

# Markets & Investing: Big Earnings, Big Spending

February 2026



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## Executive Summary

- **Strong results amid uncertainty:** The S&P 500 returned 17.9% despite widespread economic uncertainty.
- **Fundamentals remain strong:** Earnings growth is well above historical norms, and interest rates have stabilized.
- **Inflation is moderating:** Longer-term rates suggest stable to easing inflation, even as 2022 lingers in memory.
- **Discipline matters:** Equity growth is essential, but rebalancing helps keep portfolio risk aligned.

## A Year That Defied Expectations

Markets are prone to surprise you. 2025 was a working illustration. The S&P 500 delivered a 17.9% total return for the year despite uncertainty driving deep concern about the economy. The uncertainty primarily came from the new administration's combination of policy and delivery, evolving views about the prospect of new technology, and the abrupt reintroduction of significant tariffs. All this confusion masks two important fundamentals. First, earnings are growing well above historical rates and are expected to continue doing so. Second, interest rates have stabilized at levels that suggest some combination of strong growth for the economy and slightly elevated, but stable inflation expectations.

## Bad Sentiment, Better Reality

Generally, surveys of consumers and businesses began the year poorly and have only worsened, while objective data (GDP, employment, consumption, etc) suggests that the U.S. economy remains healthy and resilient. There have been some better periods of sentiment and worse, but the general deterioration in sentiment started with Covid and skepticism has been the most consistent factor since. Meanwhile, unemployment remains low by historical standards, inflation has moderated, and the economy is growing.

## Trade Noise, Inflation Memory, and AI Questions

Obviously, sharp changes in trade policy are part of the concern. Tariffs are being reintroduced at a high rate and announced at a level that is pure hyperbole. While much remains to be learned on ultimate trade policies and tariffs, the very high headline rates announced in early 2025 have not come to fruition. Inflation is another factor. While inflation has moderated substantially from 2022 highs, it was a bad experience and people are not inclined to trust the declining growth rate of prices until satisfied based on personal criteria that can be hard to measure; therefore, it shows up negatively in sentiment surveys. Artificial Intelligence (AI) is being perceived and assessed in ways that lean negative right now, which we believe also contributes to the salty outlook. Explaining pretty good results for the economy in general and investments specifically probably comes down to an underappreciation of just how big, dynamic, and resilient the US economy is. I believe our brains are highly sensitive to concern around potential fault lines with the sensitivity made stronger because we Americans have it pretty darn good. Said differently, we have a lot to lose. We also tend to see a static environment where statistics drive behavior rather than behavior responding to and ultimately driving statistics. Our (approximately) \$30 trillion U.S. economy reflects 340 million Americans acquiring what we need or want while adjusting along the way. There are a staggering number of moving parts to the U.S. economy. That doesn't mean the fault lines aren't real; however, things are more durable than commonly perceived.

## Employment Holds, Inflation Lingers

Unemployment remains low by historical standards but has risen gradually from very low levels, in which there were not enough workers to fill needed positions. Following very large negative revisions to prior (very strong) payroll reports in 2024 and again in 2025, the Establishment Survey has lost credibility. The Bureau of Labor Statistics (BLS) gathers information regarding new hires and specific industry trends with a survey of businesses where the sampling procedures are not working as well as they once did. Whether businesses aren't answering or the BLS is not asking the right businesses the right questions, the survey has not been effective for several years. Therefore, the Household Survey is carrying the water. For the Household Survey, the BLS checks in with a sample set of individuals to develop a picture of the labor force participation and unemployment. December unemployment was 4.4%, down from 4.6% in November, which in turn was about flat with September. October was not reported due to the Government shutdown. The rate is higher than the 4.2% reported in November 2024, but it remains low by historical standards. Post shutdown, returning to a steady cadence of employment reporting should iron out perceived glitches attributable to the October interruption. Each new report should restore confidence in the accuracy of the series.

Inflation is still hanging around. While inflation rates have been stable, they remain above the Federal Reserve's somewhat arbitrary 2%

target. For December, the Consumer Price Index, excluding volatile food and energy, increased 2.6% year over year, which was better than anticipated and flat with the November report. While this is improvement for an economist, it is important to remember that the price level remains significantly higher than it was prior to 2021. Prices don't typically revert, so people still feel the impact of recent inflation in a visceral way. That said, future inflation expectations have remained anchored at about 2.24% based on the breakeven implied by Treasury Inflation Protected Securities (TIPS). Together with stability of longer dated treasury rates, the evidence suggests that inflation is stable to moderating; however, high inflation from 2022 may be a wound that only time can heal.

Recent Fed voting and forecasts have been divided about the balance between the dual mandate of price stability and full employment. After cutting the Fed funds rate to 3.75% on December 10, Fed officials see healthy 1.8% Real GDP growth, falling unemployment, and falling inflation. There is a lot of dispersion among the Fed Governors, but the expectation for the Fed Governors and the derivatives market is one or two rate cuts in 2026. The factors creating a reticence to cut are stable labor markets and uncertainty regarding the impact of tariffs on future inflation rates. Those who want more aggressive cuts see restrictive monetary policy as a factor for slow employment growth and mortgage rates that restrict housing affordability. The executive branch's input and actions have turned this into a debate about Fed independence. We do believe that the

Fed policy needs to be independent.

## AI Realities: Economics Matter

People have started to ask harder questions about AI. A euphoric response to the launch of ChatGPT in November 2022 has settled into a more intricate debate about the economics of the platforms and what developments mean for individuals, communities, and markets. First, there is the concern about large amounts of debt and other financing arrangements being used to build expensive infrastructure. Much of the spending is being done with internally generated cash from phenomenally profitable high-growth companies; however, there are also younger companies involved that are accessing debt capital markets to fuel investment. People are having flashbacks to the cables laid in the 1990's to facilitate Internet access, which resulted in overcapacity and extensive bankruptcies. At this point, it is difficult to see how the business is going to develop. The opportunities are boundless, but the development of the models does not seem to be producing any breakaway winners; the newest model generally receives the best reviews regardless of who programmed it. What we do know is that it is available to everybody at reasonable cost, which is a good thing and should further drive demand and expand use cases. Our thought is that today's big spenders will not likely earn abnormal economic profits for basic access to the models. Rather, the innovation around how to use the new capabilities to provide useful services for people and businesses are what we need to watch. It is just getting started.

We do believe the build-out will go ahead and possibly accelerate with the support of capital markets and eager consumers. ChatGPT's CEO clumsily, but probably accurately, noted that there are national security as well as national competitiveness considerations that will likely backstop development economics.

We believe the concern about the price of AI infrastructure misses the fact that everyone involved wants to bring the price (and energy required) down. Technology is an inherently deflationary industry due to intense competition and efficiency. Any pricing power that does exist reflects new innovations that offer higher value for the consumer. We don't expect that to change. These are very high-value problems to solve and people are working on delivering cheaper and more efficient solutions. There are also concerns about the impact on jobs, power prices, water consumption, and on more existential levels, critical thinking, and human connection. It might have something to do with slow hiring. Companies are eager to tout new use cases and greater efficiency. We'll see. There has never been a (non-military) technology step-change that didn't "grow the pie."

## Big Spending, Big Earnings

Consumer spending continues to grow at a healthy clip despite the negative mood reflected in surveys. The dynamics behind the growth have been christened the "K-shaped" economy. Wealthy consumers are spending more and account for far more spending than lower income cohorts. There are many explanations, but it seems that the

"wealth effect" is driving strong spending among those who own assets (that have appreciated) and price levels and concern about the future are limiting spending among others. Wage growth has been healthy (3.8% for the month of December), but finding new work is more difficult for reasons that are little understood. We believe we do need spending and employment growth to broaden for sustainable growth. Additionally, labor productivity has been very strong relative to historical levels. This is not great if you are looking for a new job today, but it does create the opportunity to grow faster without sparking inflation and increases the value of each job for the jobholder over the long run (leading to higher paychecks in real terms). We're optimistic.

S&P 500 earnings grew 11% in 2024, probably grew about 12% in 2025 and are forecast to grow almost 15% in 2026 compared to the long-term average of 6% to 7%. The forward S&P 500 Price/ Earnings Multiple for the next 12 months is 22.5X, reflecting expectations for continued growth. To meet the growth expectation for 2026, the capital spending for artificial intelligence needs to continue and a broader group of index constituents need to participate including companies in the financial and consumer discretionary sectors. We believe this depends on job growth and broadening investment beyond data center facilities and equipment, which is probable given fiscal stimulus, deregulation, lower interest rates, a multi-year period of weak consumer sentiment, low rates of investment (outside datacenters), and low inventories.

## Risk Management In a High-Price Market

An intermediate maturity bond portfolio yields about 2 percentage points more than it did in 2021. In a market with stable inflation, falling short-term rates and relatively high equity prices, this is a good thing. It is easy to fall into a routine of deferring capital gains and letting equities grow to a larger percentage of portfolios. It could be the best thing for growing wealth, but not for managing risk. The growth provided by equities is necessary for maintaining spending power long into the future; however, low capital gains rates are a small price to pay for keeping portfolio risk well aligned. The markets have looked past many events in recent years, but there will be something out there that will cause a serious drawdown. Take some gains, pay some taxes, but don't be caught wildly overweight in equities when the inevitable "shoe" drops. We recommend a thoughtful investment policy that accurately addresses both goals and risk tolerance, disciplined adherence to equity targets, and reducing very large single stock positions. Over time, this should result in healthy returns and limit the risk of drawdowns outside of expectations.

## Looking Ahead

While I am looking forward to many things in 2026, I believe there is an underappreciated milestone. July 4, 2026 represents 250 years since the signing of the Declaration of Independence. I think this is something to get very excited about. I grew up in the '70s and recall our making a big deal out

of America's Bicentennial in 1976. In my opinion, a quarter millennium is a bigger milestone. The intervening years have not been perfect, but I do believe that document set in motion ideals that are worth gratitude and celebration every day, but particularly on our 250th birthday. We appreciate the opportunity to serve our valued clients. We wish you a healthy and prosperous 2026! ■