WESTEND Advisors
A VICTORY CAPITAL® INVESTMENT FRANCHISE

Economic and Market Commentary

Q4 2025

Macro Drives Markets. WestEnd Knows Macro.

Cycle Mature, But Not Over the Hill

Following a third consecutive year of strong equity returns in a mature economic cycle, we see both opportunity and risks ahead. We are cautiously optimistic for 2026 and believe a select mix of portfolio allocations balancing economically sensitive and defensive exposures is warranted.

SUMMARY

- Economic growth slowed in 2025 amid significant policy and economic uncertainty, but markets provided strong returns globally, led by renewed AI and tech-related outperformance.
- We see inflation leveling off, easing monetary policy, and potential for a temporary economic reacceleration in 2026, but a soft labor market and lingering policy uncertainty present fundamental risks.
- Robust earnings growth expectations should support positive-if-below-consensus equity returns, but market risks include lofty valuations and historic concentration in tech-related mega-caps.
- We believe an active balance of economically sensitive and defensive exposures provides the opportunity for outperformance in 2026 through capturing upside and risk management.

Q4 AND 2025 REVIEW

As noted in our recent 2025 Year-in-Review Commentary, the first half of 2025 was marked by a surge of economic uncertainty and market volatility, particularly tied to U.S. trade and tariff policy. Market leadership also temporarily broadened out in Q1 as the concentrated market leadership of AI and tech-related mega-cap companies that had characterized the past few years faltered in Q1, partly due to concerns over cheaper AI technology from China. International stocks generally outperformed the U.S. early in the year, particularly in U.S. dollar terms as the dollar fell versus major currencies.

By mid-year, economic uncertainty had eased somewhat, and U.S. stocks had recovered from April's post-"Liberation Day" rout, with the S&P 500 reaching new highs, largely led, once again, by mid-phase sector mega-cap stocks. Passage of the One Big Beautiful Bill Act (OBBBA) at the start of Q3 renewed hope for positive policy tailwinds, particularly from extension of various tax cuts and corporate tax provisions. However, evidence of stagnation in the labor market also became more widely recognized, rejuvenating anticipation that the Fed would resume rate cuts, which it did at the September FOMC meeting, helping equities push to further new highs.

Strong Markets Amid Uncertainty
Despite lingering uncertainly, particularly over tariff policy and the labor market, U.S. stocks provided a third year of double-digit returns, and international outperformed.

Most recently, Q4 started with a six-week Federal government shutdown, the longest on record, which disrupted most Federal economic data releases. However, various private and state data releases we regularly follow provided ongoing insights into economic trends. Despite the much-delayed Q3 GDP release showing faster than expected growth in the quarter, full-year economic growth is still on track to slow in 2025 versus 2024. The Fed cut rates two more times in Q4, as concerns over soft labor market data apparently outweighed inflation risks. This helped to further steepen the Treasury yield curve, as longer-dated Treasury yields held fairly steady and shorter-term bond yields edged down. U.S. stocks continued their march to new highs in Q4, though volatility ticked up from Q3. The S&P 500 returned 17.9% for 2025, while broad U.S. bond indices posted returns in the 7% range, their best in five years.

Internationally, economic growth in most developed regions remained below the U.S., but we saw signs of reacceleration in both Japan and Europe, despite lingering trade policy headwinds. International equities outperformed the U.S. in 2025 as monetary easing and relative economic acceleration abroad buoyed confidence and as a declining dollar boosted international returns for U.S.-based investors.

Throughout 2025, we balanced economically sensitive and defensive exposures across our strategies to align with our macroeconomic outlook for slower growth. We also refined exposures as conditions evolved to take advantage of shifting opportunities. We are pleased with how our portfolios were able to capture market upside while managing risk amid shifting areas of uncertainty in 2025.

OUTLOOK

Overview. We see reasons for cautious optimism in 2026, as well as areas of concern. The global economic cycle remains in a mature phase, in our view, though various factors in the U.S. should help

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extend—and could temporarily accelerate—economic growth going into 2026. The international economic outlook remains mixed. We believe global economic trends still favor U.S. economic and market outperformance, though we also see attractive opportunity in Asia. Europe and other regions remain less vibrant, in our view.

Broadening Opportunity
While we see concentrated risk in tech-related mega-caps, we also see opportunity from a potential broadening out of market leadership.

From a market perspective, historic levels of sector and stock concentration present a significant potential risk, following several years of narrow tech-related mega-cap outperformance. However, earnings expectations are positive across a range of sectors, and this broadening of growth could support continued positive market returns and shift market leadership to sectors where valuations are less stretched than in mid-phase tech-related sectors. However, history suggests a fourth consecutive year of high-teens or 20%+ returns is unlikely. Meanwhile, the relatively normalized Treasury yield curve could support healthy U.S. fixed income returns, particularly if inflationary pressures or economic growth ease in the back half of the year.

U.S.: The U.S. economic cycle is still maturing, in our view, but growth could temporarily reaccelerate in early 2026. While AI and tech-related investment was a key growth driver in 2025 and should remain positive in 2026, we believe various factors present additional near-term growth potential. We see healthy expected earnings growth across a range of sectors that could support positive equity returns, though lofty valuations are likely to moderate market upside.

The U.S. consumer, a bulwark of economic growth, retains healthy fundamentals. Aggregate income trends are fairly stable, albeit decelerating, with real (inflation-adjusted) personal income growth trending around 2% year-over-year, while household balance sheets have benefited from appreciating asset values. These and other factors have, in turn, supported continued consumer spending growth. However, in contrast to these fundamental trends, consumer sentiment as measured by the long-running University of Michigan survey is at historic lows.

Frontloaded Economic Growth
Various factors tied to fiscal and tax policy could give a boost to U.S. economic growth in the first half of 2026, but the positive impulse of these factors appear likely to fade as the year progresses.

We anticipate a potential boost in both consumer sentiment and economic activity this year as expansionary provisions of the OBBBA kick in. These include extension and retroactive expansion of personal income tax cuts, which should boost refund payments in 2026, as well as corporate benefits including permanent extension and temporary expansion of bonus depreciation on qualifying investment. The positive impulse from these policies, however, is likely to be concentrated in the first half of 2026 and fade in the back half of the year.

Coming into 2026, the labor market remains fairly stagnant, in what has been called a "no hire, no fire" state. The levels of both hiring and separations have trended down since early 2022, and converged in mid-2025, leaving net job growth essentially flat in the back half of last year. Wage growth is also slowing, with average hourly earnings down to just 3.5% year-over-year in November, the lowest reading since May of 2021.

Inflation remains above the Federal Reserve's 2% target, and we expect core inflation to level off around 2.5% in 2026, as some inflationary pressures from tariffs ease later in the year. Against this backdrop, we anticipate the Federal Reserve is likely to cut the Fed Funds rate two or three times in 2026, but we believe it is nearing a neutral rate and market expectations for more cuts could diminish.

Profit margins for corporate America have been holding up at historically elevated levels. We believe this can help mitigate the need for increased layoffs and also support capital investment. However, investment in AI and other productivity enhancing measures could keep a cap on hiring in 2026, as companies seek to preserve margins amid ongoing uncertainty. We have seen labor productivity pick up in recent quarters, and a continuation of that trend should help sustain earnings growth.

Earnings-Driven Gains
Expected growth in earnings for 2026 should support gains across a range of sectors, while lofty valuations may limit upside.

From a market perspective, we anticipate earnings will be a key driver of stock returns in 2026, while extended valuations are a potential headwind. Consensus estimates show an acceleration in earnings growth for most sectors and, therefore, the broad market in 2026. We believe this should support a broadening out of sector leadership in the U.S., which presents opportunity for investors to benefit from active sector allocation, even as broad market returns are likely to be lower than in recent years.

Examples where we see such opportunities include Financials and Health Care. Financials should benefit, in our view, from continued economic growth and improving credit growth. In this environment, the steepened yield curve and M&A trends should support earnings growth for the sector. For Health Care, we expect an easing of policy headwinds that weighed on the sector in 2025. We previously had concluded that, at their most punitive, various policy announcements could have reduced Health Care sector EPS by about 16%, but we expected the ultimate impact to be more limited in scope, which seemed to play out in Q4 as policy uncertainty eased. Additionally, we believe the Biotechnology industry within Health Care should benefit from a capital infusion tied to M&A as large pharma and biopharma companies seek to backfill product pipelines through acquisition ahead of various patent expirations coming in the back half of the decade.

AI and tech-related mega-cap stocks that have dominated equity market returns over the past three years should remain a key market influence in 2026. Their prior outperformance, supported by both

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strong fundamentals and valuation expansion, has driven historic market concentration in the mid-phase Information Technology and Communication Services sectors. Coming into 2026, we believe expectations for AI investment and monetization, which led to valuation expansion, may have peaked. New technologies present uncertainty and often see a period of euphoric optimism ("trees to the sky"), followed by information dissemination and rationalization. We believe the market is now better understanding the economics and adoption curve behind AI, and that a rationalization of expectations in 2026 could weigh on valuations for AI-related stocks. For example, in our view, accelerating free cash flow assumptions seem out of step with expectations for a simultaneous acceleration of capex for AI companies. Additionally, the monetization path for AI providers is highly sensitive to inputs, where a modest adjustment in demand or pricing for AI could have significant impacts on revenue, earnings, and free cash flow for these companies. In normal times, fundamentals that are sensitive to competition warrant low valuation multiples, not high multiples.

Risk to AI Assumptions
Expectations for AI demand and revenue growth that underlie tech valuations may reflect a best-case scenario that could be subject to rationalization, particularly if AI adoption is slower than expected or logistical hurdles slow AI investment.

That said, growth outlooks for AI are robust and strong near-term earnings growth could offset potential multiple compression. Thus, we retain a significant but selective exposure to these mid-phase sectors in U.S. equity allocations across portfolios, which we believe can help us continue to capture market upside if AI-driven outperformance persists.

For the U.S. economy and broader market, we see a notable alignment of analyst expectations, with a near-universal consensus that economic growth will continue (and possibly accelerate) in 2026, and a cluster of forecasts for U.S. stocks to provide low double-digit returns supported by earnings growth. While this consensus is not far from our own base case outlook (continued economic growth and healthy single-digit equity returns), the widespread and tightly bunched optimism seems to be pricing in uniformly positive dynamics. This gives us pause, as it seems to assume both limited downside to valuations and upside to fundamentals for most sectors, whereas we see more nuance and have reasons to believe that the most economically-sensitive sectors could face disruption from unpredictable policy shifts and ongoing mature-cycle dynamics, either of which could hinder those companies' ability to meet optimistic earnings targets. Given our mindfulness of the valuations of mid-phase sectors, which are being supported by high growth expectations, we are balancing our positioning across portfolios with active allocations to a mix of economically sensitive U.S. sectors, such as Financials, and defensive U.S. sectors like Health Care, where we see strong earnings potential with less valuation risk.

In global and balanced portfolios that allow for broader range of market capitalization, we have also shifted some of our U.S. exposure into an opportunistic small-cap allocation. We believe many of the headwinds facing small-caps are beginning to abate. The Federal Reserve is now over a year into its cutting cycle, with further rate cuts expected, and the loan growth backdrop has improved alongside easing credit conditions. Small-caps may also offer relative insulation if the more highly valued areas within the large-cap space are unable to meet elevated growth expectations. As a result, we see small-caps as an increasingly attractive-yet-underappreciated part of the U.S. market, which we believe has the potential to outperform in a continued, broader expansion.

International: We believe the global economic cycle remains in an advanced stage, with supportive monetary and fiscal policy offsetting slower labor demand, sluggish non-tech manufacturing, and lingering drag from tariffs. We saw some acceleration in economic growth across developed countries in late 2025, including in Japan, Europe, and the U.K., but this growth is expected to moderate in 2026, and a shift to above-trend global growth remains unlikely, in our view. Still, despite our expectation that the U.S. will outgrow its developed peers again in 2026, we see areas of opportunity abroad.

Inflation has moved closer to target in Europe and Japan, which could continue to bolster household consumption in 2026. Most major central banks are expected to ease monetary policy further in 2026 (though at a slower pace), with the notable exception of the Bank of Japan, which remains on an upward normalization path for its policy rate following nearly a decade of negative interest rates.

We expect fiscal policy to be neutral-to-modestly supportive in Europe, Japan, and China, driven by targeted defense and green infrastructure spending in the Eurozone and potential rollout of energy subsidies, cash handouts, and tax cuts in Japan. In EM Asia, high-tech manufacturing and rate cuts provide growth support, in our view, but decelerating credit growth in China is an area to watch.

U.S. tariffs remain a wildcard globally, but considerable progress has been made to ease uncertainty. China and other countries have also increased focus on developing non-U.S. markets and supply chains, which could further reduce risk related to U.S. trade policy.

Within our global portfolios, we remain underweight to international equities, overall, but we have select overweights of Developed and EM Asia. We believe the tech investment cycle should be a positive for EM Asia, and the region's valuations are at roughly a 35% discount to the U.S. In Japan, we see prospects for relatively attractive economic growth, with potential support for domestic consumption from policies such as energy subsidies, transfer payments, and tax cuts. We remain underweight to Europe, where we see continued headwinds from protectionist policies and political volatility.

Fixed Income: After the yield curve steepened materially in 2025, driven by declining short-term rates and stable long-end yields, we expect further steepening to be focused at the ultra-short end of the curve, driven by further interest rate cuts at the Federal Reserve. In contrast, the back-end of the yield curve has now completely normalized, in our view, with the 5-to-30-year spread now above long-run average and median levels.

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With our outlook for further rate cuts and some continued disinflation, we see value in longer-duration Treasury bonds. We believe the fair value for the 10-year Treasury yield is approximately 4.0%, based on our internal model estimate assuming long-run real GDP growth and inflation at 2.5% each. Thus, in balanced portfolios, we have focused our Treasury exposure in longer-dated securities.

Steep Curve, Narrow Spreads
With the recent steepening of the yield curve, we see value in longer-term Treasury securities, but risk to longer-term corporate bonds tied to compressed credit spreads.

Investment-grade credit spreads compressed significantly in the second half of 2025, with option-adjusted spreads across all 11 sectors now near post-Financial Crisis lows. As such, we see little benefit from owning longer-term credit, but we do see risk if spreads widen. Credit spreads at-or-below current levels have historically coincided with neutral to outright underperformance for corporate credit. Thus, in contrast to our long-term Treasury exposure, we are focusing our corporate credit exposure at the short end of the curve.

Real Assets: For multi-asset portfolios, real assets offer the potential for less correlated return streams and can lead to better risk-adjusted returns at the portfolio level. However, our research shows that a simple buy-and-hold approach to real assets is not additive to returns over the long term. We believe more tactical exposure based on macroeconomic analysis makes more sense.

Currently, we believe macroeconomic factors, including a weaker dollar, falling real interest rates, and elevated economic uncertainty, create a favorable environment for gold. That said, returns have outpaced our macro-driven gold model, which we attribute to ongoing demand from global central banks and, more recently, flows from ETF investors. While we remain constructive around macroeconomic factors with respect to gold, a surge in retail participation has historically marked the later stages of gold bull markets, which keeps us from adding more exposure at this time.

At this point in the cycle, our analysis suggests that more economically sensitive real asset exposures are not materially more attractive than traditional risk assets, such as equities. Thus, in multi-asset portfolios, we maintain moderate allocations to real assets, with a focus on gold and a small allocation to energy infrastructure

CONCLUSION

As we consider how 2025 played out and contemplate 2026, we see a range of opportunities and risks that highlight the importance of active management. Passive investment primarily relies on diversification for risk control, but the presumed diversification of major equity indices has been diminished by the buildup of severe market concentration in AI and tech-related mega-cap stocks. Simultaneously, areas that may offer some of the best earnings growth and attractive valuations in 2026 now represent unusually low weights in major indices and, thus, passive portfolios. We believe our active portfolios are positioned to seek opportunities across a range of exposures and mitigate risk from unintended market concentration. Further, as always, we maintain flexibility to adjust positioning as conditions and our outlook evolve.

WestEnd Advisors Investment Team | January 5, 2026