

## The Coming Year In A Word (Or Two): Cautiously Optimistic

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There are powerful forces at work in the coming year and beyond that render us optimistic: we expect solid economic growth, solid earnings growth likely to broaden beyond the “usual suspects,” and a still-resilient consumer. Simultaneously, we must remain cautiously on guard for equally real risks and vulnerabilities that could trigger higher-than-average volatility.

Despite our optimism, the odds of a double-digit stock market drawdown/correction along the way are nearly a sure bet. We make that prediction not with any particularly novel or keen insight but with respect for history: U.S. stocks have suffered such gut-wrenching events in 8 of the past 10 years<sup>1</sup>, all the while tripling in value over the same time frame. These painful episodes are not a bug of healthy equity markets. They are a distinct feature.

On balance, though, the tug-of-war between opportunity and risk still tilts toward cautious optimism. Below we outline the forces pulling in each direction, and why we are positioning your portfolios accordingly.

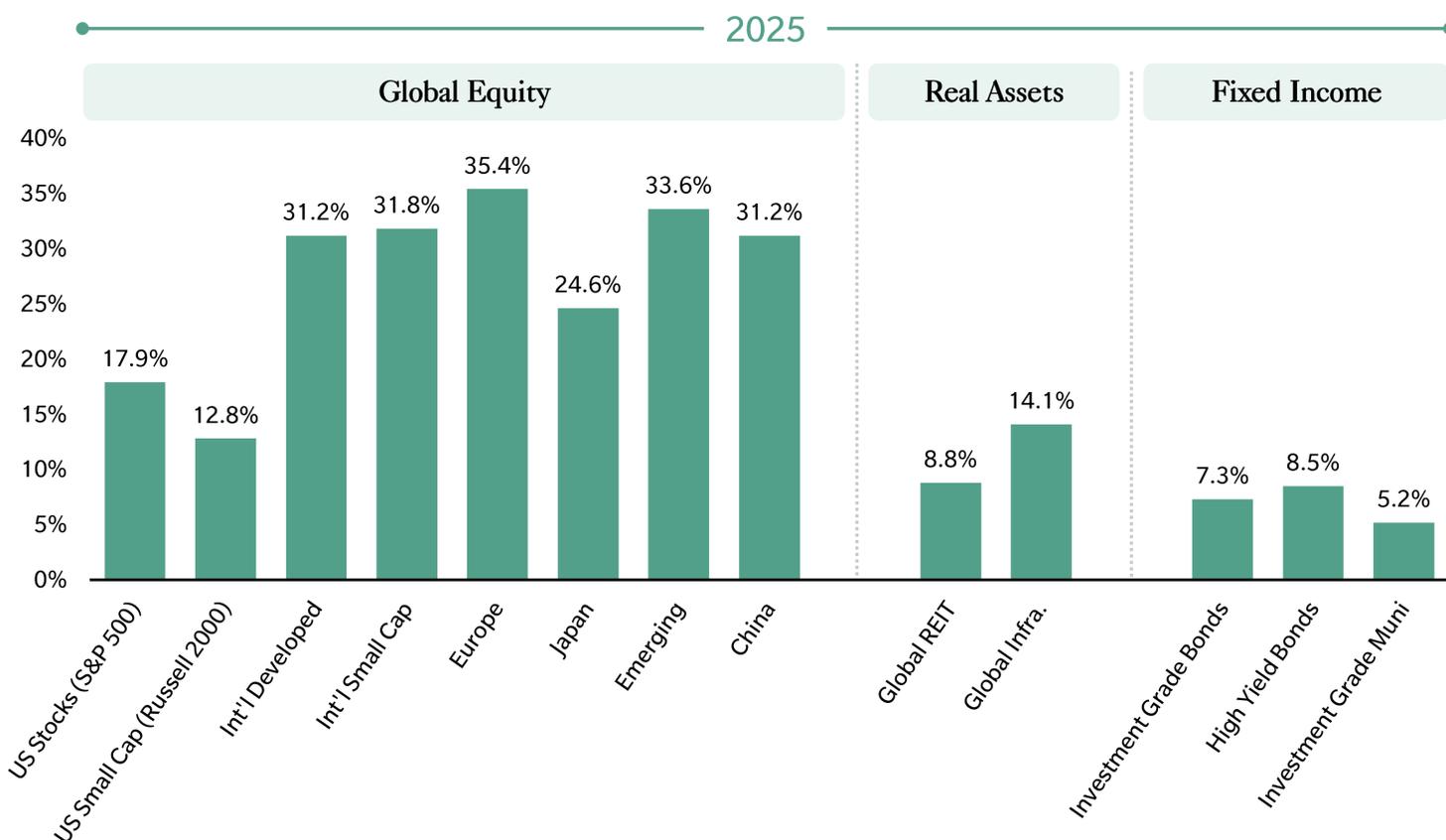
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<sup>1</sup> And 19 of the past 25 years.

## *First, the Optimism*

2025 got off to a rough start. Markets moved up in the first few weeks of the year but then suffered a massive sell-off on the heels of historic new tariff policies. Markets bottomed, however, when the administration pressed “pause” on their implementation. From early April, markets started their ascent northward and essentially never looked back. Below is a chart showing the 2025 returns of major equity, real assets, and fixed income markets.

### *U.S. and Global Markets: A solid year all around*



Source: Standard & Poor's, MSCI, FTSE, DJ Brookfield, Bloomberg, ICE BofA. Index returns. Any investment can result in total loss. Past performance is not necessarily indicative of future performance.

Many of the elements that drove that recovery will still play out in the coming year (and years).

## *Fiscal and Monetary Stimulus*

A defining feature of the current environment is the degree to which fiscal and monetary policy are reinforcing one another.

On the fiscal side, OBBBA—the One Big Beautiful Bill Act—represents a meaningful injection of economic stimulus. Extended tax cuts should put additional discretionary cash in the hands of households and businesses. Targeted provisions—reduced taxation on tips, overtime, new tax benefits for those over 65,

tax-deductible auto loans, and expanded SALT (state and local tax) deductions—should further support U.S. consumers. For businesses, more favorable tax treatment for capital expenditures and R&D lowers the after-tax cost of investment<sup>2</sup> and improves cash flows. In all, OBBBA is expected to add a full percentage point of GDP in the coming year.<sup>3</sup>

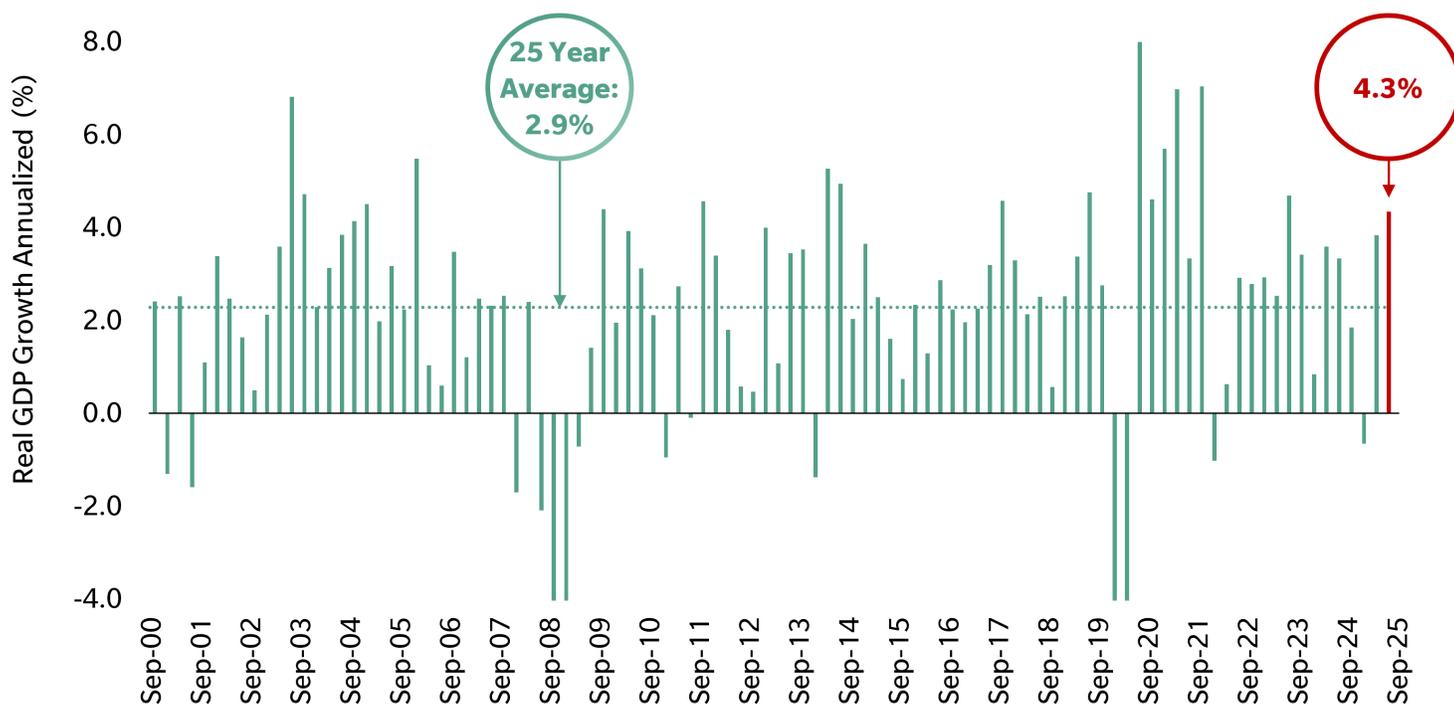
Monetary policy will remain supportive as well. Over the past year and a half, the Federal Reserve has cut short-term rates by a cumulative 175 basis points (1.75%). There is a lag effect to this stimulus, so 2026 should reap most of the benefits.

Recent GDP growth above 4% is much higher than the average over the past quarter-century, and momentum is expected to carry forward. Our base case is continued above-average growth; even a more pessimistic scenario would still likely avoid a recession.

### *Economic growth appears solid*

## Economic Growth

Much better than average



Source: U.S. Bureau of Economic Analysis

<sup>2</sup> This accounting treatment may seem a bit arcane and byzantine, but it allows businesses to expense 100% of capital expenditures or R&D expenses in the first year instead of depreciating them over a typical 5, 7, or 10-year period. It does not change the nominal tax a company pays, but it dramatically changes when they pay it which has real economic benefits: freeing up cash flow for hiring, inventory builds, debt reduction or additional investment in software, logistics, or advanced manufacturing tools.

<sup>3</sup> This is an estimate from the Congressional Budget Office.

## *Business Investment*

Corporate investment—particularly in technology, artificial intelligence (AI), and automation—remains vibrant. Hyperscaler capex on AI and data centers is growing rapidly and could exceed \$0.5 trillion by the end of 2026, supported by a wave of partnerships across chips, cloud, and infrastructure. Importantly, this is not only “big tech” spending: we are also seeing broader corporate budgets shift toward software, security, automation, and efficiency projects. OBBBA’s fiscal incentives reinforce this trend, encouraging firms to modernize and expand.

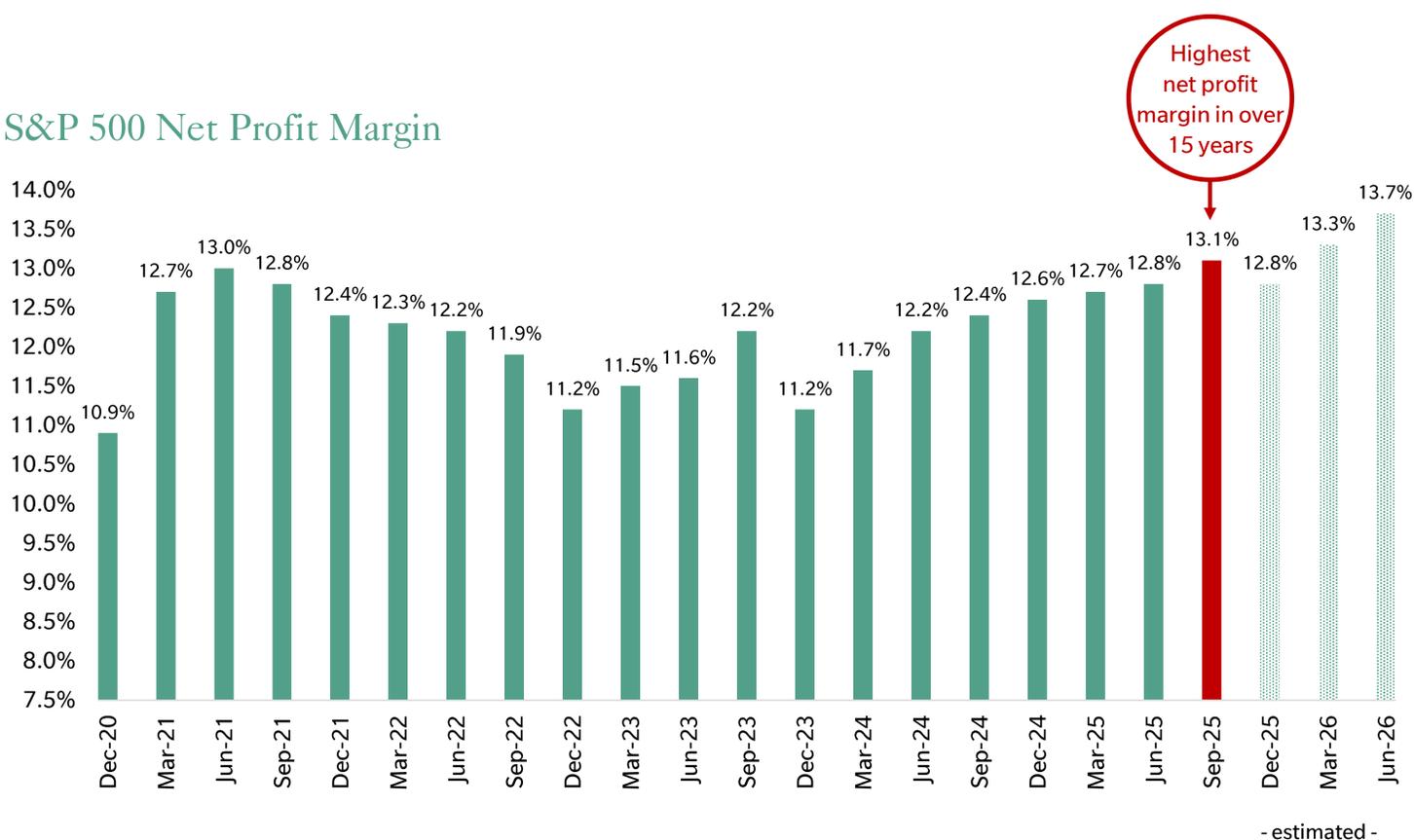
## *Productivity, Profitability, and the Evolution of Artificial Intelligence*

AI has moved beyond the novelty phase. The conversation is shifting from generative tools to agentic systems that can execute tasks such as automating workflows, optimizing logistics, and augmenting human labor. 2026 will be a “show me” year, as companies face pressure to demonstrate tangible returns on heavy AI spending.

If successful, these technologies could improve productivity, expand profit margins (beyond their record highs), and help offset demographic and labor constraints. Productivity gains remain one of the few ways an economy can grow faster without reigniting inflation.

### *Profit margins: highest in 15 years*

#### S&P 500 Net Profit Margin



Source: FactSet. FactSet has been maintaining the Net Profit Margin since 2009. Today’s margins are the highest since they started measuring it.

## *Customer Resilience Beneath the Headlines*

As we discussed in our prior letter, *The Prosperity Paradox*, there remains a yawning gap between consumer sentiment and consumer behavior. Survey data suggests spending reticence, but actual spending data suggests resilience.

Headlines about rising credit-card delinquencies also deserve context. Many measures suggest households have been managing credit responsibly: See charts below. A growing share of consumers pay balances in full each month, and fewer carry revolving balances. In other words, there are stress signals at the margin, but not the broad-based deterioration that typically precedes a sustained pullback in consumption.

Consumer spending—roughly 70% of GDP—remains healthy, with travel, entertainment, and restaurant dining holding up well, most notably among higher-income households (of note, higher-income households account for a disproportionate amount of overall consumption). Even interest-sensitive purchases like furniture and other durable goods have posted multiple consecutive quarters of growth, encouraging given the higher cost of financing.

Early data on the 2025 holiday season is encouraging: MasterCard SpendingPulse data showed retail sales growing over 4% over last year (“holiday” items rose even more) despite earlier surveys suggesting that consumers were prepared to cut back. To be sure, consumers used more online shopping venues this year, so price-shopping or value-based shopping is indicative of some consumer softening, particularly among lower-income households.<sup>4</sup>

The wealth effect, driven by three consecutive years of rising stock markets and higher home values, could also support spending in the coming year. That doesn’t mean every household is thriving, but it does mean that aggregate consumer spending should continue to provide a tailwind for the economy.

Employment remains the foundation. Unemployment remains below historical averages. New and continuing jobless claims are still near multi-decade lows. Real wages have risen for more than 30 consecutive months. Consumers may express anxiety, but they are still working, earning, and spending.

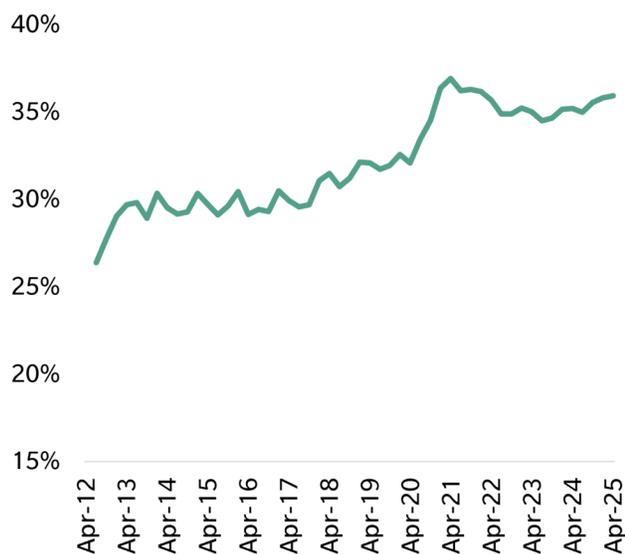
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<sup>4</sup> See Bank of America Institute, “Consumer Checkpoint; Merry but Measured.” December, 2025.

## Consumers have been behaving more responsibly, not less

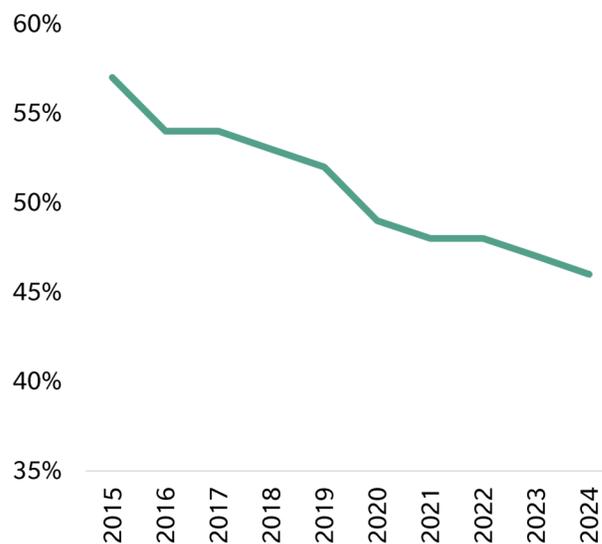
### Credit Cards:

% Making Full Balance Payment



### Credit Card Usage:

% Carrying A Balance

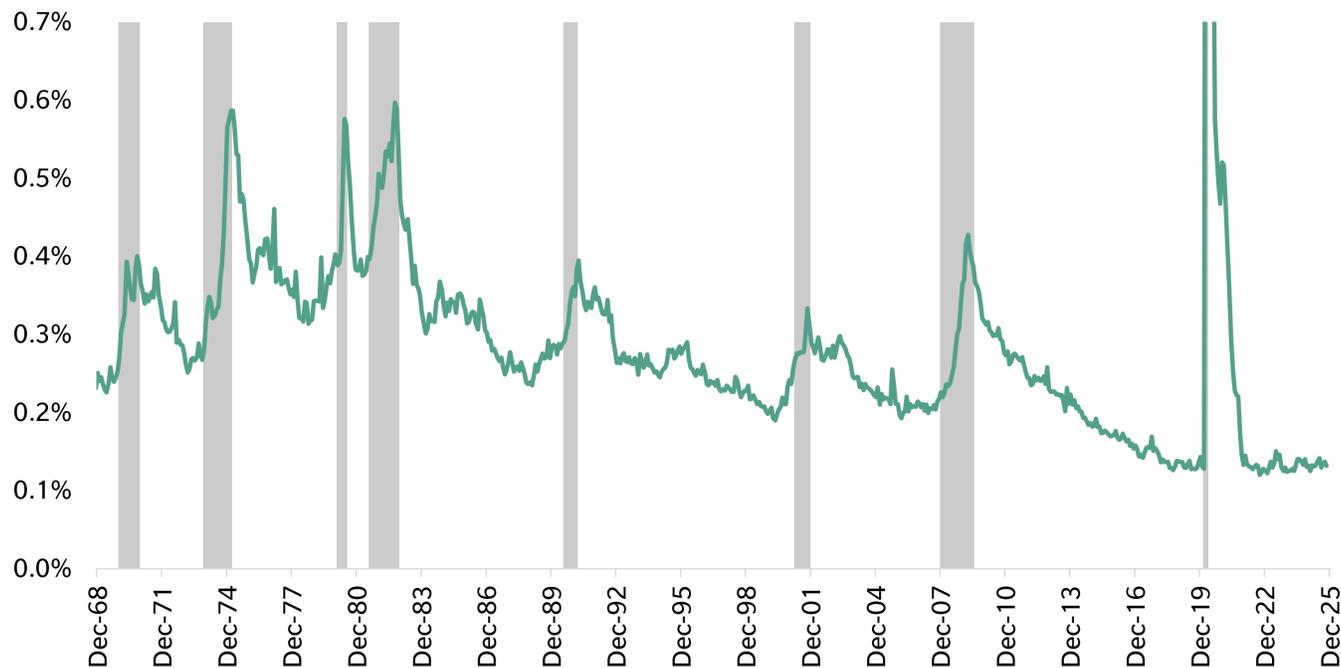


Source: Federal Reserve, Economic Well-Being of U.S. Households, published May 2025. Carrying a balance means at least once in the past year.

## Initial unemployment claims: some of the lowest in half a century

### Initial Unemployment Claims

As % of Civilian Labor Force



Source: FRED, Ballentine Partners. Initial claims divided by civilian labor force level (1,000s). Data has been truncated due to the extreme effects of the Covid era. Gray bars represent recessions.

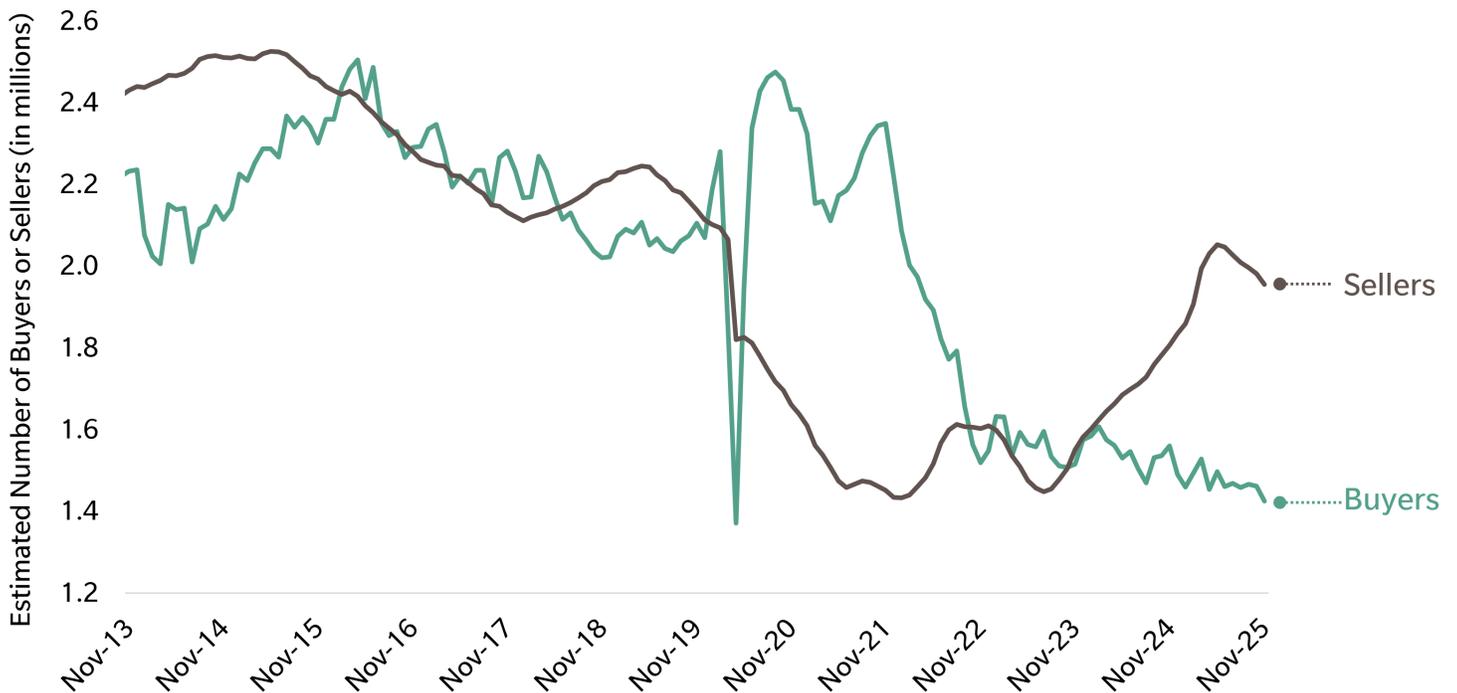
## Tangible Progress on Inflation

The latest CPI print came in at 2.7%, below expectations. Gasoline prices have recently dipped below \$3 per gallon nationally, which is both an economic and psychological boost. Egg prices, which are a high-frequency purchase and a frequent 2025 news story, have fallen 44% from summer highs. In many regions, rents are actually *declining* (remember the difference between disinflation, or prices rising at a slower rate, vs. deflation, which is prices actually coming down). While housing prices in the aggregate have continued to rise, 2025 ends the year with significantly more sellers than buyers—the widest gap we’ve seen in over a decade, which portends lower housing prices. Shelter costs make up roughly a third of CPI calculation, so this is meaningful. That combination of cooling shelter costs alongside moderating energy and food costs helps explain why inflation expectations have become better anchored.

*Housing dynamics: prices will be under pressure to come down*

### Sellers Outnumber Buyers:

One of the widest gaps in over 12 years



Source: U.S. Bureau of Economic Analysis

The affordability issue (i.e., not the inflation rate, per se, but the actual price level of goods and services) remains a lingering psychological pain for many, but the actual balance sheets and income statements of most American families are in solid shape.

## *Now the Caution*

### *Valuation Risk*

The largest investment risk today is valuation, particularly among the largest U.S. companies, the Magnificent Seven.<sup>5</sup> After years of strong stock price performance, expectations embedded in those prices are high, some argue absurdly high. In a recent Bloomberg survey, 21 out of 21 Wall Street strategists forecasted a 2026 rally. When expectations are that elevated, we cross into uncomfortable bullishness territory, as even small disappointments, such as an earnings miss by a penny, modestly slower growth, or cautious guidance from senior management, can trigger outsized volatility.

In AI-related sectors, analysts have raised concerns about aggressive accounting assumptions that may be flattering near-term earnings. There is growing concern that these supposed “asset-light” business models have become “asset-heavy” with the unprecedented expenditures on data centers, energy supply, and hardware. Competition risk is also real. In early 2025, headlines around a Chinese AI entrant (DeepSeek) helped trigger a sharp one-day \$600 billion drop in Nvidia’s market value, reminding investors that high valuations can magnify reactions to both real and rumored threats.

Some observers compare today’s valuations to the tech bubble of the 2000s era. While we disagree with that conclusion for many reasons,<sup>6</sup> the underlying nervousness itself can increase fragility. Expensive valuations do not *ipso facto* presage declines, but they do reduce the margin for error.

### *Soft Data and Pockets of Consumer Stress*

Consumer confidence, a key measure of “soft” data, remains unusually low. Within the labor market, a no-hire-no-fire dynamic has taken hold, masking underlying weakness. So while the chart before shows low levels of layoffs or unemployment claims, new hiring is also subdued.

While headline labor data remains solid, stress is evident in certain pockets. Unemployment among younger workers and recent graduates has been rising for more than a year. The resumption of collections on defaulted federal student loans in 2025 adds another source of financial stress for some households. These vulnerabilities bear watching because they can affect confidence and spending even before they show up in broader economic data.

### *The Sheer Amount of Uncertainty*

Markets hate bad news. They hate uncertainty even more. And several sources loom large in the coming year.

Tariff policy remains unsettled, with the Supreme Court expected to rule soon on the legality of the tariffs. A ruling against the administration could raise questions around which tariffs remain, whether

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<sup>5</sup> Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, Nvidia, Tesla.

<sup>6</sup> We wrote about this extensively in our Q3 Investment update. Our contention is that comparisons between today’s environment and those surrounding the Tech bubble are unfair: interest rates are lower by almost half, profit margins on the S&P 500 are nearly double, the quality of the S&P 500 is higher (in terms of balance sheet strength, lower earnings volatility, higher return-on-equity, etc.). Importantly, while the largest companies make up a concentrated weight in the S&P 500 index, this weight is proportionate to the share of earnings these companies are generating. Also, the financing of their capital expenditures is coming from free cash flow; back in the tech bubble, it was primarily debt issuance.

refunds would be owed, and what alternative policies might follow—each with its own timing and potential legal challenges. Even if the path clarifies, it remains uncertain how trading partners will respond, and whether the end result is a one-time adjustment or an ongoing bargaining cycle that keeps companies cautious about hiring and capital spending.

At the Federal Reserve, impending leadership changes and rising internal dissent have increased scrutiny of independence and credibility, which are issues that markets take seriously. Even a perception that the Fed is becoming more political can matter, because it influences inflation expectations and, ultimately, long-term interest rates.

AI's long-term promise is substantial, but timelines, adoption rates, and labor impacts remain uncertain. Further, while hyperscalers' capital expenditure on AI projects and related data centers is stimulative to the economy, it's possible that this spending binge is overdone or early. A recent JP Morgan study pointed out that Tech spending in 2025, as a percent of GDP, is larger than the Hoover Dam, Triborough Bridge, the Golden Gate Bridge, LaGuardia Airport, the Manhattan Project, the Apollo Project, and the U.S. Interstate highway system, combined.<sup>7</sup> Markets may be pricing progress faster than reality can deliver. It would not be the first time. Long-term societal impacts of AI are beyond the scope of this letter, but profound, nonetheless, and sources of anxiety.

While geopolitical uncertainty is a mainstay of all markets, 2026 begins with a particular poignancy. The Russia-Ukraine war, now in its fourth year, seemed to be heading to a resolution, but recent bombings of Ukraine on Christmas Day were particularly galling for U.S. congressional and European leaders. This was followed by reports of the bombing of Putin's personal residence. So tensions are back to an escalated status. Also, as of this writing, the U.S. had just completed a military incursion into Venezuela to forcibly remove President Maduro from office, setting in motion a host of questions related to its legality, its immediate repercussions, the signal it sends to other Latin and South American nations (dubbed "The Donroe Doctrine"), and the mixed signals it sends to Russia and China related to their intentions in Ukraine and Taiwan, respectively. And of course, there's the oil. Venezuela has the largest oil reserves in the world (estimated at 300 billion barrels). Early comments from the Trump administration promise improved infrastructure and increased investment and production, which could be disinflationary if more supply is pumped into the system. But the timing and magnitude of this are very open to debate.

### *Inflation, Debt, and Yields*

Finally, there is the long shadow of inflation and debt.

Bond markets have historically played the role of disciplinarian, as "bond vigilantes" responding to debt, profligate spending, or too much stimulus. In 2026, any hint of a waning appetite for U.S. debt, or any loss of faith in Fed independence, could compel the vigilantes to push bond yields higher, raising borrowing costs and tightening financial conditions, and possibly being the prick that deflates high asset values.

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<sup>7</sup>JP Morgan, Eye on the Market, Outlook 2026

## *Portfolios, Positioning, and Prudence*

Taken together, these opposing forces explain our cautious optimism.

Practically, we believe this is a year to emphasize prudence: staying diversified, keeping risk aligned with goals, rebalancing discipline, and taking advantage of any future sell-offs with aggressive tax-loss harvesting techniques.

More specifically, there are things we are doing to manage the valuation risk, where it exists:

- **International diversification:** In 2025, we trimmed U.S. equity exposure to lean more heavily into non-U.S. markets, where valuations are more reasonable. International stocks far-outperformed the US., the first time in many years. Looking forward, Europe, in particular, has potential for further gains as cheaper valuations, fiscal stimulus related to defense and infrastructure spending could unlock value. In Japan, stock buybacks are accelerating, particularly useful for taxable investors, as they defer gains (vs. paying out an immediately taxable dividend). Further, as U.S. interest rates are likely to fall further and the current administration's efforts to re-shore manufacturing, the weakening trend of the U.S. dollar (i.e, strengthening of the Euro and Yen) may continue, helping the returns of non-dollar assets.
- **Small and mid-cap tilt:** We have maintained a tilt toward small and mid-cap U.S. equities, which remain attractively valued relative to large caps, at some of the widest discounts in over 20 years.
- **Rebalancing discipline:** After the rapid run-up in Q3 and Q4, we rebalanced U.S. holdings to keep portfolios aligned with long-term targets, where appropriate. We want to remain sensitive, as always, to the tax implications of such trades.
- **Credit risk management:** In fixed income, we are holding a smaller-than-normal allocation to credit risk, reflecting caution about spreads and corporate leverage. The premium an investor receives for holding credit risk is the lowest in 27 years.
- **Research.** Our research agenda remains robust in 2026: whether future trims of U.S. large-cap stocks are warranted, additional tax alpha strategies (such as long-short direct indexing, innovative strategies for single-stock concentration risk, and more), and our build-out of the private equity, alternative income investments, private real asset, and private impact platform continues apace.

## *Final Thoughts*

Our role is not to build the “optimal” portfolio for any one outcome but to create a robust portfolio for *multiple* potential outcomes.

Investors who remain disciplined, diversified, patient, and adaptable are best positioned to navigate this environment. That perspective, rather than any single forecast, continues to guide our approach as we look toward 2026 and beyond.

## About the Author

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### Pete Chiappinelli, CFA, CAIA, Partner & Chief Investment Officer

Pete is a Partner and Chief Investment Officer at the firm. He is focused primarily on Asset Allocation in setting strategic direction for client portfolios. Pete has 30 years of experience in research, investment strategy, and thought leadership regarding the management of multi-asset class portfolios, inclusive of equities, fixed income, and alternatives.

His work has been featured in leading financial publications such as *The Wall Street Journal*, *The New York Times*, *Barron's*, and others in Canada, Europe, and Asia. His market commentaries have been featured at major industry conferences, in TV documentaries on capital markets history, and on social media outlets. Prior to joining Ballentine Partners in 2022, he was a Senior Portfolio Strategist on GMO's Asset Allocation team. Prior to that, he was an Institutional Portfolio Manager at a specialized unit within Fidelity Investments and was the Managing Director of Institutional Investment Strategy & Research at Putnam Investments.

He is a graduate of Carleton College and holds his MBA from The Wharton School at the University of Pennsylvania. Pete holds the Chartered Financial Analyst (CFA) designation, is a member of the CFA Institute and CFA Society Boston, and he holds the CFA Institute Certificate in ESG Investing. He also holds the Chartered Alternative Investment Analyst (CAIA) designation and was the founding President of CAIA Boston. Pete lives in Hingham, MA with his wife, Cheryl, and enjoys travel, cooking (definitely not a "foodie," but a "foodie wannabe"), sourdough breadmaking, and conjuring up ways to embarrass his three children.

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