Fourth Quarter 2025
Investor Letter

Market Review

The S&P 500 Total Return Index and the NASDAQ both rose 2.7% during the quarter, while the Bloomberg Aggregate Bond Index rose 1.1%. For the year the S&P 500 rose 17.9%, the NASDAQ rose 21.1% and the Bloomberg Aggregate Bond Index rose 7.3%.

While the gains for the quarter were modest, there were three sharp selloffs during the quarter, each of which was followed by a recovery. In mid-October markets sold off when China threatened to tighten restrictions on exports of rare earth minerals, and the US threatened to retaliate. (Later in the month an agreement was reached and both sides backed down.) In November the market sold off on fears of an "AI bubble." Markets recovered again into early December as the bubble discussion subsided. Markets declined again later in December, mostly due to higher interest rates, especially longer-term rates.

Notwithstanding the volatility, economic growth continued to be good. Earnings reports released during the fourth quarter showed continued strong performance by US companies (up over 10%) and analysts believe the fourth quarter was good as well (up over 8%).

One potentially concerning metric is the rising level of unemployment. In the past 18 months unemployment has increased from approximately 3.8% to 4.6%. This is unusual because the top line economic numbers for the economy are strong. If this number continues to increase it would presumably elicit a response from policymakers.

The Year Ahead

There are a number of events and developments which will impact markets in 2026. *There will almost certainly be unexpected ones as well.* Here are some of the most likely ones we expect to impact the headlines and at least short-term market performance.

New Fed Chairman. In January or February a new chair of the Federal Reserve is expected to be announced to replace Jerome Powell, whose term ends in May. The new Fed Chair will likely favor a more accommodative approach to interest rate policy, which in the short term should be positive for financial markets. Longer term, there is the potential for higher inflation.

Midterm elections. In November midterm elections will be held in the US. Often markets are weak in the period leading up to an election and then rally afterwards. This pattern could be seen again this year.

Various Geopolitical Events. This category is often the most discussed and least consequential one for investors. It includes the potential for conflicts in Europe, Taiwan, the Middle East, Latin America and other hot spots. As we've said on numerous occasions, we do not advise making investment decisions based on such events.

Market Valuation Concerns. Equity valuations are higher than normal, especially for large cap tech stocks. There is data which shows that when the market is overvalued future returns are lower than normal. This concern will likely impact market performance throughout the year, as it did in the fourth quarter 2025. (See below for our thoughts on the "AI Bubble".)

General Economic Concerns. The economy continues to be remarkably strong, but as always there are concerns. As mentioned above, the rising unemployment figures will be watched closely. The huge investment in AI will also be a factor and could be a major risk if it were to slow.

Stocks Reasonably Valued

While we don't time the stock market, we do look at valuation metrics to determine whether the overall market or certain parts of the market are under or over-valued. This information helps with asset allocation and with our selection of different investment managers. Importantly, valuation data is only helpful when it is at extremes in either direction. Most of the time (probably 90%) stocks are somewhere between slightly under or slightly overvalued. In such cases valuation data doesn't help with investment decisions. When there are more extreme readings we make clients aware of them. In December 2024 we wrote a special note to clients saying the market was overvalued and that a correction could be seen in the intermediate term. The market ended up peaking in February of 2025 and then falling almost 20% from its peak. During the market fall we wrote two notes to clients advising them not to sell into the weakness. The market ended up bottoming very quickly in April of 2025, followed by a strong recovery.

As the new year begins, the metrics we use show the market somewhere between fairly valued and slightly undervalued. We aren't recommending portfolio changes based on valuation criteria.

Recessions Remain Difficult to Predict

There have been multiple forecasts of recessions by leading economists in recent years, all of them wrong. In 2022 almost all economists predicted a recession would result from the steep interest rate hikes the Fed imposed in its attempt to slow inflation. The recession never came. Last year many predicted a recession would be caused by the tariffs which were placed on nearly all US trading partners. Not only did a recession not happen, the economy actually accelerated, with real GDP growing at a 4.3% annualized rate in the third quarter, and with some estimates of over 4% in the fourth quarter. This has led some to question why economists are so bad at predicting recessions, and others to wonder whether recessions themselves are obsolete.

The question of why economists are so bad at predicting recessions is a complicated one. The future is inherently hard to predict of course, and something as complex as the US economy is particularly hard to forecast or model. Add in the fact that many, many smart people are all watching the economy, and that their actions have an impact on the economy itself, and one starts to see why economic forecasting is so difficult. It doesn't mean, of course that, economists are useless. As a very prominent economist (and former president of Harvard) pointed out recently, geologists know everything about rocks, but they still can't predict earthquakes. They (economists and geologists) still have a purpose, even if it isn't forecasting.

Recessions aren't obsolete, but it is very possible their frequency, causes and nature has changed. The classic model of a recession was based on an economy that was much different than the current one. Highly cyclical industries such as manufacturing, railroads and agriculture used to dominate the economy. These industries were highly capital intensive and subject to boom and bust cycles which made recessions (or depressions) fairly common. The US economy today is roughly three quarters services, which as a whole are much less cyclical. This is an important part of the reason the economy has been recession resistant in recent years. On the positive side, it means the Fed can raise interest rates and not cause a recession. The inverse may also be true, of course, i.e. the Fed may not be able to prevent a recession by lowering interest rates.

In recent years, recessions have been caused more by crises or outside events than classic cyclicality. The short recession after the Tech Bubble in 2000, the longer recession following the near collapse of the banking system during the Financial Crisis of 2008, or the short recession during the Covid pandemic all fall into this category. Perhaps in the future economists will find a way to get better at predicting such events.

AI Bubble

As noted above, there is considerable concern about whether the AI sector has become massively overvalued, a condition offered referred to as a "bubble". Talk of the potential AI bubble dominated the financial media during the quarter, with some of the discussion more insightful than others.

In reality, a bubble in AI *can exist* or *not exist* on several different levels. One of these is in financial markets. It is possible that investor enthusiasm around AI may have reached levels where today's stock prices already factor in the best case scenario. (For the record, we don't believe that is the case.) Another place where an AI bubble could exist is in the real economy, specifically in the massive investments being made by companies to build out AI applications, infrastructure, data centers, software, etc. The investment boom created by AI is truly massive. According to JP Morgan, AI-related investment contributed an amount equivalent to roughly 1% of GDP to economic growth in 2025. Investment at this scale has created massive demand for electricity, materials, workers, and other components and those will in turn drive up costs and lower the return companies expect on their investments. Should companies decide to meaningfully slow their investment in AI, it would have a huge impact not only on AI companies, but on the entire economy. In our view, this is where the potential bubble exists, not so much in the current level of valuations.

Predictions of US Decline

For as long as the US has been a superpower, there have been those who forecast its painful demise. Supporters of this theory note that superpowers often undergo cycles of rise and fall over several centuries. The downside of the cycle generally includes global over-expansion, issuance of too much debt, and high levels of income inequality. People today point to the high level of debt of the US government, huge foreign commitments, and such things as the trillion dollar pay package recently awarded a well-known entrepreneur.

There is no doubt the US faces serious issues, but in our view those looking for signs of decline might do well to look elsewhere. Take Europe for example. Thirty years ago the US and Europe had roughly the same GDP (adjusting for purchasing power parity.) Today Europe's GDP is approximately 65% of the US. On a purchasing-power-adjusted basis, France's economic output per person is comparable to that of Mississippi, which while beautiful, is a relatively poor state. Also, while income inequality is a real issue, it looks much different in the US than in Europe. The wealthy executive with the large pay package referenced above had to borrow money to meet personal expenses just 17 years ago. Like him or not, he risked everything he had to build several large companies. This sort of economic dynamism doesn't exist anywhere else in the world. Compare this to a member of England's upper class whose family has been living in the same enormous country home for 700 years, graduated from Oxford and whose primary occupation is overseeing a herd of several hundred sheep. To us, this is much more what economic decline looks like than what is currently seen in the US.

Update on the Non Tech Economy

With so much attention focused on the new technologies like artificial intelligence, the rest of the economy is often overlooked. Yet non tech companies continue to make up most of the US GDP, employ millions of people, and account for the bulk of large companies listed on the major stock exchanges. As 2026 begins, we thought it would be interesting to review this often overlooked part of the investment landscape. The table below shows

some key metrics for the non-tech portion of the economy, along with summary data for large cap tech.

Non-Tech Summary Selected Metrics vs. Magnificent 7

Sector	Typical Revenue Growth	Approx. P/E Range	Economic Sensitivity	Investment Theme
Health Care	4–6%	17–20x	Low–Moderate	Demographic and product driven
Financials	3–5%	10–13x	High	Credit conditions & confidence
Energy	2–4% (volatile)	8–12x	High	Commodity prices & capital discipline
Industrials	4–6%	16–20x	Moderate–High	Capital spending & infrastructure
Railroads & Shipping	3–5%	15–18x	High	Early economic signals
Materials	2–4%	12–16x	High	Construction & manufacturing cycles
Coal	Flat–Declining	6–10x	High	Industrial & power demand signal
Consumer Staples	2–4%	18–22x	Low	Pricing power & brand strength
Utilities	2–4%	17–21x	Low	Regulation & infrastructure investment
Magnificent 7 (Tech)	10–15%+	25–35x	Moderate	Earnings concentration & innovation-driven growth

*The figures in the table are estimates based on **long-term historical averages and current market ranges**.*

As can be seen from the chart above, the growth rate for non-tech companies is in the mid-single digit range, substantially lower than the 10-15% (or higher) rate for the fastest growing technology leaders. This is a key reason why Western Pacific clients generally have significant holdings in leading technology companies. That said, well-chosen investments in other sectors have also provided great returns over time. Rather than relying primarily on growth, successful companies in these sectors also increase shareholder returns through efficient capital allocation, balance sheet management, and efficiencies brought on by employing new technologies such as artificial intelligence.

Thank you as always for being a client. Please feel free to reach out to Roger or me if you would like to discuss your investments.

Best Regards,

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