



## 2025 Q4 Economic Update and Outlook

Economist and investor John Hussman [stated it well](#), “The defining feature of every bubble is the same: a growing *inconsistency* between the long-term returns that investors expect *in their heads* – based on extrapolation of the past, and the long-term returns that properly relate prices to likely future cash flows – *based on valuations*. Every bubble smuggles the same tragic past into the same tragic future by packaging it with new wrinkles that convince investors that “this time is different.” Ultimately, they still end the same way.”<sup>1</sup> How realistic are current expectations? The average Gen Z survey respondent expects to reach financial independence at the age of 32. 60% think that working a full-time job will not allow them to reach their goals.<sup>2</sup> And apparently, financial independence doesn’t mean living in a tiny house and buying second-hand clothes. 72% think they will be wealthy.<sup>3</sup> We could dismiss this as the fantasies of the young, but this mindset has infected the culture at large. In 2023, Natixis did a survey of investor expectations and found that the average investor expected returns of 15.6%, while financial advisors expected a less shiny 7%. While this data is now two years old, two more years of strong market returns probably hasn’t hurt sentiment. The generic portfolio is 60% stocks and 40% bonds. We know that the ten-year treasury bond yields 4.2%, so we can back into an 8.9% implied return on the stock part of the portfolio to hit the 7% number (ignoring fees). While that is a little below the long-term average of 10%, part of the historic return is from the earnings multiple expanding. For instance, over the last thirty years (roughly corresponding with the internet being commercial), the price increase of the S&P 500 averaged 8.4% per year, while the dividend yield over that time averaged 1.77%, for a total return of a little over 10%. Earnings only grew 4% annualized during that period, however, meaning that the rest of the return (~4% annualized) was from the market getting more expensive relative to earnings. If we assume stocks have reached a permanently elevated plateau, and that earnings continue to grow at 4% per year, US stocks will earn a little under 6% going forward. Even financial advisors may prove overly optimistic, though they look like a bunch of stick-in-the-muds compared to the public. If stocks go back to historical average multiples, returns could be negative for a decade.

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<sup>1</sup> (John Hussman, 2026)

<sup>2</sup> (Gottsegen, 2025)

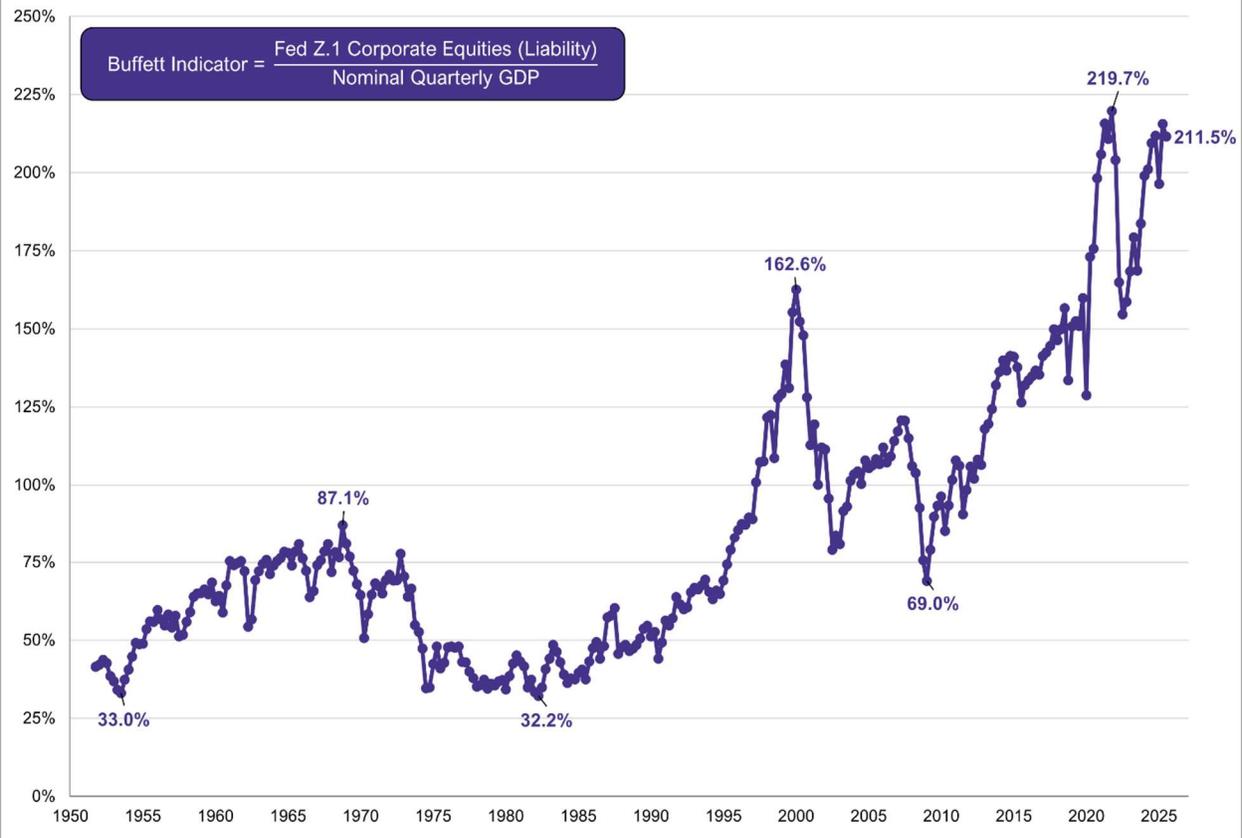
<sup>3</sup> (Davis, 2022)

I recently heard the founder of an investment company give his view on markets. He described stocks as “fairly valued”, which means they are not a bargain, but not clearly overpriced either. I asked how he could say that when the Cyclically Adjusted Price/Earnings Ratio (CAPE) is at a level only surpassed once in history (right before the tech bust in 2000). He replied that a metric that includes ten years of earnings is not useful because it doesn’t give credit to what companies are doing now. This is the point, though. Earnings are cyclical, largely driven by the profit margin cycles. Quoting Hussman again, “Over a century of market cycles, we find that price/revenue ratios and margin-adjusted price/earnings ratios are more reliable than raw P/E multiples, because profit margins vary considerably over time. A single year – or even decade – of earnings can be unrepresentative of long-term outcomes.”<sup>4</sup> A few years of above-average growth is more likely the result of a strong cycle, not a new paradigm where competition relaxes, and companies can earn permanently higher margins. Using revenue-based metrics or expanding the number of years evens out these cycles. Otherwise, we pay “peak multiples on peak earnings.” History has shown that the CAPE is more predictive of future returns than a one-year P/E, but even the trailing twelve-month P/E is about 50% above its fifty-year average and about 25% above its thirty-year average. Other metrics corroborate extreme multiples – Price/Book Value has surpassed the tech bubble high. Price/Sales is above its 2021 peak, and over 100% above its median level this century. The chart below compares the value of the market to the size of the economy. This doesn’t even account for the unprecedented number of very large private companies.

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<sup>4</sup> (John Hussman, 2026)

## The Buffett Indicator: Corporate Equities to GDP



Profit margins are a commonly overlooked aspect of earnings cycles. This is how much of a company's sales are left over for the shareholders after all expenses. This is important because margin growth or shrinkage can be as powerful as revenue growth in determining earnings growth. Profit margin is cyclical – it generally expands in good economic times and then falls in a recession. T. Rowe Price [notes](#) that margin grew throughout the 1990's, peaking at 12.2% in 2000 before dropping to 9.1% in the tech bust. While a few percentage points may seem like no big deal, it corresponds to 25% drop in profits. From there it quickly bounced all the way up to 14.2% in 2007, before dropping to 11.5% in the GFC, a drop of about 20%. Profit margin then resumed its climb, reaching 16.4% in late 2025.<sup>5</sup> This means that companies are now making about 25% more profit on every dollar of sales than they were at the peak of the tech bubble. Profit margins have experienced short cycles in a secular climb. Each peak and trough has been higher than the previous one. We should ask why that is and whether it will sustain. If company management is more enlightened and less competitive or the business environment is somehow significantly better, or the economy has shifted to more profitable industries, this

<sup>5</sup> (Corris, 2025)

trend may be a permanent shift, rather than just a long-term trend that will reverse. There is some evidence for each of these explanations, but more powerful is what has happened with taxes and interest rates. T. Rowe Price cited a 2023 paper showing that the share of Earnings Before Interest and Taxes (EBIT) going to interest and taxes decreased from a high of about 60% in the early 1980's to about 25% in 2022, which fully explained the faster growth rate of earnings in that period relative to prior periods. (In other words, quicker profit growth was due to lower tax and interest rates.) This also explains the vast majority of the increase in profit margin. Looking forward, there are a few possibilities: 1) interest and tax rates continue to fall, boosting earnings growth, 2) rates stabilize and earnings growth rates slow to historical levels, 3) rates start to rise back toward historical levels reducing profit margins and slowing earnings growth or even turning it negative, 4) companies adjust to lower rates and compete more vigorously for employees and customers, bringing profit margins down. While I don't expect interest or tax rates to go back to early 1980's levels, I don't expect them to fall further and could see some increase in response to the large US fiscal deficit and national debt. The last couple of decades have seen massive new industries dominated by a small number of competitors (or oligopolists) such as personal computers, software, internet search, online retail and electronic consumer products. Each of those areas is now mature, and the dominant companies are entering into competition with each other for the highly profitable cloud services and highly unprofitable artificial intelligence. Both of these are much more capital-intensive relative to the capital light businesses these companies have historically dominated. This is a recipe for falling margins, driving slower or even negative earnings growth.

For the last quarter, International Stocks beat US stocks, and US Value beat US Growth. It was a strong finish to a strong year, with nearly every asset class making money, and most exceeding their long-term returns. Value and small both lagged growth stocks, but the new year has started strong for both. We maintain a tilt to value and small, which have historically earned better returns than the US large cap space, the last decade notwithstanding.

YTD Total Return	1 month Total Return	3 month Total Return	6 month Total Return	1 year Total Return	3 year Total Return	5 year Total Return	10 year Total Return
Emerging Markets 34.4%	Emerging Markets 3.0%	World exUSA 5.3%	Emerging Markets 16.3%	Emerging Markets 34.4%	US Growth 31.2%	US Growth 15.3%	US Growth 18.1%
World exUSA 32.5%	World exUSA 3.0%	Emerging Markets 4.8%	US Small 14.9%	World exUSA 32.5%	S&P 500 23.0%	Commodities 14.7%	S&P 500 14.8%
US Growth 18.6%	US Value 0.7%	US Value 3.8%	US Growth 11.8%	US Growth 18.6%	World exUSA 18.3%	S&P 500 14.4%	US Value 10.5%
S&P 500 17.9%	Muni Bonds 0.1%	S&P 500 2.7%	S&P 500 11.0%	S&P 500 17.9%	Emerging Markets 17.0%	US Value 11.3%	US Small 9.6%
US Value 15.9%	S&P 500 0.1%	US Small 2.2%	World exUSA 11.0%	US Value 15.9%	US Value 13.9%	World exUSA 10.0%	World exUSA 9.1%
US Small 12.8%	Aggregate Bonds -0.1%	Muni Bonds 1.6%	US Value 9.3%	US Small 12.8%	US Small 13.7%	US Small 6.1%	Emerging Markets 8.9%
Aggregate Bonds 7.3%	Commodities -0.3%	US Growth 1.1%	Commodities 5.1%	Aggregate Bonds 7.3%	US Real Estate 6.9%	US Real Estate 4.9%	Commodities 6.1%
Commodities 7.1%	US Treasuries -0.3%	Aggregate Bonds 1.1%	Muni Bonds 4.6%	Commodities 7.1%	Aggregate Bonds 4.7%	Emerging Markets 4.7%	US Real Estate 5.8%
US Treasuries 6.3%	US Small -0.6%	Commodities 1.0%	Aggregate Bonds 3.2%	US Treasuries 6.3%	Muni Bonds 3.9%	Muni Bonds 0.8%	Muni Bonds 2.3%
Muni Bonds 4.2%	US Growth -0.6%	US Treasuries 0.9%	US Treasuries 2.4%	Muni Bonds 4.2%	Commodities 3.9%	Aggregate Bonds -0.4%	Aggregate Bonds 2.0%
US Real Estate 3.8%	US Real Estate -2.1%	US Real Estate -2.3%	US Real Estate 0.7%	US Real Estate 3.8%	US Treasuries 3.6%	US Treasuries -1.0%	US Treasuries 1.4%

Past performance is no guarantee of future results. You cannot invest directly in an index.

\*Data as of 12/31/2025

## The New Federal Reserve Chairman Appointee

While Kevin Warsh still needs to be confirmed, he is expected to be the new Fed Chair. Sometimes called the most powerful person in the world, the Fed Chair is closely watched by the market for clues about what will happen with US monetary policy.

To learn more about Warsh, we look to economist and Fed Watcher Ed Yardeni. Warsh has indicated that he is interested in reducing the Fed Funds rate and also reducing the size of the Fed balance sheet.<sup>6</sup> These seem to be contradictory moves. For the layperson, the Fed only sets the short-term rate – the rate that banks can borrow at the discount window. Longer-term rates are set by market dynamics, and are heavily influenced by short-term rates, expectations of future Fed action, and supply and demand in the market. Historically, the Fed moving rates around has been likened to pushing on a string. It moves the front end of the string much more than the back end. By encouraging banks to borrow money and lend, the Fed hopes longer-term rates will fall. This works, but not perfectly. In the Great Financial Crisis (GFC), the Fed reduced the Fed Funds rate to 0%, but wanted to do more. Not wanting to pay banks to take money, and wanting to more directly impact the longer-term rates, it began buying longer-term government bonds with

<sup>6</sup> (Yardeni, 2026)

conjured money. This increase in demand pushed the rate curve downward. This was called Quantitative Easing, or QE, and was supposed to be a temporary emergency measure. It was popular, and the public always wants more economic growth (with less concern about the long-term effects), so the Fed followed with an encore – QE2. And then three and four... Pundits started calling it QEternity. As is common with government policy, what is meant to be temporary becomes an entitlement. When the Fed finally started reducing its bloated balance sheet, pundits referred to Qualitative Tightening, instead of just normalizing. After years of shrinking its holdings at a glacial pace, the Fed has paused. Mr. Warsh advocates continuing to bring the balance sheet back toward historical norms and again letting market forces set the long-term rate, while the Fed goes back to focusing on the short-term rate.<sup>7</sup> The impact of cutting the short-term rate and reducing the balance sheet would likely be to have higher long-term rates and lower short-term rates. While Mr. Marsh claims this is good for Main Street and pulling support away from Wall Street, banks tend to borrow at the short-term and lend long-term. Mortgage rates could go higher, but shorter-term credit card and car loan rates may go lower. Maybe.

It's important to remember that there are twelve voting members of the Federal Open Markets Committee (FOMC) and that the chair only gets one vote on interest rates. While Chairman Warsh would be able to set policy on how the Fed communicates, and would become the primary spokesman, his one vote may not change actual policy. He has been critical of the Fed, so he may have a challenge getting the other 11 voting governors to come around to his view.

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<sup>7</sup> (Yardeni, 2026)

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