WILKINS
INVESTMENT COUNSEL

2026 INVESTMENT OUTLOOK

The year 2025 will be remembered as one of resilience for both the capital markets and the economy. The second Trump administration led with its mercurial trade policies early in its first year and the S&P 500 quickly discounted such uncertainty with a rapid 19% decline in price by April 8th. The economy weakened incrementally in the spring as both global trade and household consumption growth moderated and government spending fell due to the impact of the DOGE cost-cutting measures. In fact, the OECD estimates that without booming AI investments the U.S. economy contracted by 0.1% in the first half of 2025.

Nonetheless, President Trump's constant reversals during the early days of the latest trade war (leading the media to label him "*TACO Trump,*" short for *T*rump *A*lways *C*hickens *O*ut), reinforced a buy-the-dip mentality in the stock market that persisted throughout 2025. It took just 2.8 months from the early April stock market low for the S&P 500 to hit a new all-time high, the second fastest recovery in markets in the last 75 years, trailing only the sharp 1.9 month reversal in the fall of 1982. Not only did equities rise in 2025 but Treasuries, corporate credit, and broad commodities all advanced in unison, delivering the strongest cross-asset performance since 2009.

Global AI investment of $1.5 trillion in 2025 (per Gartner), with a preponderance occurring in the U.S., has supported the investment component of GDP and driven 22% earnings growth for the so-called Magnificent 7 tech titans, leading to substantial stock price appreciation and an above average total return for the headline indices below. The average stock per the S&P 500 Equal Weight Index (which is a more diversified composition and removes the lop-sided concentration of the largest equities at the top) turned in a solid 11.4% total return for the year. Such wealth creation for the upper quintile of society underpinned the consumption-driven U.S. economy during the back half of 2025 despite a government shutdown and meager employment growth.

Tariff-driven inflation has been less than forecast to date and crude oil prices have declined 28% since mid-January and remain in a bearish price trend, enabling the Federal Reserve to lower its short term interest rate by 75 basis points since mid-September to a current mid-point of 3.625%. Thus, monetary policy has been expansionary on the margin and has supported the bullish sentiment that has prevailed in the capital markets since spring. Fiscal support has also been unleashed. Passage of the administration's tax bill and substantial deregulation has also lifted sentiment and helped buoy business confidence. Treasury Secretary Bessent, known for his market-savviness as a former investor, has proven to be an avid seller of the administration's economic policies to the public, bringing some calm to markets amidst an otherwise turbulent first year of the second Trump administration.

Fourth quarter earnings reporting season is just weeks away and S&P 500 EPS growth is forecasted to be up a solid +8.2% y/y in Q4. The last six weeks of trading has generally seen participation broaden. AI-related stocks have underperformed as investors question longer run ROI metrics while more diversified indices and economically-sensitive equities outperformed. Investment flows seem to be rotating to the more undervalued parts of the stock market as investors position to benefit from the anticipated boost in economic growth to start the new year. The Dow Jones Transports, historically a leading indicator for the remaining parts of the stock market, are up nearly 13% since November 20th and foretell a potentially positive start to 2026 for broader equities.

2025 Total Returns

	12/31/25	% Change
Dow 30 Industrials	48,063	+14.9%
S&P 500	6,846	+17.9%
NASDAQ Composite	23,242	+21.2%
MSCI ACWI ex-USA	421	+33.1%

The Dow 30 Industrial Index is a price-weighted index of 30 US blue-chip companies. The S&P 500 Index is a market capitalization-weighted index of 500 large capitalization stocks commonly used to represent the US equity market. The NASDAQ Composite Index is a market capitalization-weighted index of over 2,500 companies listed on The NASDAQ Stock Market. The MSCI ACWI ex USA Index is a market capitalization-weighted index representative of developed and emerging market stocks excluding the U.S.

Outlook

The new year commences on somewhat of a Goldilocks footing. GDP growth is expected to accelerate in the first quarter while inflation decelerates, a combination which has historically been a positive omen for capital market sentiment and fundamentals. Bloomberg consensus forecasts Q1 2026 GDP growth of 2.5% compared to the 1.8% fourth quarter estimate exiting last year. The Federal Reserve is forecasting full year growth to be 2.3% in 2026 versus the 1.7% advance of 2025. The recovery from the 43-day government shutdown during the start of the fourth quarter is a partial factor in the upgraded forecasts for both the first quarter and full year forecast for 2026. However, fiscal benefits from the administration's One Big Beautiful Bill Act will also kick-in as the first quarter progresses, especially as the lower-80% households who need it most file their tax returns.

Treasury Secretary Bessent is projecting $100-$150 billion in tax refunds, which could be between $1,000-$2,000 per household, while some on Wall Street like UBS estimate $50-$55 billion in refund checks. Such benefits accrue from provisions like the higher SALT deduction, the deduction for overtime and tips, and the $6,000 deduction for most seniors over the age of 65. Many households will also benefit from less tax withholding in paychecks. The nonpartisan Tax Foundation estimates that average after-tax pay will increase by 5.4% as a result of the changes, which could accelerate spending on goods and services in 2026. However, some analysts question whether such benefits will enable the U.S. economy to escape its so-called K-shaped recovery post-pandemic (where only the upper quintile experiences rising wealth while the lower 80% struggle) and re-start the virtuous cycle of accelerating payroll growth and subsequent consumption. Some households could also see much of the fiscal benefits offset by higher health/property/auto insurance expenses as well as the AI-driven boost to utility costs.

The employment backdrop continues to be best described as a "no hire, no fire" situation. Payroll growth has been weak since the so-called Liberation Day tariffs were rolled-out in early April, averaging just 38,600 additions per month since then. Yet layoffs are quite low and resemble an economy making solid mid-cycle progress. Weekly jobless claims are averaging just 217K on a four-week moving basis and remain in a neutral trend, well below the 500K-700K+ spikes experienced during a typical recession. Unfortunately, hiring plans in corporate America remain on the back burner. At a gathering of CEOs in Midtown Manhattan in December organized by the Yale School of Management, 66% of business leaders surveyed said they planned to either fire workers or maintain the size of their existing teams next year. Only 33% indicated they planned to hire. Some companies are also pausing as they evaluate the potential for AI to substitute for labor over the medium run.

The latest inflation print for November released on December 18th sustained the disinflationary trend that has persisted since inflation peaked in late 2022. Core CPI was up 2.6% y/y for the month, the lowest reading since March 2021. This print was well below the Bloomberg consensus survey although there is a chance that the reading was impacted by the government shutdown and additional data collection could lead to a revision. Nonetheless, inflation is moving in the right direction and the bearish price trend in crude oil prices, which feeds into many other downstream products and processes, could help sustain that trend. The International Energy Agency is forecasting a supply glut of 3.8 million barrels per day for 2026 due to OPEC+ production increases over the past year. Crude oil prices near $56 per barrel are the lowest since early 2021.

It remains to be seen if an effective tariff rate near 16%, the highest since 1935, bites more acutely in 2026 and interrupts the current disinflationary trend. Retailers noted in recent earnings calls that they are feeling the effects of tariffs and are yet to pass on the full impact via higher prices. Corporations seem to be depleting older inventories, absorbing some costs, re-shuffling supply chains, and taking a wait-and-see approach until the Supreme Court rules on the administration's so-called IEEPA authority. Even if many of the existing tariffs are invalidated by the high court, it is likely that most will be simply re-instituted under some other regulatory and executive branch authority.

The economy and inflation have been surprisingly resilient to tariffs thus far and the more time that passes without a sharp impact, the more likely the Federal Reserve will look through such flawed economic policy, enabling some additional short term interest rate cuts. The FOMC dot-plot projects just one 25 bps rate cut in 2026 to arrive at a fed funds rate of 3.375% by the end of the year while derivatives markets are currently discounting two cuts. Regardless, the Fed is nearing its consensus 3.0% neutral interest rate, which theoretically enables the economy to achieve its potential GDP growth (which most assume to be near 2%) while maintaining full employment and stable inflation. Chairman Powell's term ends in May and it is nearly certain that President Trump nominates a new chairman in January that is more dovish.

Perhaps more significant to the financial markets is what happens at the longer end of the yield curve in 2026 and beyond, which is less sensitive to central bank policy. Despite the Fed cutting its short term policy rate by 175 bps since mid-September 2024, the 10-yr U.S. Treasury yield has risen 55 bps since that first cut and currently yields 4.19% as investors contemplate rising fiscal imbalances. DoubleLine warned in a piece in late December that "the tide may be turning for developed economies" that have historically gotten a pass from the "vicious loop that has played out time and again in developing economies. Embedded benefits and rising fiscal costs hurt the outlook for growth and public spending, leading to currency depreciation and rising rates, which in turn fuel social tensions and political instability." Simply put, longer term borrowing costs for nations under the fiscal-social gun will likely continue to increase. This has implications for the pricing of many financial instruments including public equities, household mortgages, and corporate paper.

The rise in long term interest rates is not just occurring in the U.S. Eurozone 10-yr yields in countries like Germany and France are back to the highest levels since 2011 prior to the region's debt crisis. So-called JGB (Japanese government bonds) 10-yr benchmark yields are now safely above 2% for the first time since 1999. The sharp rise in long term JGB yields over the past year bears watching, in particular. Institutional investors and hedge funds borrowed Japanese yen for many years with JGB yields trapped near 0% to fund more speculative and/or higher yielding investments elsewhere like tech stocks, digital currencies, and U.S. Treasuries. While the unwinding of these "carry trades" seems to be orderly at the moment, such strategies are intricately connected via leverage pools exceeding tens of trillions of dollars. A further unwinding of this exposure could get messy amidst additional increases in long term interest rates or a spike in volatility that forces margin calls.

The pickup in GDP growth forecasts for 2026 has Wall Street analysts modeling an acceleration in earnings growth for the stock market. Headline S&P 500 earnings per FactSet are expected to increase by more than 14% this year (compared to 11.5% growth in 2025), driven by Magnificent 7 earnings growth of 22% (which is a similar rate as last year). However, the “Other 493” companies in the headline index are modeled to grow 12.5% in 2026 (versus 9.4% last year), which would be the fastest EPS growth for that broad subset of the market since 2021. The rotation in flows that has been occurring since mid-November favoring the broader equity universe compared to the expensive AI stocks could continue well into 2026 if the above fundamentals prevail. The average stock trades at just 16.9x forward earnings compared to the 15-yr average of 16.1x, a modest 5% premium and offering better value relative to the names at the top of the index.

Global AI spending is expected to surpass $2 trillion in 2026 according to Gartner, a 33% increase over the prior year, supporting multiple sectors and the world economy. However, some chip stocks are particularly vulnerable to a sharp downturn if lofty expectations are not met and more investors become impatient with the high levels of capital investment that are occurring, diluting free cash flow and generating little if any return on capital at the moment. Historically, investors have ascribed much lower valuation multiples to such stocks exhibiting declines in free cash flow and returns and especially when outlays are being financed with rising debt levels, as is the case with some data center names. AI will bring net benefits to society over the longer run and enhance economic productivity but the mind-boggling estimates for the data center buildout—$10 trillion by some forecasts—and the insatiable appetite for financing the rollout could bring some pain for both debt and equity investors if a glut were to appear.

The outlook for the year ahead is prone to risks that could disrupt both economic and capital market progress. Geopolitical risks, like the weekend events in Venezuela, are always on our minds but impossible to model and quantify the impact. The credit cycle is long in the tooth and history has taught us that when too much money competes for returns, as seems to be the case in private credit and some aspects of banking at the moment, standards loosen and misallocation of capital subsequently occurs. The financial system and markets are also leveraged with the most debt ever and prone to such credit being called should an unknown hazard arrive on the scene. Wall Street forecasters are famously bullish but the current level of optimism for 2026 should worry a contrarian as nearly all agree on a higher stock market in the year ahead. Strategists’ year-end price targets for the headline indices are also clustered the tightest in almost a decade, according to Bloomberg data. Such lockstep views are more prone to disappointment should corporations fail to deliver.

Investment Conclusion

We are cognizant that valuations are quite stretched at the index level, which historically has been a harbinger for lower long term returns for equities. However, should the current broadening of the rally continue throughout the new year it could favor active managers like us who can find value in long term individual compounders trading at reasonable prices. While it is prudent to hold some excess cash given the convergence of money market and Treasury yields at the short end of the curve, rates still remain above the probable fed funds neutral rate of interest that is likely to prevail over the next year or two. Thus, fixed income should continue to be a solid ballast for investors preferring some portfolio balance and risk mitigation.

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