



Headwinds and Tailwinds for 2026

2025 was characterized by a strange mix of headwinds and tailwinds affecting the markets and the economy. This created an environment that often seemed at odds with itself- one foot on the gas and one on the brake. Many of these dynamics are likely to persist into 2026, so let's take a closer look at them.

Headwinds

Weakening Labor Market

The labor market has undeniably weakened over the past year. The unemployment rate in January 2025 was 4%- a level most economists consider to be healthy. By the last read of the year, it had risen to 4.6%. The percentage of workers quitting their jobs has been falling steadily for several years, indicating that they believe they'll have difficulty finding another job. Likewise, real average hourly earnings growth has been falling, meaning workers have lost some bargaining power on wages.

Recent jobs gains have been heavily concentrated in the "private education and health services" and "leisure and hospitality" sectors. In fact, if it weren't for those two sectors, we would have posted a net loss in total jobs over the past year. While there are many good jobs in these sectors, they are also relatively low-productivity, which could be a potential issue for economic growth going forward.

High Stock Valuations

Stock valuations remain very stretched by nearly all measures. The chart below shows the Shiller CAPE Ratio- one of the most popular measures of market valuation. This metric compares the S&P 500's price to the 10-year moving average of inflation-adjusted earnings. This ratio smooths out some of the short-term noise by looking at earnings over a longer period.



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SPECIAL POINTS OF INTEREST

- If you would like to schedule a meeting for planning or portfolio questions, don't hesitate to contact us!
- Q1 Market & Office Closures:
 - MLK Day- Mon., Jan. 19th, 2026
 - Presidents Day - Mon., Feb. 16th, 2026



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As you can see, the ratio is currently higher than it was at the end of 2021, and it is just 6.6% below the all-time high in 2000. Other valuation measures paint a similar picture. While valuation cannot be used as a timing mechanism, it does suggest that forward returns may be lower.

Weakening Dollar

The dollar index fell by some 9.6% in 2025. This was a headwind for US stocks relative to their foreign peers, with foreign stocks nearly doubling the performance of U.S. stocks. For American investors, foreign stocks offered the dual benefits of share price appreciation and favorable currency translation due to the falling dollar. While we don't expect another deeply negative year for the dollar, many of the pressures on the dollar remain, which could be a headwind for U.S. stocks on a relative basis. In addition to the weakening dollar, foreign stocks remain much more reasonably valued than their American peers.

Tailwinds

Easing Financial Conditions

Financial conditions eased substantially in 2025 due to stock market gains, the falling dollar, and falling short-term interest rates. These factors should set the economy up to be able to run hotter in 2026 than 2025. Furthermore, large stock market corrections are typically associated with tightening financial conditions, making this factor a tailwind for the markets too. However, there are tradeoffs- lower short-term interest rates have removed some of the downward pressure on inflation, and the lower dollar could result in higher-priced imported goods for American consumers. Nevertheless, barring a resurgence in inflation, these factors should be a tailwind for the markets and economy.

Continued AI Buildout Spending & Productivity Gains

Most estimates attribute 30% - 60% of US GDP growth in 2025 to the ongoing AI buildout. JP Morgan's research indicates that large technology companies spent approximately \$342 billion on data center construction in 2025, and we don't see signs of this stopping any time soon. There are currently more data centers under construction than there are existing data centers. It's truly difficult to overstate the impact that the AI buildout has had on the economy over the past few years, and it should continue to be a tailwind in 2026.

Increasing adoption of AI should result in higher productivity for workers and businesses. Productivity booms are incredibly beneficial to the economy because they allow the economy to grow without increasing inflation. A clearly defined surge in productivity could therefore provide the Fed cover to continue to lower interest rates, further easing financial conditions. That being said, productivity growth has been fairly anemic thus far in the AI era.

Index	Q4 Total Return	YTD Total Return	1 Year Total Return
S&P 500	2.3%	17.9%	17.9%
DJIA	3.9%	14.9%	14.9%
Nasdaq Comp	2.3%	21.1%	21.1%
MSCI EAFE	3.8%	32.1%	32.1%
Russell 2000	1.9%	12.8%	12.8%
US Aggregate Bond	0.7%	7.2%	7.2%

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Deficit Spending

Federal deficit spending has continued virtually unabated. The Congressional Budget Office estimates the 2025 budget deficit was nearly 6% of GDP- a level historically only seen during deep recessions and World War II. While this presents many issues on a long-term basis, in the short run, it is very supportive of the economy and, therefore, the stock market. We see no end in sight to the current low-tax, high-spending regime.

What Could Go Right

As humans, we spend considerable time thinking about what could go wrong. But as investors, it pays to be optimistic. So, let's look at a few things that could go right over the next year.

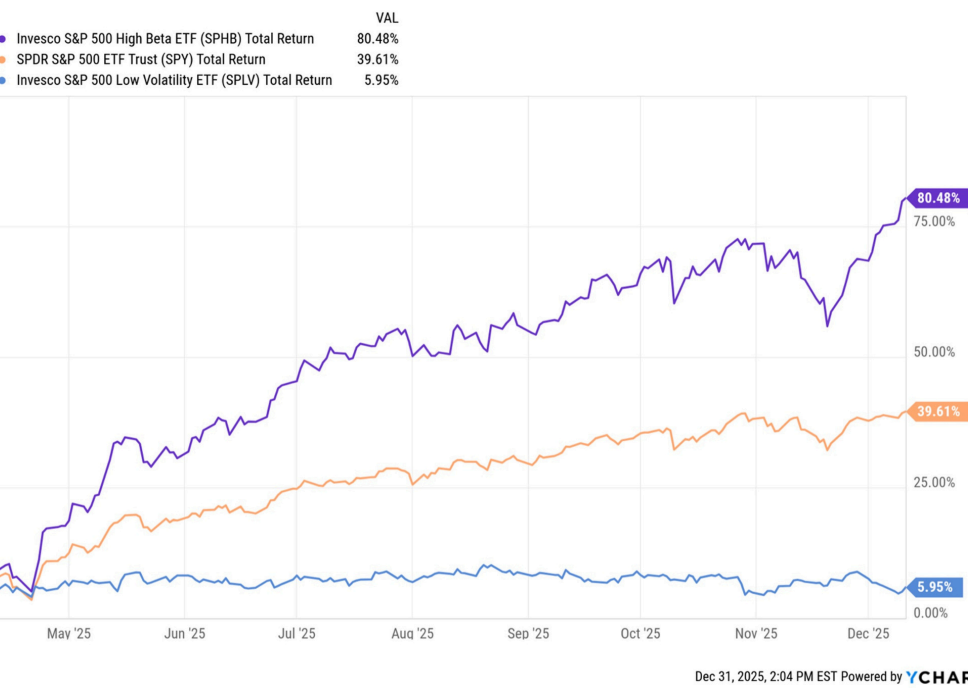
The Housing Market Could Unlock

Interest rates are very normal on a historical basis, but they are substantially higher than they were in the COVID era and affordability continues to worsen- essentially locking up the residential real estate market. Homeowners don't want to move and lose their low interest rate and first-time homebuyers feel locked out of the market due to unaffordability. We have already seen an easing in rents on a national level, so it stands to reason we could see some progress in residential real estate broadly.

If interest rates continue to fall without a resurgence in inflation, it's possible that the housing market could start to thaw. Homebuilders have shown that they are willing to provide incentives to buyers to help with rates as well, and there is ample new home inventory. This would be a welcome change after three years of a worsening market.

Stock Participation Could Broaden

The tenor of the market changed dramatically following the post-Liberation Day low. A much more balanced market gave way to one that was dominated by the most volatile stocks in the market. As you can see in the chart below, the returns of the most volatile stocks in the S&P 500 (High Beta) were nearly double the index from April 8th to the high on December 11th. Meanwhile, the total return on low volatility stocks (which had been leading the way in 2025 prior to the April lows) was nearly 34 percentage points below the index. Furthermore, only three sectors



(Technology, Communications Services, and Industrials) outperformed the market in 2025, with the remaining eight sectors all underperforming, often by substantial margins. Broader participation would be a welcome shift.

How We're Positioned

We ended 2025 with low levels of cash and a normal allocation to bonds. We focused on increasing our exposure to international stocks in 2025, and barring a change in the market, we plan to continue to do so (while managing the level of realized capital gains). As we mentioned, valuations are much more attractive abroad, and there are several factors applying downward pressure on the dollar.



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We were very pleased with the performance of the bond side of client portfolios in 2025, but there were several factors that worked against us on the stock side post-liberation day. All else equal, we try to select stocks that are higher-quality, lower-volatility, and higher-dividend-paying in our custom portfolios. We know these factors offer long-term benefits, but they were simply out of favor in the back half of the year. High volatility stocks won't outperform forever, but until then, we are using our increased exposure to foreign equities to gain access to stocks with similar momentum at lower levels of volatility and valuation.

Updates & Things to Keep in Mind for 2026

Retirement Contribution Limits Increased:

- 401(K)
 - The salary deduction limit has increased by \$1,000 to \$24,500
 - The catch-up contribution is going up to \$8,000 (age 50-59 and 64+)
 - The super catch-up contribution (ages 60-63) is \$11,250
 - Catch-up contributions may need to be Roth contributions if your income is over \$150,000
- IRA/Roth IRA
 - The contribution limit has increased to \$7,500.
 - The catch-up contribution increased to \$1,100 (age 50+)

Standard Deduction Increase & Extra Deduction for Seniors

The standard deduction is increasing to \$16,100 for single filers and \$32,200 for couples who are married filing jointly (MFJ). Don't forget that for anyone 65+, there will be an additional \$6,000 deduction (\$12,000 for couples) through 2028.

Charitable Giving Deduction

Starting in 2026, you deduct up to \$1000 in charitable contributions even if you don't itemize. MFJ couples can deduct up to \$2000. This is a significant change in the One Big Beautiful Bill Act, which will hopefully have a positive impact on charities.

SALT Deduction Cap Increase

Taxpayers who itemize can deduct certain state and local taxes (SALT). The amount that can be deducted has been capped at \$10,000 for several years, but in 2026, that amount increases to \$40,000. This will increase by 1% per year through 2029 and will revert to \$10,000 in 2030. The SALT deduction is phased out by 30 cents for every dollar over \$500,000 in Modified Adjusted Gross Income.

Annual Gift Tax Exclusion

The annual exclusion remains unchanged at \$19,000. This means you can gift \$19,000 to as many people as you'd like without filing Form 709 for the IRS. Couples can give a combined amount of \$38,000 to as many people as they'd like if they consent to gift splitting.

First Required Minimum Distribution

If you turn 73 this year, you now must take annual distributions from your IRA, 401(k), etc. The amount depends on the account balance as of 12/31/25. Generally, we recommend withholding federal and state income tax from Required Minimum Distributions (RMDs).

Trump Accounts Arrive in July

Trump accounts were announced in July 2025 in the OBBBA but won't be available until July 5th, 2026. There is a one-time \$1,000 federal contribution available to children born in 2025-2028. Form 4547 will be used to open Trump accounts and request the \$1,000 contribution. Information will be available here as it becomes available: <https://www.trumpaccounts.gov/>

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