AVITY Investment Management Inc.®

PERSPECTIVE

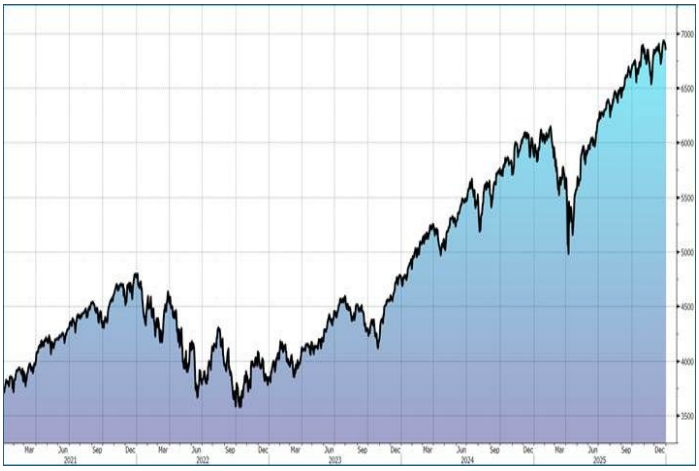
January 2026

Global markets defied a complex backdrop in 2025, delivering robust returns across both equity and fixed income investments. Shifting trade policies and geopolitical tension created volatility but were ultimately outweighed by corporate earnings strength and lower interest rates. While high equity valuations, persistent inflation and geopolitical uncertainty remain areas to monitor, the global economy is positioned to deliver another year of growth driven by fiscal expansion, consumer spending, technology investment and the lagged impact of easier monetary policy.

THE ECONOMIC YEAR IN REVIEW

The U.S. economy displayed resilience through 2025 while navigating a dynamic environment including April's tariff announcements, a cooling labor market and record-long government shutdown. The housing market remained sluggish due to stubbornly high mortgage rates, which reduced inventory and affordability. The Federal Reserve's preferred inflation barometer, the Personal Consumption Expenditures Price Index, remained sticky in November at 2.8%, well above their 2% target. Consumer sentiment was muted, particularly among lower income households, who face disproportionate pressure from high prices. The unemployment rate of 4.6% is low by historical standards but has risen from 4.0% earlier in the year. Joblessness for younger demographics has been particularly acute. While hiring trends slowed, layoffs were also subdued throughout the year. Despite some challenges, consumer spending in aggregate remained solid. Average hourly earnings of 3.7% continued to exceed headline inflation, though the pace of real wage growth has moderated. Consumer net worth reached all-time highs fueling households' propensity to spend, especially for higher income cohorts. The U.S. dollar stabilized in recent months after pronounced weakness in the first half of the year, which boosted overseas sales for domestic companies. The One Big Beautiful Bill Act, passed in July, provided meaningful incentives for business investment among other stimulative provisions. Importantly, spending on artificial intelligence remained vigorous with some estimates suggesting the infrastructure buildout contributed as much as half of real GDP growth in the last year. Overseas, European economic activity was slightly positive as the region faced tariff headwinds and mounting fiscal pressure. Emerging markets experienced faster economic growth on average while China continued to wrestle with a deepening property crisis and weak consumer confidence. Geopolitical tensions persisted in Europe and the Middle East but had little measurable impact on financial markets. Overall, the global economy remained durable in 2025 as the implementation of U.S. tariffs did not trigger the economic contraction that was widely feared.

S&P 500 Index—Past Five Years



Source: Bloomberg

THE OUTLOOK FOR 2026

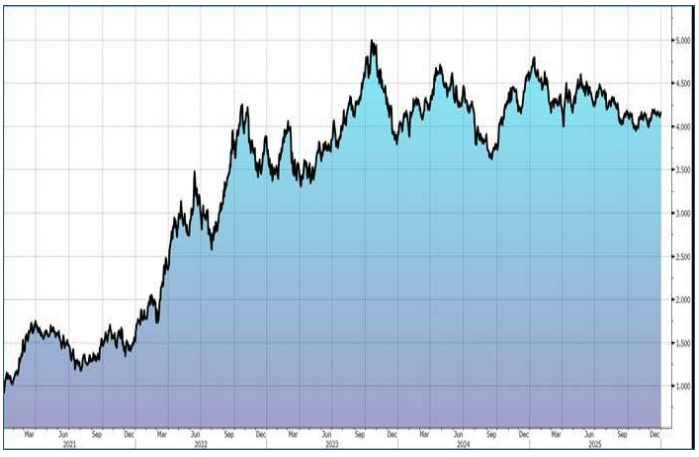
The U.S. economy will benefit in the year ahead as key aspects of fiscal stimulus take effect and the impact of interest rate cuts come to bear. Larger than normal tax refunds and a reduction in many state income taxes are likely to provide a boost to discretionary income for consumers. Regulatory relief should spur loan growth in the financial services sector, streamline permitting for infrastructure projects, and accelerate more affordable drug development. Recent improvement in labor productivity, a key component of non-inflationary economic growth, is likely to continue. There are early indications that the vast investments in artificial intelligence are contributing to efficiency gains. Inflation expectations are likely to remain well-anchored as lower costs for labor, energy and housing should offset potential price pressures from tariffs, fiscal stimulus and easier monetary policy. Existing tariffs

imposed by the U.S. last year may be further negotiated or potentially struck down by the Supreme Court. The latter would be disruptive, with potentially positive implications for growth and inflation but negative implications for the deficit and interest rates. Developing economies are benefitting from strong commodity demand and population growth. China's domestic consumption remains soft, but the country stands to benefit from accelerated AI adoption and access to cheap energy while its manufacturers adroitly re-route trade to non-U.S. markets. Growth in the European Union should persist at a moderate pace as the region adapts to protectionist shifts and increases military spending. Japan is navigating higher inflation and faces structural headwinds including a declining population and heavy debt load. On balance, the U.S. is expected to remain a principal engine of global growth, driven by supportive fiscal policy, technology leadership and reduced regulation, providing a favorable backdrop for financial markets.

FIXED INCOME

Bond portfolios recorded constructive returns in 2025 as interest rates declined across the maturity spectrum. The Fed cut its overnight lending rate by 0.75% in the second half of the year to a target of 3.75%. U.S. government bond yields have returned to a typical structure, with longer maturities providing higher yields than shorter issues. Most bonds now offer a yield meaningfully higher than the rate of inflation. Despite the decline in yields last year, rates remain well above the average of the past dec-

Ten Year U.S. Treasury Note Yield—Past Five Years



Source: Bloomberg

ade, biased higher at the long end of the curve by elevated inflation and large fiscal deficits. Upward pressure on rates could be compounded by a strong economy and any perceived threat to the Fed's autonomy, which would likely heighten inflation expectations. In the municipal bond market, taxable equivalent yields are attractive in part due to a record level of issuance. Corporate credit spreads remain historically tight, reflecting strong underlying balance sheets and low delinquency rates. In client bond portfolios, we continue to favor an intermediate duration achieved through a laddered approach to reduce volatility and reinvestment risk.

EQUITIES

In 2025 the U.S. stock market registered a third consecutive year of strong returns, characterized by broad participation across sectors, investment styles and geographies. The S&P 500 Index was up 17.9% for the year, overcoming a steep, but brief, correction in April catalyzed by tariff announcements. Gains were fueled by double-digit corporate profit growth and modest expansion in equity valuations, which concluded the year at the high end of their historical range. Record stock buybacks and a nearly 50% increase in global merger and acquisition activity reflected growing CEO confidence as trade uncertainty diminished throughout the year. Technology stocks once again led the market, though performance across industries was more balanced with health care and financial stocks gaining strength in recent months. Artificial intelligence remains a central theme for market participants. A healthy debate has emerged regarding the sustainability of the AI infrastructure buildout, specifically with respect to circular and debt financing models and the long-term return on investment. We anticipate that investor focus will eventually shift from capacity building to the adoption and utility of these tools. Ultimately, there are businesses across a range of industries, from manufacturing to consumer products, that are positioned for efficiency improvements from the deployment of AI. Following last year's gains, markets reflect high expectations for sustained profit growth and lower interest rates. With price-to-earnings multiples near a record high, any deviation from the optimistic forecast could trigger a pullback, especially in the most speculative areas. Risks that could challenge the outlook include a potential curtailment in AI capital expenditure, a continued rise in the unemployment rate, a resurgence in inflation and heightened geopolitical tension. The U.S. intervention in Venezuela introduces a new vector of uncertainty that carries potential implications for commodity markets and U.S. relations with Eurasian powers. In this rapidly evolving landscape, our strategy remains anchored to a disciplined selection of high-quality stocks at reasonable valuations that can compound capital over the course of the business cycle.