Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

Quarterly Market Update

Fourth Quarter, 2025

LOOKING AHEAD TO AN ACTION-PACKED YEAR

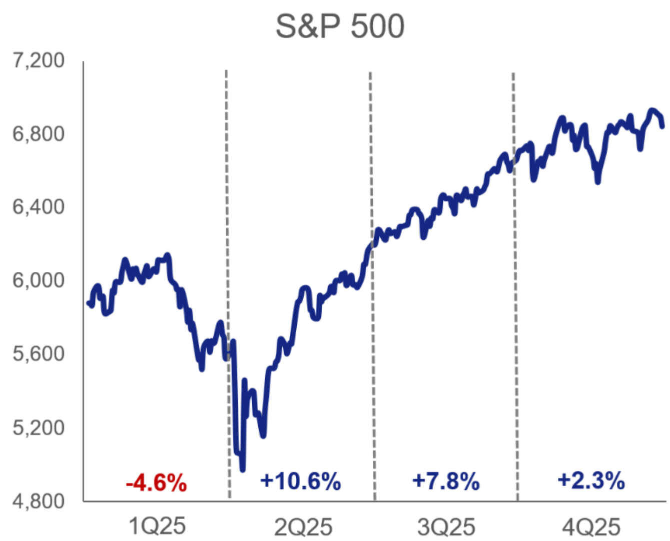
Outlook uncertain, what's new? In the 1950s, a journalist asked UK Prime Minister Harold Macmillan what the greatest challenges to his administration's plans for the country might be. Known for his wit, Macmillan replied simply, "Events, my dear boy, events." And so it is every year at this time when everyone is trying to position themselves for the year ahead.

What we do know. We are confident of a few significant drivers of the economy and the markets as we head into 2026: 1) there will be meaningful stimulus to the consumer in the form of tax refunds from 2025's One Big Beautiful Bill Act (currently projected at over $150 billion); 2) there will be a new chairman of the Federal Reserve; and 3) there will be midterm elections in the fall. Given the fact that the U.S. economy is likely to benefit from monetary and regulatory easing in addition to fiscal stimulus in 2026, we believe there may be a central tension for the economy, policymakers, and investors.

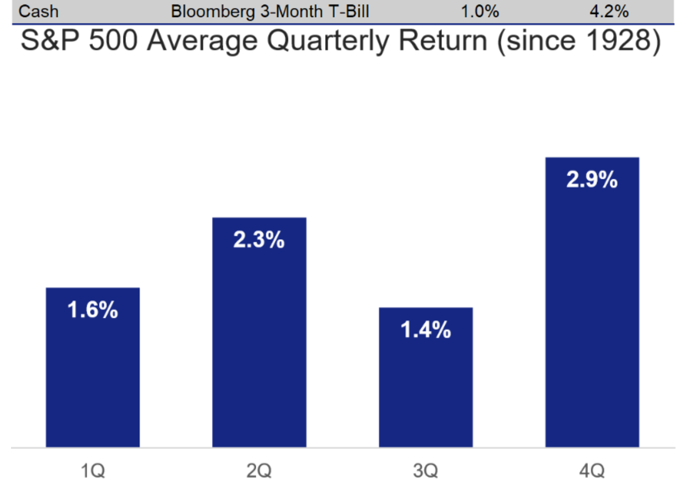
Fiscal boosts. In a way, the One Big Beautiful Bill is one big bet on supply-side reforms. Given current national debt levels and an apparent lack of discipline when it comes to federal spending, the entire economy is in a footrace of sorts between inflation and hoped-for productivity improvements. In other words,, running the economy overly hot can spark inflation (too much money chasing too few goods) but productivity improvements allow workers to produce more goods with the same, or fewer, inputs.

Fed in focus. Another challenge for 2026 will be the new Fed chair's willingness to incur the wrath of the president on the one hand (by not cutting rates enough) and the wrath of the global capital markets on the other (a "politicized" Fed could spark bond-selling that pushes long-term yields higher). It seems fair to assume that, given all the drama surrounding the appointment, the new chair will have a pretty short honeymoon.

Can rotation continue? As far as the markets are concerned, a broad-based recovery in the economy prompted by policy stimulus could finally provide the conditions under which the equal-weight S&P 500, small caps, and value-oriented sectors like Financials may outperform. Valuations are stretched by historical standards, though at the same time, corporate profit margins have never been higher than they are today. We will be watching the yield on 10-year Treasurys as a harbinger for trouble. This bull market, though robust, has tended to run into trouble when the 10-year yield gets north of 4.50% (see page 2).



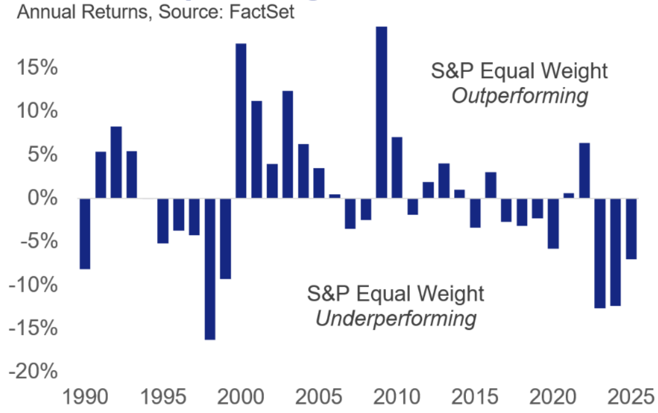
Asset Class	Representative Benchmark	Q4 2025 Total Return	FY 2025 Total Return
US Large Cap	Russell 1000	2.4%	17.4%
US Small Cap	Russell 2000	2.2%	12.8%
International	MSCI AC World ex-USA (USD)	5.1%	33.1%
Commodities	Bloomberg Commodity	5.9%	15.8%
Gold	LBMA Gold PM ($/ozt)	14.2%	67.4%
Municipal Bonds	Bloomberg Municipal Bond	1.6%	4.3%
Taxable Bonds	Bloomberg US Aggregate	1.1%	7.3%
Cash	Bloomberg 3-Month T-Bill	1.0%	4.2%



Source: Data for this page come from data-provider Factset.

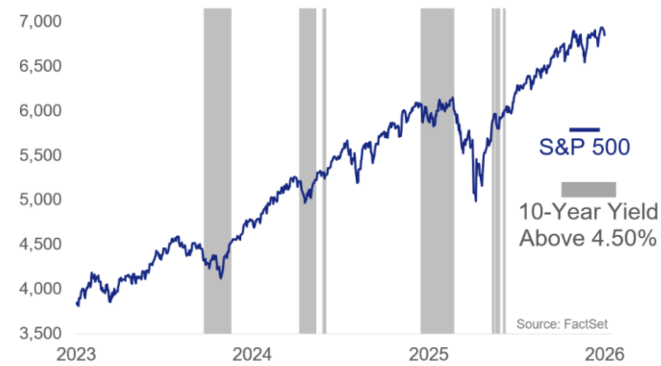
S&P 500 Equal Weight relative to S&P 500

Annual Returns, Source: FactSet



While the S&P 500 Equal Weight is up 43% over the last 3 years, it has meaningfully lagged the increasingly concentrated cap-weighted version of the index. That could be set to change this year. Our belief in a cyclical upswing for the American economy (boosted in no small part by fiscal and monetary stimulus) and the recent price action of various sectors says to us that there is likely to be a rotation out of fan favorites like Technology and into 2025 underperformers like Financials and Consumer Discretionary. We remain overweight the equally weighted S&P 500 relative to the Index itself.

The stock market has hit more turbulence when the 10-Year Treasury has been north of 4.50%

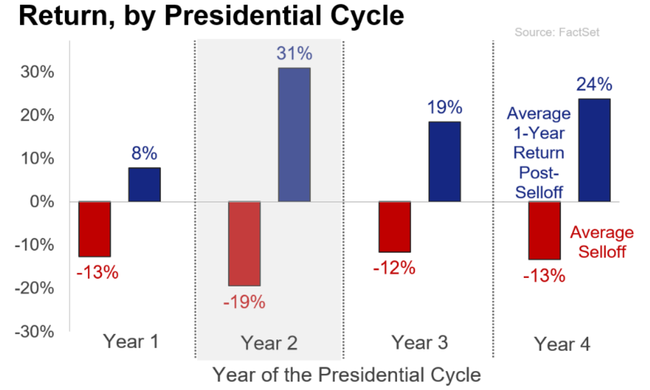


Apart from trade-related volatility in April 2025, the upward trajectory of stocks seems to only slowed when the 10-year Treasury is at 4.50% or above. The Department of the Treasury seems to know this, lately preferring to fund America's debt at the short-end of the curve rather than at long-end (creating scarcity at the long end of the curve helps keep long rates tamped down). With the S&P 500 trading at 27x-28x trailing earnings, it's difficult to describe the market as cheap. There are some good reasons that the S&P 500 is trading rich versus history, but higher long-term rates may cast doubt on the supposition that it should.

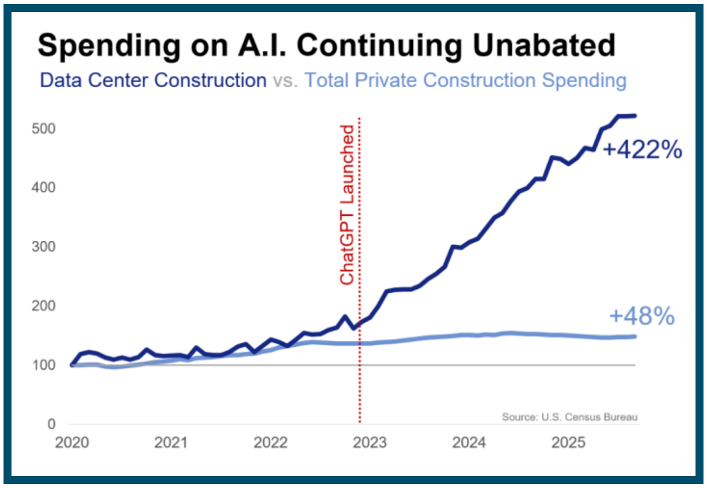
CPI Rent (Light Blue, Left Axis) vs. Permanent Job Losers (Dark Blue, Right Axis)

We're not overly worried about sustained inflation in 2026. With monetary policy restrictive (even after several rate cuts), demand should slow. Consumers are more likely to balk at higher prices, and the corporate sector must similarly manage cost pressure. As such, payroll employment has stalled. Fortunately, weekly jobless claims have remained rangebound near historically low levels—but for those unemployed, it's been tough to find a new job. This labor market uncertainty is already taking some steam out of rent increases, helping to anchor inflation and allowing the Fed to keep cutting rates in 2026.

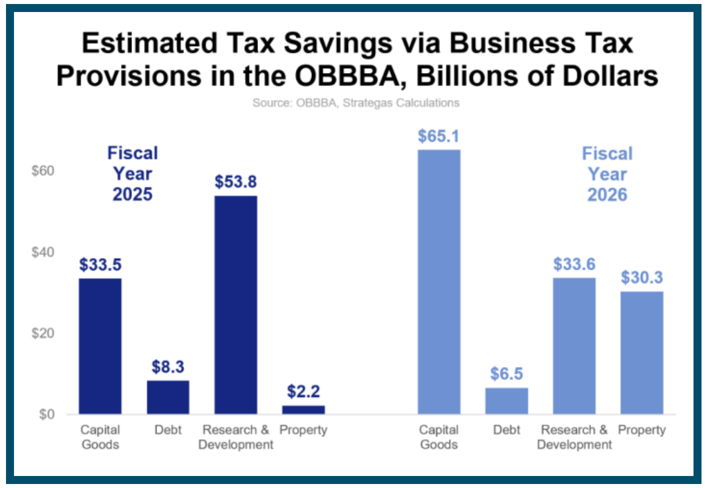
S&P 500 Selloffs and 1-Year Post-Selloff Return, by Presidential Cycle



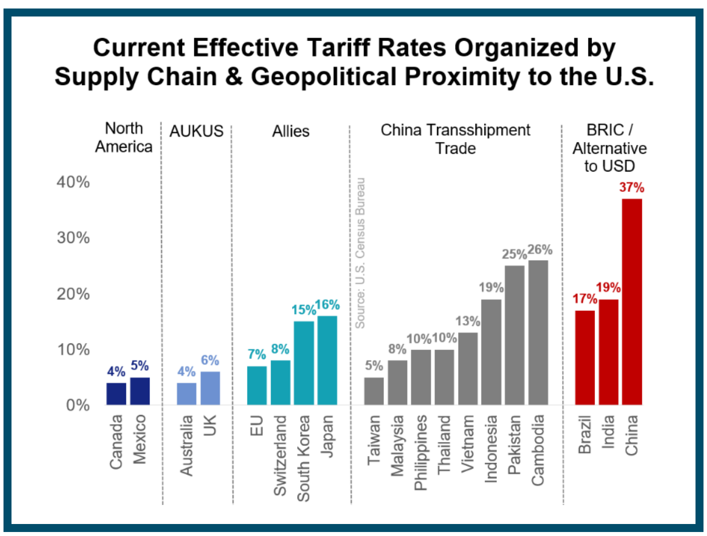
Despite midterm election years having the highest average economic growth rate of any year in the presidential cycle, the midterm year is on average the worst for stocks (equity markets are good at pricing in higher growth before the growth hits). However, this volatility has also led to great buying opportunities: one year from the bottom, stocks have historically been up by an average of 31%, and in addition, the S&P 500 has not declined in the 12 months following a midterm election since 1946. It will be interesting to see if this pattern continues given the levels of stimulus hitting in 2026.



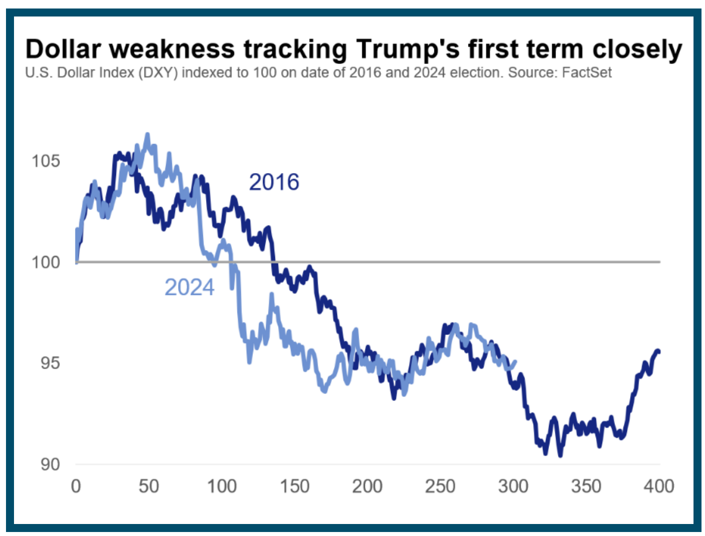
Capital spending on the AI buildout has boosted top-line GDP in recent quarters but poses risks as well. The primary challenge facing the Tech sector as it heads into 2026 is the sustainability of (increasingly circular) capex spending. At the same time, questions are emerging as to how these growing obligations will ultimately be financed. With a widely anticipated Technology-sector debt expansion expected in 2026, investors may be less willing to pay the same elevated valuation multiples for Tech equities as they have in the past.



The main thrusts of the fiscal policy tailwind ahead are derived from passage of the One Big Beautiful Bill, which was backloaded into 2026 and serves as an economic cushion if the labor market weakens further from here. But assuming the labor market holds, $150 billion of consumer tax cuts start getting distributed in February. Business tax cuts are even larger, set for $200bn+ through expensing of factories, capital goods, and research and development. This should be a boost for both AI capex and broader efforts to reshore production.



In our view, President Trump is trying to use tariff policy (in part) to move critical supply chains closer to the U.S. This has resulted in lower tariffs based on a country's proximity to the U.S., rendering Canada and Mexico the biggest winners from this policy and buying time with China to de-couple. Tariffs are a big part of the administration's broader strategy, which has helped inform our base case that if the Supreme Court strikes down many of President Trump's tariffs imposed using IEEPA, the administration will focus on legally recreating the current tariff structure via different trade authorities.



While dollar weakness was a big story in 2025 – helping propel global stocks – it is not a much different picture than President Trump's first term. In fact, this action appears a natural result of some previously-noted trends. In a way, the escape valve for an economy that has been "over-served" by policy stimulus is often the value of its currency, especially its value versus precious metals (as we saw in 2025). Although we don't think the dollar is losing reserve currency status, foreign central banks and other institutions with substantial holdings of financial assets appear to be diversifying their currency reserves beyond the dollar.

S&P 500 Index (Large Cap / U.S. Stocks): A representative sample of 500 leading companies in leading industries of the U.S. economy. These are equity securities of large capitalization (generally $7 billion plus market cap) companies having growth and value characteristics. ● **Russell 2000® Index (Small Cap / Small Core):** Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. These are equities of small capitalization. ● **MSCI EAFE Index Net (International / Developed Markets):** A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US and Canada. As of December 2024, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. ● **BBgBarc Aggregate Bond Index (Taxable Bonds / Bonds):** Composed of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years. ● **BBgBarc Muni Bond Index (Municipal Bonds):** Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, part of a transaction of at least $50 million, issued after December 31, 1990, and have a year or longer remaining maturity ● **FTSE 3-month T-bill Index (Cash):** This index measures monthly return equivalents of yield averages that are not marked to market. It consists of the last one-month and three-month Treasury bill issues, respectively. ● **Bloomberg Commodity Index (Commodities):** Composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Subindices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs.

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