We are once again closing the books on a remarkable year for markets. 2025 was another strong year, continuing the long secular bull market in the United States. The S&P 500 finished with a total return of 17.9%, the third straight year of returns above 17%. This strong return was achieved despite the S&P 500 enduring a bear market decline of 20% from mid-February through early April, when tariff announcements caused a market panic before recovering sharply throughout the remainder of the year. Gains were once again powered by many of the largest mega-cap technology stocks, but market breadth improved towards the end of the year, as the "Magnificent 7" group of stocks peaked in October, with many other areas of the market outperforming in November, December, and into the first week of January. While the U.S. had another strong year, international stocks had a phenomenal year, outperforming the U.S. by the largest margin since 1986. Nearly every major international market outperformed the U.S., driven by weakness in the U.S. dollar and government stimulus measures passed in places such as China and Europe.

Looking ahead to 2026, we remain positive on markets and the economy. In many ways, the economic environment could start to resemble "goldilocks": falling inflation, falling oil prices, falling interest rates, rising productivity, and tighter credit spreads all helping lead to solid real GDP growth. Oil prices, after hitting $120 per barrel during the start of the war in Ukraine, have been on a nearly continuous decline since then to a current price of about $59 per barrel. The recent stunning removal of Venezuelan President Nicolas Maduro may lead to a further leg down in oil prices, as President Trump has indicated a strong desire to increase oil production in the country that reportedly holds the largest reserves in the world. Should inflation continue to slow, we would expect that interest rates may continue to drift lower and interest rate volatility to remain subdued, both of which should benefit interest rate sensitive areas of the economy such as housing and autos. A new Federal Reserve chairman in 2026 may also help aid a decline in rates, as current Chair Jerome Powell's term ends in May. While market "favorites" for the new chair have varied over the past few months, the overwhelming expectation is that the President will name a "dove" to the position, meaning someone whose focus is on supporting the economy through cutting interest rates, rather than a "hawk" who is focused on lowering inflation through elevated or rising interest rates.

The "One Bill Beautiful Bill Act" should also add a tailwind to the economy in the coming year. The signature legislation of the Administration, which passed last summer, should primarily benefit the economy in 2 ways: tax refunds and business incentives. Since the bill passed mid-year but applied retroactively to the beginning of 2025, many workers did not see benefits in their paychecks last year but instead will see them as lump sum tax refunds this coming Spring. Goldman Sachs estimates that these net tax refunds will inject $100 billion into the economy in the first half of the year, strongly supporting growth in consumer spending. On the business incentive side, companies can immediately write off the full cost of capital expenses in 2026, incentivizing large spending on equipment, machinery, and R&D. The Congressional Budget Office projects that the total impact of the legislation will boost GDP growth by 0.4% in 2026. This "goldilocks" economic backdrop, if it comes to pass, should be supportive of continued GDP and corporate earnings growth. Wall Street consensus is for S&P 500 earnings per share to reach $306 this year, reflecting above average 15% year-over-year growth.

Despite the momentum in the economy, there are ample reasons for investors to be cautious. Markets are forward looking and have been pricing in many of the previous noted catalysts since the “Liberation Day” lows back in April. This optimistic forward view is reflected in current equity valuations, which are elevated by almost any metric on a historical basis. The rise in valuations, alongside positive earnings growth, has been a tailwind for the market for many years now. The S&P 500 has returned over 15% for 3 straight years, an occurrence with only 4 other instances since 1950. In the subsequent year in those cases, 2 had positive returns and the average return was 4.2%. Both the win rate (50%) and the average return (4.2%) are below average results following such a strong 3-year run. For the market to deliver another year of gains similar to the last 3 years, valuations will need to expand even further from here. While this is not impossible, it will require much to go right with interest rates, profit margins, credit spreads, and forward growth expectations.

The flipside of “goldilocks” expectations is that it also provides the backdrop for disappointment. Some of the risks coming into the year include a spike in interest rates, trade war turmoil, a slowdown in A.I. spending, and geopolitics. A hotter than expected economy could lead to higher inflation and ultimately calls to raise instead of cut interest rates. Tariff fears have cooled recently, but a U.S. Supreme Court ruling on their constitutionality is expected soon. A ruling against the Administration, and the resulting efforts to reinstate tariffs in different ways, may result in short-term confusion and chaos. Doubts around the sustainability of A.I. infrastructure spending have been creeping into investor minds over the past few months, especially as Google has gained ground against market leader OpenAI. OpenAI remains unprofitable and is dependent on venture capital fundraising to continue its massive spending on chips and data center infrastructure. If investors start to question their strategy and funding starts to dry up, it will have several negative downstream effects, as A.I. spending has propped up the stock market, consumer spending, and economic growth in different ways over the past 3 years. Finally, the recent operation in Venezuela reminds us of the precarity of geopolitics, where the situations in Ukraine, Taiwan, or elsewhere could send a negative shock nearly overnight.

The economy and markets have withstood a lot over the last 5 years: the COVID pandemic, the highest inflation since the 1970s, the war in Ukraine, the fastest Fed hiking cycle in a generation, and the Trump trade war. Despite all of these issues, corporate America has continued to innovate and grow. Real GDP, real personal consumption, corporate profits, capital spending, and the stock market all hit record highs in 2025. We believe this momentum will continue and remain long term optimists on the American economy even if we should experience elevated stock market volatility in the coming year.

Please do not hesitate to contact any of us in the office if you wish to discuss investment strategy or your own individual financial circumstances. All of us here at Graybill Wealth Management wish you a Happy New Year and a healthy and prosperous 2026!