

Fourth Quarter 2025

# Quarterly Market Insights



## HIGHER GEAR

### EXECUTIVE SUMMARY

- The Fed navigates a divided path
- Productivity gains could be fueling growth
- Market leadership is finally broadening
- Earnings growth is the primary focus
- Housing policy takes center stage in 2026

The fourth quarter of 2025 was a period of recalibration, as the optimism of the summer gave way to a more nuanced assessment of the path toward 2026. While the U.S. equity market extended its strong second-half advance, leadership narrowed and volatility increased as investors digested lofty valuations and shifting economic signals. The S&P 500 posted a 2.66% gain for the period, but the headline figure belied a quarter characterized by a sharp mid-period correction and a burgeoning hiring divide within the domestic labor market.

The quarter began on solid footing, supported by a strong third-quarter earnings season that saw S&P 500 profits climb 14.5% year-over-year—nearly double the preseason forecast. Sentiment was further bolstered on October 29 when the Federal Reserve delivered its second rate cut of the year. However, the mood shifted abruptly following Halloween. From October 29 through November 17, the S&P 500 experienced a 5.1% pullback as concerns mounted over the durability of the artificial intelligence infrastructure buildout and the high capital spending requirements of mega-cap leaders. Shares of NVIDIA (NVDA), for instance, fell over 12% in November despite strong earnings, as emerging competition in the AI chip space and concerns about OpenAI’s ability to meet its financial commitments prompted a rotation out of technology and into defensive laggards like health care and consumer staples. As seen in Chart 1, value groups began to outperform their growth peers in November.

Economic data during the quarter highlighted a two-speed labor market impacted by AI productivity, though official government readings were notably obscured by an extended federal shutdown that left market participants relying on private-sector proxies. In October, job cut announcements surged to their highest monthly total since March, with more than half of the 153,000 cuts concentrated in the technology and warehousing sectors. Firms like Amazon and UPS announced significant reductions in corporate roles, citing a transition toward automation and generative AI to drive efficiency. This cooling at the top was mirrored by a divergence in private-sector payrolls; ADP data showed small businesses shed 120,000 positions in November, while larger firms—bolstered by stronger balance sheets and broader

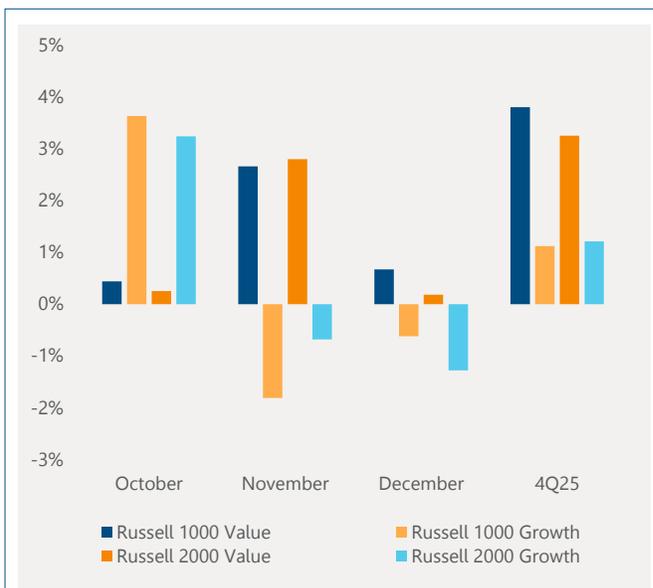
pricing power—continued to add workers.

The Federal Reserve remained a central focal point, executing a third 25-basis-point cut on December 10 to bring the policy rate to a range of 3.50% to 3.75%. However, the decision revealed a notably fractured FOMC, marking the most divided vote since the pandemic era with only four regional presidents supporting the move. While Chair Powell maintained a dovish tone, describing policy as “near neutral,” the internal disagreement suggested that the bar for additional easing in 2026 has moved higher. This caution was echoed in the fixed income markets, where 30-year government bond yields trended higher globally amid concerns over rising public debt and fiscal deficits.

In the credit markets, signs of stress emerged in October as defaults by Tricolor and First Brands tested investor nerves. Meanwhile, credit-default swaps for Oracle widened significantly, reflecting anxiety over the aggressive leverage used to fund its \$26 billion AI data-center expansion. Despite these idiosyncratic bouts of volatility, the broader high-yield market remained resilient, reflecting a decade-long shift toward higher-quality, BB-rated issuers. Lower-quality issuers have increasingly migrated toward private credit markets.

As the quarter drew to a close, market leadership showed signs of broadening beyond the “Magnificent Seven.” Cyclical sectors, including financials and materials, emerged as bright spots in December, aided by a surge in most commodities led by precious and industrial metals. With S&P 500 revenue growth expanding

CHART 1  
The November Value Rotation



Bloomberg. Data as of 12/31/25. Past performance does not guarantee future results.

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at its fastest pace in three years and tariffs failing to ignite broad inflation, investors enter 2026 with the hope that a resilient corporate sector, fiscal stimulus, and a supportive, albeit divided, Fed can maintain the current expansion.

### Tech Turbulence

The November pullback was largely characterized by a shift in how investors appraised the technology sector's "build-out" phase. Following a period of significant expansion, baskets of large-cap semiconductor and software stocks experienced drawdowns of 10% to 15% from late October through the third week of November. This period of profit-taking emerged as the market began to more closely scrutinize the long-term return on investment (ROI) associated with the massive capital expenditure and growing order backlogs related to data center infrastructure.

OpenAI and Oracle (ORCL) were frequently cited as the focal points for these concerns. Specifically, the "Stargate" initiative—a joint AI data-center project involving OpenAI, Oracle, and other partners—represents a capital commitment potentially reaching hundreds of billions of dollars. While demand for AI services remains high, some participants questioned the sustainability of such spending without a more immediate path to profitability. The reliance on future capital raises to fund these infrastructure ambitions made financing risks more prominent, leading some analysts to draw comparisons to the infrastructure overbuild seen during the late 1990s.

CHART 2  
Software Led the Tech Drawdown



This cautious sentiment extended to specialized cloud infrastructure providers, including CoreWeave (CRWW) and Nebius (NBIS), which were impacted by reports of construction and delivery delays at key data centers. These logistical hurdles suggested that the timeline for converting infrastructure investment into revenue might be longer than previously anticipated.

As shown in Chart 2, software stocks also faced headwinds as the rapid development of AI "coding agents" raised questions about future business models of many prominent software-as-a-service (SaaS) industry. Investors expressed concern that the increasing efficiency of AI-generated code could lead to a commoditization of software, placing pressure on traditional seat-based pricing. With enterprise buyers reasserting price discipline and AI compute costs potentially crowding out other technology spending, the software sector saw a notable compression in multiples, contributing to the broader market pause in November.

### Data Fog

The clarity of the economic landscape was compromised during the quarter by a nearly seven-week government shutdown, which delayed the release of October and November nonfarm payroll data until mid-December. When the revised figures were finally published in early January, they revealed a labor market under pressure; the U.S. economy lost 173,000 jobs in October, followed by modest gains of 56,000 in November and 50,000 in December. Much of the initial volatility was concentrated in the public sector, as federal government employment fell by roughly 160,000 in October due to furlough effects and deferred resignations that originated in the short-lived DOGE era.

Beyond the government sector, the underlying data suggested a broader cooling of labor demand. Job openings retreated from an August high of 7.66 million to a 15-month low of 7.15 million in November, indicating that employers have shifted their focus toward maintaining existing headcounts rather than expanding capacity. This caution was compounded by the lingering effects of high interest rates and the uncertainty surrounding shifting immigration and tariff policies. The recent shift in immigration policy, in particular, has notably reduced labor supply, which likely provided a floor for wage growth even as hiring momentum slowed.

Despite these headwinds, the unemployment rate ended the year at 4.4%—up from 4.0% in January but still well below thresholds historically associated with economic contractions. Inflation also remained a persistent factor, holding near the 3% level throughout the quarter. Elevated services costs and the impact of higher tariffs kept headline figures above the Federal Reserve's 2% target, complicating the path for further monetary easing.

Perhaps the most striking development of the quarter was the divergence between labor data and output. While hiring appeared stagnant, the final estimate for third-quarter real GDP surprised market participants with a robust 4.4% growth rate. This "growth-employment gap" has led many economists to conclude

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that productivity gains are doing the heavy lifting. If the economy is indeed producing more with fewer workers, it would explain how growth remains resilient even as the labor market enters a period of visible softening.

### The Productivity Puzzle

The divergence between GDP growth and employment growth witnessed in the fourth quarter has increasingly centered the economic debate on the productivity variable. While the labor market has entered what some observers call a "no-hire economy"—averaging just 44,000 new jobs per month over the last five months of 2025—output has remained remarkably resilient. The mathematical result is a surge in nonfarm productivity, which according to the U.S. Bureau of Economic Analysis, spiked to an annualized rate of 4.9% in the third quarter (see Chart 3) This represents a significant acceleration from the long-term average of 1.9% and has sparked a lively debate over whether the U.S. is entering a higher-growth regime.

Two schools of thought have emerged to explain this trend. One camp attributes the shift to structural changes, including tighter immigration policies that have mechanically lifted average output per worker by reducing the influx of lower-productivity labor. In this view, firms facing labor scarcity are accelerating investments in technology and process efficiency. While analysts at Oxford Economics suggest that firms are not yet replacing workers with AI on a massive scale, the broader adoption of automation is allowing companies to "do more with less," maintaining profit margins even as hiring stalls.

Conversely, other economists argue the boom is cyclical and driven by a "K-shaped" consumer. In this scenario, wealthier households—those earning over \$150,000—now account for a record share of big-ticket purchases, such as 43% of new car sales. This concentrated demand provides the necessary "output" to keep productivity figures high, even as lower-income demand wavers under the pressure of persistent services inflation and higher borrowing costs.

Regardless of the root cause, the implications for monetary policy could be significant. If the economy can continue to grow without a large expansion of the workforce, the Federal Reserve faces less urgency to cut rates to "save" the labor market. Stronger-than-expected growth data, paired with a stable 4.4% unemployment rate, has led major institutions to push back their expectations for further rate relief. Markets now anticipate a shallower path of rate cuts in 2026 as Fed officials wait for clarity on whether this productivity surge is a temporary cyclical gift or a permanent technological shift that will define the rest of the decade.

### Fed Policy: The Divided Path to Neutral

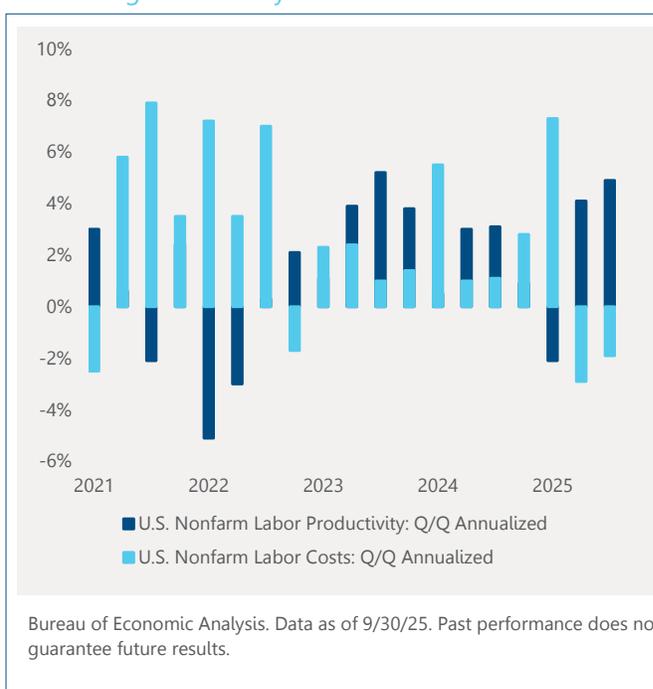
Following 75 basis points of easing over the final three months of 2025, the Federal Reserve entered the year-end in a state of internal friction. While the FOMC delivered two additional 25-basis-point cuts in the fourth

quarter—bringing the benchmark rate to a range of 3.50% to 3.75%—the decisions revealed a growing rift between the committee's doves and a contingent of hawkish regional presidents.

The October 29 Federal Open Market Committee (FOMC) meeting served as a pivot point. In addition to the rate cut, policymakers announced the conclusion of quantitative tightening (QT), effective December 1, pivoting toward a strategy of rolling maturing agency debt into Treasury bills to maintain bank reserves. However, the decision was marked by dual dissents: Governor Stephen Miran advocated for a more aggressive 50-basis-point move, while Kansas City Fed President Jeff Schmid preferred no change at all. This lack of consensus was even more pronounced during the December 10 FOMC meeting, which featured the most divided vote since before the pandemic. With three formal dissents and only four regional Reserve Bank boards requesting a discount rate reduction, the committee signaled that the path toward further easing is no longer a foregone conclusion.

In his press conferences, Chair Jerome Powell underscored the difficulty of navigating a "Data Fog." He cautioned that the federal government shutdown had likely distorted payroll figures, warning that November's readings might eventually be revised lower or even turn negative. On the inflation front, Powell was notably explicit regarding the "price shift" caused by tariffs, suggesting they remain the primary contributor to excess inflation and will likely peak in early 2026.

CHART 3  
Percolating Productivity



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This period of transition is amplified by the fact that Chair Powell's term is set to conclude in May 2026. Online prediction markets currently identify former Fed Governor Kevin Warsh as the frontrunner to succeed him, with Warsh recently overtaking White House Economic Council Chair Kevin Hassett as the most likely nominee. However, the field remains dynamic; BlackRock's Head of Fixed Income, Rick Rieder, has emerged as a formidable third candidate, reportedly bolstered by the high regard in which he is held by Treasury Secretary Scott Bessent.

By characterizing current policy as being within a "range of reasonable estimates of neutral," Powell has effectively shifted the Fed into a risk-management mode for his final months. For investors, this suggests a "Goldilocks" environment of resilient growth and supportive policy, yet one that remains highly sensitive to both the next several rounds of data and the impending shift in central bank leadership.

### Housing and Affordability

As the Federal Reserve navigates their path to neutral under a new Chair beginning in May, the Trump administration has increasingly sought to use executive and fiscal levers to address one of the primary economic concerns for many voters: the persistent challenge of housing affordability. With the 2026 midterm elections approaching, the White House has elevated housing policy to a central pillar of its political platform, with Treasury Secretary Scott Bessent suggesting the administration may even declare a national housing emergency to underscore the urgency of the crisis. This focus follows a historic supply shortage and a pandemic-era buying boom that caused the S&P Case-Shiller 20-City Composite Home Price Index to surge nearly 70% between January 2020 and August 2025.

To counter these pressures, President Trump introduced a batch of high-profile initiatives in early January. On January 7, he pledged to bar large institutional investors from purchasing more single-family homes, asserting that "people live in homes, not corporations". While this proposal was aimed at critics who argue Wall Street buyers box out first-time homeowners, some experts noted that corporate landlords own less than 1% of the total single-family housing stock, questioning whether a ban would significantly move the needle on broad prices.

The following day, the President directed Fannie Mae and Freddie Mac to purchase \$200 billion in mortgage bonds to drive down interest rates and monthly payments. FHFA Director Bill Pulte confirmed the enterprises have the cash to execute these purchases quickly, a move that triggered an immediate rally in mortgage bonds and stocks of home lenders and mortgage servicers.

Beyond these direct interventions, the administration has continued to evaluate innovative lending solutions to loosen the "lock-in effect" currently freezing the market. Director

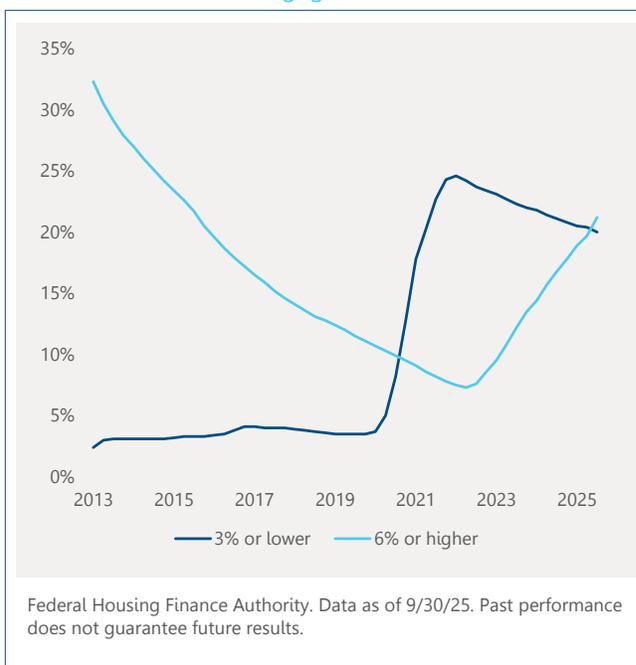
Pulte noted the White House is actively studying "portable mortgages," which would allow homeowners to transfer their current low rates to new properties. While a separate proposal for 50-year mortgages was panned by industry analysts for its high long-term interest costs, the persistent push for such measures highlights a White House determined to address the cost of living before voters head to the polls.

Notably, recent data indicates a natural rebalancing may already be underway unrelated to the Trump administration's actions. According to an analysis of FHFA data, as of September 30, 2025, the percentage of outstanding mortgages with rates above 6% reached 21.2%, officially eclipsing the 20.0% share of loans with rates below 3% (See Chart 4). This crossover could mark a symbolic turning point in the rate lock-in era, suggesting that the amount of time elapsed since mortgage rates first spiked in 2022 is beginning to foster a gradual resetting. As more households trade in older loans for current rates or enter the market for the first time, this "natural thawing" provides a glimmer of hope for a more balanced housing market in 2026.

### Broadening: Green Shoots

As the housing market begins this natural transition, the stabilization of the American household's largest asset may provide a critical psychological and financial tailwind for the broader economy. The resulting increase in mobility and consumer confidence could reinforce the nascent rebound in relative earnings growth for the average stock, setting the stage for more diversified market participation in 2026.

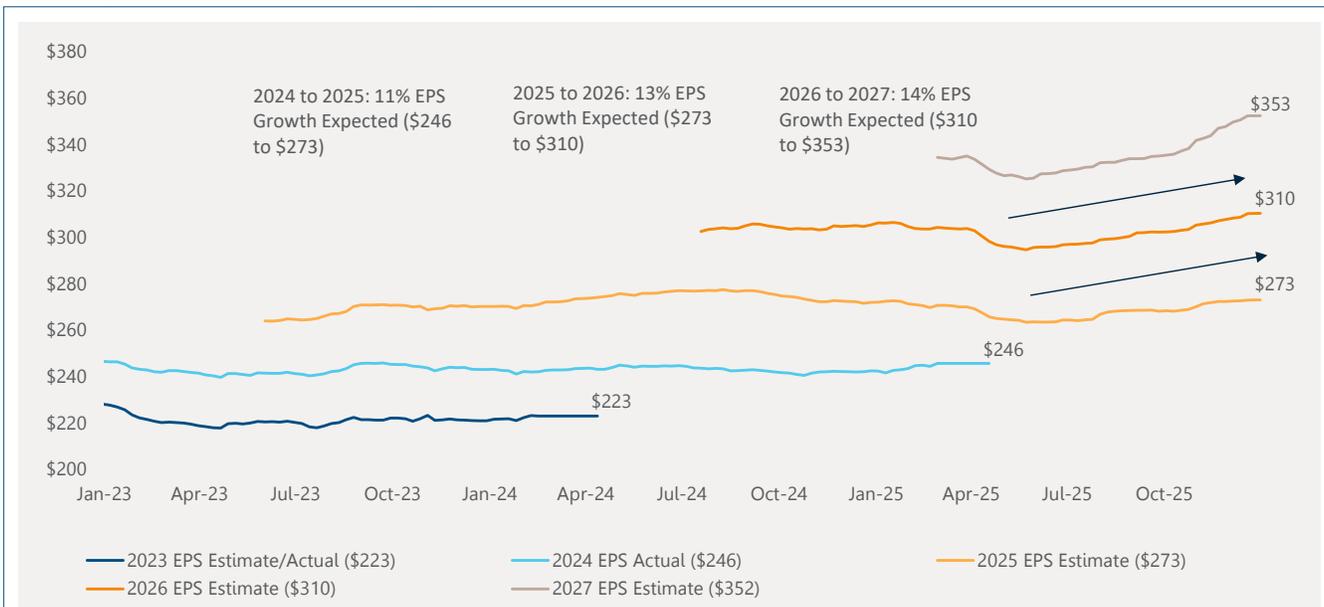
CHART 4  
30-Year Fixed-Rate Mortgage Buckets



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CHART 5  
Great Expectations: S&P 500 Earnings Growth Estimates



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Following an extended period where a handful of mega-cap technology leaders dominated index returns, the U.S. equity market appears positioned for a more balanced environment in 2026. This historic concentration is reflected in the stark performance disparity between the capitalization-weighted and equal-weighted S&P 500 Index from 2023 through 2025, with the former returning a cumulative 85% compared to 40% for the latter. However, increased signs of a recovery in earnings growth beyond the Magnificent Seven cohort suggest this dynamic could be shifting. Analysts expect positive earnings-per-share revisions across large-, mid-, and small-cap stocks.

The implementation of the One Big Beautiful Bill Act (OBBBA) is expected to serve as a primary catalyst for this transition. Pro-growth measures within the act, specifically the reinstatement of permanent 100% immediate expensing for domestic R&D and equipment, are projected to bolster capital spending across a wide range of industries. These fiscal incentives are estimated to add between 0.25% and 1% to U.S. GDP this year.

While monetary policy is likely to remain supportive, the Federal Reserve is expected to provide a more cautious pace of easing than the administration prefers. A primary risk to this broadening theme would be a significant pickup in inflation or a sustained rise in long-term Treasury yields, which could pressure sectors more sensitive to the economic cycle. However, the inflationary impact of trade policy has been more contained than

initially feared. Due to various carve-outs and exemptions, the effective tariff rate is expected to settle between 6% and 8%—less than half of the levels assumed just six months ago—allowing corporate margins to remain resilient as the market enters this new phase of the cycle.

### Transition to Earnings

As the market's leadership group attempts to expand, the fundamental engine of the rally is also undergoing a transition. With the valuation rerating that defined the post-2022 recovery now largely complete, the burden of proof for the next leg of the cycle has shifted squarely onto corporate performance.

After three consecutive years of robust gains, U.S. large-cap stocks are projected to deliver more modest returns in 2026. This marks a shift from the last three years, where valuation expansion was the primary driver of index returns. Following a substantial upward rerating of the S&P 500 from 2023 through 2025, valuation-driven gains are expected to be muted this year year. Instead, corporate earnings are projected to be the primary engine of growth, contributing an estimated 10%-12% to the S&P 500's return according to GS Asset Management estimates.

This transition toward earnings-led returns reinforces the theme of broader participation. When a market is driven primarily by valuation expansion, gains tend to be concentrated in a limited group of high-sentiment industries and names. Conversely, a market driven by earnings growth often enables a more diverse array of industry groups and styles to contribute based on their specific fundamental progress. Bottom-up analyst estimates aggregated by Bloomberg highlight this healthy trajectory, with

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S&P 500 adjusted earnings-per-share expected to grow 11% in 2025, accelerating to 13% in 2026 (See Chart 5).

Sector-level forecasts underscore the areas where this fundamental strength is most concentrated. The technology (+27%), materials (+23%), and industrial (+15%) sectors are expected to deliver the strongest profit growth in 2026, benefiting from the ongoing secular trends in automation and infrastructure investment. In contrast, more defensive or interest-rate-sensitive areas like consumer staples (+4%), energy (+4%), and real estate (+6%) are projected to see the weakest growth. While elevated valuations and geopolitical volatility may leave stocks susceptible to intermittent episodes of weakness, the combination of a constructive economic backdrop and a supportive policy mix suggests that earnings growth can support risk assets in 2026.

### The U.S. Investment Cycle: Beyond the Digital Frontier

The broader market participation expected in 2026 is underpinned by a massive, multi-year investment cycle that extends well beyond software applications into the physical foundations of the U.S. economy. This "super-cycle" is driven by the convergence of AI infrastructure, grid modernization, and a strategic resurgence in domestic manufacturing. Large U.S. technology companies alone are projected to triple their annual capital investment to over \$500 billion by 2026, with much of this "AI-energy nexus" spending directed toward the data centers and related power connectivity.

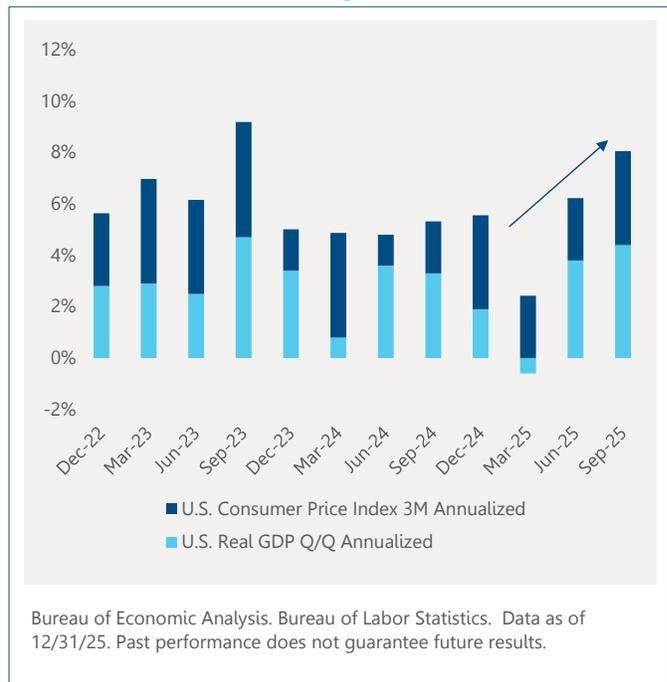
This digital expansion has triggered a corresponding surge in the power and utilities sectors. After a decade of stagnant demand, U.S. electricity consumption is accelerating, with some forecasters projecting that data centers will drive up to 44 gigawatts of additional demand by 2030. To meet this, the utility sector is entering a capital expenditure phase industry analysts project will total up to \$1.4 trillion through 2030—double the investment seen in the prior ten years. This spending focuses on smart grid systems, battery storage, and capacity from nuclear and gas-fired plants.

At the same time, the drive for supply chain resilience is fueling a reindustrialization of America. Sparked by the One Big Beautiful Bill Act and new trade policies, over \$1 trillion in new investments for domestic production capacity were announced in 2025, led by the electronics, semiconductor, and drugmaking industries. This manufacturing revival creates tailwinds for the broader economy, as the construction and operation of these facilities demand extensive materials, specialized labor, and infrastructure.

### Outlook

As we move into 2026, the U.S. economy appears poised to shift into a higher gear, transitioning from a period of peak policy uncertainty toward a more durable, investment-led phase of growth. The case for optimism is anchored by a Federal Reserve that has re-entered easing mode and a fiscal policy boost in the pipeline. With inflation holding in the 2%–3% range and the labor market showing signs of

CHART 6  
Nominal Growth Accelerating into 2026



softness, we anticipate an additional 50 to 75 basis points of rate cuts over the next twelve months. This supportive monetary backdrop is complemented by resilient private sector balance sheets; unlike prior cycles, neither U.S. consumers nor corporations appear overleveraged.

The economic data fog of late 2025 is clearing to reveal a robust investment cycle. Despite earlier financing concerns, the pace of AI capital expenditure and energy infrastructure buildout is accelerating, while a percolating IPO and merger market underscores a renewed appetite for risk and capital formation. Furthermore, the inflationary impact of trade policy has proven milder than many feared, as exemptions and market adjustments have contained the impact of recent tariffs.

However, this constructive outlook is not without its hurdles. Years featuring both midterm elections and the appointment of a new Fed Chair historically invite bouts of market volatility. We also remain mindful of global crosscurrents, specifically higher long-term bond yields in Europe and Japan, which could dampen international growth. While signs of life in the U.S. housing market are a positive signal, affordability angst could lead to unexpected policy shifts.

Ultimately, the confluence of double-digit corporate earnings growth and an expected productivity boost suggests a favorable environment for risk assets in the year ahead with a bias toward cyclical areas of the market. Provided intermediate-term Treasury yields remain within a comfortable 4% to 5% range, the U.S. economy and stock market looks well-positioned to maintain its momentum and overcome periods of elevated policy uncertainty.

# Economic Outlook and Investment Policy

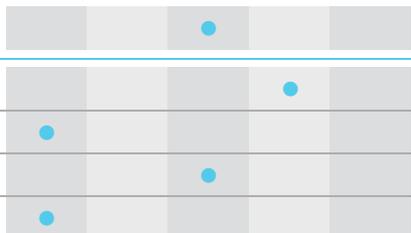
## ECONOMIC FACTORS

## CURRENT OUTLOOK

U.S. GDP Growth	We expect U.S. GDP growth to accelerate above 2% in the first half of 2026 as the pro-growth elements of the OBBA begin to impact activity.
Federal Funds Rate	The Fed is likely to reduce its policy rate by another 50 basis points in the second half of the year after the new Chair takes over in May.
Inflation	CPI is likely to waver around 2.5% in 2026 as higher prices for goods and commodities will probably offset housing disinflation.
Employment	A low-hiring and low-firing environment could persist well into 2026 with weak payroll growth but an unemployment rate that stays near 4.5%.
Consumer Confidence	Consumer sentiment could have bottomed out in November during the government shutdown and might be poised for a spring recovery.
Oil	The Trump admin's focus on crude oil production and supply is likely to keep WTI in a benign range between \$55-\$65/barrel in 1H26.
Housing	We expect a gradual pickup in housing market activity amid a series of policy actions and an average 30-year mortgage rate approaching 6%.
International Economies	Fiscal stimulus in Germany and China, corporate reform in Japan, and a weaker USD should continue to support foreign stocks in 1H26.

## FIXED INCOME

MINIMUM      NEUTRAL      MAXIMUM



## CURRENT OUTLOOK

Investors in 2026 should prioritize diversified sources of income while avoiding overextension into lower-quality credit. We favor short- to intermediate-term U.S. government and investment-grade corporate bonds, positioning we expect should benefit from a steepening yield curve. Within taxable markets, securitized debt—specifically higher-coupon agency mortgage-backed securities—remains attractive, potentially bolstered by bank deregulation and the prospective re-privatization of Fannie Mae and Freddie Mac.

While corporate fundamentals are supportive, tight valuations demand discipline. We emphasize issuers with resilient profiles and strong balance sheets to navigate the significant 2026 high-yield refinancing wave. For tax-aware portfolios, the municipal sector shows solid fundamentals despite reduced relative value recently. We continue to view high-quality bonds as an important tool for dampening portfolio volatility, offering significant coupon income and capital appreciation potential as the economy navigates its next phase.

## EQUITIES

MINIMUM      NEUTRAL      MAXIMUM



## CURRENT OUTLOOK

Target equity weightings should be maintained in portfolios as the market is likely on the cusp of entering a more fundamentally-driven phase. With valuation expansion likely exhausted, profit growth must perform the heavy lifting for future gains. We anticipate S&P 500 earnings growth to accelerate, supported by a strong nominal GDP backdrop and a robust investment cycle in AI and energy infrastructure.

We anticipate a broadening of leadership across U.S. stocks as earnings participation extends beyond mega-cap technology. Additionally, signs of improving global growth and a potentially weaker dollar could boost lagging value and cyclical areas of the global market.

We expect periods of volatility in 2026 as markets recalibrate for midterm elections and a leadership transition at the Federal Reserve. Consequently, we advocate for diversified exposure with an increased focus on exposure to relative earnings growth strength and cyclical areas of the economy poised to benefit from an upshift in nominal U.S. GDP growth.

## ALTERNATIVES\*

MINIMUM      NEUTRAL      MAXIMUM



## CURRENT OUTLOOK

Most portfolios should maintain a moderate allocation to gold given our assessment that the economic, policy, and geopolitical backdrops remain well suited for the precious metal. The resumption of Fed rate cuts, elevated developed-nation government deficits, recent U.S. geostrategic adventurism, and the desire of global central banks to diversify their U.S. dollar reserves should enable gold to improve the risk-adjusted returns of portfolios in coming quarters. Our alternatives allocations, as seen in the table to the left, are designed to decrease the overall risk profile of our five investment objective-based portfolios. (CAP PRES, IWSG, BAL, GWSI, and GROWTH.)

The above minimum/neutral/maximum recommendations represent MainStreet Advisors' current positions relative to our Strategic Asset Allocation ranges.

Views expressed have a 6-12 month horizon and are those of the MSA Investment Committee.

\*Cap Pres: Capital Preservation, IWSG: Income with some growth, GWSI: Growth with some income

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### IMPORTANT DISCLOSURE INFORMATION

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