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Market Review and Outlook 4Q25

Highlights

Stocks recorded a third straight year of double-digit gains in 2025, with the S&P 500 Index posting a total return of 17.9%.

The market's outsized returns were fueled by sustained enthusiasm in the artificial intelligence boom, easing monetary policy, resilient economic activity, and continued earnings expansion.

A small subset of AI stocks continue to drive a disproportionate percentage of the market's returns and earnings, but broader participation across other sectors will be required to extend this multi-year bull market rally.

The S&P 500 Index closed the year at a forward P/E multiple 22.0x, nearly 30% above the historical average, leaving equities susceptible to a potential correction if corporate earnings fall short of seemingly aggressive consensus expectations.

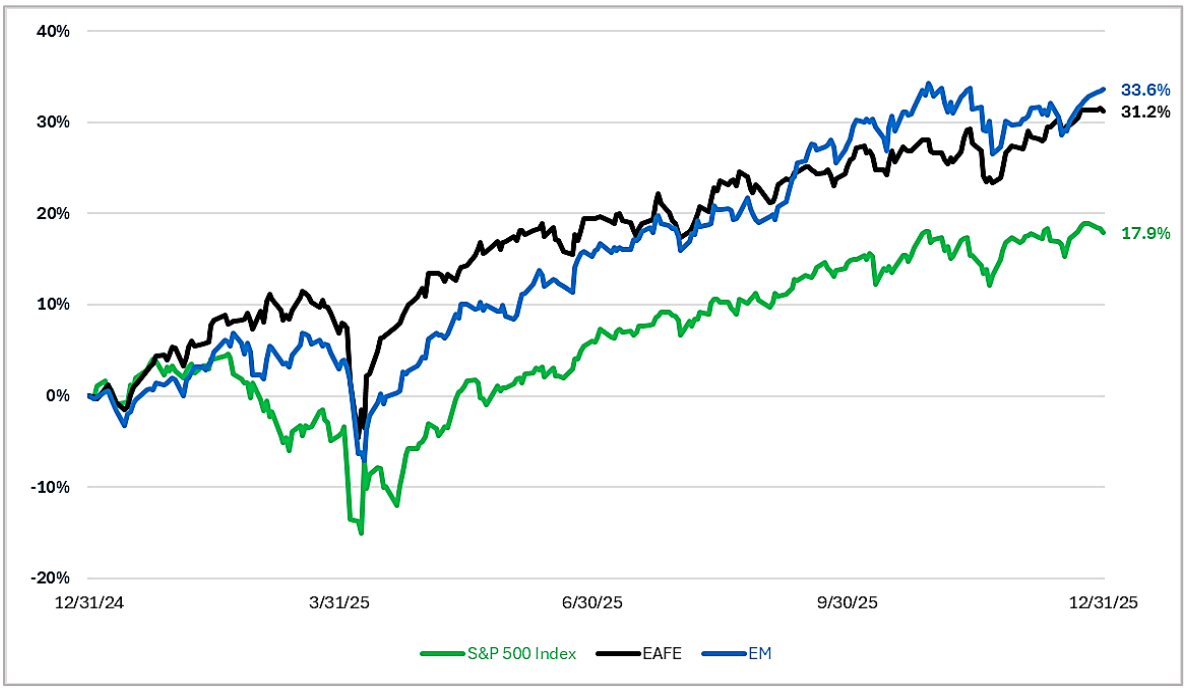
Fixed income reported its best performance in five years, with the Bloomberg U.S. Aggregate Bond Index delivering a total return of 7.3% in 2025.

We continue to favor short- to medium-duration bonds over more fiscally sensitive long-term bonds.

Market Review and Outlook

Global equities reported another year of impressive performance in 2025, as stocks transcended a hectic market backdrop impacted by unprecedented changes to global trade policies, immigration enforcement, and government spending (i.e., DOGE). The S&P 500 Index posted its third consecutive year of double-digit gains with a total return of 17.9% in 2025, despite experiencing a fleeting bear-market correction in April. International market returns proved even more robust, with developed markets (EAFE) increasing 31.2% and emerging markets (EM) surging 33.6% during the year. The outperformance of non-US stocks was aided by a ~10% decline in the dollar (against a basket of other developed-market currencies), which provided an added boost to US-based investors' overseas equity returns.

Global Equity Market Returns
(12/31/24 - 12/31/25)



Source: FactSet

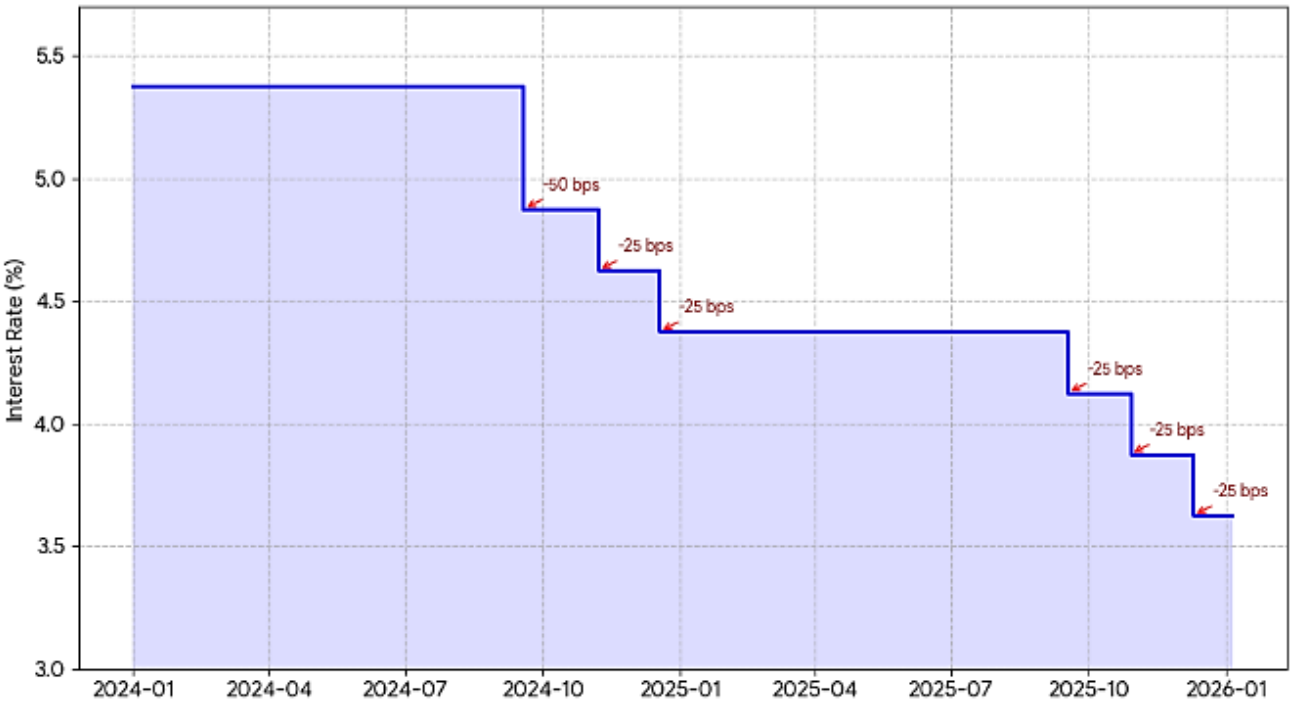
The current bull market, which began on October 13th, 2022, is now in the fourth year of its vigorous run—with the S&P 500 Index (including dividends) nearly doubling (+96%) from the start of the rally through the end of 2025. This equates to an annualized return of 23.1%, far surpassing the long-term average of 11.0%. The market's outsized returns during this cycle have largely been fueled by four key factors: 1.) the boom in artificial intelligence stocks, 2.) easing monetary policy, 3.) a surprisingly resilient economy, and 4.) accelerated earnings growth. As such, the sustainability of those factors is likely to play a pivotal role in determining where the markets are headed from here.

The artificial intelligence theme, which promises unlimited economic benefits (purportedly outweighing its potential drawbacks), has been a well-documented and enduring market catalyst over the last few years. That said, vulnerabilities to the AI story have started to percolate more recently, as elevated mega-cap stock valuations, unprecedented market concentration, and the emergence of bubble-like attributes have started to draw increased scrutiny. With its uninhibited capital spending plans and "circular" financing agreements, the current AI supercycle is exhibiting undeniable parallels to the telecom boom of the late 1990s—in which optical fiber networks were overbuilt as fiber-owning companies recklessly invested to

capitalize on the nascent growth prospects of the internet. While the internet obviously went on to become a revolutionary technological development, the path to get there included periods of painful pullbacks for even the most successful companies of the era (to say nothing of the numerous entities that didn't survive). By some accounts, AI could become an even more transformative technological advancement than the internet. Nonetheless, companies may end up overinvesting in their AI infrastructure to curb the fear of being left behind, which could restrict those firms' earnings prospects (and valuations) if their monetization plans prove smaller and slower to materialize than expected.

Following a prolonged pause of monetary action through most of 2025, the Federal Reserve resumed interest rate cuts later in the year at three consecutive meetings (Sept, Oct, Dec) to respond to cooling labor market conditions—despite sticky inflation continuing to hold above its 2% target.

Federal Funds Effective Rate
(12/31/23 - 12/31/25)



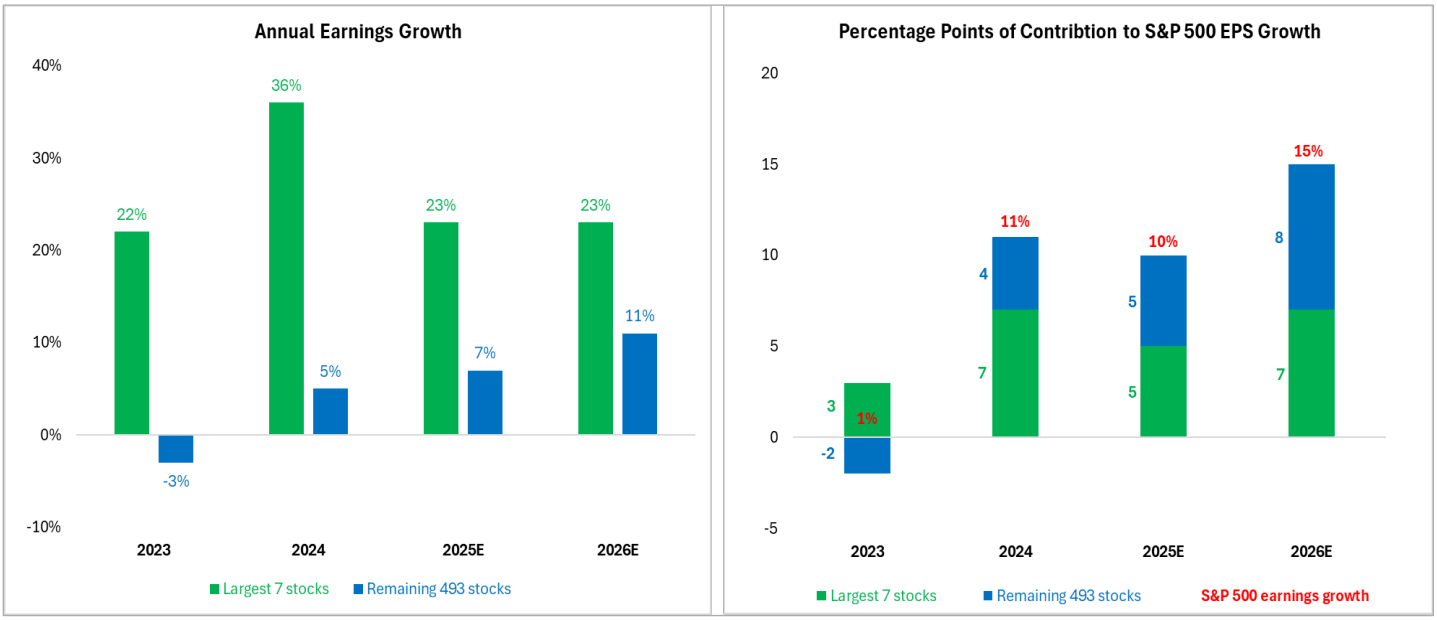
Source: Board of Governors of the Federal Reserve System (US) via FRED®

When the Fed initiated its first batch of rate cuts in September 2024, officials predicted they'd get inflation back to their 2% target by 2026. The committee members' updated projections following the latest December policy decision now puts the 2% arrival date in 2028. A case could be made that the lingering inflation problem is being exacerbated by the Fed's accommodative posture. It's hard to argue that rates remain restrictive against the backdrop of historically rich equity valuations, stable economic growth, accelerating earnings expansion, and explosive private credit lending activity. Nonetheless, the market is still pricing in two or three rate cuts for 2026 (following the December 2025 cut which lowered the federal funds rate to 3.50%-3.75%), versus the Fed's more cautious outlook for one cut. If economic growth remains positive (despite softening labor conditions) and the Fed hopes to eventually bring inflation back down to its 2% target, it seems unlikely that the committee will be able to cut rates as aggressively as the market expects. Thus, interest rate expectations and corresponding equity valuation assumptions may have to reset as the year progresses.

The U.S. economy has weathered the trade war better than anticipated, but GDP growth in 2025 (forecasted at +1.9%) decelerated from the above-trend rate averaged over the prior four-year period during the post-pandemic recovery. Durable consumer spending activity and robust AI investment have been critical components to the economy's sustained resiliency. Given that AI capex has been relatively labor un-intensive and narrowly concentrated, however, it hasn't provided a material contribution to the labor market (and may even be starting to negatively impact employment). While the economy added an average of 122,000 jobs per month in early 2025, that figure plummeted to an average of just 17,000 over the last seven months. Also, the unemployment rate climbed to a four-year high of 4.6% in November and wage growth has been slowing. Assuming the labor market doesn't experience recessionary-like weakening over the coming months, several tailwinds could provide an offsetting boost to the economy in 2026, including: net fiscal stimulus from new tax provisions in the One Big Beautiful Bill Act (OBBBA), the lagged impact of recent interest rate cuts, and still-expanding AI capital investment. With those factors in place, economic growth in 2026 is projected to be in line with 2025, with a real GDP increase of 1.8%.

Steady economic expansion is providing a fertile backdrop for corporate profits, with operating margins holding near record highs and the S&P 500 expected to report 10% earnings growth for 2025. Higher tariffs threatened corporate profitability, with an estimated 70% of the added costs being absorbed by businesses during the year, but companies offset the impact through cost-cutting initiatives, productivity gains, supply-chain adjustments, and selective price increases. It's important to note, however, that the mega-cap tech stocks continue to drive a disproportionate amount of the S&P 500's earnings expansion. The Magnificent 7 companies account for half of the index's estimated profit growth during 2025, and they are expected to continue to provide a significant contribution to earnings growth in 2026.

S&P 500 Annual EPS Growth Rate and Contribution Source
(2003-2027E)



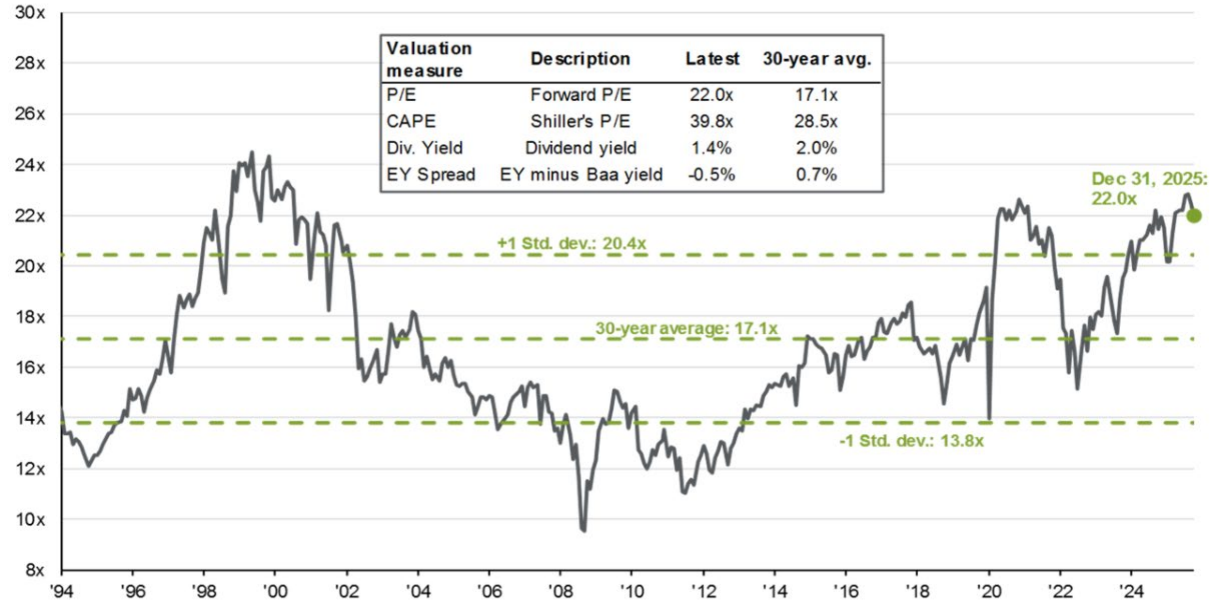
Source: FactSet, Goldman Sachs Investment Research

The market's reliance on a small subset of AI stocks to fuel its earnings growth is not healthy or sustainable. For this bull market to endure, broader participation will be necessary, with other sectors of the economy playing a more meaningful role in the profit expansion story. Encouragingly, domestic companies

are only beginning to see the effects of new corporate tax breaks from the OBBBA passed in 2025—which could fuel wide-ranging earnings momentum in 2026 and beyond. Also, the value-enhancing benefits of AI are expected to broaden beyond the initial wave of innovators (the technology giants that have dominated the AI narrative to date) to the enablers (companies building the physical infrastructure required to support AI workloads) and eventually to the adopters (entities across diverse industries that are applying AI technology to transform their operations, enhance productivity, and create new products and services). So, there is certainly a runway for this profit growth cycle to become more encompassing. Whether these catalysts are strong enough to drive the 15%-plus EPS growth estimates analysts are currently forecasting for 2026 and 2027, however, remains to be seen. Back-to-back years of mid-teen earnings growth would be unusual (particularly on the heels of 10%-plus profit growth in 2024/2025) and well above the long-term average annual EPS growth rate of 8%-9%, so some skepticism over those lofty projections is warranted.

Potentially overly optimistic earnings estimates become even more worrisome when the market is ascribing historically elevated valuation multiples to those projections. The S&P 500 Index ended 2025 trading at 22.0 times consensus forward 12-month earnings estimates, which is nearly 30% above the 30-year historical P/E average of 17.1x. While valuation multiples for the index have touched these levels in the past (during the euphoric late 1990s/early 2000s and initial stages of the 2020 COVID recovery), P/Es have historically reverted to (or beyond) their means over time due to declining prices (the numerator) and/or growth in earnings (the denominator). Given that earnings growth estimates are already well above historical norms, stock prices may prove extremely vulnerable to any negative market surprises.

S&P 500 Forward P/E Multiple
(12/31/94 – 12/31/25)



Source: Bloomberg, FactSet, Moody's, Refinitiv Datastream, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management

While equities have the ability to churn higher, we believe it's prudent to be mindful of downside risks that could emerge after the relentless market run over the past few years. The market's path may become bumpier, and leadership may evolve going forward, but a temporary pullback could be viewed as healthy if it allowed earnings to catch up to valuations—potentially extending the life of this secular bull rally. Lower entry points would also provide a better opportunity for investors to put idle capital sitting on the sidelines into the market, as today's elevated valuation multiples constrain the long-term outlook for equity returns.

Core Portfolio

During the fourth quarter, we initiated a new position in Generac Holdings (GNRC).

Generac manufactures standby generators (backup electric-power systems) for residential, commercial, and industrial markets. The home standby (HSB) generation market remains significantly under penetrated, with just 6.5% of U.S. homes having installed these backup power systems. Due to a constrained U.S. electrical grid and seemingly intensifying weather patterns, power outage severity appears to be expanding. The country's increased reliance on intermittent generation sources (wind/solar) and accelerating electrification trends are likely to drive additional supply/demand imbalances. This could be a catalyst to drive more consumers towards permanent home standby generators, particularly given the increasing importance of reliable residential power with more people working from home and aging in place. In the commercial and industrial (C&I) market, unprecedented energy demand from AI is driving massive data center construction, requiring dependable and high-capacity power solutions. Because new power plants can't be built fast enough to meet this surging electricity demand, data centers are increasing looking at high-powered backup generator systems as a solution to bridge the electricity supply/demand imbalance. While backup generator peers like Caterpillar and Cummins are also expected to benefit from increased datacenter-driven demand, Generac offers a more "pure-play" investment on this growth opportunity.

Tactical Portfolio

There were no changes to our tactical portfolio in the fourth quarter as it continues to emphasize investments in gold, uranium companies, and regional banks—all beneficiaries of strong tailwinds that we believe will continue in 2026.

Gold prices shattered multiple all-time highs during the year. The rally was initially triggered by a safe-haven surge in gold demand amid trade policy uncertainty, which was later compounded by concerns over rising US debt and fiscal deficits, a shift in the Fed's monetary policy stance driving lower interest rate expectations, a decline in the US Dollar (USD), and a historic month-long US government shutdown.

Uranium prices were pressured early in the year, after getting caught in the tariff crossfire, but aggressive buying resumed in April as buyers gained increased clarity on tariff exemptions. A structural supply deficit and insatiable demand from the AI sector for nuclear power provides an extremely bullish outlook for uranium, which extended the rally in uranium markets through the balance of the year.

Regional banks continue to see solid credit conditions and resilient consumer activity. More importantly, after navigating a multi-year inverted yield curve (when long-term interest rates were below short-term rates), re-steepening of the yield curve has allowed banks to borrow at lower short-term interest rates and lend at higher long-term rates, lifting net interest margins. Lower interest rates are also boosting loan demand, while deregulation has freed up banks' excess capital buffers and ignited more M&A activity.

Fixed Income

Bonds delivered strong results during 2025, with the benchmark U.S. Aggregate Index producing a 7.3% total return for the year. High starting yields (with the 10-year at 4.6% in early 2025) provided investors a healthy income cushion, and the reacceleration of interest-rate cuts by the Fed towards the back half of the year boosted the prices of bonds. The 10-year Treasury yield ended the year at 4.1%, which is at the lower end of its yield range over the last two years, but remains near the high end of its post-2008 range and still offers a compelling rate that exceeds inflation. If the economy continues to expand and inflation remains sticky, there may be less room for rate cuts by central banks in 2026, however. This could result in muted bond price appreciation potential, and therefore, less-robust total returns for fixed income assets overall this

year relative to last year. We continue to believe short- to medium-duration bonds offer the best risk/return profile in this asset class, as they still offer attractive yields, are more likely to see price appreciation from any future Fed rate cuts and are less sensitive to current fiscal/macro risks than long-term bonds.

Final Thoughts

The past year offered investors another lesson on the value of staying invested in the market during unnerving times. Erratic changes to trade policy understandably rattled markets early in the year, but staying patient while the clouds of uncertainty passed ultimately proved highly rewarding.

The year ahead is certain to bring its own challenges and we believe investor complacency could be setting the market up for a potential correction. Trying to predict the timing or magnitude of such an event, however, almost invariably proves futile. Instead, we will continue to focus on owning quality investments that can withstand the market's volatile swings and deliver solid long-term returns—using temporary pullbacks as an opportunity to redirect mounting cash balances into more rewarding opportunities.

As always, we extend our gratitude for the trust you place in us to manage your assets.

All the best in the new year!

Parkside Investments, LLC

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