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Quarterly Market Review

Fourth Quarter of 2025

Tailwinds Intact, Expectations Elevated

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Fourth Quarter 2025

The fourth quarter of 2025 reinforced a familiar but increasingly important message for investors: the U.S. economy remains resilient, even as financial markets are priced for a high degree of perfection. Economic momentum improved into year-end, supported by policy tailwinds, solid consumer fundamentals, and sustained investment activity. At the same time, elevated valuations across risk assets leave little margin for error should growth or earnings disappoint.

Economic and Policy Backdrop

Economic growth rebounded strongly in the second half of the year following tariff-related distortions earlier in 2025. Q3 GDP surged to 4.3%, confirming that early-year weakness was largely transitory and that underlying demand remains intact. Consumer spending, business investment, and productivity gains all contributed to the acceleration. Looking ahead, we expect growth to moderate but remain above trend, with our 2026 GDP outlook centered near 2.9%.

Despite persistently weak consumer confidence surveys, hard economic data continues to paint a more constructive picture. Core retail sales remained solid through year-end, supported by healthy household balance sheets, steady income growth, and resilient labor market conditions. The disconnect between sentiment and spending remains notable, suggesting consumers are continuing to spend even amid inflation fatigue.

Inflation trends remain uneven. Core CPI showed some easing late in the quarter, reflecting moderation in goods prices and shelter costs, while core PCE inflation remains stickier, driven in part by healthcare services. This divergence underscores the challenge facing policymakers. We believe the Federal Reserve is increasingly willing to tolerate inflation modestly above its stated 2% target, but additional policy easing beyond two cuts is unlikely absent a clearer slowdown in activity or labor markets.

Equities

Equity markets delivered positive but more measured returns during the fourth quarter. While growth and mega-cap leadership remained intact, early signs of leadership broadening emerged, with healthcare and select value-oriented and defensive segments outperforming. This shift suggests investors may be becoming more selective and valuation-aware, even as dominant growth themes continue to support index-level returns. The S&P 500 advanced 2.7% during the quarter, finishing the year up 17.9%.

Leadership remained concentrated in growth-oriented sectors. Communication Services was a standout performer, gaining 33.6% for the year, supported by resilient advertising demand, improving digital monetization, and continued enthusiasm around AI-enabled platforms. Information Technology also delivered strong full-year gains of 24.0%, though returns moderated in Q4 as valuations became more demanding and investors rotated toward areas with more visible near-term earnings support.

From a style and factor perspective, Growth (+22.2%) significantly outperformed Value (+13.2%) for the year, though the gap narrowed modestly during Q4 as valuation sensitivity increased. Momentum lagged during the quarter amid profit-taking in crowded trades, while Quality delivered solid performance both quarterly and year-to-date. Fundamental-oriented strategies also performed competitively. The Research Affiliates Fundamental Large Cap Index returned 3.97% in Q4 and 17.37% for the year, benefiting from broader sector exposure and despite reduced reliance on mega-cap leadership. Dividend-Growth strategies lagged the broader market during both the quarter and the year.

Equity market concentration remains elevated. The ten largest constituents of the S&P 500 now comprise approximately 39.2% of the index, historically large exposure to a narrow set of companies. By comparison, the Research Affiliates Fundamental Large Cap Index has a top-ten weight of approximately 18.8%. In this environment, we favor alternative weighting schemes, such as fundamental weighting, to mitigate concentration risk while maintaining exposure to large-cap equities.

Fixed Income and Credit

Fixed income markets delivered solid returns during the fourth quarter, complementing equity performance. The Bloomberg U.S. Aggregate Bond Index gained 1.1% during the quarter and 7.3% for the year, driven by a combination of lower interest rates and steady income.

Treasury yields declined between 40 and 75 basis points across short and intermediate maturities over the course of the year as inflation pressures gradually eased. The yield curve steepened, reflecting improving growth expectations alongside persistent hopes for future rate cuts. Securitized assets, particularly U.S. agency mortgage-backed securities, were among the strongest performers on both a total return and excess return basis, supported by falling interest rate volatility and attractive carry.

Corporate bonds posted solid total returns but lagged securitized sectors on an excess return basis, reflecting historically tight spreads and increased sensitivity to issuance. Intermediate corporate bonds outperformed longer-duration corporates during the quarter, as elevated M&A activity and higher issuance volumes in extended maturities weighed on longer-dated securities.

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High yield bonds outperformed investment grade credit on both a total return and excess return basis, benefiting from stable economic growth, contained default expectations, and attractive carry. While corporate fundamentals remain strong, valuations suggest limited room for further spread compression.

Most of our active fixed income strategies delivered positive excess returns during the quarter, outperforming their respective benchmarks by approximately 5–14 basis points in Q4. For the full year, most strategies finished ahead of benchmarks by roughly 24–49 basis points, reflecting effective sector allocation and credit selection as credit and MBS outperformed Treasuries amid falling interest rate volatility.

Strategic Outlook

Our outlook remains cautiously optimistic. The economy continues to benefit from policy tailwinds, rising productivity, and resilient private-sector demand. However, elevated valuations across equities and credit argue for disciplined positioning and tempered return expectations. We favor alternative weighting schemes such as fundamental weighting as increasingly attractive as a means to mitigate concentration risk while maintaining diversified large-cap equity exposure. In fixed income, intermediate-duration strategies offer a more attractive balance of yield and interest rate risk than longer-duration bonds.