

Good Afternoon and Happy New Year,

2025 was another year for the record books. There were 39 record highs for the S&P 500, resulting in another year of double digit returns of 17.9%. International stocks did even better, gaining 31% for the year (source :WSJ) Even so, I think one of the unique things about 2025 was that it didn't feel like the third year of double digit stock returns. In April, the S&P 500 fell 20% on the heels of surprise tariff announcements. Inflation remained stubbornly above the Fed's target of 2% and there was a 43 day government shutdown. Despite all this, stock earnings exceeded analyst's expectations, the Fed resumed their rate cut program and the global economy continued to expand.

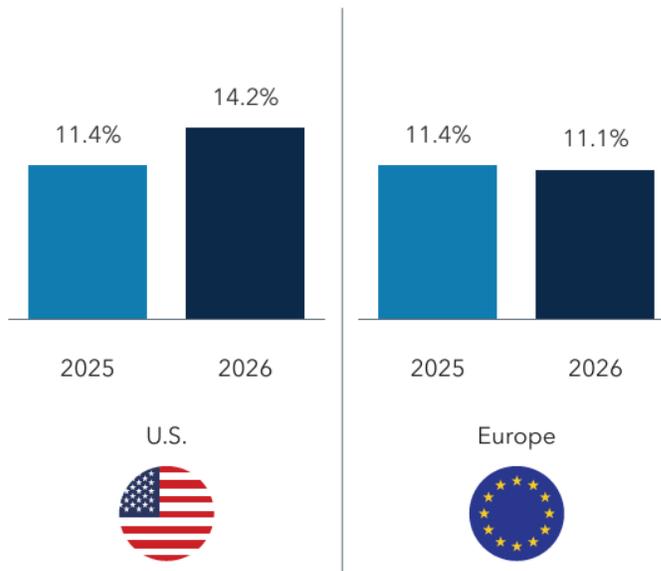
The big question as we start 2026 is "what's next?" Is it reasonable to expect a fourth year of 10%+ returns in the U.S? I think it is important that we look at positive signs alongside potential risks on the near-term horizon.

## Positives

### 1. Earnings are expected to increase in 2026

Estimated earnings growth for 2026 for the U.S. are 14% and 11% for Europe. Market performance tracks earnings over time. Should earnings growth come to fruition, it is reasonable to expect similar price performance.

#### Consensus Earnings Growth



Source: FactSet, MSCI, Standard & Poors

### 2. The economy remains resilient

Gross Domestic Product for the 3<sup>rd</sup> quarter of 2025 came in higher than expected at 4.3%. While possibly affected by the Government shutdown, it indicates economic growth

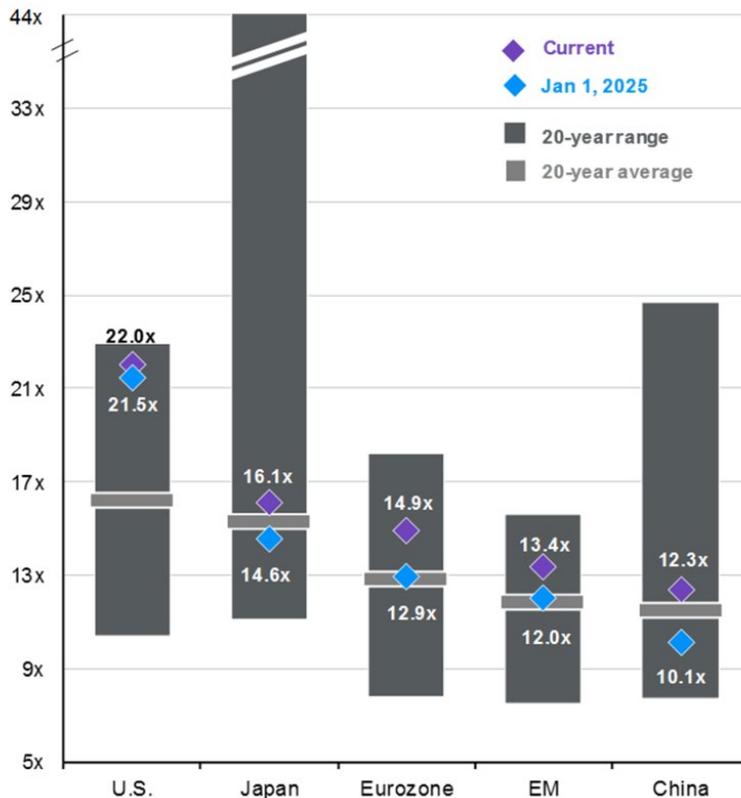
continues at a solid pace. Other indicators such as retail sales have been moderating but are still in positive territory.

### 3. International stocks remain compelling

International stocks outperformed the U.S. by more than 10% last year, and they still look attractive. It is important to note that much of the performance of the S&P 500 over the last three years came from the largest seven (mostly growth) stocks. International Developed markets do not have this level of concentration in their holdings.

#### Valuations by region/country

Forward P/E ratio



Source: JP Morgan

#### Possible warning signs:

1. **The rate of unemployment is increasing and recently hit its highest level in four years**

Job growth is still positive, but it is slowing. Employers added an average of 34,600 jobs per month in 2025, compared to 170,000 per month in 2024. Policy uncertainty surrounding tariffs was a large contributor to this slowdown. Should this uncertainty abate in 2026, job creation will likely increase, but for now, this metric bears watching closely.

## Unemployment rate



Note: Seasonally adjusted

Source: Labor Department via St. Louis Fed

## 2. Market valuations in the U.S. remain elevated

By almost any measure, U.S. stocks are near their historical highs in terms of price relative to earnings, sales, or dividend yield. While this does not mean the S&P 500 is due for an imminent drop, it does raise the bar in terms of future earnings. Should those fail to come in as expected a correction could ensue.

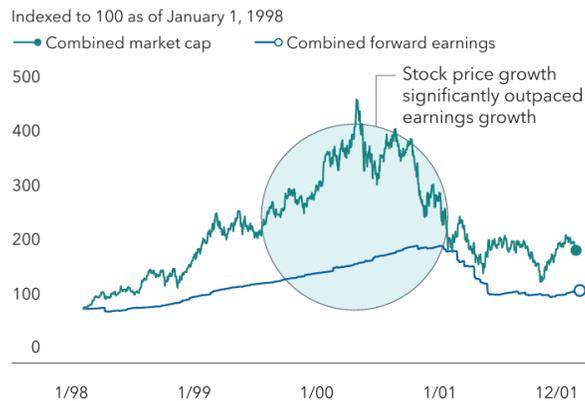
## 3. Artificial Intelligence – are we in a bubble?

This is probably the biggest concern I hear from our clients today. The primary concerns are:

- Valuations are high and A.I. stocks in particular are in a bubble.
- The large amount of investment put into building A.I. may take years to generate a net positive return.

I agree that valuations for the S&P 500 in general are near historical highs. However, this has been supported by earnings growth. Looking at the largest A.I. stocks (NVIDIA, Microsoft, Apple, Amazon, Meta, Broadcom and Alphabet) and comparing them to the largest stocks of the dot-com era shows two different pictures. As shown in the chart below, earnings growth has risen alongside stock appreciation, lending support to current prices. Another key differentiator is their investment in A.I. has come largely from cash flow, not debt.

### Dot-com era: Price vs. earnings (1998-2001)



### AI era: Price vs. earnings (2020-present)



Source: Capital Group, Bloomberg

### Wild Card

One more thing to consider: 2026 is a mid-term election year. Historically, this has proven to be the worst year for market performance of an election cycle, with stocks finishing the year higher 53% of the time, as compared to 78% of the time for the other three years. Returns for the S&P 500 have averaged 4.6% during a mid-term election year compared to an average gain of 11% for the other years (source: Barron's). Call this a wild card if for no other reason than we can expect an increase in market volatility at some point related to the anticipated outcome of the election.

### Conclusion

I think the best phrase to summarize the outlook for 2026 is "Positive, but..." At the present, the tailwinds continue to blow favorably for both stock and bond returns. But just as sailors take warning when they see red skies in the morning, there are plenty of clouds on the horizon that could cause a tempest in the weeks or months ahead. Should one occur, there will be plenty of opportunities left in its wake.

### Portfolio updates

1. I've increased the allocation to International Developed Market equities in order to allow for additional growth in 2026. Even with their strong performance in 2025, they remain compelling.
2. Although Small Capitalization stocks lagged the Large Capitalization sector in 2025 by a few percentage points, the current climate of declining interest rates and a resilient domestic economy continues to make them an attractive investment.

3. Given the expectation for a more challenging market this year, I continue to favor diversifying across investments in 2026. This includes Buffered Indexes, Dividend Growing stocks and Preferred stocks. Should we experience a correction or more muted returns, these investments will provide an alternative source of return that will be largely independent of stock prices.

As always, please let me know if you have any questions or comments on the markets or economy, or your investments in particular.

Very truly yours,

James Herrell



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