

Fourth Quarter 2025 Market Commentary

An Oxford Harriman & Company Market Commentary

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Markets navigated a complex environment in the fourth quarter. The quarter began with a government shutdown, which lasted 43 days and delayed key economic data releases. The lack of timely information made it difficult to assess the economy's strength and contributed to periods of volatility as the market reacted to incomplete information. The Fed cut interest rates by a total of 0.50% but signaled a pause, hinting that it could cut less than the market expects in 2026. Investors remain excited about the potential of artificial intelligence, but they've become more focused on which companies are best positioned to turn AI demand into near-term profits. Additionally, investors are concerned that the lofty valuations of the AI sector could parallel the early days of the internet and be a catalyst for a market decline should multiples contract. Nonetheless, the S&P 500, Dow Jones Industrial Average, Nasdaq, and small-cap stock indices each set new highs in 2025.

In this commentary, we recap the fourth quarter's defining themes and events, review performance across key market areas, and look ahead to 2026.

Government Shutdown Creates a Lapse in Economic Data

An important event this quarter was the government shutdown and its impact on economic visibility. The shutdown started on October 1st and immediately disrupted the release of key reports on employment, inflation, and growth. To fill the data gap, the market and economists turned to corporate earnings reports and surveys from non-government sources. The shutdown lasted through mid-November, making it the longest in history, and resulted in a data backlog that is still being cleared as the new year begins.

The labor market continued to soften in the fourth quarter, with unemployment rising to a four-year high as hiring slowed. However, the consumer's resiliency to spend remained. Consumer spending has cooled since 2022, but it remains steady despite

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affordability challenges and persistent inflation. The homebuilder sentiment index moved slightly higher in the fourth quarter, but it remains below 50, an indication that housing activity continues to run below pre-pandemic levels. Most importantly, GDP growth rose to 4.3% in the third quarter, up from the second quarter's 3.8%. This represents the strongest consecutive quarters of growth since 2021, before the Fed's aggressive rate-hiking cycle.

The data reveals a late-cycle economy that is slowing but not breaking. Labor market conditions are soft, consumer spending is slowing, and housing is under pressure, but the economy shows few signs of significant stress. The strong third-quarter GDP reading indicates the economy reaccelerated after slowing in the first quarter, suggesting consumers and businesses altered their behavior in 2025 due to shifting trade policy and tariffs. Now that trade policy uncertainty has eased, there's a debate about where economic activity will settle in 2026. The uncertainty explains the Fed's cautious tone and the market's heightened sensitivity to updated data releases.

Fed Cuts Rates Twice but Signals a Pause in Early 2026

The Federal Reserve continued its rate-cutting cycle in the fourth quarter, but policymakers delivered a more nuanced message than simply lowering rates and offering forward guidance. The Fed has cut interest rates by a total of 1.75% since starting its rate-cutting cycle in September 2024. Two of those cuts came in the fourth quarter, with 0.25% reductions at the October and December meetings. However, the messaging behind the two cuts changed. Officials have grown more cautious and divided, with several voting members favoring either no cut or a larger cut.

Uncertainty around Fed policy led to wide swings in market expectations. Investors moved between pricing in multiple rate cuts and a slower, cautious rate-cutting cycle. Fed officials themselves appeared divided, with some warning that monetary policy remains too restrictive and risks slowing economic growth, while others caution that cutting too soon could reignite inflation. The shutdown added to the confusion by delaying key economic data, making Fed policy a source of near-term uncertainty and market volatility.

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As we enter 2026, investors are trying to determine what happens next. By the end of 2025, Fed officials made clear that the threshold for additional rate cuts is high, but they also stressed the need for flexibility and patience. The current backdrop is a mix of cooling inflation, a soft labor market, and a still-expanding economy. The setup appears to be similar to late 2024, when the Fed cut multiple times before pausing for nine months. This time, it's the shutdown data fog making it difficult for the Fed to forecast policy.

The Fed has signaled that it will pause in early 2026 and potentially cut fewer times than the market previously expected. The prospect of additional rate cuts and lower interest rates is supportive in principle, but the policy outlook is now more sensitive to incoming data. That sensitivity contributed to the fourth quarter's stock market volatility, and it will likely remain a key market driver in early 2026.

The AI Trade Becomes More Selective, and Valuations Have Become a Concern

Earnings reports continued to signal strong demand for AI-related computing power and data centers, and leading tech companies reported large, growing backlogs. However, investors started to look beyond headline growth and focus on AI's economics.

Artificial intelligence remained a key investment theme in the fourth quarter, but the narrative matured. AI stocks entered the quarter with strong momentum, powered by robust earnings, a boom in data center construction, and a growing list of large-scale infrastructure investment projects. Investors were optimistic that AI capital expenditures would translate into growth and increased profitability, and many AI-related stocks benefited from broad enthusiasm toward the industry.

Midway through the quarter, the market's focus shifted. Earnings reports continued to signal strong demand for AI-related computing power and data centers, and leading tech companies reported large, growing backlogs. However, investors started to look beyond headline growth and focus on AI's economics. Questions emerged about the capital needed to build and maintain data centers, the impact of aggressive capex spending on balance sheets, and whether companies could maintain the current pace of AI infrastructure spending without pressuring cash flow. Strong earnings and ambitious spending plans were no longer enough to push a company's stock price higher, and sector leadership shifted toward firms demonstrating pricing power

and a path to profitability. The changing AI narrative created periods of volatility and rotation within the tech sector, but it doesn't necessarily mean the end of the AI trade. As with many transformative technologies, the initial excitement appears to be giving way to a focus on execution and profitability rather than broad enthusiasm and growth at any cost.

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At the same time, valuations across much of the AI sector have become increasingly stretched, raising concerns about forward return potential. Many leading AI-related equities now trade at multiples that assume sustained high growth, continued pricing power, and flawless execution over multiple years. While these assumptions may prove correct for a select group of industry leaders, the margin for error has narrowed considerably. Any slowdown in demand, moderation in capital spending, or disappointment in monetization timelines could result in outsized price volatility given the elevated expectations currently embedded in valuations.

Another emerging risk is the growing concentration of AI exposure within major market indices. A relatively small number of mega-cap technology companies now account for a disproportionate share of index performance, driven largely by enthusiasm around AI leadership. This concentration increases market vulnerability, as weakness in a handful of highly weighted names could have an outsized impact on broader equity benchmarks. From a portfolio construction standpoint, this dynamic reduces diversification benefits and heightens the risk that index-level returns become overly dependent on a narrow segment of the market.

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Looking ahead to 2026, these valuation and concentration dynamics represent the potential for a market pullback, particularly if macroeconomic conditions tighten or investor sentiment shifts away from growth-oriented themes. A re-rating of AI stocks does not require a collapse in fundamentals, only a recalibration of expectations. Periods of correction or consolidation may ultimately prove healthy, allowing earnings growth to catch up with stock prices and creating more attractive entry points for long-term investors. As the AI investment cycle matures, markets are likely to reward discipline, balance sheet strength, and demonstrable returns on capital rather than scale and ambition alone.

Equity Market Recap – Stock Market Ends the Year Near All-Time Highs

Stocks closed out the year with another quarter of gains, building on their momentum from earlier in the year. The S&P 500 gained 2.7% in the fourth quarter, bringing its year-to-date return to nearly 18%. The Nasdaq 100, an index of leading tech companies, gained 2.5%, raising its full-year return to 21%. Those headline returns were constructive, but the main development was a shift in market leadership. Large-cap value proxies led the market, with the Dow Jones Industrial Average and the Russell 1000 Value each gaining approximately 4.0%. The Russell 2000 also increased for the quarter, gaining 2.2%.

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Despite solid gains across the stock market, the pace of the rally continued to slow from the second and third quarters. Sector breadth also remained narrow, with the health care sector being the only one to outperform the broader index. Health care stocks benefited from renewed interest amid increased AI scrutiny and a pause in tech leadership. The sector's defensiveness and improved earnings stability were catalysts, but the quarter wasn't defined by a flight to safety. The defensive trio of real estate, utilities, and consumer staples were the weakest sectors, signaling limited investor concern about the economy.

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The shift in market leadership was modest, but it was notable. Continuing our comments above regarding index concentration, the percentage of S&P 500 companies outperforming the index has hovered around 30% during the past three years. This is significantly below the historical average of 49% and the three lowest years since 2000, illustrating how a small group of stocks (AI) has driven the S&P 500's gains. The fourth quarter rotation occurred as the Fed cut interest rates twice, a move that the market believes will ease pressure on companies.

International stocks continued to outperform U.S. stocks, extending their gains from earlier in the year. Both developed and emerging market indices gained nearly 5% in the fourth quarter. For the full year, each gained over 30% and outperformed the S&P 500 by more than 13%. Their outperformance isn't a case of U.S. weakness, with the S&P 500 gaining nearly 18%, but rather broad international strength.

2025's double-digit outperformance by international stocks over U.S. stocks is rare. In fact, the last time non-U.S. markets beat the U.S. by a similar margin was 2009, during the post-financial crisis rebound.

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A weaker U.S. dollar played a significant role, with the softness driven by rising trade tensions and policy uncertainty.

2025's double-digit outperformance by international stocks over U.S. stocks is rare. In fact, the last time non-U.S. markets beat the U.S. by a similar margin was 2009, during the post-financial crisis rebound. That year saw international equities surge far ahead of U.S. stocks. 2009's outperformance was fueled by a sharp recovery in global markets, especially in emerging economies, combined with a weaker U.S. dollar, which amplified foreign-market returns for USD-based investors.

It's also worth noting that sustained international equity outperformance over the U.S. was also seen in the early to mid-2000s. During the 2002–2007 period, non-U.S. stocks enjoyed a multi-year run of beating U.S. equities (a trend associated with the post-dotcom “lost decade” for U.S. stocks). However, on a single-year basis, 2009 stands out as the most recent case of such pronounced outperformance by international markets prior to 2025.

Credit Market Recap – Bonds Trade Sideways

The bond market was relatively quiet in the fourth quarter. Yields on shorter maturity U.S. Treasury bonds fell as the Fed cut twice, while longer maturity yields ended the quarter modestly higher as economic activity remained solid and inflation stayed near 3%. Overall, the bond market has transitioned from a source of volatility during the Fed's 2022-2023 rate-hiking cycle to one of relative stability. Changing rate cut expectations and economic uncertainty have triggered periodic volatility, but the overall path has been mild.

Corporate bonds traded higher in the fourth quarter. Credit spreads widened during periods of stock market volatility, but the moves were orderly and short-lived. The investment-grade and high-yield bond markets showed few signs of stress, and default expectations remained low. Both investment-grade and high-yield gained roughly 1% for the quarter, capping off strong full-year returns of approximately 8%.

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As the new year begins, credit spreads remain tight by historical standards. Investment-grade and high-yield spreads are at their tightest levels in decades, signaling investor confidence in corporate fundamentals and the economy. While spread tightening has supported corporate bond returns, it means valuations are no longer cheap. Corporate bonds offer compelling yields for income-focused investors, but they also come with important trade-offs. When spreads are this tight, there's less margin of safety if earnings or economic growth disappoint. For investors, we believe it's important to balance income potential with credit risk.

2026 Outlook – Market Strength Raises the Bar

Before we turn the page to 2026, it's worth summarizing 2025. The year began with the stock market hitting new highs in February, only to reverse sharply as trade policy uncertainty triggered a nearly 20% sell-off. However, the sell-off set the stage for one of the strongest recoveries in decades. Fueled by AI enthusiasm, rate cut expectations, strong corporate earnings, and resilient economic growth, the S&P 500 set more than 35 new highs through year-end.

The S&P 500 finished 2025 with an advance of nearly 18%, its third consecutive year of double-digit gains. It's been an impressive run that included a global pandemic recovery, aggressive rate hikes, and the rise of AI. Through it all, the stock market's gains have been supported by solid economic growth and strong corporate earnings.

Looking ahead, the bar is now higher. Today's starting point is very different than a few years ago, or even last year. Stock valuations are more expensive, credit spreads are near their tightest levels in decades, and expectations for earnings and economic growth are high. We don't believe any of these are red flags on their own, but they frame a market that already prices in rate cuts, strong earnings, and solid economic growth. The combination doesn't necessarily signal a stock market sell-off, but it leaves less room for positive surprises and less margin for error.

Despite the higher starting point, there are many positives. The tech sector is experiencing a wave of innovation not seen since the internet era of the late 1990s.

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Companies are generating record profits. The S&P 500's earnings grew by double digits over the past two years, with expectations for continued solid growth in 2026. Consumers, the engine of the U.S. economy, continue to spend. Interest rates are coming down, which could unlock economic activity that higher rates delayed in the past few years. Financial markets are open and functioning, and there's no clear sign of systemic stress.

The intra-year decline in 2025 is not unusual, and we have discussed market corrections in past commentaries. Since 1980, the S&P 500's average peak-to-trough decline within each calendar year is approximately 14%. These intra-year declines are a normal part of equity investing. Sizable corrections happen frequently but don't always derail the year's outcome. History shows that double-digit intra-year declines often coincide with strong year-end performance, underscoring that investors who stay the course through volatility are often rewarded.

Some things we are watching that could be potential catalysts for a 2026 decline include the following:

Lofty AI Valuations

We covered this extensively above, and we believe this remains a primary risk as we move through 2026.

Another Government Shutdown

Ongoing fiscal disagreements and a divided political landscape increase the likelihood of budgetary standoffs, particularly around funding deadlines and debt ceiling negotiations. While past shutdowns have typically been short-lived and have not caused lasting damage to the broader economy, they often introduce short-term market volatility, weaken business and consumer confidence, and delay government payments and data releases. As we experienced in 2025, a prolonged shutdown could weigh on economic growth at the margin, disrupt federal contractors and public-sector employment, and add uncertainty at a time when markets are already sensitive to valuation, concentration, and macro risks.

A Softening In Housing Prices

Higher mortgage rates, stretched home valuations, and slowing household formation

could weigh on demand. While a broad-based housing downturn is not currently expected, even modest price declines could have meaningful spillover effects on consumer confidence, household wealth, and discretionary spending. Housing has historically played an important signaling role for the broader economy, and a period of price stabilization or mild correction could reinforce concerns about slowing growth. In that environment, housing-related weakness could contribute to episodic market volatility and act as an additional headwind for equities in 2026, especially if combined with tighter financial conditions or labor market cooling.

Corporate Earnings

After several years of strong profit growth, pricing power, cost discipline, and optimism around productivity gains from technology investments, earnings forecasts now assume a relatively smooth economic backdrop and continued margin resilience. Any slowdown in revenue growth, pressure from higher labor or financing costs, or delays in realizing expected returns on capital spending could lead to downward earnings revisions. With equity valuations already reflecting optimistic assumptions, even modest earnings disappointments could prompt sharper market reactions, increased volatility, and multiple compression. As markets transition from rewarding growth narratives to demanding consistent execution, earnings risk becomes a meaningful factor that could contribute to market pullbacks or periods of consolidation in 2026.

Geopolitical risk

2026 began with the surprise U.S. military intervention in Venezuela on January 3, an event that unsettled regional stability and sent tremors through oil markets. Analysts note that crude prices are likely to jump on such supply risks, with Venezuela's upheaval raising fears of tighter output in the near term, even though a post-conflict regime change could eventually restore production.

Beyond this acute crisis, other geopolitical fault lines continue to weigh on the market outlook. Russia's grinding war in Ukraine persists with no clear end in sight, heightening uncertainty and keeping Europe's energy and commodity supplies vulnerable. At the same time, fraught U.S.-China relations, from renewed trade

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Many strategists caution that geopolitical flare-ups remain a potent threat to equities, as such shocks can trigger abrupt risk-off moves in markets. History shows that these events often lead to spikes in volatility, dollar strength, and equity drawdowns, even if their direct economic fallout proves manageable.

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disputes to saber-rattling over Taiwan, threaten to disrupt global commerce by undermining critical supply chains (for semiconductors, rare-earth minerals, etc.). Many strategists caution that geopolitical flare-ups remain a potent threat to equities, as such shocks can trigger abrupt risk-off moves in markets. History shows that these events often lead to spikes in volatility, dollar strength, and equity drawdowns, even if their direct economic fallout proves manageable. In a market that has priced in relative stability, any escalation on these geopolitical fronts could have an outsized impact, driving investors toward safe-haven assets, undermining risk appetite, and potentially catalyzing a broader market decline.

We can't predict what lies ahead, but we will continue to use a disciplined approach focused on long-term goals, diversification, and risk management, as we believe this is the best way to navigate the markets. Our team will continue to closely monitor incoming economic data and evolving market trends to help ensure portfolios remain aligned with your long-term objectives, regardless of what the market does in the short term.

Best wishes for the upcoming new year,

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S&P 500 Index is a capitalization-weighted index calculated on a total return basis with dividends reinvested. The index includes 500 widely held U.S. market industrial, utility, transportation and financial companies.

Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values.

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