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INVESTMENT ADVISORS

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INVESTMENT REVIEW AND OUTLOOK

Pivot?

The fourth quarter witnessed another strong quarter for stocks and bonds. The S&P 500 had a total return of 2.7% and the Bloomberg Aggregate Bond index returned 1.1%. Value stocks outperformed growth stocks. The S&P Value Index gained 3.2% vs. the S&P Growth Index return of 2.2%. International stocks outpaced domestic shares with the MSCI All-Country World Index returning 3.4%. Among developed markets, Japan was a standout and the Nikkei 225 Index gained 12% in the quarter. For the full year, the S&P 500 had a total return of 17.9% and global stocks returned 18%, as measured by the MSCI All-Country World Index. The Lipper Balanced Fund Index had a return of 13.4% for 2025.

The economic news in the quarter was generally favorable: inflation continued to moderate, U.S. real Gross Domestic Product (GDP) increased 4.3% in the third quarter and the U.S. unemployment rate remained at historically low levels.

Against this benign backdrop, several notable developments occurred during the past quarter and over the last 12 months. Bitcoin and several other cryptocurrencies declined significantly in the quarter. Bitcoin declined by over 30% while Ethereum lost over 34%. This is notable because cryptocurrencies had been closely correlated with the NASDAQ Index and that correlation ended in 2025.

Another notable change in recent months has been a shift in the direction of U.S. Government fiscal policies. For much of 2025 tariffs played an important role in generating revenue for the federal government and it is estimated that total tariff revenue collected last year approached $289 billion according to the Bipartisan Policy Center. However, beginning in the fall of 2025 an important transition began as month-to-month growth of tariff revenues began to taper while the impact of recently enacted federal legislation began to affect economic growth via increased capital spending levels due to more generous depreciation allowances. For the full year 2025, U.S. capital spending is estimated to be $5.4 trillion which represents an increase of 4.4% according to the Federal Reserve Bank of St. Louis. Looking into 2026, this fiscal transition is expected to continue as the anniversary of tariff implementation occurs in April and a change in tax policies is expected to increase tax refunds to consumers by over $150 billion, according Strategas Research.

In the realm of geopolitics there have also been several notable developments. In the Middle East, the landscape has changed dramatically over the last 12 months. Closer to home, the results of the fall elections were largely as expected, however the margin of victory in several high-profile races was much greater than recent polling had suggested.

Time will tell whether some of the above developments represent a longer-term pivot or a more transitory adjustment. However, overall, the current economic backdrop remains constructive.

The Great Debate(s)

Whether in investing or in life, the picture looking forward is rarely clear; and the list of subjects for debate is endless. Currently, there are two topics receiving much debate and we wanted to touch on each.

We have written frequently about the important developments in artificial intelligence (AI). The rapid advancement of AI capabilities and the accompanying investments have broad implications for productivity, competitiveness, and economic growth. In 2025 alone, total AI spending is estimated to be $1.5 trillion which represents a 50% increase over the prior year, according to Gartner Group. AI is being broadly adopted by government and businesses and examples of increased productivity are being discovered daily. For example, PNC Bank reports that it recently implemented a real-time digital tool for retail customers that is expected to save customers approximately $125 to $150 million in overdraft fees annually.

There is little debate over the impact of AI on productivity. The debate centers primarily around the level of AI infrastructure investment and the expected payback on that investment. The very large AI investments, which are projected to continue growing through this decade, are causing concern for several reasons. Among the large AI providers, capital spending as a percentage of the company's cash flow has risen significantly and this contrasts with the trend of recent years. Another development drawing attention has been the use of non-traditional financing vehicles for some large AI data center projects. These vehicles include complex partnerships as well as off-balance sheet financing. Finally, there is a natural skepticism that arises when large sums are being invested at a rapid pace. While the dollar amounts invested for AI infrastructure are well known, the return on those investments is less well understood.

Part of our job is to be skeptical, and we are watching AI developments with a close eye. Financial strength is core to our investment philosophy, and our AI exposure reflects that investment tenet. Nevertheless, we have not been reluctant to "take some chips off the table" among our AI holdings. The rewards for AI investors have been rich in recent years, and the pathway forward is less clear.

In our last letter we discussed the topic of private credit. Private credit represents debt obligations that are issued to be held until maturity by the lender. Unlike publicly traded bonds, these securities are not liquid, and they are often issued by borrowers with lower credit ratings. The purchasers of private credit are typically institutional investors such as insurance companies or the credit arms of private equity funds. Due to the rapid growth of private credit issuance as well as the recent high-profile bankruptcies of several private equity-backed businesses, there is an understandable debate about whether we are experiencing the fallout from a private credit "bubble." As is the case with AI, we are following events carefully and we would like to share a few observations.

Although there have been intermittent market disruptions such as COVID, Brexit, etc., the last major financial crisis was in 2008-2009 and we are pretty far along in the current credit "cycle." The significant rise in interest rates between 2021-2022 has caused, and continues to cause, challenges for less well capitalized businesses that are in need of refinancing. Part and parcel with this trend, we observe that there is a natural bifurcation taking place within the private equity industry whereby larger players with established track records and ample financial resources are able to navigate the current environment while smaller participants who may lack resources are finding the environment more challenging. For example, large private lenders have more flexibility and financial resources to restructure loans. This flexibility may not be available to smaller firms that lack scale.

In our judgement it is too early to make a broad call on the current credit cycle. However, we are attuned to the risks that emanate from lax underwriting and/or illiquidity. For that reason, we have stressed credit quality and above-average liquidity in our fixed income holdings.

Overlooked

Given the strong stock market leadership from a narrow group of companies over the last few years, ("Magnificent Seven," et. al.) we have been increasingly drawn to opportunities among the "S&P 493." We continue to find high quality opportunities in sectors such as financial services, consumer cyclical and food and beverage. Given the ongoing large government fiscal deficits in developed economies, we are retaining our holdings in the gold exchange traded fund.

As always, we welcome your comments and questions.