in the coming year. Any additional interest rate cuts by the Federal Reserve should help to lower mortgage rates further, empowering more consumers. Good things are happening, but we acknowledge risks abound. That is one of the reasons we own bonds in almost every client portfolio; they can provide a safe haven when equity markets become too frothy.

On behalf of clients, we remain persistent in our efforts to evaluate the sometimes-bewildering array of investment risks and opportunities. We believe on-going vigilance to appropriate asset allocation, disciplined diversification, periodic rebalancing, and long-term compounding is the most proven path to financial and investment success.