The fourth quarter of 2025 capped off a third consecutive year of double-digit gains for U.S. equities. While the year experienced several bumps along the way—most notably a brief bear market in April—markets ultimately looked past geopolitical worst-case scenarios surrounding tariffs and quickly bid up financial assets. By year-end, investors enjoyed another strong year of returns, with the S&P 500 gaining 17+% and the Bloomberg Barclays Aggregate Bond Index returning 7+%.

One of the primary drivers of this ongoing bull market has been loose financial conditions, highlighted by the Federal Reserve's rate-cutting campaign that began in late 2024. More recently, the Fed has pivoted toward suspending quantitative tightening, opening the door to the potential for renewed quantitative easing. Additionally, a new Fed Chair is expected to be announced, who is widely anticipated to favor loose monetary policy and lower rates. This presumed dovish bias has historically added fuel to bull markets. Another potential tailwind is the 2025 tax cuts, expected to take effect in spring 2026, which could act as stimulus for U.S. consumers.

2025 also saw Nvidia surpass a $5 trillion market capitalization, making it larger than most developed economies on a GDP basis. While impressive, this highlights a key risk looking forward: the enormous capital expenditures hyperscalers have made in AI may ultimately disappoint in terms of return on investment. A worrying thought given the extreme concentration within the equity market, as AI-related stocks now make up a substantial portion of total market capitalization (the "Magnificent Seven," excluding Apple, account for over 27% of the S&P 500).

The labor market has remained sluggish and is one of the largest risks to economic stability. While the current unemployment rate of 4.4% remains historically healthy, the trend has been steadily worsening. The job market is characterized by a "low hire, low fire" environment, with many companies citing efficiency gains from AI adoption. More concerning is the elevated unemployment rate among recent college graduates, with individuals aged 22–27 experiencing a 5.8% unemployment rate—levels not seen in over a decade barring the COVID period. Elevated unemployment among entry-level workers could pose longer-term challenges, as AI has already replaced some tasks traditionally performed by younger employees.

Third-quarter real GDP growth came in well above expectations at 4.3%, driven primarily by strong consumer spending. Rising asset values over recent years have contributed to a wealth effect that has disproportionately benefited higher-income households and supported elevated spending. On the other hand, cost-of-living increases continue to pressure lower-income consumers, reinforcing what is being called a "K-shaped" economy. Inflation remains stubbornly elevated but appears to be slowly trending toward the Federal Reserve's 2% target. So far, tariffs have largely been absorbed by companies rather than consumers. Looking ahead, monitoring employment trends will be critical, as AI/technological advancements may continue to reshape labor markets and broader economic dynamics.

While the AI theme dominated markets throughout 2025, there were encouraging developments beneath the surface. Small-cap stocks, healthcare, and energy all delivered strong returns, suggesting the long-awaited broadening of this bull market may be underway. This is a welcome development as breadth widening is a key characteristic of sustainable bull runs. Equity valuations remain historically elevated, with the S&P 500 trading at a forward P/E above 22x. That said, analysts are projecting approximately 15% earnings growth for the S&P 500 in 2026, which helps support current levels.

The Magnificent Seven stocks have recently begun to show signs of weakening relative to the broader S&P 500. While this may prove to be short-term in nature, history serves as an important reminder that today's winners are not always tomorrow's leaders. In 2000, at the peak of the dot-com bubble, the four largest technology companies were Microsoft, Cisco, Intel, and Nokia, yet only Microsoft went on to outperform the broader market over the following decades. Our continued focus on appropriate diversification and active management should position us well as leadership inevitably evolves.

Fixed income also delivered strong performance in 2025 across maturities, credit qualities, and global markets. The rate-cutting cycle has resulted in significant yield-curve steepening, with short-term Treasury yields declining alongside the federal funds rate, while longer-term yields remain elevated due to deficit and inflation concerns. Credit spreads remain exceptionally tight, and despite relatively high base yields, forward-looking fixed income returns appear average. We will continue to remain patient, while ready to act accordingly during future risk-off periods that may offer more attractive yield in credit markets.

We hope you had a wonderful holiday season and look forward to meeting again in the New Year! As always, please do not hesitate to contact us if you have any questions or concerns, or to schedule a portfolio review.

Prepared by Flagship Capital Management, Inc.
400 W State Street | Suite 3 | Media, PA 19063
T 610.565.9580 | flagshipcap.com