2026 – The Year of the "Definitely, Maybe"

"It's not about being right, it's about getting it right."

– Joe Dumars (Detroit Pistons player and executive along with '03 NBA Executive of the Year)

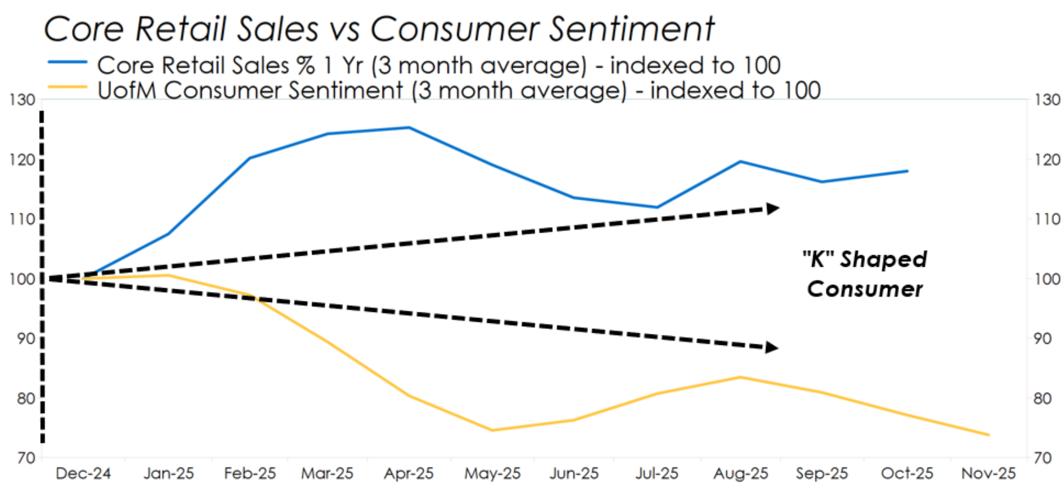
As we roll into the start of a new year, we're tasked with that "magic 8-ball" exercise of things to come and are reminded of Yogi Berra's sage advice that it's "very difficult to make predictions, especially about the future". Taking that to heart, we often approach forecasting with a healthy dose of intellectual humility. As a result, we're more inclined to opine on a broader schematic than pretend to forecast a date and market level with any kind of accuracy – something that's not particularly good for one's health. <u>This time around, we've been struck by the number of dichotomies that make it rather dangerous to form a generalized view of the</u>

	Generalized View	Nuanced View	
Consumer	*"The consumer remains resilient."*	*High-income consumers maintain strong spending power from the wealth effect*	*Low and middle-income households struggle from affordability pressure*
Labor	*"It's a no-hire, no-fire labor market."*	*Structural tightening results from aging demographics and immigration policy*	*Structural loosening results from AI productivity initiatives*
Profits	*"Profits are solid."*	*Earnings growth is improving for the small and mid-caps*	*Earnings growth is leveling off in the larger cap companies*
Fed	*"The Fed is getting more accommodative."*	*Lowering interest rates loosens policy to improve affordability as inflation cools*	*A new Fed chair is often tested by the market resulting in a tightening of financial conditions.*
Policy	*"Fiscal stimulus will be a tailwind."*	*Midterm election years often coincide with accelerating economic growth resulting from policies of the incoming Administration*	*Midterm election years tend to usher in above average intra-year volality as markets "buy the rumor and sell the news"*
Markets	*"The AI story is early innings."*	*AI promises to be a transformative application*	*Leading edge AI stocks might be pricing in a lot of the good news*

world. We're calling this concept, the year of the "Definitely, Maybe" as a way to remind ourselves that prudent investing more often requires thinking about things on the basis of a color continuum as opposed to either black or white.

Bringing this concept to life, we've laid out views across several categories in the table on the prior page. The generalized view is seen as the consensus, more or less. Most of these statements are uncontroversial but are also, perhaps, overly simplified – which doesn't allow room to acknowledge the dichotomies that exist under the surface. We think the more nuanced vantage point provides a better window into the competing thoughts that investors are grappling with heading into 2026.

The first category involving the US Consumer is a good example. In general, personal consumption remains solid (with growth accelerating in the last two quarterly GDP reports) and the unemployment rate low (8th decile), indicating that the consumer remains resilient. A look at the chart below confirms that core retail sales growth has been improving over the last year, however, consumer sentiment has clearly been headed in the opposite direction. This "K" shaped pattern suggests a more nuanced view might be appropriate. While limited layoffs have helped the consumer's position broadly, the high-income consumer has been better supported by the wealth effect from higher financial markets. Meanwhile, it's been the low to middle-income consumer that's felt the affordability pressures from the step up in inflation levels, while experiencing more muted home price appreciation for the better part of the past two years. This has led to a much more depressed consumer sentiment trend and implies that the bifurcated US consumer might be more fragile should labor markets weaken. The good news is that last year's budget bill is expected to provide significant support to discretionary income in the form of a very healthy tax refund season so it's not clear which way this breaks.

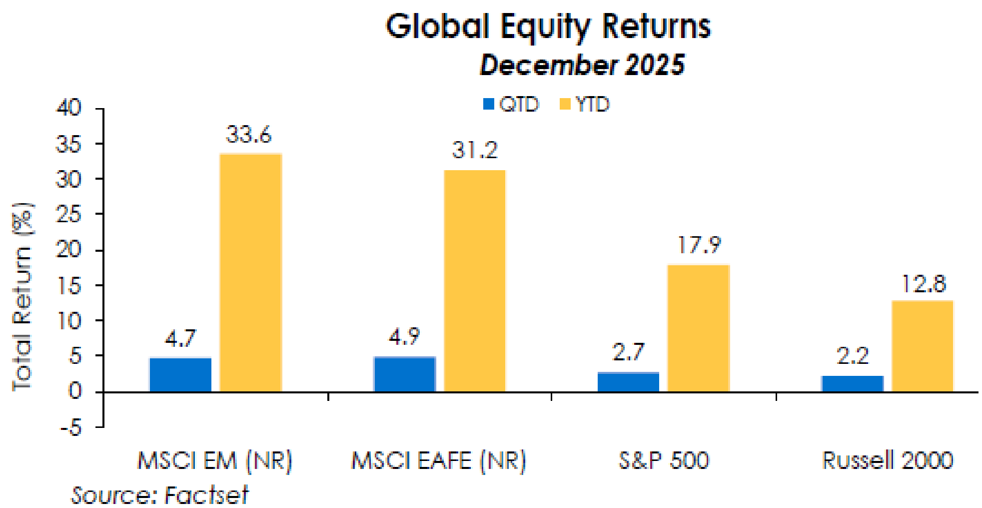


Source: Factset; Core Retail Sales defined as Retail Sales less auto, gas, building materials. Consumer Sentiment defined as University of Michigan Consumer Sentiment Index.

The point to all of this is to be aware of these dichotomies and, as investors, keep flexibility of thought at a premium when tactically positioning portfolios.

International markets outperformed in December as the dollar continued its decline while US markets were flat and Commodities and REITs saw negative returns. Full year returns were generally quite strong with Stocks and Commodities up the most followed by solid returns for Bonds – and REITs – which were up more modestly.

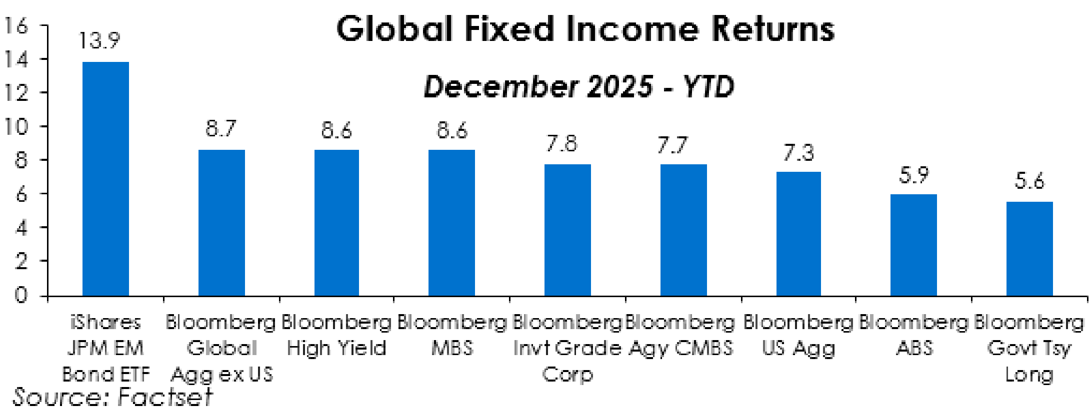
Stocks



Foreign stocks posted leading returns for the quarter and full year. Domestic stocks lagged though still delivered solid returns as well. Not withstanding more muted returns into year end, US Large Caps (S&P 500) performed well for the year – on the back of strong corporate earnings and AI optimism. US Small Caps (Russell 2000) lagged their larger cap brethren amid higher overall rates and elevated inflation lessening their earnings upside. International markets (MSCI EM and EAFE) delivered market leading returns for the year due to fiscal stimulus, central bank rate cuts, and a weaker dollar. From a sector perspective, 2025 outperformance was driven by AI influenced areas including Communication Services, Information Technology, and Industrials – though all sectors delivered positive returns for the year.

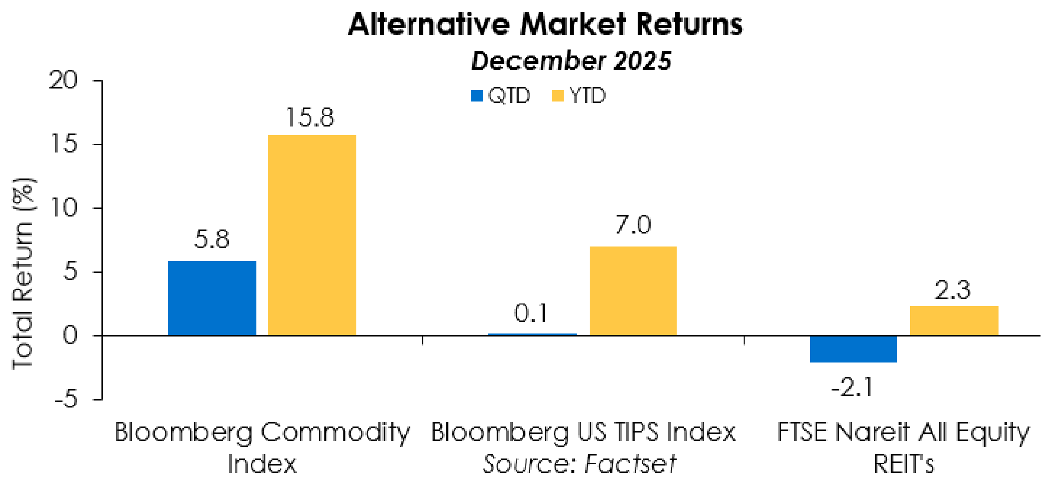
Bonds

After pivoting to an easing bias in the back half of 2024 and then leaving rates unchanged for the first half of 2025, policymakers resumed their easing stance with 25 basis point interest rate cuts at their September, October, and December meetings – moving the Fed Funds down to a range of 3.5%-3.75%. The Fed's "dot plot" implies one additional cut (25 bps) by the end of next year while the Rates market expects two additional cuts. Bonds performed well for the year with returns generally up high single digits – helped by lower rates and tighter (High Yield) credit spreads. Emerging Market Debt (iShares JPM EM Bond ETF) was the standout for the year due to dollar weakness and fiscal stimulus while Long Dated Treasuries (Bloomberg Gov't Tsy Long) lagged.



Alternatives

Commodities delivered strong full year returns, helped by stellar performance in Precious Metals along with strong performance in Industrial Metals. Meanwhile, publicly traded Real Estate (REITs) lagged in the quarter and year as the outlook for additional rate cuts diminished into year end. Finally, year-to-date returns on Treasury Inflation-Protected Securities (TIPS) performed slightly better than nominal Treasuries as inflation expectations rose in Q1 though have moderated and moved sideways since.



Market Outlook

"There are two kinds of people in this world: those who believe there are two kinds of people in this world and those who are smart enough to know better."

– Tom Robbins (1980)

As noted in the opening, we think the tactical view for 2026 will require the awareness of more nuanced views and the avoidance of oversimplication. This will likely demand flexibility of thought that results in "strong convictions, loosely held". Below is a republication of these views so that additional points can be made.

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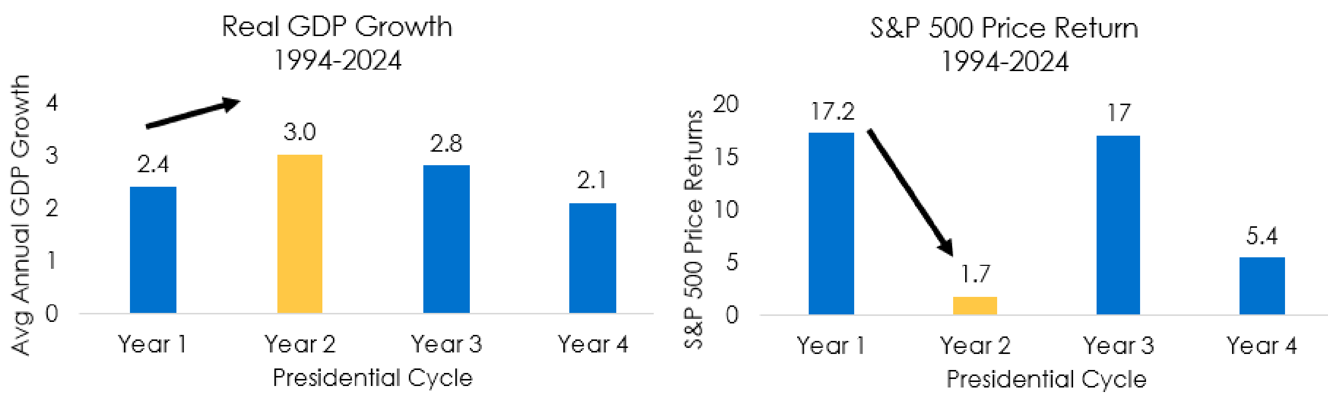
<u>While the "K-shaped" consumer is a good example of the dichotomies present in today's backdrop, another notable instance relates to the fiscal policy setup and how markets tend to respond in a more nuanced or counterintutitive way.</u>

The four year Presidential cycle has become a two year cycle of legislative policy and a two year cycle of executive policy. That is, the incoming Administration vigorously establishes its legislative agenda in the first couple of years recognizing that midterm elections often lead to a loss of legislative power. In practical terms, this has generally led to a backdrop where the second year of a presidency results in an acceleration in GDP growth from policies established – while the going is good – and in the hopes of trying to hang on to leadership in the midterms. <u>While fiscal stimulus and accelerating economic growth might be expected to yield the strongest market returns of the Presidential cycle, the opposite has tended to occur over the last thirty years.</u> Please see the charts below. Perhaps this reflects the market's anticipatory nature in looking ahead as opposed to assessing the here and now. As a result, a "buy the rumor, sell the news" dynamic seems to be what plays out. Recognizing this somewhat contradictory confluence requires the avoidance of making generalizations and understanding that a more nuanced view is needed. <u>Consequently, midterm election years have been associated with above average intra-year volatility which increases the importance of having both offense and defense in portfolios.</u>

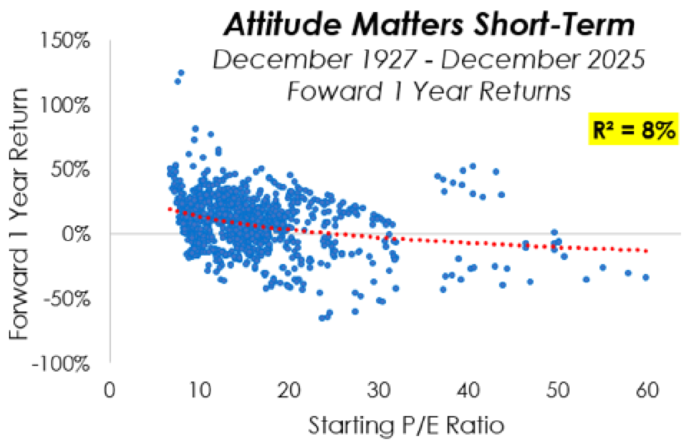


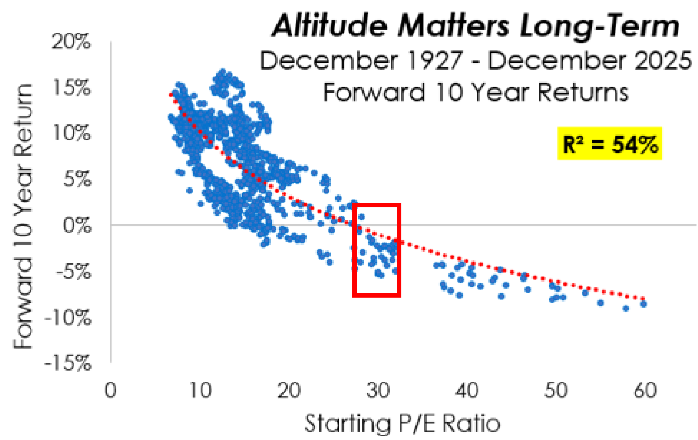
Source: Strategas Research Partners

<u>While the tactical frame means having a more flexible view of where opportunities and risks might be, the strategic frame requires the discipline to "keep the main thing the main thing".</u> As much as we opine on the factors that influence the shorter term setup, the fact remains that starting valuations tend to be the most influential factor on long-term returns. In short, what you see is what you get. In the past, we've described this as, "Attitude matters in the short run, but Altitude matters in the long run."

Please see the charts on the next page for context. In the short run (chart on the left), S&P 500 returns measured over a one year period have very little to no relationship with the starting price to earnings valuation multiple.

Investor opinion – driven by a number of factors – can shape popularity for markets and drive short term results that can be both expected and unexpected. However, the chart on the right shows that the S&P 500 returns measured over a much longer ten-year period does indeed have a much more important relationship with the starting price to earnings valuation multiple. We think remembering this concept is an important step to maintaining discipline as a long-term investor.





Source: PE ratios were calculated monthly based on the value of the S&P 500 and trailing 12-month S&P 500 Normalized Earnings. Normalized Earnings were calculated by determining the constant long-term growth rate that best fit actual S&P 500 earnings. This process is meant to smooth out short term fluctuations in earnings caused by the business cycle. Forward returns are price appreciation only and do not include dividends. Historical S&P 500 data was gathered from Robert Schiller's website (http://www.econ.yale.edu/~shiller/) and Factset.

So what are the implications and key takeaways for portfolios?

- We think 2026 will require more of a chess than checkers mentality in understanding that nuanced views might mean multiple paths to an outcome. This means that shorter term decisions demand some degree of flexibity given the "K-shaped" dichotomies that exist.
- Having a balanced portfolio with some defense and offense may be helpful with diversification representing a compelling "twofer" (two for one) opportunity – risk reduction and upside optionality.
- Investors' long-term discipline will continue to be tested and will likely require going against the grain (looking different than the benchmark).
- As the pendulum swings to one side, limiting exposure where the risk/reward is less favorable (and concentration risk is high) should be top of mind and lends itself to diversification.

Please see the summary table on the next page.

From a portfolio positioning perspective, we continue to emphasize the importance of diversification and balance. Our macro overweights and underweights have been relatively modest as we've opportunistically rebalanced portfolios in order to maintain that degree of balance. Where portfolio's do look different is in the degree of diversification one level lower. As a result, we've remained UW the most expensive and

"Chess is like looking across the ocean. Checkers is like looking down a well."
- Dr. Marion F. Tinsley

2026 KEY TAKEAWAYS	
Be flexible with regards to views **in the short run**	"K shaped" nature of backdrop requires loosely held convictions
Diversification with a **mix of offense and defense** remains a compelling opportunity	"Twofer" benefit of risk reduction and upside optionality
Stay disciplined and keep the "main thing the main thing **in the long run**	Don't let short run dynamics dictate long run decisions
Limit exposure to speculative areas and lean into diversification	Returns are highest where capital is scarce and lowest where capital is abundant

concentrated areas where we've viewed the long-term risk reward less favorably. US Large Caps are a good example given that today's concentration in the largest companies has now made the S&P 500 quite top heavy with the top 10 holdings representing about twice the exposure it averaged during the period from 1990-2010. For investors willing to stay diversified, this mean-reversion potential offers upside which is likely to come when investors have deemed that the pendulum has swung too far. The timing of such an episode is a notoriously difficult question to answer with any kind of certainty. But perhaps investors should take comfort knowing that they generally don't need to. That's because staying diversified still allows one to participate in the solid absolute returns that help one achieve plan success. And at the same time, not overly exposing one to the extreme risks that may ultimately come in the form of exceedingly depressed returns when the bill comes due. In our opinion, that's what prudent investing is all about.

Within equities, our positioning incorporates balance geographically and within our US Large Cap exposure especially (away from the top of the market). Our bias has generally been to have more exposure to less expensive areas (down market cap). As such, we've maintained a larger OW in Cyclical Value and Defensive sectors combined with a smaller sized cap bias. We remain UW the most concentrated and expensive Cyclical Growth areas and think that if AI is as transformative as advertised its benefits will need to accrue to more than just the select few.

Within fixed income, we remain biased toward the higher quality US Core Fixed Income segment – where we're slightly longer in duration for diversification purposes. We've maintained an EW to International Fixed Income, where the end of negative interest rate conditions has led to more attractive opportunities. Maintaining a higher quality bias means that we still remain UW the most expensive part of the bond market (High Yield) where extremely tight spreads have made this unattractive in our view.

Within alternatives, we remain fairly balanced across the board with neutral positions in Diversified Alternatives, Real Estate and Commodities. Last year, we adjusted our mix of Diversified Alternative managers in order to provide greater insurance against market volatility by emphasizing income and short exposure – areas that can benefit from choppy market conditions, thus, enhancing diversification.

Thanks for giving this a read.