Confluence
INVESTMENT MANAGEMENT

The 2026 Outlook:

Implications of the New Techno-Industrial State

SUMMARY OF EXPECTATIONS

THE ECONOMY

ECONOMIC GROWTH

After its big slowdown in early 2025, we expect the US economy to reaccelerate in the coming quarters, leading to good growth in 2026. We expect the main sources of growth to be solid consumer spending, especially by higher-income households, and robust corporate investment, especially in infrastructure related to artificial intelligence (AI).

We expect these trends to be bolstered by stimulative fiscal and monetary policies, ongoing enthusiasm for the promises of AI, and less policy uncertainty.

RECESSION RISK

Importantly, we do not expect a recession in 2026, although "tail risks" (e.g., geopolitical events), could trigger an unexpected downturn. However, it should be noted that policymakers have demonstrated they can act aggressively to counteract downturns, which suggests that investors should not over-index to such events.

THE NEW TECHNO-INDUSTRIAL STATE

POLICY SHIFTS

We believe the economy is increasingly being dominated not just by the AI-investment boom, but by a broader policy shift in which government officials more enthusiastically wield influence over the economy, often using industrial policy to advance national security, resilience, or other goals beyond profit maximization.

NAVIGATING A NEW ERA

With the dawn of this ***new techno-industrial state***, investors need to pay closer attention to the goals and plans of powerful officials in order to understand the evolving investment environment.

MARKET OUTLOOK

Our asset class expectations call for more moderate performance returns than in 2025, but with balances tipped to the upside, especially for US and foreign stocks.

FIXED INCOME

SHORT-TERM

Against the backdrop of a more interventionist techno-industrial state, the Federal Reserve will be under strong pressure to cut its benchmark short-term interest rate more aggressively in 2026 than in 2025. This is especially the case given that the US administration will likely replace several key policymakers at the Fed with more dovish officials. That will likely give a boost to short-term bonds, while weighing on obligations with longer maturities, putting some upward pressure on long-term bond yields.

SUMMARY OF EXPECTATIONS (cont.)

FIXED INCOME

LONG-TERM

Nevertheless, we expect the government will redouble its efforts to cap long-term yields. Longer-term bonds are therefore expected to produce returns similar to their current yields, while the yield curve should steepen only modestly.

US EQUITIES

BASE CASE FORECAST

Incorporating our expectations for economic growth, financial conditions, and other factors, our quantitative models suggest that overall corporate profit margins should moderate in 2026 versus their record-high in 2025. We project that S&P 500 operating earnings will equal about 6.3% of gross domestic product, which would put S&P 500 operating earnings at $235.33 per share.

We assume the price/earnings ratio on that figure will expand from about 25.5 in late 2025 to 28.5 in 2026. As a result, we think the S&P 500 price index will end 2026 between 6,400 and 7,000, with a point estimate of 6,710, up about 2.1% from the levels as of this writing (a return of roughly 3.5% including dividends). However, our modeling suggests the P/E ratio could well expand more than we're assuming, creating significant upside risk to our cautious expectations.

CAPITALIZATION & GROWTH/VALUE

Based on the strong influence of index investing, we expect large cap stocks and growth stocks to continue performing well.

FOREIGN EQUITIES

WEAKENING DOLLAR

While our expectation for US stock performance is modest for 2026, we believe that the weakening US dollar and more stimulative fiscal and monetary policies abroad will bode well for foreign stocks.

FOREIGN VS. DOMESTIC

As such, we expect returns on foreign stocks will exceed those of US stocks. Among foreign equities, we continue to favor defense stocks.

COMMODITIES

GOLD

We expect global central banks to continue buying gold aggressively, creating continued tailwinds for the yellow metal. However, our modeling suggests gold prices are already stretched, especially if the Fed's interest rate cuts are backloaded until late 2026. Gold prices may not rise as fast in 2026 as they did in 2025.

OTHER COMMODITIES

Other major commodities, such as oil, may also struggle against high levels of supply. On the other hand, we think the continuing AI boom will buoy natural gas and uranium prices as those commodities are essential to generating much of the electricity needed for AI data centers.

Implications of the New Techno-Industrial State

The year 2025 will be remembered as a period defined by initial uncertainty that ultimately yielded to powerful resilience. The year opened with a turbulent first quarter, marked by panicked asset-selling in the face of an escalating global trade war. This anxiety proved to be short-lived. Sentiment decisively improved as new trade policies gained clarity and fresh deals were finalized. Asset prices recovered and were further catalyzed by the passage of pivotal tax legislation, which provided an additional boost to tech investment. Underpinning the entire year was that the surprising durability of consumer spending consistently reinforced the economy's underlying strength.

Even more fundamentally, the growing dominance of the technology sector, industrial policy, and activist government participation in the economy showed that the United States and other key economies have embarked on a new era of economic statecraft that we are calling the ***"new techno-industrial state."*** As we will discuss below, this new and still-evolving model of political-economy will create both opportunities and risks for investors.

THE ECONOMY

2025 RECAP

At the time of this writing in late 2025, the US economy remains firmly in an expansionary phase, with signals pointing toward a potential acceleration as the year draws to a close. The start of 2025 presented headwinds, and growth slowed sharply as negative net exports weighed on the overall figures. This initial weakness stemmed mostly from firms aggressively building inventory ahead of anticipated tariffs. The second quarter saw a complete reversal of this dynamic as imports fell and exports surged, with foreign companies attempting to pre-empt new tariffs. Comprehensive official data isn't yet available for the third quarter, but preliminary indicators are exceptionally strong.

Federal Reserve Bank of Atlanta GDP Now Estimate

Source: Federal Reserve Bank of Atlanta

GDP Growth. For instance, the Atlanta Fed's most recent GDPNow estimate suggests third quarter gross domestic product (GDP) grew at a seasonally adjusted, annualized rate of 4.2% (see first chart). This robust performance can be largely credited to the sustained strength of consumer spending and a notable rebound in technology investment.

Despite the volatility in headline GDP growth due to fluctuations in trade flows and inventory building, the underlying domestic economy has shown surprising consistency. This resilience is best captured by Final Sales to Domestic Purchasers, which is widely considered a measure of *core* GDP.

Core GDP Projected to Remain Steady

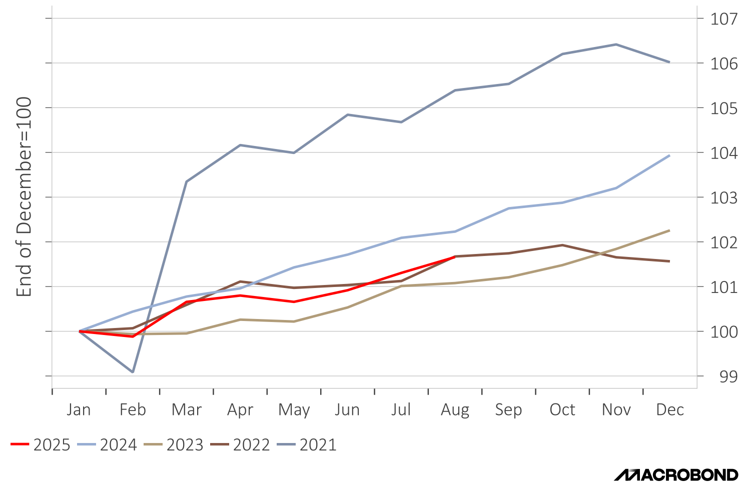
Source: BEA, Federal Reserve Bank of Atlanta, Confluence

As shown in this second chart, this indicator confirms that trade tensions did not meaningfully impact underlying economic activity in the first half of 2025. The first quarter did see a moderate slowdown in consumer spending, but that was partly offset by higher investment, mainly driven by technology companies building out their infrastructure. The second quarter saw a precise reversal of this trend: investment eased, while consumption spending picked up the slack. Expectations remain high for sustained strength in both consumption and investment spending for the third quarter, which is expected to show healthy growth.

Consumer Spending. Against the backdrop of economic uncertainty, the consumer has emerged as the year's unlikely hero. Despite inflationary pressures from tariffs and other factors, consumer demand has persisted, even if reluctantly. The spending surge manifested in two key areas: a sharp rise in vacation and leisure activities by wealthier households, and robust goods purchases driven by the "front-running" of staple goods and excitement for new AI technology. Supporting this trend is a dual dynamic where households were buoyed by both continued real wage gains and increased access to consumer credit. Consequently, while spending has cooled in 2025 from last year's pace, it continues to track the average pace of the last five years.

US Real Personal Consumption Expenditures

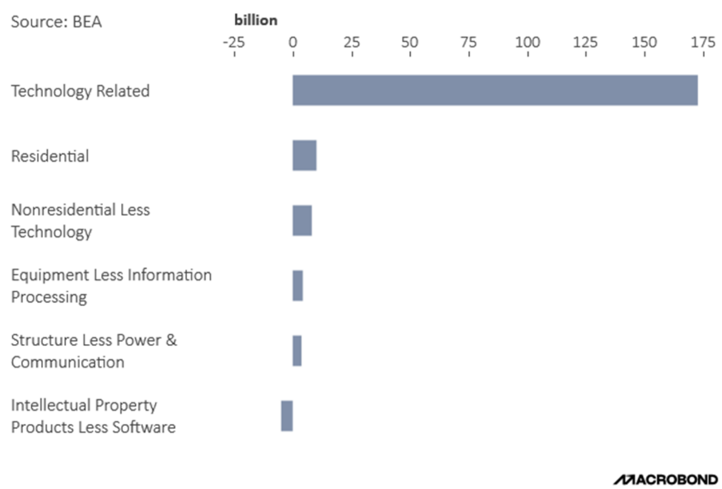
Source: BEA



Tech Spending. Although consumer spending remained an important contributor to growth in 2025, the main source of the economy's sustained strength was AI-related investment. This was the year's most significant shift as major technology companies sharply ramped up their capital expenditures, motivated partly by targeted tax incentives and accelerating geopolitical competition. During the first half of the year, tech-focused spending vastly outpaced investment across all other sectors, confirming AI's resilience amid recent trade tensions. Given the government's strong, ongoing support for the sector, this increased investment in AI is set to play a major and sustained role in the economy as the US works to cement its position as the global leader in technology.

Technology Leads H1 2025 Investment Spending Surge

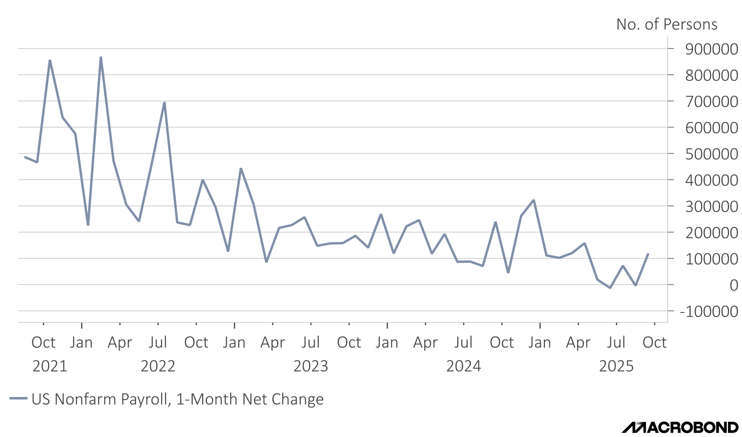
Source: BEA



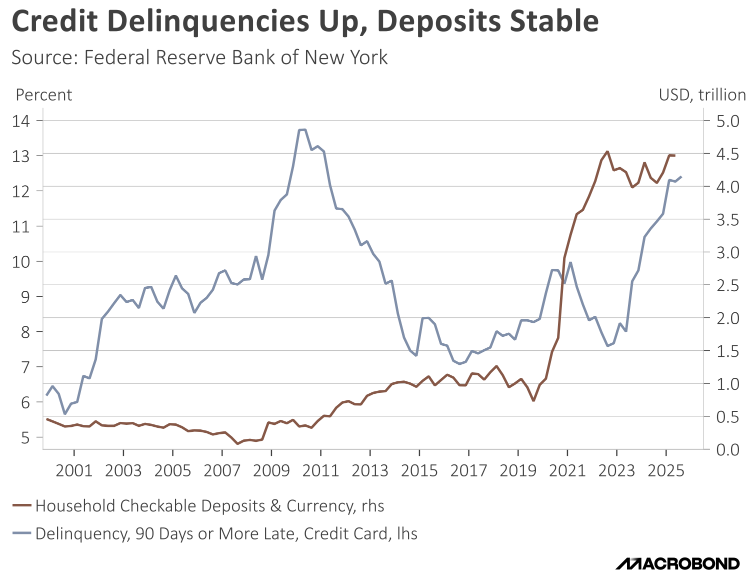
Labor Market. Despite exhibiting overall stability, the labor market does show some blemishes, driven by a deceleration in net hiring across multiple sectors. Job gains are increasingly narrow, concentrated largely in Education & Healthcare Services and Leisure & Hospitality. Conversely, cyclically sensitive segments – specifically Professional Business Services, Manufacturing, and Information & Technology – have registered falling payrolls. While firms are reluctant to hire new staff, it's important to note that they are also hesitant to release existing workers. Evidence for this is the slight climb in the unemployment rate from 4.0% to 4.4% in September. Even as the market cools, joblessness remains historically low.

Nonfarm Payrolls Reflects Weakening Labor Demand

Source: BLS



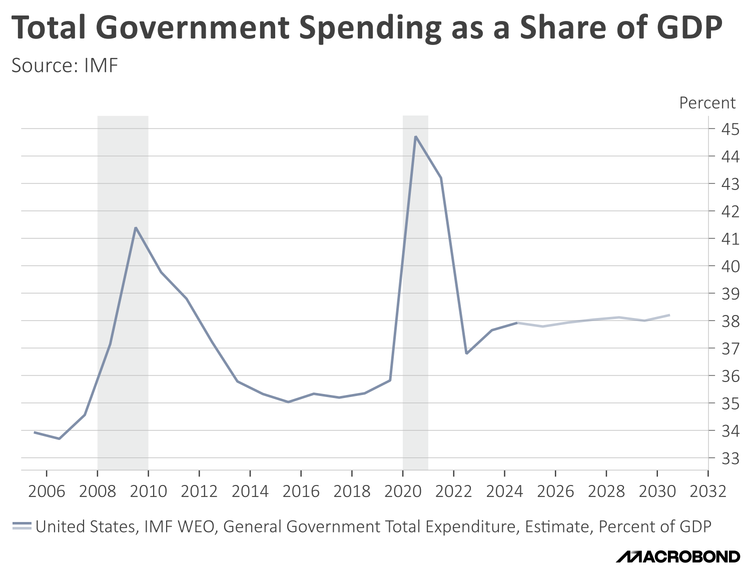
Credit Vulnerability & Resilience. The moderation in job growth has intensified consumer financial vulnerability, particularly among lower-income households increasingly reliant on debt. This distress is most evident in delinquency rates, which have climbed to their highest level since 2013, driven mostly by high-risk borrowers struggling to manage credit card and auto loan payments. Yet, this localized financial strain is offset by a critical counterbalance – aggregate household deposit levels remain substantially elevated relative to pre-pandemic benchmarks. This significant savings buffer suggests that, despite pronounced pockets of weakness, overall consumption looks set to retain its momentum throughout the upcoming year.



WHAT TO EXPECT IN 2026?

Compared with 2025, when full-year growth was held back by softness during the first quarter, the economy is expected to reaccelerate into 2026. This reacceleration reflects a combination of policy developments aimed at unlocking latent economic potential and boosting productivity.

We believe the pace of growth in 2026 will hinge on three key pillars: substantial stimulus from fiscal and monetary policies (see chart); broader adoption of AI technologies that could deliver meaningful productivity gains; and the stabilization of trade policy, which would give global businesses the clarity they need to plan and invest with confidence. Together, these forces are set to reinforce one another, creating tailwinds for both consumer spending and capital investment.



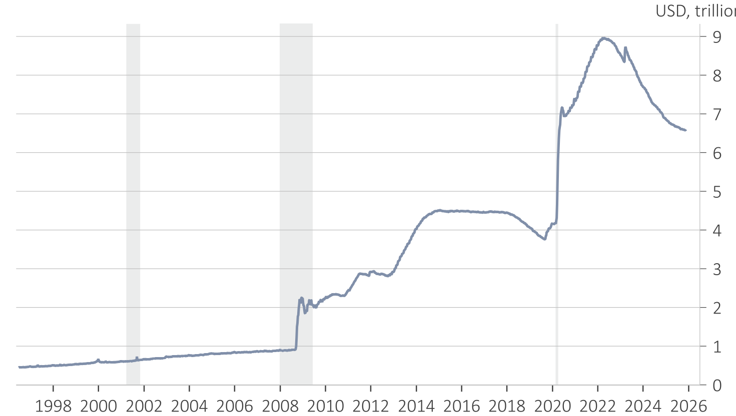
Fiscal Policy. The One Big Beautiful Bill Act (OBBBA) was signed into law in mid-2025, but its full economic impact is staggered and projected to be heavily felt starting in 2026. For example, new tax deductions for tips and qualified overtime income became effective in 2025, but workers must wait until they file their tax returns to realize the bulk of the benefit as a lump-sum refund, translating into delayed, but significant, consumption power in the first half of 2026. Concurrently, crucial changes affecting corporate taxes, specifically the permanent reinstatement of 100% bonus depreciation and expanded interest deductibility, are designed to sharply reduce the effective cost of capital. This legislation should spur increased corporate investment spending in the year ahead, but the permanent nature of the tax change is key as it immediately improves project hurdle rates and also encourages delayed capital expenditure.

Monetary Policy. The Fed is expected to keep shifting its monetary policy in a more accommodative direction, largely in response to the weaker labor market and tightening liquidity in short-term funding markets. The gradual deterioration in labor conditions has already led the Fed to cut rates twice this year, with the possibility of a third cut on the table. If the hiring slowdown continues, further rate cuts are likely to follow.

This dovish shift is further reinforced by rising stress within the banking system as short-term funding markets have shown significant strain following the depletion of the Overnight Reverse Repurchase (ON RRP) facility. These liquidity pressures recently prompted the Fed to pause and ultimately end its quantitative tightening program. Speculation that the problem may get worse could open the door to Fed intervention through open market operations or by expanding its balance sheet to ease the funding stress.

US Federal Reserve Banks: Total Assets

Source: Federal Reserve



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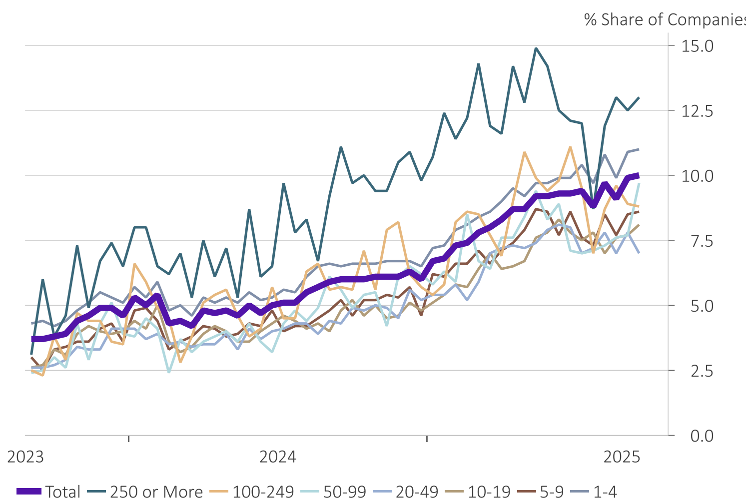
AI Technology Investment and Adoption. While the pace of job creation has slowed, the economy's sustained growth is largely attributed to a sharp, accelerating increase in AI technology investment and adoption. Many firms are prioritizing automation and efficiency gains over expanding their human workforce, resulting in a structural shift that has driven a significant pickup in aggregate productivity figures. Overall, AI utilization reached an all-time high of 10% in 2025, reflecting steady usage growth across most sectors. However, a notable divergence exists as large firms have recently exhibited hesitation, often struggling with legacy systems and internal bureaucratic inertia. In contrast, smaller companies and startups have steadily embraced the technology, successfully deploying it for core, task-specific functions. This suggests that productivity gains could be uneven across sectors and industries.

Share of Firms Adopting AI, By Size

Source: US Census Bureau



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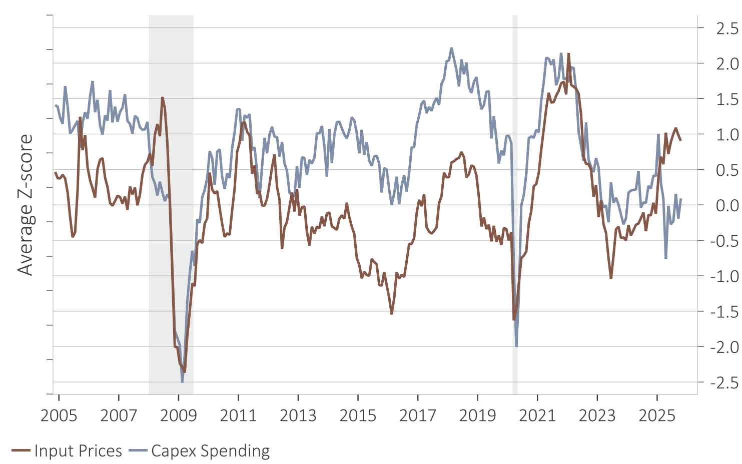
Stabilizing US Trade Policy. Besides policy stimulus and the AI boom, another potential tailwind for the economy in 2026 is the likely stabilization of US trade policy, stemming in part from the Supreme Court's expected ruling on the president’s authority to impose broad tariffs. The key economic benefit of the ruling is that it removes policy uncertainty, which has historically caused businesses to defer long-term capital expenditures and complex sourcing decisions (see last chart on this page). Regardless of the outcome, a definitive legal boundary will allow firms to move beyond their "wait-and-see" approach and finalize strategies with greater confidence. If the court affirms executive tariff power, it would solidify the current trade policy environment and validate existing investment pledges. Conversely, if the court denies this power, the defined boundaries would remove the immediate legal risk currently clouding billions of dollars in imports, offering significant relief and a positive catalyst for corporate planning.

Regional Fed Manufacturing Surveys

Source: Federal Reserve



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CONCLUSION

In sum, our baseline forecast anticipates accelerating economic growth into 2026, followed by a moderation that holds full-year growth to about the average pace over the last couple of decades.

The main risk to this forecast — the hinge point for a potential recession — is the possibility of wider debt defaults originating in the household sector and propagating into the private sector, especially concerning the capital-intensive AI buildout. Although this is not seen as likely in our current baseline, it's an important risk that we are keeping under close watch. And of course, "tail risks" such as a geopolitical crisis or a natural disaster could also temporarily trip up the economy.

THE NEW TECHNO-INDUSTRIAL STATE

We increasingly believe that today's economic performance and financial market dynamics are best understood with reference to a new, evolving model of political economy. As mentioned above, we refer to this model as the ***"new techno-industrial"*** state, in part because of the way AI investment is helping to buoy economic growth but also because of the way that technology titans and government officials are adopting industrial policies to promote the interests of the technology sector and related industries, and, more broadly, to directly influence the economy. These government policy actions over the past few years have raised concern among investors. During the Biden administration, the CHIPs Act and the Inflation Reduction Act were industrial policy measures designed to support a specific industry (semiconductors) or encourage foreign direct investment into green energy. Overt government intervention into the economy was a change in policy from what emerged in the late 1970s, when policymakers purposely worked to remove government intervention in the economy via deregulation.

On balance, the Trump administration has further extended government intervention into the economy. For example, it has taken a 10% stake in struggling semiconductor giant Intel in return for government support. It has also called for export tariffs on semiconductor sales to China. And of course, it has aggressively implemented import tariffs as part of trade deals and demanded direct foreign investment into the US in sort of a "reverse Marshall plan." For those who came of age in the 1980s and 1990s, this sort of government intervention in the economy is jarring. However, government guidance of the economy isn't new — this activity was normal from the postwar period into the 1970s.

THE *NEW* NEW INDUSTRIAL STATE

In 1967, John Kenneth Galbraith published a book titled *The New Industrial State*, in which he argued that firms in major industries were not profit maximizers but rather operated to manage other goals. The US, in the midst of the Cold War, approached the economy with an emphasis on national security. This led to several policies designed to meet national security interests:

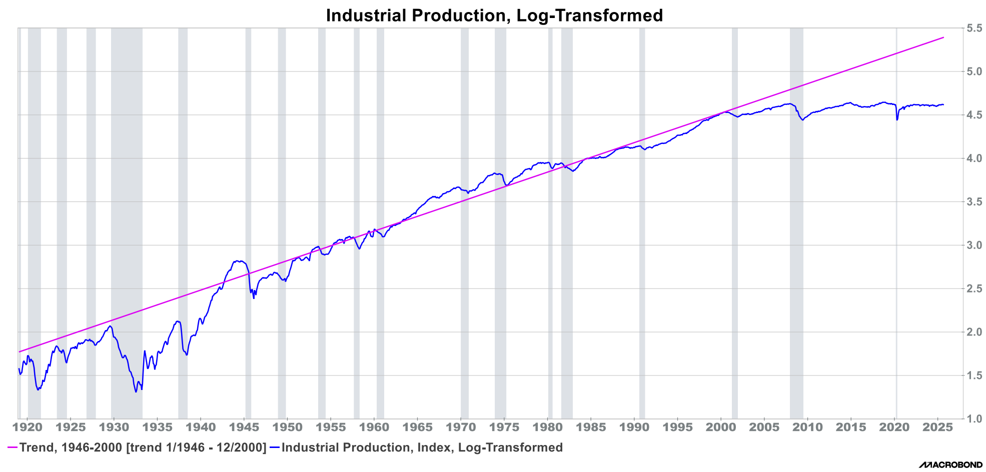
- There was a high value placed on labor peace. Unions were encouraged and they flourished at large firms that had market power due to their monopolistic or oligopolistic market structure.
- Management's interests were not aligned with capital owners. As first discussed by Adolf Berle and Gardiner Means in 1932, management instead balanced stakeholder interests, including labor, management itself, and the government. Profit maximization was not the primary goal, at least among the large firms.
- To maintain market stability, technological change was carefully managed. Many of the large firms had industrial labs that developed cutting-edge technologies. However, these often were not rolled out to the public or were captured for defense purposes.

This security-driven system stayed in place until the inflation of the 1970s. Policymakers then decided to address inflation by deregulating, essentially concluding that allowing markets to determine investment allocation decisions would lead to lower inflation. Deregulation also fostered the rapid adoption of technology, further expanding supply. The collapse of the Soviet Union and the end of the Cold War appeared to confirm that relying on markets not only lowered inflation through expanded supply, but it had also led to the end of communism. After 1990, globalization expanded, supported by the expansion of the internet, which allowed for the separation of design and production. Firms shifted to profit maximization, labor power was sharply curtailed, and management became aligned with owners through the idea of shareholder primacy, which was bolstered by the practice of including equity in the compensation of corporate managers.

Although deregulation began while the Cold War was underway, the program accelerated with the collapse of the Soviet Union. The end of communism convinced firms that they should focus their investment decisions solely on efficiency. For example, since it was believed that the risk of geopolitical conflict between the Great Powers had become very low, it was considered prudent to build and rely on critical semiconductor foundries within range of China's short-range missiles.

The return of industrial policy in the last two administrations is consistent with the return of Great Power competition after a long period in which the US was the unrivaled global hegemon. Relying on markets to allocate investment and production is reasonable when national security risks are low. However, now that those risks have become elevated again over the past decade, it's reckless to assume that markets will make allocations consistent with national security goals.

This chart shows what happens under conditions of market primacy. US industrial production rose on trend until 2000, near the time when China entered the WTO. Since then, however, the gap between the trend line and production has widened to levels not seen since the depths of the Great Depression. If market efficiency is all that matters, allowing China to produce the majority of industrial goods is fine so long as the US can import.



However, if the US faces the prospect of war with China (either trade or kinetic), the country may not have the industrial base to fight for any duration.

RISING GOVERNMENT INFLUENCE

As noted above, government influence on markets has been growing this decade, but investors have probably not fully incorporated the need to account for this development. Here are some of the areas where we anticipate further government interaction:

- **Artificial Intelligence.** Although AI has the potential to improve workers' productivity, it also could become a key component of national defense. If weapons systems increasingly rely on AI to either assist or make battlefield decisions, then supremacy in this arena is imperative. At present, there is massive private sector investment into AI, as discussed in our review of the economy in 2025; we would not be surprised to see government support to assist in the buildout of this industry. In some respects, the aforementioned investment in Intel could be related to supporting this effort.
- **Health Care.** On the other side of the spectrum, the healthcare stocks have seriously lagged the overall market recently. This may well reflect a fear among investors that the government will limit profitability in this sector as a way to dampen price pressures.
- **Consumer Staples.** Consumer staples stocks have also lagged recently. In large part, that probably reflects weak consumer spending among less affluent households. Nevertheless, we think it could also reflect investor concerns that the political system will use the "bully pulpit" to criticize price increases and push down profit margins.
- **Oil.** Oil prices have been weak on concerns that the administration is pressing for lower gasoline prices. This worry has also weighed on equities in this sector.
- **Nuclear.** The need to build out the nation's electrical infrastructure has benefited uranium-related equities and power equipment suppliers. There is evidence that the strict regulatory environment that has slowed nuclear power expansion may be in the process of being relaxed.

- **Rare Earths.** China has developed a chokehold on these key commodities mostly because it is willing to suffer the environmental degradation from processing these ores. The US has taken aggressive actions to address this problem, including guaranteeing a floor price to MP Materials, a US miner of rare earths, supporting new US firms in this industry to add capacity, and inking a deal with Australia to jointly produce these materials.

In sum, investors will increasingly need to take industrial policy into account when making investment decisions. Due to the expanding power coalescing in the executive branch, it's also likely that massive shifts in investment policy could develop with each new administration. The important takeaway from these trends is that markets are no longer solely being driven by market forces and are increasingly dominated by policy decisions.

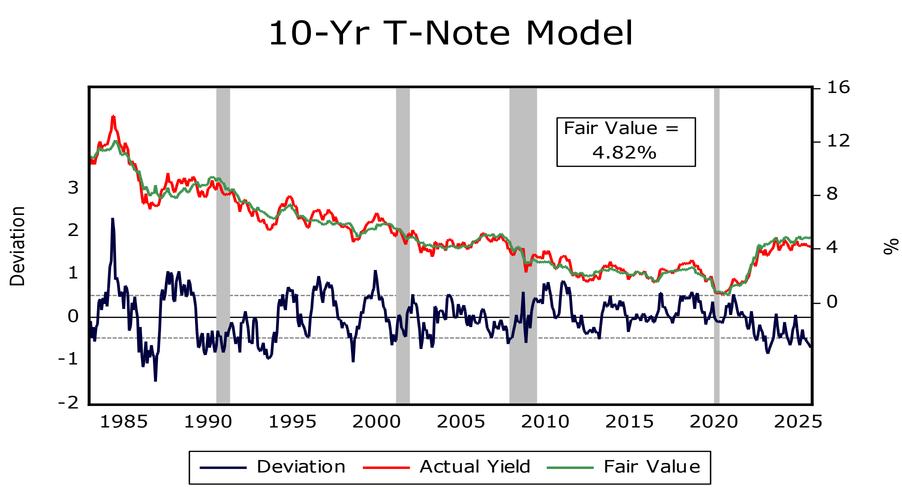
FINANCIAL AND COMMODITY MARKET OUTLOOK

As the new techno-industrial state becomes more established in 2026, the implications for financial markets will become clearer and more pronounced. Asset classes will likely behave differently than investors got used to during the 30 years of globalization following the Cold War. They will also differ from the trends observed during the transition period from roughly 2008 to 2025.

As discussed below, the prospects for fixed income are mostly tied to the likelihood of increased political pressure on the Fed to further push down short-term interest rates. That could spark concerns about a rise in consumer price inflation and the risk of surging long-term rates, but activist economic and financial policies will aim to cap long-term yields. The resulting monetary stimulus, fiscal stimulus from last summer's tax and spending bill, ongoing AI investment, continued strength in high-end consumer spending, and a less volatile policy environment will likely support US stock valuations. At the same time, global uncertainties and the new US policy stance will likely keep the dollar relatively weak and on a weakening trajectory, which suggests we can expect outsized returns from foreign equities and commodities.

FIXED INCOME

We expect the US administration will keep pressing the Fed to cut interest rates. In part, this reflects the administration's political philosophy, which calls for expanded executive power. On top of that, since congressional elections occur in November, the administration will want to tip the scales in favor of Republicans by ensuring strong economic growth and lower inflation. Finally, the administration will have the opportunity to replace Fed Chair Powell and probably some other Fed policymakers by mid-year. These considerations will dovetail with efforts by the Treasury Department to put downward pressure on longer-term Treasury yields, potentially affecting pricing across other fixed income markets.

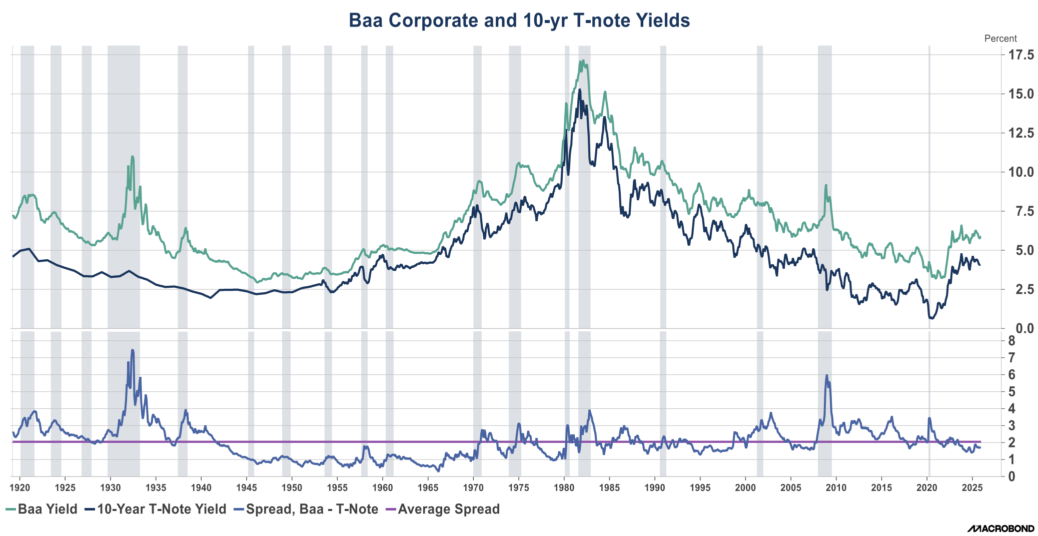


Sources: Macrobond, CIM

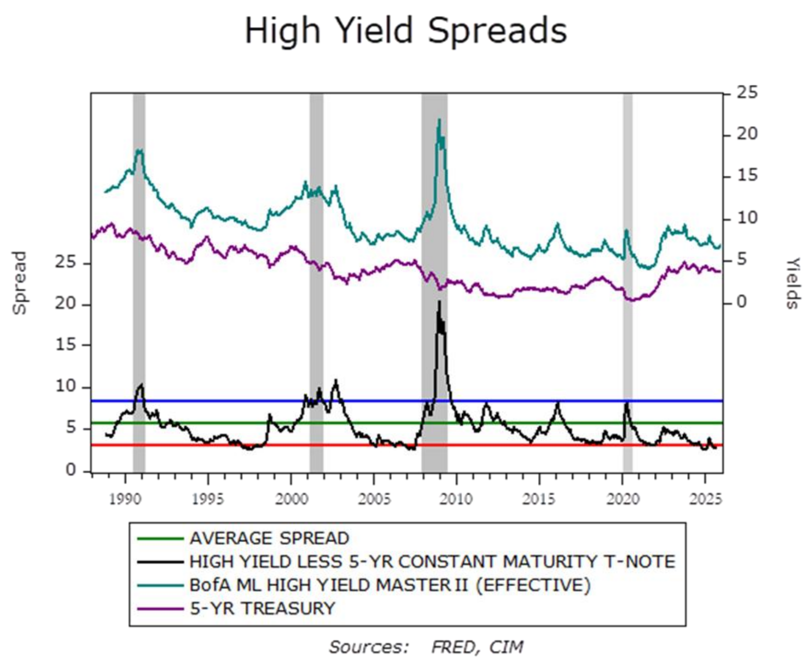
As in recent years, the US bond market in 2026 faces a test, with trillions of dollars in Treasury obligations set to mature and then needing to be refinanced. Along with the issuance required to fund the big federal budget deficit, this enormous supply has had the potential to boost market volatility and put upward pressure on interest rates. However, long-term yields haven't spiked. Why not? One reason is that Treasury Secretaries Yellen, under President Biden, and Bessent, under President Trump, have both managed to mitigate its impact by boosting the issuance of Treasury bills. This strategy, dubbed "Activist Treasury Issuance," has limited the supply of longer-maturity obligations versus shorter-maturity paper, keeping longer-term yields lower than they otherwise would be. In addition, we believe bond investors expect continued government activism aimed at pushing down longer-term yields going forward. We think this helps explain why the yield on the benchmark 10-year Treasury note is currently about 4.10%, far below the 4.82% that our model suggests would be fair value (see chart).

Because of political pressure to hold down interest rates and the likelihood that more dovish officials will be joining the policymaking Federal Open Market Committee (FOMC), ***we anticipate the Fed will cut its benchmark fed funds rate more aggressively in 2026 than in 2025.*** That's especially true after May, when the relatively hawkish and cautious Chair Powell's term will end. Of course, unacceptably high inflation or spiking longer-term interest rates could force the new FOMC to hold the line on rate cuts. However, if inflation and economic growth remain near their current levels, we think the new FOMC will keep cutting rates. Moreover, if inflation concerns threaten to maintain high longer-term interest rates or push them even higher, we expect Fed policymakers and the broader government could begin working to cap them. In 2024 and 2025, it appeared that officials could tolerate 10-year yields of up to 5.0% before intervening. In 2026, the yield ceiling could well be lower, keeping the yield on the 10-year Treasury note at 3.5% to 4.5%. That would suggest longer-term Treasury yields may rise only slightly in 2026. ***In other words, longer-term Treasury returns may be little different than their current interest yield.***

Meanwhile, credit spreads remain tight, with the excess of investment-grade bond yields over the 10-year Treasury yield near multi-decade lows. We surmise the strong pricing for corporate bonds reflects optimism about the Fed's ability to engineer stable-to-lower yields while fostering continued economic growth. However, it is now becoming increasingly clear that the AI boom is becoming more reliant on debt of various types, from publicly traded investment-grade bonds and junk bonds to lesser-quality private credit that has the potential to hurt the regulated public credit markets if defaults spike. Some corners of the corporate debt market and consumer lending markets have also seen rising default rates. As a result, ***we consider corporate bonds to be modestly overvalued at this time.***



The yield spread is even narrower between below-investment-grade corporates and Treasurys of comparable maturities. In fact, high-yield spreads are not only exceptionally tight, but they are approaching all-time lows. Such was last observed in the lead-up to the Great Financial Crisis, suggesting that a correction may be imminent. As with investment-grade debt, the narrow spread likely reflects market optimism about economic prospects, with expectations of central bank rate cuts and corporate tax reductions already priced in. If the current modest default experience begins to worsen, ***a revaluation of high-yield corporate debt could occur***, which would lead to widening high-yield spreads.

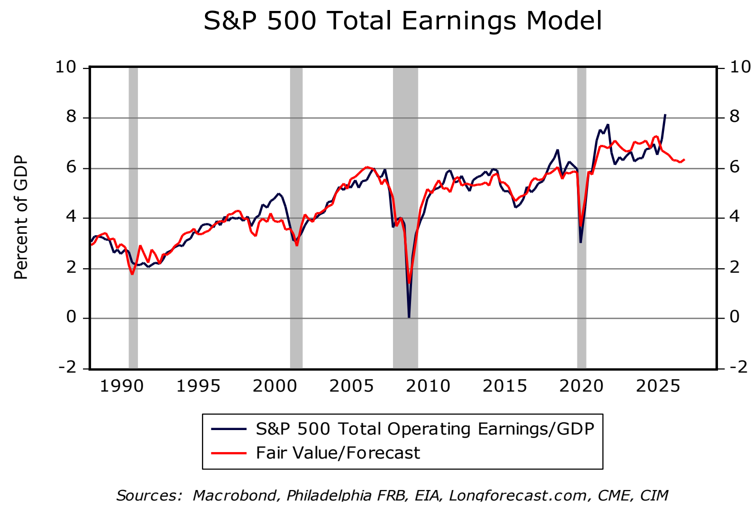


US EQUITIES

To gauge the likely performance of US stocks in the coming year, we start with an estimate of corporate profits. We then apply a price/earnings ratio to those earnings to calculate the year-end figure for the S&P 500 stock price index, which tracks stocks with large market capitalizations. Finally, we try to gauge the relative outperformance or underperformance of large cap stocks versus small cap stocks and "growth" stocks versus "value" stocks. As discussed below, ***we currently forecast that the S&P 500 price index will end 2026 between 6,400 and 7,000, with a single-point estimate of 6,710, up 2.1% from levels at the time of this writing*** (late November/early December).

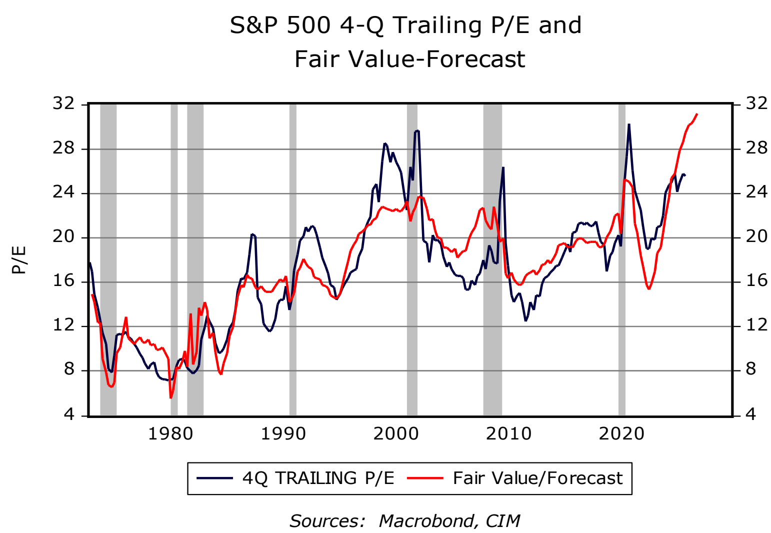
S&P 500/Large Cap Stocks. Our S&P 500 forecasts are based on several key sub-forecasts, as discussed in the following bullet points. Based on our discussion of US economic trends above, we expect nominal GDP to be up about 4.4% from the previous year. We expect S&P 500 operating earnings to average 6.3% of nominal GDP across the four quarters of 2026, or about $235.33 per share. Finally, we expect a P/E ratio of about 28.5x on those earnings.

While economic growth looks set to continue accelerating versus its pace in the first half of 2025, we think **nominal GDP growth** for 2026 will cool slightly from 2025, as discussed in our opening section. Our forecast for 2026 assumes nominal GDP growth of 4.4%.



As shown in this first chart, **S&P 500 operating earnings as a share of GDP** have been trending upward since the end of the Cold War. They reached a record high of 8.1% of GDP in the third quarter of 2025. However, our model indicates they will fall to 6.3% of GDP in 2026. Such a narrowing of profit margins would be dramatic, but we have decided that using our modeled number is an appropriately conservative, cautious approach for the coming year.

After all, there is often a large disparity between actual and modeled earnings during a market boom like we are seeing today or as we experienced during the technology frenzy of the late 1990s. In such cases, companies are given a lot of leeway to use optimistic assumptions for their profit calculations. Firms then write down their overly valued assets as a market correction and/or a recession eventually approaches, bringing reported earnings back down to modeled levels. Such write-downs could well occur in 2026 if economic growth slows too much or if cracks appear in the foundations of the AI boom.

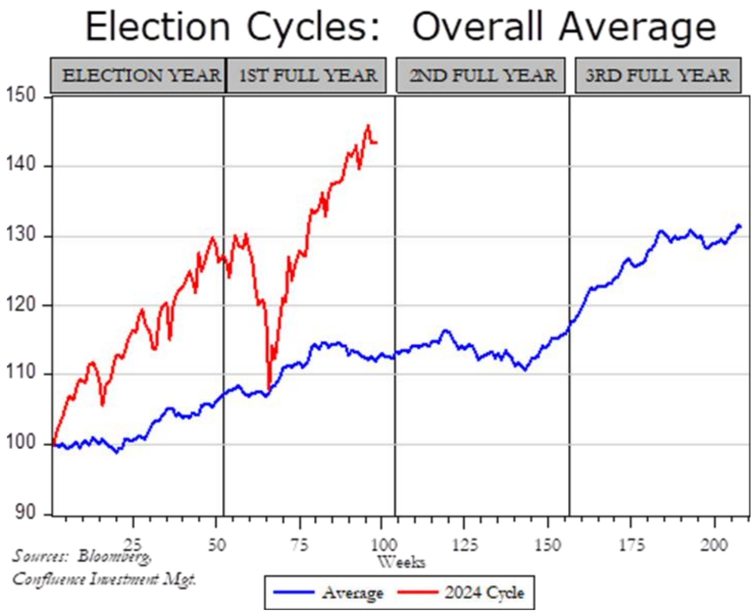


We note that S&P 500 operating earnings typically ranged 2-3% of GDP in the last decades of the Cold War from 1965 to 1990. If we're correct that the post-Cold War era of relative peace and globalization is now over, it would not be unreasonable for margins to enter a period of secular decline that could potentially begin in 2026.

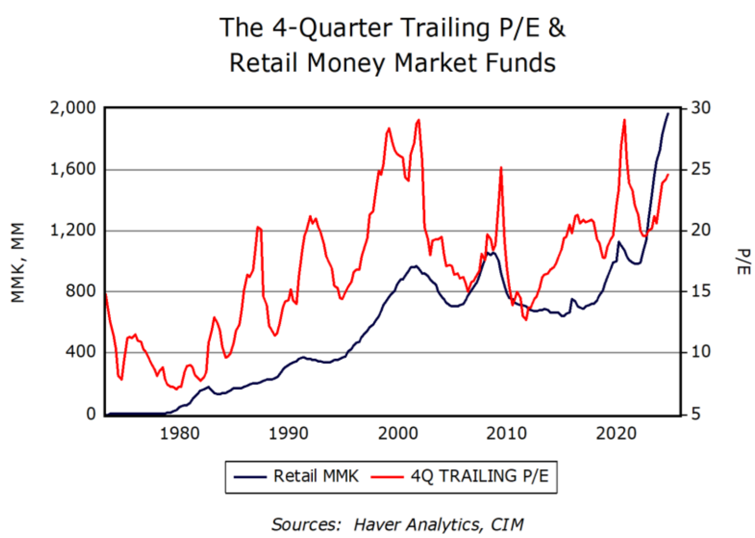
To derive a figure for **S&P 500 operating earnings per share**, we assume a divisor of 8,529, essentially unchanged from today's divisor.

Finally, we use a model to estimate the **S&P 500 fair-value P/E ratio.** Our model is based on annual CPI inflation, the five-year standard deviation of CPI inflation, the annual growth in the M2 money supply, the size of the federal fiscal deficit, the yield on the 10-year Treasury note, total money market fund balances, and a binary variable for recession. The model currently suggests the P/E multiple will end 2026 at a record high of about 31.1x, up from 25.5x currently.

However, forecasting such a high multiple is imprudent, in our opinion, in part because we are cautious about the current market euphoria cooling, but also because our analysis indicates that stock prices typically rise only marginally in the second year of the presidential election cycle. Therefore, our base case assumption is that the multiple rises only about halfway to its modeled level in 2026, to 28.5x. Multiplying our estimate of S&P 500 earnings per share by 28.5x produces our estimate that the S&P 500 price index should stand at about 6,710 at the end of 2026, with the most likely range being 6,400 to 7,000.



So, why is our model projecting such a high multiple? Almost every independent variable is projecting multiple expansion. We are not only expecting weaker inflation, but the volatility of inflation is projected to decline as well. The fiscal deficit, which is positively correlated within the model to the P/E, is expected to remain elevated. The fed funds rate is projected to decline, which is also supportive. The 10-year Treasury yield is also expected to remain low, further boosting the multiple. However, the factor that is having the most impact is retail money market fund levels (RMMK).

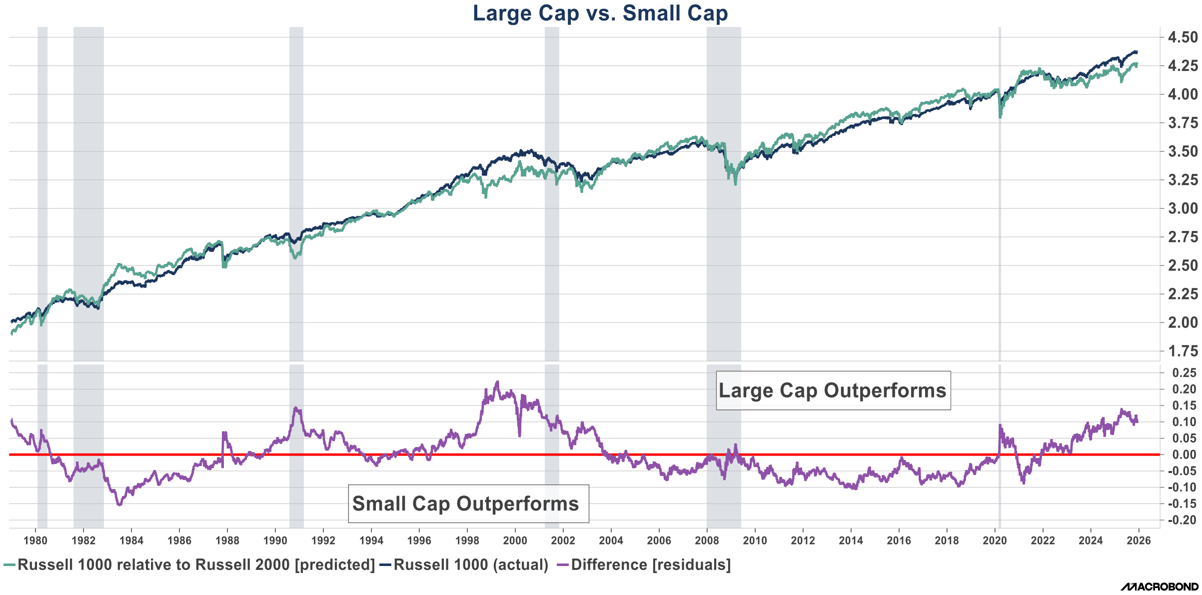


Over time, the S&P 500 P/E multiple is positively correlated with RMMK at the 75% level. Recently, RMMK has increased sharply, and the P/E has lagged somewhat. A careful observation of the data, however, shows that when RMMK is elevated and begins to decline, the P/E tends to spike higher in something akin to a "last hurrah" before the multiple turns lower. So far, we are not seeing signs of a downturn in RMMK. Perhaps the Fed's projected interest rate cuts will lead to lower returns on cash and trigger outflows. Although that would tend to suggest that the end of multiple expansion is near, investors need to be aware that these outflows initially bring multiple expansion and can suggest unusually robust index gains.

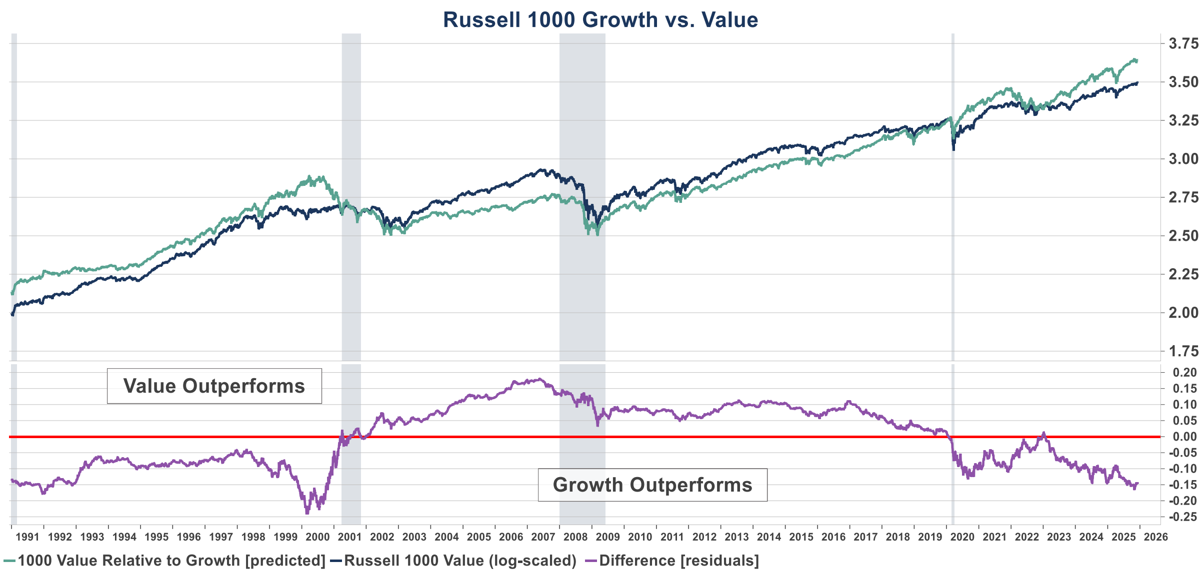
In sum, our quantitative models point to narrower profit margins in 2026 but also a significant expansion in the P/E ratio. To generate our estimate of US stock performance in 2026, we have elected to take the relatively cautious, conservative approach of assuming a moderation in profit margins and a relatively limited multiple expansion. ***The balance of risks to our estimate are therefore probably to the upside.*** Barring a geopolitical conflict or surprise disaster of some sort, our base-case forecast is potentially too conservative.

Large Cap vs. Small Cap Stocks. For the last few years, the US stock market has been extremely narrow, in the sense that the indexes weighted by market cap have been driven almost entirely by just a dozen or so stocks. The leaders have been mostly large cap technology stocks related to AI. Smaller cap stock values have lagged far behind (see chart on the next page). In theory, this dynamic has left the relative value of small and mid-cap stocks far more attractive than that of large cap equities. However, it's important to remember that much of the upward pressure on large cap stock prices probably stems from the fact that capital flows into the stock market these days are largely allocated via market cap-weighted indexes, channeling more funds into large cap stocks than into mid-cap and small cap names. This dynamic is likely to continue buoying large caps, at least until investors become net sellers of stocks, in which case the reverse could hold. Indeed, while we are relatively cautious and conservative regarding our outlook for profits and multiple expansion, we are more certain of this ongoing dynamic of index investing.

Given our outlook for sustained economic growth in 2026, we think large caps and mid-caps will still have the advantage over small caps in the coming year.



Growth vs. Value Stocks. Similarly, the recent outperformance in growth stocks and the lagging performance of value stocks tells us that value-style stocks are probably a better buy and should be poised to catch up at some point. Nevertheless, continued investor preference for index investing is likely to keep channeling an outsized share of new capital into "growthier" equities, supporting their prices. This suggests that growth stocks will continue to perform well versus value stocks in 2026.



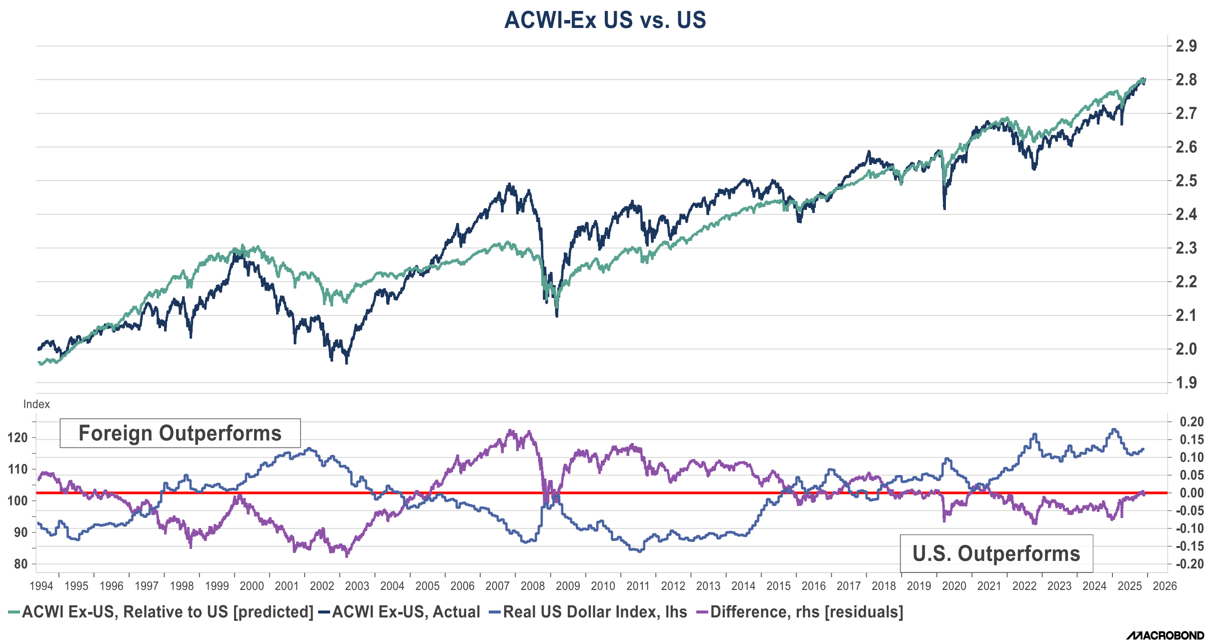
FOREIGN EQUITIES

We believe that the extended period of outperformance for US stocks versus foreign stocks has now come to an end, heralding what will likely be a long period in which foreign stocks provide the better returns. As we discuss below, a key reason for this forecast is that the US dollar finally appears to be at the start of an extended period of gradual depreciation against other major currencies, and such environments tend to give an advantage to foreign equities. In addition, the long bull markets in the dollar and US equities up to 2025 have left foreign valuations relatively low, which should entice investors.

Finally, we believe the more chaotic geopolitical environment and the return of activist government policies around the world will foster more stimulative economic policies in other areas, especially Europe. Many foreign countries will therefore enjoy stronger demand, increased revenues, and higher earnings in their home markets.

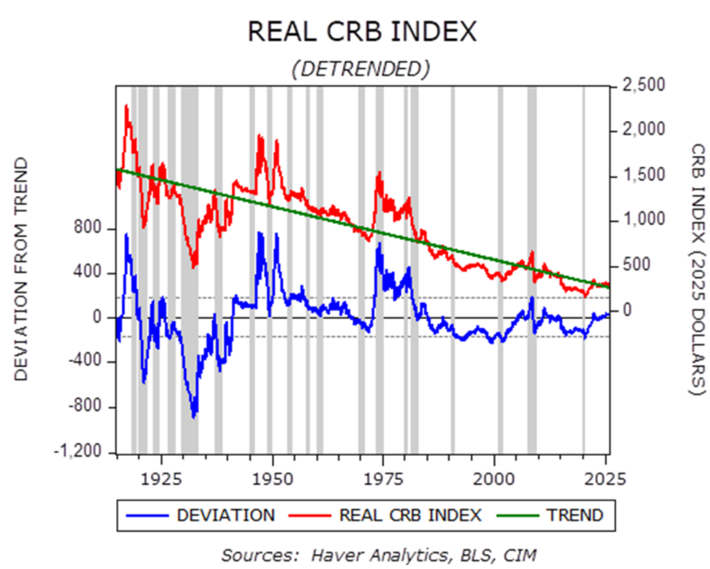
Impact of the Dollar. Our research indicates that foreign stock performance is heavily influenced by the value of the US dollar versus other currencies. When the greenback is appreciating, foreign stocks typically struggle, and vice versa (see next chart). In turn, our analysis suggests that the dollar's value can be driven by the US investment cycle and capital inflows from abroad. These days, the relatively strong, investment-driven economic growth in the US should therefore be a magnet for foreign capital. However, we think those attractions now are being outweighed by investor concern about US policies that have become less friendly to international trade and capital flows.

At the same time, geopolitical developments such as China's rising power across multiple dimensions and Russia's aggression in Eastern Europe appear to have sparked a greater commitment among many countries to boost economic growth, especially in areas such as infrastructure and defense. As international investors become less certain of US economic policies but more aware of improving economic prospects in Asia and Europe, ***we expect continued tailwinds for foreign stocks in 2026.***



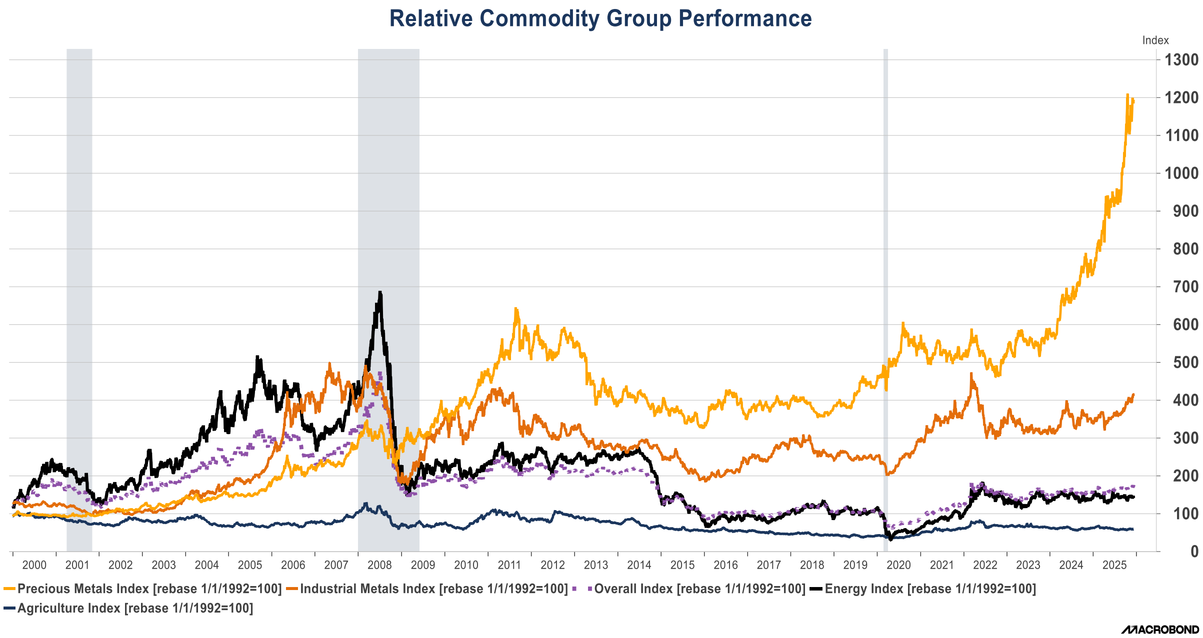
ALTERNATIVE INVESTMENTS

Finally, we address the prospects for gold and precious metals, mineral commodities, and other natural resources in 2026. First, we note that over the very long term, commodity prices typically fail to keep up with the rise in general prices. In other words, inflation-adjusted commodity prices tend to decline. That makes sense in a capitalist economy, which gives natural resource companies strong incentives to find and develop new supplies and increase their productivity in bringing those supplies to market. Capitalism also provides strong incentives for buyers to become more efficient in their use of commodities.



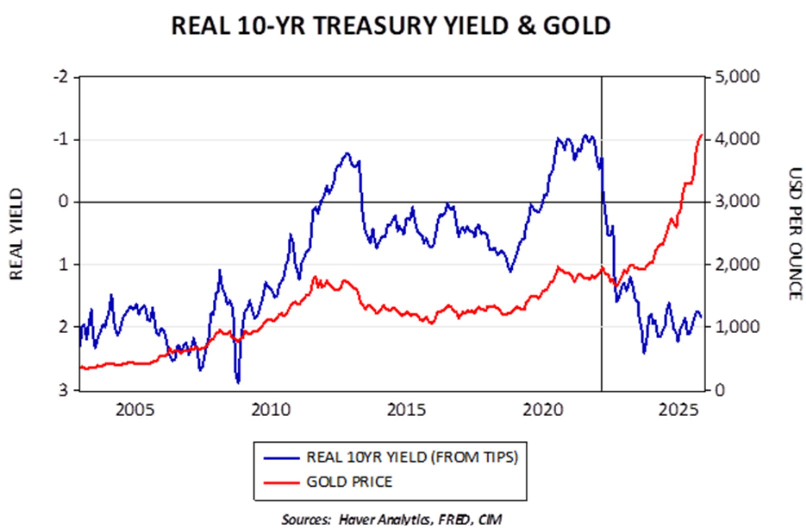
That said, as shown in this chart, commodity prices often surge in times of elevated geopolitical tensions as the world is witnessing now with the intensifying US-China rivalry. We anticipate these geopolitical forces, especially the potential for the China/Russia bloc to weaponize its commodity supplies, will support commodity prices generally now and into the future.

When we observe subgroups of commodity prices, precious metals prices have far outperformed the rest of the commodity complex, as shown in the next chart.



Gold & Precious Metals. Today's geopolitical backdrop is especially supportive for gold and other precious metals. Not only are some investors looking to precious metals as a hedge against geopolitical conflict, but many central banks have increased their buying after the US and Europe responded to Russia's 2022 invasion of Ukraine by freezing the Kremlin's US dollar holdings.

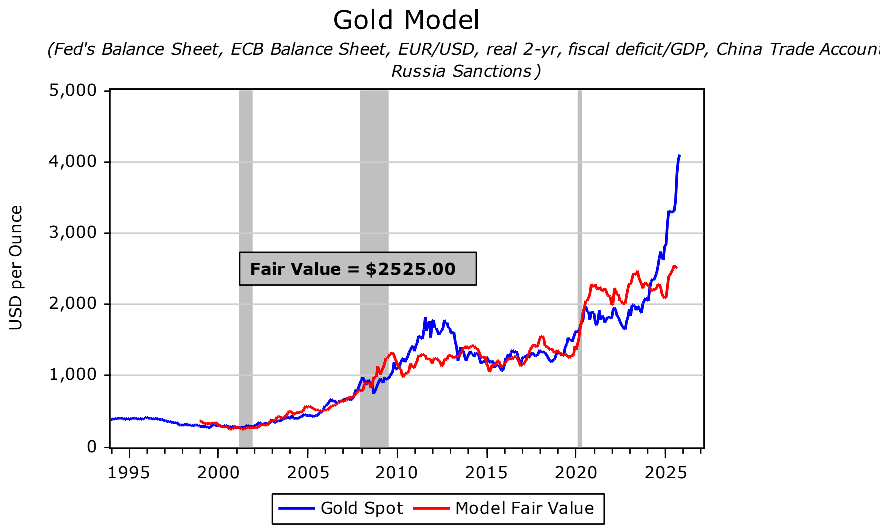
Note on this first chart that gold prices tended to track the real 10-year interest rate generated from the TIPS market. The vertical line represents when Russia invaded Ukraine. Obviously, there has been a significant divergence since then.



Nevertheless, precious metals have also faced competition as more investors buy cryptocurrencies on the belief that they will be a hedge against geopolitical uncertainty and inflation. Finally, the Fed's still-elevated interest rates, coupled with lower inflation, have left "real" interest rates relatively high. Historically, high real interest rates have been a negative for gold and other precious metal prices. In 2026, the Fed's more rapid interest rate cuts still may not be enough to bring down real interest rates, which would limit further gains for gold and other precious metals. Indeed, our gold model suggests that gold prices are wildly overvalued, as shown in the final chart on the following page.

The reason for this divergence is that a new fundamental factor has emerged: central bank buying. In the wake of the sanctions imposed on Russia and Iran, foreign reserve managers now face the risk that losing favor with Washington could render their primary reserve asset – US Treasurys – nearly worthless. This fear makes central bankers insensitive to price. The fear of running afoul of the US is leading to strong demand for gold, which explains why prices are rising in the face of fundamental factors that are traditionally bearish. Given the state of the world, we expect this demand source to continue.

At the same time, it is nearly impossible to determine whether the current price of gold is fairly valued. Given our views on the state of the world, our take is that gold should remain well bid. The most recent version of our gold model includes a binary variable that accounts for the freezing of Russian foreign reserves and uses China's trade account as a proxy for its central bank gold demand. Although it still indicates gold is richly valued, there has been growing talk that Chinese authorities are using state intermediaries to hide the full extent of their gold purchases. Since that gold is nearly impossible to track, this additional buying may account for the appearance of excessive value.



Sources: Macrobond, FRED, CIM

Other Commodities. Based on our expectation for a reacceleration of economic growth in the US into 2026 and improving economic growth in many Asian and European countries, we would expect some support for most global commodity markets. However, we believe the actual prospects for specific key commodities will be driven more by supply issues and the extraordinary demands of today's AI boom.

- **Crude Oil:** The US has become the world's leading oil producer, and the improved efficiency of US companies has enabled them to keep output at or near record levels despite relatively low prices. Supportive policies from the new administration have reinforced this trend. Meanwhile, the Organization of the Petroleum Exporting Countries (OPEC) and its Russia-led partners increased their output again throughout much of last year, despite a slowdown in global demand, which further capped prices. Notwithstanding the potential for transient price shocks from geopolitical tensions, this abundant supply picture supports our outlook for soft prices in the new year. Also worth noting is that the Trump administration has emphasized the goal of lower gasoline prices; keeping oil prices suppressed is the most effective way to achieve this goal.
- **Natural Gas:** In contrast with the oil situation, prospects for natural gas prices have improved strongly over the last year in the face of increased demand due to the electricity generation needed to power the multitudes of new AI data centers being built. In addition, the growth of global infrastructure for liquefied natural gas (LNG), including liquefaction facilities, export/import terminals, and the LNG tanker fleet, continues to unify the global market. Prices in the US have historically been lower than in either Europe or Asia, most recently due to the loss of Russian supply for the European market. The combination of available US supply, growing LNG exports, and shortages in other global markets could lead to rising natural gas prices in the US.
- **Industrial Metals (e.g., copper):** Since demand for these metals tends to track economic growth, we expect demand for these metals to improve in 2026, in line with our general economic outlook. Supply in the new year, however, will vary from metal to metal, depending on production conditions in a small number of the world's biggest and best mines. Miners in recent years have experienced declining ore concentrations, increasing labor unrest, and a rising tide of environmental protests affecting supply. This means that prices for these metals are likely to experience volatility and differing trends from one metal to another as the next year progresses.
- **Uranium:** After a correction in the second half of 2024, uranium prices have again been trending upward, reflecting increased commercial interest and policy support for nuclear electricity generation. As much as the resurgence of nuclear power has steadily gained durable support, the market is also getting reacquainted with just how long it takes to bring new plants online. We remain bullish about the long-term price for uranium, but the metal's price action over the last couple of years is a reminder that uranium values can be volatile.

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