NEVILLE, RODIE & SHAW, Inc. / INVESTMENT COUNSEL
Established 1933
200 MADISON AVENUE, NEW YORK, N.Y. 10016

TELEPHONE: (212) 725-1440
FAX: (212) 689-8746

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## Quarterly Review and Outlook

With the Federal Reserve cutting interest rates and corporate earnings growth remaining strong, the stock market advanced to a new high in the fourth quarter. Investors were able to look through a record long federal government shutdown and concerns about an AI capital spending bubble. While inflation remains somewhat elevated, running in the high two percent range vs. the Fed's target of 2%, it is at a level that investors find manageable. Market performance was more broadly distributed amongst stocks, particularly in the fourth quarter. Leading sectors for the year included communication services, technology and industrials. While all the Magnificent 7 stocks - comprised of Apple, Alphabet (Google), Amazon, Meta (Facebook), Microsoft, Nvidia and Tesla – generated positive returns for the year, only two outperformed the S&P 500 index.

In response to weakening conditions in the labor market, the Federal Open Market Committee on December 10th decided to lower the Fed funds rate by 0.25% to a range of 3.50-3.75%. The committee deemed that the risk associated with deteriorating trends in employment outweighed the fact that inflation is running above target. Fed Chairman Powell pointed out that non-farm payroll growth since April has averaged ~40,000 per month which compares to ~158,000 per month in the twelve months prior. He stated that "lower interest rates should help stabilize the labor market as inflation continues to moderate." Powell went on to say that "we are well positioned to wait to see how the economy evolves from here."

The Fed's easing cycle over the past two years has consisted of rate cuts which amounted to 100 basis points in 2024 and 75 basis points in 2025. The cumulative 175 basis point reduction in the Fed funds rate has brought monetary policy from restrictive to what Fed Chairman Powell calls the "high end of the range of neutral." It might be a taller order to get rate cuts from here as Fed board members grapple with a relatively strong economy and the risk trade-off between higher than target inflation and weakening employment trends. If inflation were to moderate or employment trends deteriorate from here, further rate cuts would seem likely, but as always Fed policy will remain data dependent.

While the Fed has been reducing short-term interest rates, investors in longer dated bonds have not gone along for the ride. Since the Fed resumed cutting rates in September, the yield on the 10-year US Treasury bond has increased about five basis points to end the year at ~4.15%. At the start of 2024, the 10-year Treasury yield was at about the same level, so longer dated bond rates have not changed in two years. That said they have traded in a range between the high three to high four percent level during that timeframe. Rate stickiness at the long end of the bond market, even as the Fed has eased, reflects bond investors' concern about large US federal deficits, rising US debt levels and an inflation rate that remains above the Fed's target.

With respect to the labor market, the unemployment rate remains relatively low by historical standards at 4.6% but is up from last year's trough of 3.7%. Unemployment claims remain in a fairly tight range suggesting labor market stability. That said, businesses have been reluctant to hire as reflected in moderate gains in employment during the back half of 2025. Economists have deemed this a "no fire - no hire" environment. The hesitancy to hire likely reflects economic uncertainty and the costs associated with President Trump's tariff policies.

Even with modest gains in employment, corporate earnings have remained strong and exceeded Wall Street expectations. For 2025 earnings for the S&P 500 index are expected to have increased ~12%, about double investor expectations at the beginning of the year. For 2026 corporate earnings are expected to rise ~14%. Underpinning this earnings growth have been productivity gains, currently running at ~2.5% per annum, driven by technological advancements and cost reduction initiatives. As a result, corporate operating profit margins have been on the rise.

Investors have become increasingly concerned about the possibility of an "AI (artificial intelligence) bubble" in the stock market. The concern is based on the hundreds of billions of dollars being spent by companies such as Microsoft, Amazon and Google building out AI infrastructure, including massive data centers. The question being asked by investors is: what will be the ultimate return on investment? These "hyper-scaler" companies have all indicated they are building out AI infrastructure to meet customer demand and have internally generated cash flows as well as balance sheet capacity to be able to fund their capacity additions. This would suggest sustainability in the AI buildout process, but the risk remains they may overshoot. Time will tell. Even if there is a pause in the buildout, it seems that AI driven productivity gains and associated business advances, including more efficiently run business operations, are long-term secular trends.

Within this market environment, we have maintained our focus on investing in high quality companies with strong and sustainable earnings growth outlooks. As we've communicated in previous letters, it is our belief that earnings growth over time drives long-term capital appreciation. We look for companies with reasonably valued stocks, strong management teams and conservative balance sheets. The areas of investment focus include technology, communications, industrial, healthcare, specialty finance and select consumer stocks.

Turning to our outlook for 2026, we believe it could be another good year, but there might be some choppiness along the way. Historically, the second year of a Presidential term has brought with it stock market volatility. This might reflect the uncertainty associated with mid-term elections and the potential for policy gridlock. That said, corporate earnings are expected to advance at a healthy clip, up an estimated 14% in 2026, and inflation is expected to moderate. Crude oil prices are trading at a four-year low which will benefit consumers and businesses. Lastly, the recently passed tax bill, "One Big Beautiful Bill," should support economic activity as should deregulatory initiatives. These factors provide a supportive foundation for the stock market.

In the fixed income area, we continue to focus investments in high quality investment grade bonds. These investments consist of government, corporate or municipal bonds, depending on the investment objectives and tax status of a client. We typically ladder bond positions which allows us flexibility to reinvest proceeds upon a bond's maturity.  With the Fed easing monetary conditions and inflation comparisons getting easier next year (given the lapping of tariff effects), the conditions underlying the bond market are constructive.

As always, we are grateful for your continued trust and encourage you to reach out with any questions you may have about your investments or portfolio strategy.  In closing, we wish you a happy and healthy New Year!

*Disclosure:*

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