

In 2025, fundamentals prevailed over fear. From the depths of tariff policy uncertainty in April, the S&P 500 posted its eighth consecutive, albeit small, monthly gain in December to close out a solid quarter and a strong year. The fundamental drivers that propelled the stock market last year should continue in 2026 along with the added benefits provided by the One Big Beautiful Bill (OB BB) for consumers and businesses. The main risks for the markets are the elevated starting point for stocks and how the Federal Reserve ultimately deals with dual mandate risks.

Table 1 – Equity Index Total Returns – as of December 31, 2025

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
MSCI Emerging	2.99	4.73	33.57	33.57	16.40	4.20	8.41
MSCI Developed	3.00	4.86	31.22	31.22	17.22	8.92	8.18
NASDAQ	-0.47	2.72	21.14	21.14	31.43	13.35	17.66
S&P 500	0.06	2.66	17.88	17.88	23.01	14.42	14.81
Dow Jones Industrial	0.92	4.03	14.92	14.92	15.36	11.58	13.10
Russell 2000	-0.58	2.19	12.81	12.81	13.73	6.09	9.61
S&P 400	0.07	1.64	7.50	7.50	12.56	9.12	10.71

The election of President Trump and the subsequent introduction of the "Liberation Day" tariff policy in early April presented significant challenges to investors' confidence and resolve. Tariffs were viewed as a substantial disruption to the global economic system, with the potential for considerable unintended consequences. Furthermore, the absence of historical data or precedent regarding tariffs further complicated forecasting efforts for economists and analysts. As a result, both U.S. and global economies experienced increased uncertainty and market volatility. By December, however, many of these concerns had notably subsided.

Several leading investment bank economists initially lowered their forecasts for U.S. GDP growth and corporate earnings and sharply increased their estimates of a U.S. recession. They pointed to tariff-related inflation, decreased trade, possible retaliatory actions, and more cautious consumer spending and business investment as reasons for slower growth. However, just a few months later, they revised their outlooks upward after reports showed that second-quarter U.S. GDP grew at a 3.8% annual rate—well above the consensus projection of 2.0%. The stronger-than-expected results were driven by solid consumer spending, reduced imports, and strong business investment.

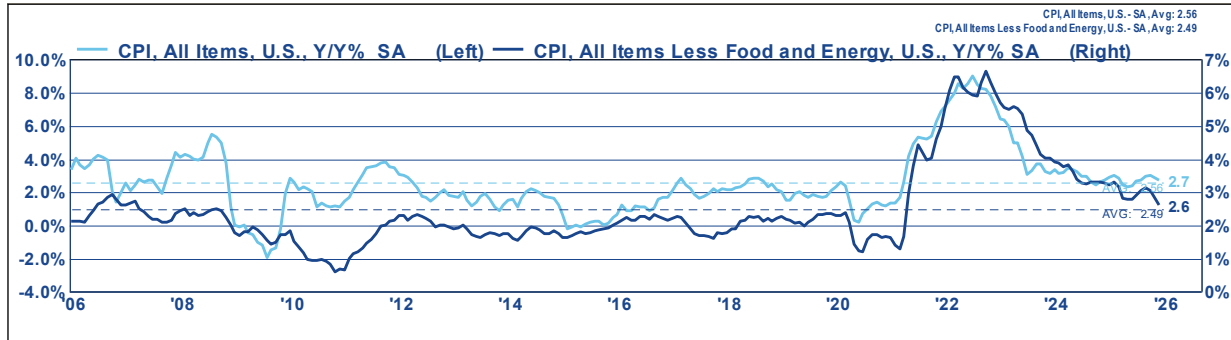
Chart 1 - U.S. GDP – 3Q25



The third quarter underscored the resilience of the U.S. economy, which recorded its strongest performance in two years by growing at an annual rate of 4.3%, surpassing the consensus estimate of 3.0%. This growth was driven by strong consumer spending, a notable rebound in exports (which added to GDP), reduced imports (which subtracted from GDP), robust business equipment spending, and investments in artificial intelligence (AI). However, economic growth is anticipated to slow to 1.0% in the fourth quarter due to the government shutdown. Looking ahead to 2026, consensus forecasts suggest growth around 2.2%, though estimates vary widely, with pessimistic projections near 1.2% and optimistic ones up to 3.5%. The Federal Reserve recently increased its 2026 growth forecast from 1.8% to 2.3%, citing consumer spending, AI-related investments, the recovery following the government reopening, and supportive fiscal policy from OB BB as the main drivers behind U.S. GDP expansion.

Since the implementation of tariff policies, both monthly (m/m) and year-over-year (y/y) inflation figures have generally met or remained below expectations. The November y/y readings for both Headline and Core CPI (excluding food and energy) were notably under consensus, at 2.7% versus 3.1% and 2.6% versus 3.0%, respectively. While tariff-related increases have contributed to higher goods inflation, these effects have been partially mitigated by a decline in services inflation. To date, higher costs for goods have largely been absorbed by producers and manufacturers; however, the Federal Reserve and economists anticipate that these costs will eventually be transferred to end consumers.

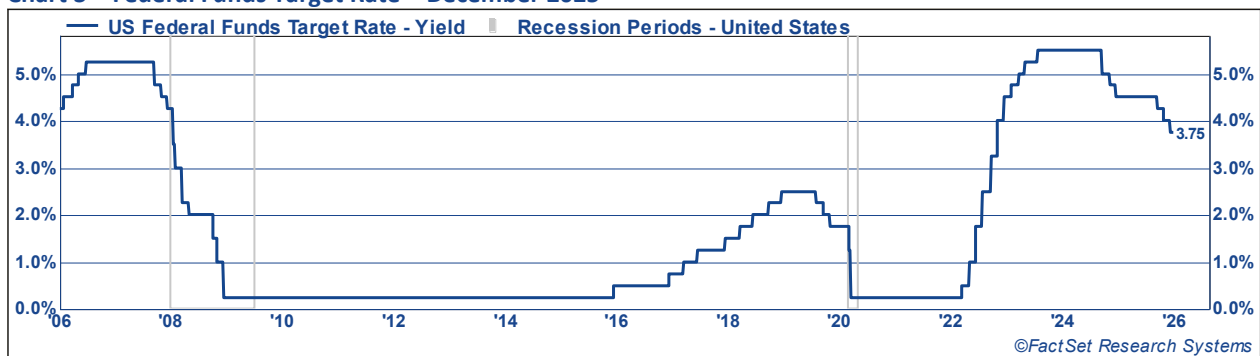
Chart 2 – Consumer Price Index – November 2025



Unless new tariffs are introduced, economists and analysts generally expect tariff-driven inflation to reach its peak during the first half of 2026, since tariffs usually affect the supply chain over nine to twelve months. Tariffs tend to cause a one-time jump in prices, and the Federal Reserve aims to prevent this from developing into persistent inflation. That's why the Fed is cautiously considering more interest rate cuts. In addition, the Fed pays close attention to long-term inflation expectations from various surveys, which remain at reasonable levels. Although inflation is predicted to gradually move toward the Fed's 2% target in 2026, some fluctuations are expected along the way.

The Fed has a dual mandate of maximum employment and price stability. The priority on these mandates shifts over time and has most recently been on inflation. Inflation has eased significantly from a 40-year high of 9.0% in mid-2022 but remains somewhat elevated relative to the Fed's 2% long-run target. While inflation has been declining, the labor market has been cooling, shifting the balance of mandate risks.

Chart 3 – Federal Funds Target Rate – December 2025



The progress on inflation has allowed the Fed to cut rates and begin to address growing labor risk, but risks remain for both mandates, which is an unusual situation. The Fed is in a challenging situation where risks to inflation are tilted to the upside and risks to employment to the downside. Having cut rates three times in the second half of 2025, the Fed feels rates are in a neutral position and can adjust to incoming data as appropriate. Until there is a clearer economic picture, the Fed is likely on hold and has projected only one rate cut in 2026.

Due to the absence of material tariff inflation last year, financial markets anticipated Fed rate cuts, resulting in lower interest rates during the latter half of the year. This environment supported strong bond returns and led to a mild steepening of the yield curve. In 2025, the 2-year Treasury note yield declined in accordance with Fed rate reductions, decreasing from 4.24% to 3.48%, while the 10-year Treasury note yield experienced a modest drop from 4.57% to 4.17%. The yield curve steepened by just 36 basis points (0.36%), which was less than expected, as a greater normalization of the yield curve had been anticipated. Historically, the average spread between the 2-year and 10-year notes is approximately 125 basis points (1.25%). Bond returns were also bolstered by narrowing credit spreads, which ended the year significantly below their historical averages. It is important to note that bond yields and bond prices are inversely related. Furthermore, for the first time in many years, I owe someone five dollars.

Table 2 – Fixed Income Total Returns – as of 12/31/2025

Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Bloomberg High Yield	0.57	1.31	8.62	8.62	10.06	4.51	6.52
Bloomberg U.S. Aggregate	-0.15	1.10	7.30	7.30	4.66	-0.36	2.01
Bloomberg Inter Gov't/Credit	0.09	1.20	6.97	6.97	5.06	0.96	2.29
Barclays Michigan Muni	0.11	1.78	4.58	4.58	4.07	0.82	2.48
Bloomberg Municipal	0.09	1.56	4.25	4.25	3.88	0.80	2.34

Regarding our investment strategy, we briefly shifted from an overweight position in stocks to a neutral weighting early last year due to uncertainty over tariff initiatives. However, we soon returned to being overweight in stocks, which remains our current stock asset allocation. Equities have benefited, and are anticipated to further benefit, from moderate economic growth, accommodative Fed policy, solid corporate earnings growth, AI investment, ongoing deregulation, resilient household spending, and advantages attributed to OBBS. For bonds, we exited our long-standing defensive posture and extended duration in anticipation of lower rates. Barring any unexpected headline events, we do not anticipate significant changes in interest rates as the Fed is expected to only cut rates once or twice this year and the rate of inflation is expected to trend lower.

In closing, it is important to remember that fundamentals and diversification matter. After three years of solid gains, stocks begin the year at an elevated starting point, especially large-cap stocks. A near-term pull back in stocks is highly likely and, like in most years, not unusual. As long as the underlying fundamentals that support stocks remain in place, stocks typically rebound in short order and continue to advance. Quite often, investors can be swayed or influenced by media or other sources and lose sight of the factors that drive markets, which are fundamentals.

Another aspect that is often overlooked is the benefit of having a well-diversified portfolio. Last year epitomized this benefit as international stocks handily outperformed domestic stocks, while high yield bonds were the best performing bond sector. Moreover, diversification helped to limit downside risk in the first quarter of 2025. Domestic stocks were down -5.0% to -10.0% on tariff concerns but were greatly offset by positive returns in international, alternative, and bond asset classes. Risk mitigation through exposure to a range of asset classes with divergent performances reduces overall volatility and enhances risk-adjusted returns. This strategic approach underscores the enduring value of diversification in navigating complex market environments. Happy New Year!!

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Sources: FactSet, Federal Reserve, Bureau of Economic Analysis, Bureau of Labor Statistics, J.P. Morgan, Goldman Sachs, Grok

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