MONTHLY

Portfolio Pulse

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2026 Outlook: Why Stop Now?

Despite a number of market risks – from tariff threats to weakening labor markets – and a volatile first half of the year, 2025 delivered strong returns across the capital markets. U.S. equities bounced back powerfully from Liberation Day lows and international equity returns were even stronger. Meanwhile, credit markets also generated solid returns and fixed income offered returns notably above the stated yields at the start of the year. As we enter 2026, we see the momentum continuing. While markets may face valuation headwinds – whether it be elevated price-to-earnings ratios, tight credit spreads or interest rates near 2025 lows – there are also potential market catalysts that should continue to support the positive-return environment.

At 17.5%, U.S. equity markets (S&P 500) are close to recording a third consecutive year of 20%+ returns (25% in 2024 and 26% in 2023). In fact, since the lows of 2022 (a year to forget, given the one-two-three punch of -18% equity-market, -11% credit-market and -13% fixed-income returns)[1], the U.S. equity market has nearly doubled (up 99%). While our base case does not call for a 4th year of 20%+ gains (though not out of the question, as we will discuss later) we do believe the positive equity momentum can continue.

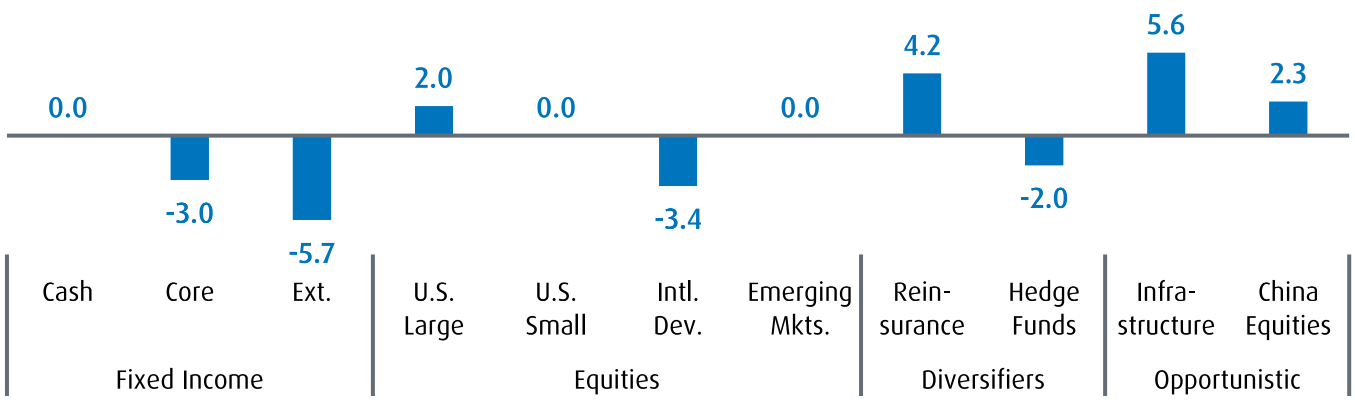
Fundamentals remain strong with S&P 500 year-over-year (yoy) sales growth up over 8% and expanding profit margins pushing yoy earnings growth up near 13%. And, while the technology sector (28% yoy earnings growth) played a big part, other sectors also did quite well – including financial-sector earnings growth at 24% and the industrial sector at 19%. Base-case catalysts for continued equity-market appreciation (we forecast a 8.8% 2026 S&P return) include a continued economic expansion – with the consumer set to get a shot in the arm in the form of a 40+% yoy increase in 2025 tax refunds; investment set to continue – and possibly accelerate, thanks to the 100% R&D (research and development) expensing courtesy of last year's tax bill; and a Federal Reserve (Fed) that we believe still has a few rate cuts left in them. Overall, we continue to recommend a risk-on portfolio positioning with a preference for U.S. equities and a focus on those companies benefiting from infrastructure buildout.

Further we see an upside risk case (25% probability) that 2026 equity market gains can rival those of the past three years. While 2025 returns were strong, ~75% of the gains came from earnings growth – with only ~15% from valuation expansion (dividends representing the other ~10%). If our base-case expectation for 10% earnings growth is closer to this year's 13% level, price-to-earnings valuations would only need to expand from the current 27.2 to 28.7 for 2026 equity gains to reach 20%+ territory. If this seems unrealistic, consider that valuations reached similar levels in the late-90s with a much smaller tech-sector weight (20% vs. today's 34%), which had much lower profit margins (~5% vs. ~20%). The dotcom era's first three years (1995-97) yielded an S&P 500 return of 125% (vs. the recent 99%); it then returned 29% in 1998 and 21% in 1999 before rolling over. Even if a bubble is forming, we may only be halfway through it.

That said, our downside risk case (also with a 25% probability) sees the recent equity market momentum grind to a halt – with the most likely culprit being poorly behaving bond markets. The Fed looks set to continue its rate cutting (to some degree) despite a ~3% inflation rate. Investors have given the Fed a pass thus far, but that may not continue if further rate cuts appear politically motivated. And, with credit spreads already tight, a bond-market investor revolt could end the party. Through our monthly asset allocation meetings, we will remain on vigilant lookout for signs of either risk case taking shape.

Maintaining a modest overweight risk heading into 2026

We maintained our modest risk-on positioning – allowing us to benefit from further market upside while maintaining flexibility.



Allocations as of 12/15/2025. Ext. = Extended; Based on Balanced Portfolio. [1]S&P 500, Bloomberg U.S. Corporate High Yield, Bloomberg U.S. Aggregate respectively

Macro Outlook

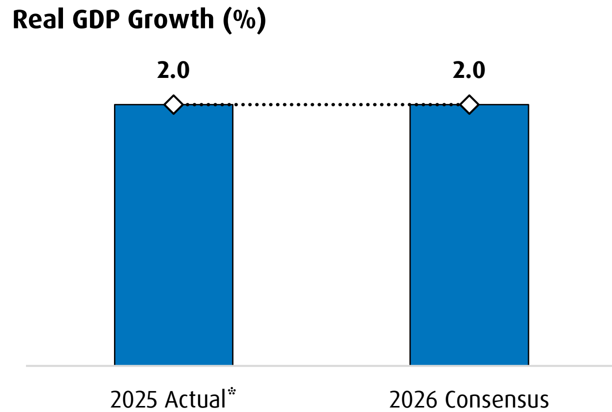
Growth

2025 economic growth is expected to clock in around 2%. Despite concerns over less job growth, the consumer kept spending – just as investment picked up, albeit heavily concentrated around AI initiatives. Given the government shutdown – depriving us of the Q3 data (while the Q4 data won't be out until late-January) – the 2025 "actual" is more of an estimate than usual. The first two quarters of the year averaged 1.6%, while Q3 is believed to be in the 3.5% range, implying ~1.5% growth in the government-shutdown impacted Q4.

The 2026 consensus also comes in at 2%, on which we will take the "over" – driven by record tax refunds (estimated at $520 billion – a 44% increase over the prior year), continued investment, a few more rate cuts and the Trump administration's pro-growth focus ahead of the midterms. The key to 2026 growth is the pace at which the consumer (~70% of the economy) continues to spend against a job-growth slowdown and some signs of stretched budgets. The tax refunds will help, but a return to jobs growth will help more.

Exhibit 1: Steady (to higher) as she goes

We believe real growth can outpace the 2% growth consensus.



Source: Bloomberg L.P. (2025). *Actual as of 12/12/2025.

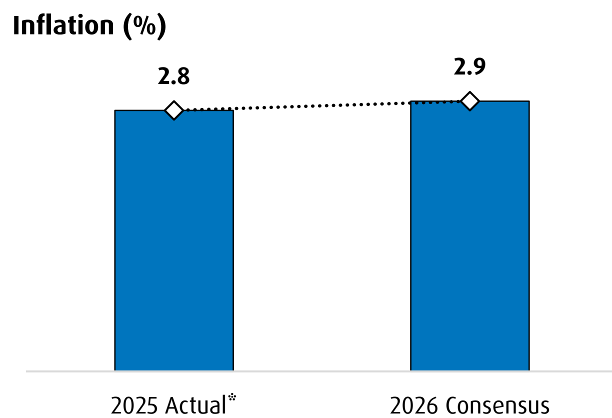
Inflation

Inflation was remarkably stable amid new tariff policy but, at 2.8%, it remains 0.8% above the Fed's 2% self-imposed target. Great progress had been made from its year-over-year 9.1% peak in mid-2022 but it has averaged 3.0% since mid 2023. Despite earlier-year fears, tariffs did not significantly add to the inflation backdrop – as inflation has remained fairly steady the past six months, and below the recent 3% average. Labor supply shortages in key areas (e.g., construction) may have been the bigger culprit in preventing a return to Fed target.

One way to get inflation closer to 2% would be a Fed-engineered recession, an unlikely prospect given the Fed's bias for more cuts – not rate hikes – in 2026. Another potential remedy would be a change in current immigration policy (narrowing the deportation focus) – a prospect we view as plausible as the administration refocuses on affordability. Deployment of AI to curb costs is also on the table. All said, we are optimistic that inflation can come under the 2.9% consensus – but 2% may be more accurately viewed as a floor.

Exhibit 2: 2% inflation – once a ceiling, now a floor

We are optimistic inflation can come in below the consensus view.



Source: Bloomberg L.P (2025). *Actual as of 12/12/2025.

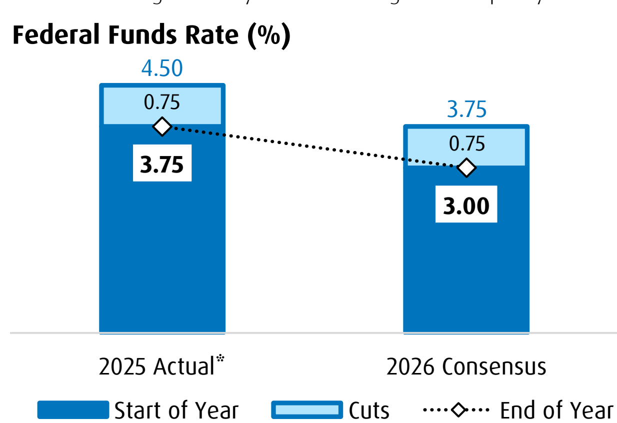
Monetary Policy

The Fed got a late start in cutting rates in 2025, with the first cut not coming until September. But, once they started, they didn't stop – with cuts in each of the last three Fed meetings of the year, lowering the Federal funds rate to 3.75%. The late-year change in approach was primarily driven by 1.) greater clarity on the inflationary impacts of tariffs; and 2.) the weakening job hiring (that actually began to surface back in May). This changed the Fed's focus from its price-stability mandate to its full-employment (other) mandate.

Technically, Fed rate-cut consensus expectations fall between 0.5% and 0.75%, vs. the 0.75% shown in the chart. We expect the latter (and possibly a full 1%) as the Fed potentially moves towards a lowered neutral rate (below 3%). That said, the expected Fed trajectory is likely to be no greater than an every-other-meeting cut (the Fed meets eight times a year to set policy). Whether the Fed cuts 0.75% or a full 1% will depend on the new Fed Chair (starts in May) – and their ability to effectively communicate the reasoning behind further cuts in a way that doesn't appear politicized.

Exhibit 3: Cut, measure, cut...

2026 could bring an every-other-meeting rate-cut policy.



Source: Bloomberg L.P (2025). *Actual as of 12/12/2025.

Market Outlook

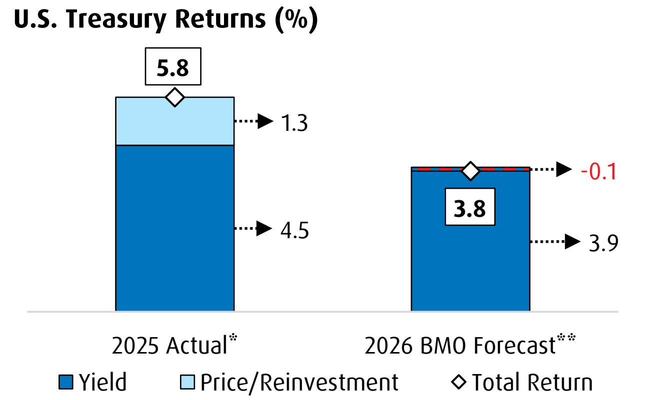
Fixed Income

Treasurys returned 5.8% through 12/12/2025 – helped by falling yields throughout the year. The 10-year yield, for example, started the year at 4.6% and, after some volatility around Liberation Day, fell into a fairly tight range by Q4 – oscillating around 4.1%. Meanwhile Inflation-Linked Bonds (TIPS) are showing a 6.8% return as we approach the final two weeks of the year. Notably, the 0.9% outperformance over Treasurys is not due to inflation – as 10-year inflation expectations (the "breakeven") have fallen slightly – but, rather, because of the longer duration of the TIPS index.

We expect our 2026 Treasurys return forecast of 3.8% will approximate the current index yield as we anticipate longer-dated rates to remain range bound. Fed rate cuts amid slightly lower inflation could exert downward pressure on yields, but rising global rates (e.g., Japan's 10-year yield doubling to near 2% in 2025) introduce competition, and could push U.S. yields higher (especially if investors believe Fed rate cuts will push the dollar lower). The key risk – per our downside risk scenario – is that the Fed is too easy or too politicized, causing longer-bond investor revolt.

Exhibit 4: Less help from falling rates

We expect 2026 U.S. Treasury returns to be closer to current yields.



Source: Bloomberg. *Actual through 12/12/2025. **Forecast as of 12/8/2025. Striped lines indicate negative returns.

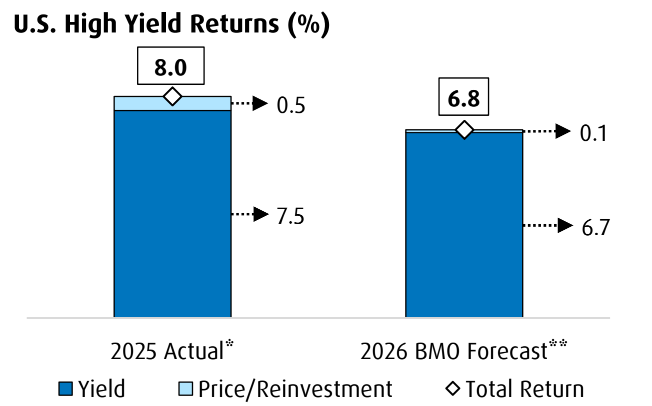
Credit Markets

High-yield credit spreads went full circle over the course of 2025 – starting at 2.8%, hitting a high of 4.5% and currently back at 2.8%. High Yield's 8.0% return thus far in 2025 is above Treasurys by 2.2% but below the long-term average 3.0% premium as falling interest rates have been a bigger driver of returns than the flat point-to-point credit spreads – though High Yield defaults have been notably modest. Elsewhere in credit-market land, Structured Credit has returned 7.3% while the year-to-date (floating-rate) Bank Loan 5.6% return is notably lower.

We forecast a 6.8% return for High Yield in 2026 – modestly below this year's returns given a lower starting-point yield but helped by the impact still-elevated inflation (certainly vs. the post-global financial crisis and pre-pandemic era) will have on defaults and credit spreads. High Yield is one of the better inflation hedges as corporate debt is easier to pay back in an inflationary environment – provided the company issuing the debt has pricing power. Also, keeping defaults low is improved credit quality – with the index's highest credit bucket (BB) weight now at ~55%.

Exhibit 5: Its all relative for High Yield

We expect lower returns, but a higher return premium to Treasurys.



Source: Bloomberg. *Actual through 12/12/2025. ** Forecast as of 12/8/2025.

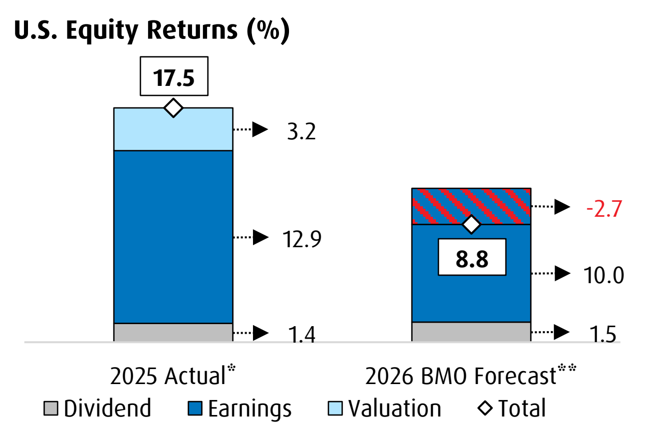
Equities

In a fight between fundamental strength and geopolitical uncertainties, strong fundamentals won out. After starting the year down 15%, Large Cap Equity rallied 38.2% to end up 17.5% as of 12/12/2025. Notably earnings growth of 12.9% contributed ~75% of year-to-date total returns – and with dividends contributing another ~10%, only ~15% is attributed to valuation expansion (challenging market-bubble claims). Meanwhile, International Developed and Emerging Market Equity returns are 30.3% and 32.8% – the weak dollar contributing 8.1% and 5.3%, respectively.

Our 8.8% 2026 U.S. Large Cap return forecast assumes 10.0% earnings growth and a 1.5% dividend yield, but some pull back in valuations as earnings "grow into" anticipatory valuations – a 2.7% hit. There is a strong chance that 2026 brings some rotation out of the high-flying tech stocks into the broader U.S. equity markets as earnings strength spreads – which may already be underway as the equal-weight S&P 500 is up 1.5% on its market-cap counterpart the past month. Without the same level of dollar depreciation, we expect International Developed to return to its lagging-return ways – though we believe Emerging Markets can provide ongoing solid gains given improving fundamentals and inexpensive valuations.

Exhibit 6: Growing into valuations

Earnings growth should continue, but some is already priced in.



Source: Bloomberg. *Actual through 12/12/2025. ** Forecast as of 12/8/2025. Striped lines indicate negative returns.

Exhibit 7: Scenarios

DOWNSIDE RISK CASE: NON-BORING BONDS	BASE CASE: ONGOING EXPANSION	UPSIDE RISK CASE: ASSET INFLATION
25% Probability	*50% Probability*	*25% Probability*
Too aggressive, overly political or poorly communicated Fed easing leads to interest rate volatility and higher long-term rates. Rate volatility alongside a backup in currently tight credit spreads disrupts equity-market momentum.	The consumer gets a boost from record tax refunds in 1Q2026, which – alongside continued investment – leads to continued economic growth. The Fed's focus on full employment leads to continued rate cuts in 2026 – despite above-target inflation.	Rate cuts and any lingering concerns around the U.S. dollar lead more to asset (rather than goods) inflation. While positive for risk assets in the near-term, it also sets up the prospect of asset bubbles in the medium-term.

Index Definitions

Bloomberg U.S. Aggregate Bond Index is an unmanaged index that covers the U.S. investment-grade fixed-rate bond market, including government and credit securities, agency mortgage pass-through securities, asset-backed securities and commercial mortgage-based securities. The Bloomberg U.S. Municipal Index covers the USD-denominated long-term tax-exempt bond market. Bloomberg U.S. Corporate High Yield Index measures the U.S.D-denominated, high yield, fixed-rate corporate bond markets. Bloomberg Muni High Yield Index is an unmanaged index that measures the returns of high yield, fixed rate municipal bond markets. S&P 500® Index is an unmanaged index of large-cap common stocks. The S&P 500® Equal Weight Index (EWI) is the equal-weight version of the widely-used S&P 500. The Russell 3000® Index measures the performance of the largest 3,000 US companies designed to represent approximately 98% of the investable US equity market. The Indxx U.S. Infrastructure Development Index is designed to measure the performance of companies involved in infrastructure development in the United States. MSCI EAFE Index Europe, Australasia, and Far East Index (EAFE) is a standard unmanaged foreign securities index representing major non-U.S. stock markets, as monitored by Morgan Stanley Capital International. MSCI Emerging Markets Index is a market capitalization weighted index representative of the market structure of the emerging markets in Europe, Latin America, Africa, Middle East and Asia.

Disclosures