

Many Economists are Cautiously Optimistic the Resilient U.S. Economy Can Keep Chugging Along, but that Sentiment will be Tested in 2026

Economic Growth Holds Steady but Many Uncertainties Seek Resolution

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ECONOMISTS AND MARKET EXPERTS ENTER 2026 HOPEFUL but not quite ready to give the all-clear signal yet. The U.S. economy showed notable resilience in 2025, performing better than anticipated despite repeated shocks and heightened uncertainty. As a new year unfolds, it remains to be seen if this resilience will persist or whether it was just a temporary shot of adrenaline before exhaustion sets in.

Annual inflation slipped to 2.7 percent in December 2025, the lowest since July, while core inflation settled at 2.6 percent, its lowest reading since March 2021. These are numbers that would have been celebrated just two years ago; now they're met with caution. While inflation is expected to cool further to 2.4 percent according to Federal Reserve forecasts, several forecasters warn that core inflation may remain stubbornly above 3 percent for much of the year due to tariffs, housing costs, and persistent inflation.

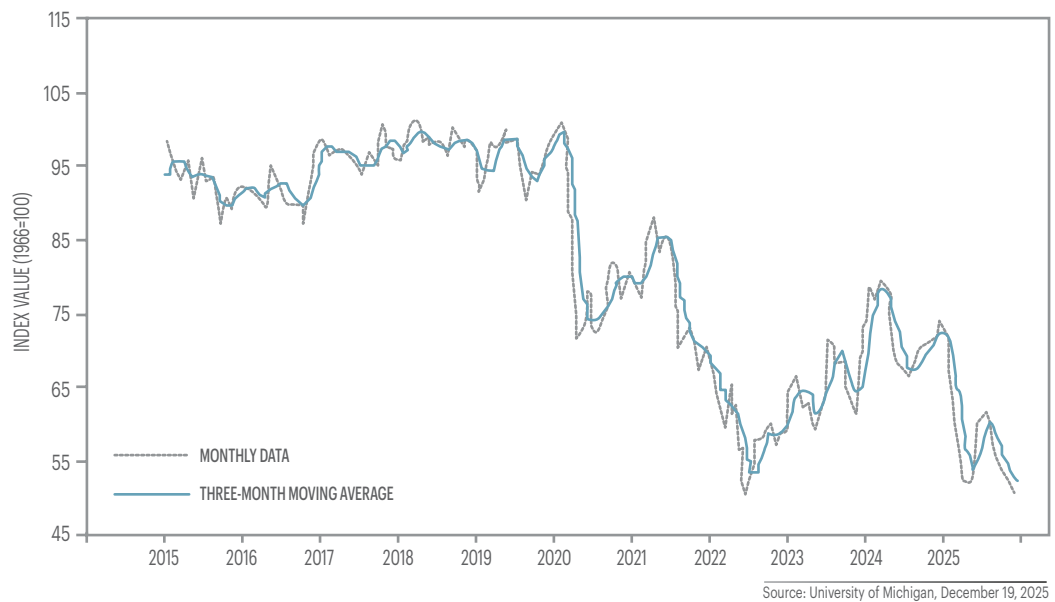
With the U.S. economy showing multiple signs of weakness, the Federal Reserve finds itself in what Chairman Powell has described as "a very difficult position." The labor market shows signs of cooling, with unemployment ticking upward, payroll growth stalling, and rising involuntary part-time employment. Job growth is concentrated in non-cyclical sectors such as healthcare and social services, which is not a good sign for future growth in the economy.

Overall consumer sentiment continues to deteriorate and is particularly weak among younger consumers and those in lower income brackets.

Consumer spending showed mixed signals in the fourth quarter of last year. Holiday sales climbed 3.9 percent compared to last year according to Mastercard SpendingPulse, but higher prices and the weak job market caused consumers to trade down or delay non-essential purchases. The divide between the health of higher income consumers and lower income consumers intensified in 2025. Though growth in spending from everyone else is stagnating, spending from the top 10 percent of earners is strengthening and now accounts for almost half of all consumer spending.

Overall consumer sentiment continues to deteriorate and is particularly weak among younger consumers and those in lower income brackets (See Figure 1). Even high-end consumers are becoming more selective, with heavy traffic in thrift shops and off-price retailers but luxury chains and department stores posted much smaller gains.

Figure 1: University of Michigan Survey of Consumers
The Index of Consumer Sentiment



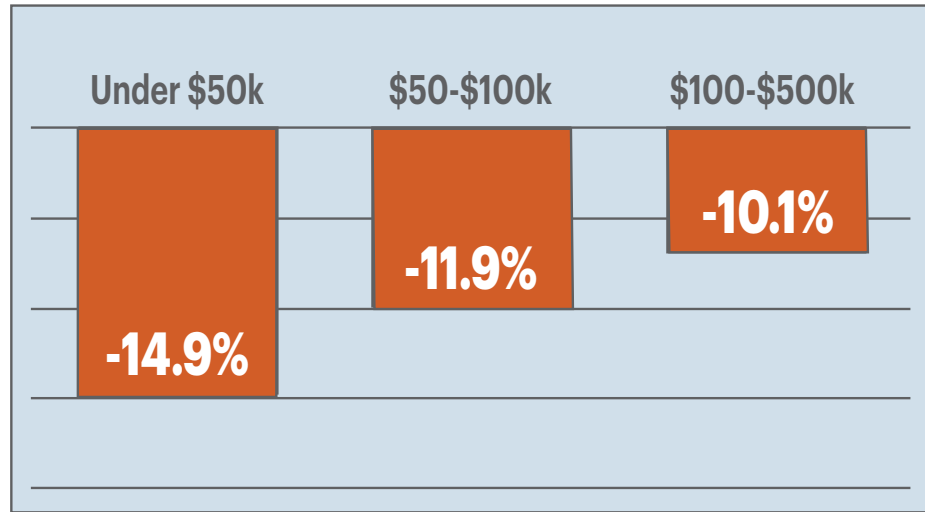
The sharp increase in United States tariffs introduced new frictions into the global trade environment, yet the expected acceleration of inflation never materialized. Bilateral deals between the United States and key trading partners helped prevent broader escalation, while front-loaded shipments created a temporary boom of imports. Trade tensions remained contained, but it is uncertain if that will continue in 2026.

U.S. fiscal policy adds another layer of complexity. The “One Big Beautiful Bill Act” signed in July 2025 will inject stimulus in the form of extra tax refunds in the first half of 2026 (See Figure 2). However, the Congressional Budget Office estimates the bill will add \$4.1 trillion to the federal deficit over the next 10 years.



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Figure 2: Fiscal Stimulus Coming in 2026
Reduction of Taxes with The One Big Beautiful Bill



Source: United States Committee on Ways and Means

Amidst all this uncertainty, corporate spending on artificial intelligence (AI) continues at a solid pace, supporting economic growth and stock market prices. Yet the scale and timing of the resultant productivity gains remain unclear. AI technology could reshape everything, but even an optimist would concede that the economic benefits of AI could take longer than forecasts suggest. The benefits also come with potential risks. For example, these benefits may be unevenly distributed, deepening existing income inequalities.

Global economic growth has proven more durable than expected, but cracks are emerging. In 2026 we will find out if this modest and uneven growth will be sustained. Will the trade tensions stay eased? Will inflation continue its gentle descent? Will the labor market stabilize or weaken further? How these issues are resolved will determine the economy’s path in 2026.

FIXED INCOME 4Q 2025 SUMMARY & OUTLOOK

A weakening U.S. labor market and moderating inflation are favorable for fixed income markets. Investors responded by bidding up prices of investment grade securities across the major market sectors, with notable outperformance from U.S. mortgage-backed Securities (MBS) and tax-exempt municipals. Labor market data released in December showed the unemployment rate ticked up to 4.6 percent, the highest rate in four years. Combined with moderating inflation, these conditions are favorable to Core fixed income strategies which responded with their best calendar year performance since 2020.

During the fourth quarter, short to intermediate maturity U.S. Treasury yields fell while longer maturity yields increased, continuing the “bull steepening” trend seen since the Federal Reserve began lowering rates in September 2024. In that time, the yield differential between two-year and 30-year maturity U.S. Treasuries has increased from nearly zero to



+1.36 percent as of December 31, 2025 (See Figure 3). Most investors expect short maturity rates to benefit from continued monetary policy easing in 2026, though concerns regarding long maturity valuations remain due to inflation uncertainty and high fiscal spending.

Figure 3:



The Fed continued to ease its policy rate by 25 basis points at both its October and December meetings in response to recent weakness in labor market indicators, bringing its policy rate to a range between 3.50 percent to 3.75 percent. The Fed's interest rate decision in December was not unanimous, with two officials voting for no change and one voting for a larger cut. Some FOMC members have indicated that further easing would require additional evidence of weakening labor markets. However, it is highly likely that a new Fed Chair, scheduled to be appointed in May, will take a more aggressive view regarding the need for cuts. As of early January, investors are pricing an additional 50 basis points of Fed interest rate cuts through the end of 2026; but these expectations are subject to change with new data or adjustments in FOMC leadership.

Investment grade corporate credit spreads experienced volatility in October and November before recovering to end the quarter just four basis points higher (See Figure 4). Investors are expressing concern about the projected amount of capital expenditures needed to build AI infrastructure (See Figure 5), which are likely to require material amounts of debt financing. Moody's estimates that at least \$3 trillion is anticipated to be needed for data center-related investment within the next five years. Recent public debt issuance from Meta Platforms and Oracle underperformed as investors reassessed the risk and return profile of funding the AI buildout, especially from more leveraged issuers. Although demand for corporate credit remains high given strong absolute yields; historically tight credit spreads and an expected surge in AI-driven debt present risks for credit investors.



Figure 4:

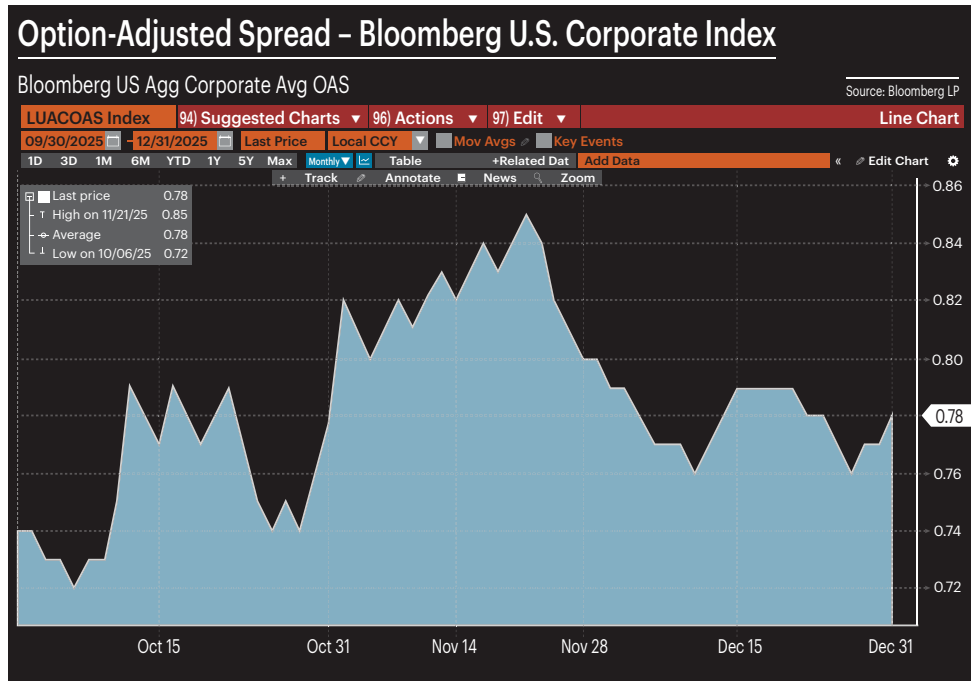
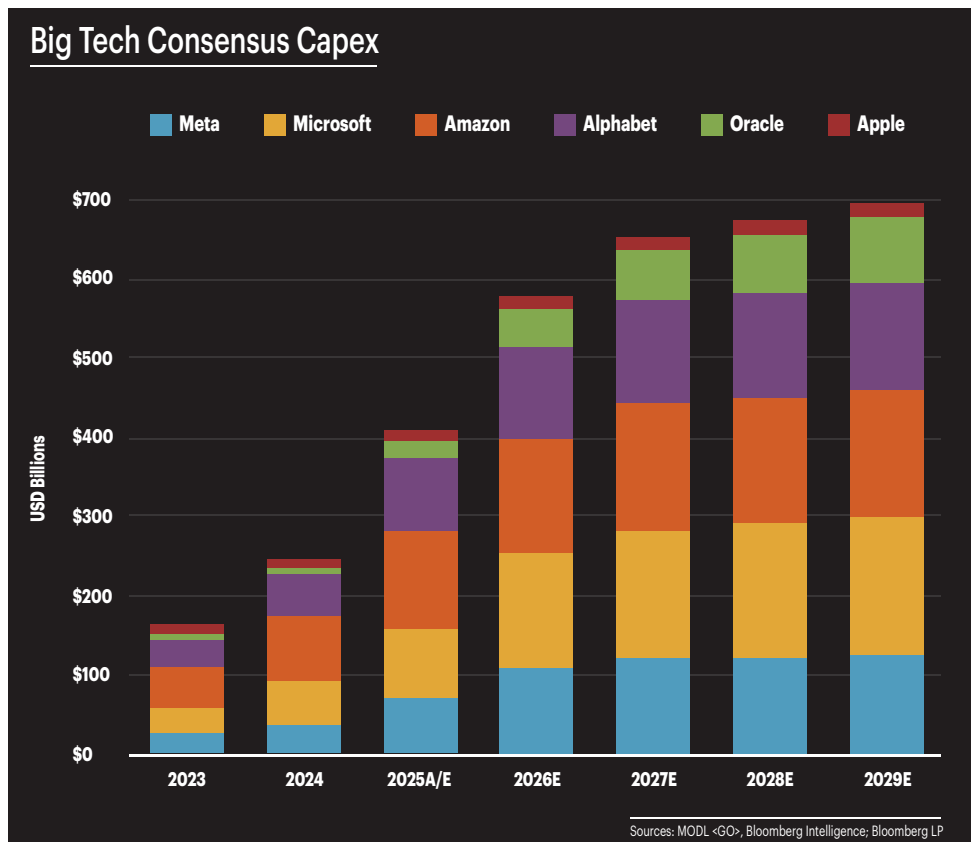


Figure 5: Capital Expenditure Estimates by Year





We believe that interest rates are attractive at their current levels as nominal yields remain above current and future expected inflation rates. Fixed income securities offer compelling income return with further opportunity for price appreciation if inflation recedes and/or economic activity stalls.

EQUITY MARKET 4Q 2025 SUMMARY & OUTLOOK

The continuation of economic growth in the United States enabled all the major U.S. stock market indices to trade at or near all-time highs through the end of last year. Despite the concerns regarding the health of the economy, corporate earnings increased in 2025 due to strong consumer and business spending, significant corporate investment in AI, and effective cost management. The Technology sector benefited the most, posting robust earnings growth. Investors looked past any stock market valuation concerns to drive these stocks higher, and the prospect of falling interest rates helped the interest rate-sensitive sectors such as banks and industrials to rally on the prospect of rate cuts.

To achieve further gains in 2026 equity markets will need to overcome several obstacles. There is the question of whether AI spending will continue to drive economic growth. Also, the S&P 500 Index is increasingly dominated by a handful of stocks that are driving the index higher. The Magnificent 7 stocks account for about 30 percent of the market cap of the index, and such concentration makes for a market that is vulnerable to rapid swings based on the fortune of a small number of companies. In addition, stock market valuations appear expensive at current valuations, which can indicate a higher risk environment.

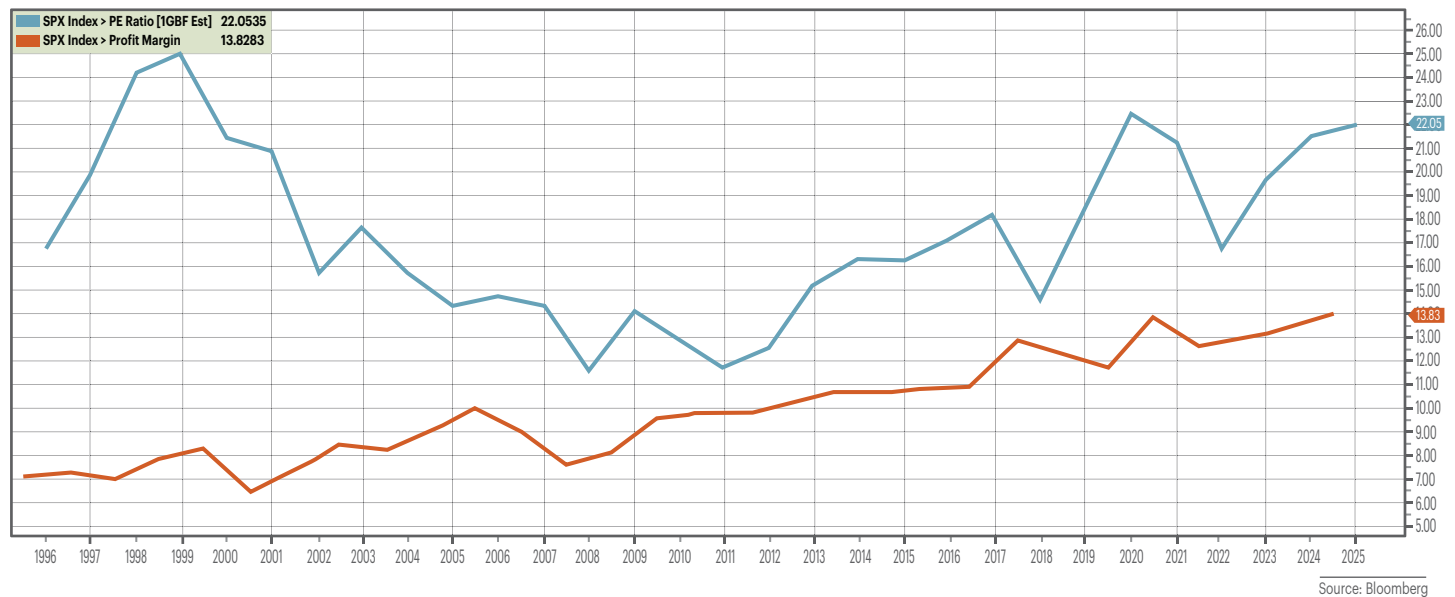
There are reasons for optimism. Some people have compared the current environment to the Dot-Com bubble of the late 1990's due to the market's rich valuations and dependence on a handful of technology stocks. However, the environment today is very different than it was then. Today's dominant companies are generating actual revenues and earnings as opposed to the mostly speculative business models of the 1990's. The current tech companies on average have operating margins of about 39 percent and a return on equity (ROE) of about 76 percent. In 2000, those tech companies averaged operating margins of about 27 percent and an ROE of only 29 percent.

As for valuation, the stock market appears expensive when looking at index-level price to earnings ratios from the perspective of both 12 month forward earnings and inflation-adjusted earnings over the past 10 years (The Shiller CAPE ratio). The S&P 500 Index currently trades around 22 times forward earnings today, which is near the 25 times earnings seen at the end of 1999. However, in 1999 the average profit margin of companies in the index was 8 percent but today that number is closer to 14 percent (See Figure 6).

The current technology companies that are leading the AI surge collectively have a price-to-earnings ratio of about 33 times next 12-month earnings. In 2000, the technology companies leading the market at that time collectively had a price-to-earnings ratio of more than 73 times next 12-month earnings.

Figure 6:

S&P 500 Forward P/E vs Profit Margin (T12m)



In addition, when these Magnificent 7 stocks are removed from the index, the remaining 493 stocks have valuations that are very reasonable. The current S&P 500 Shiller CAPE ratio is 40.59 times. If you remove the Magnificent 7 stocks, the S&P 493 Shiller CAPE is 25.9. This is below the recent 20-year average S&P 500 Shiller CAPE of 27.3. Removing the Magnificent 7 drops the CAPE ratio by approximately 36 percent. The ex-Mag 7 CAPE is much closer to recent historical averages, suggesting the broader market is more reasonably valued than the S&P 500 CAPE would indicate.

International diversification can help mitigate these risks. Last year was a good example. After underperforming for many years, many foreign stock markets had performance that was even more impressive than U.S. stock markets. The MSCI All-Country World ex-U.S. returned 33 percent for U.S. investors in 2025, significantly outpacing the S&P 500's 18 percent.

There are many reasons that could continue in 2026. There has been more fiscal stimulus in Europe than any time since post-World War II, and valuations are much lower. In fact, the MSCI Europe Index trades at a near-record discount to U.S. equities. The dividends companies pay overall are higher overseas, and there is much less concentration risk. For an investor in the stock market, a diversified approach that includes foreign stocks is as important as it has ever been.

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