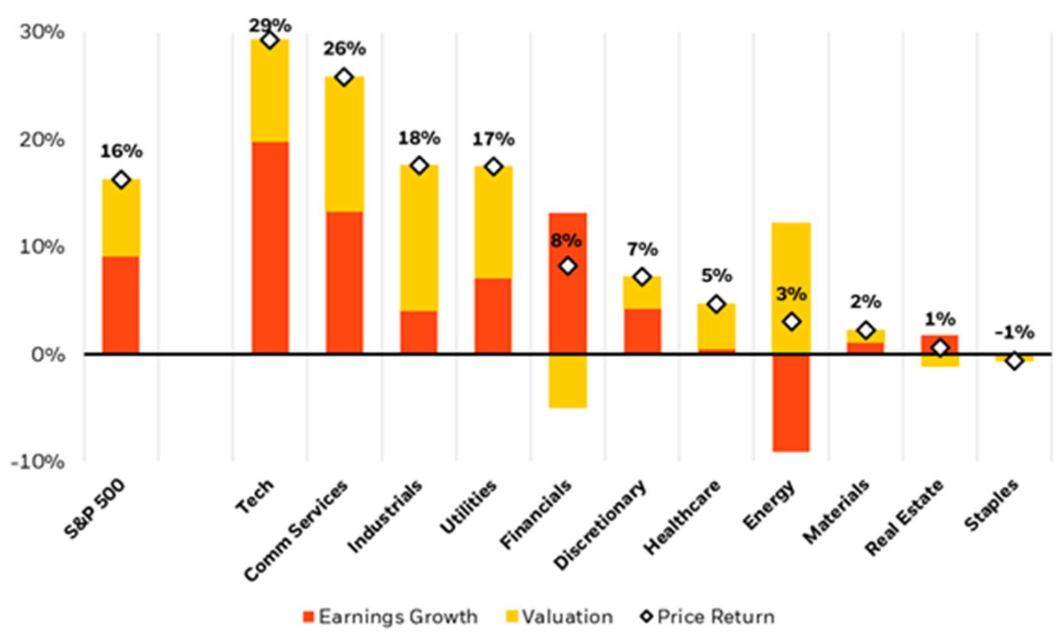
2025 Fourth Quarter Letter

Party Like It's 1999

Heading into the final weeks of 2025, despite the third straight year of double-digit stock market returns, the financial community has become obsessed with the question "are we in an AI stock bubble"? Even the mainstream media is filled with stories comparing the current boom in AI data center construction, and the stocks benefitting from this spending, with the "Dot.Com" boom-bust cycle in the late 1990's.

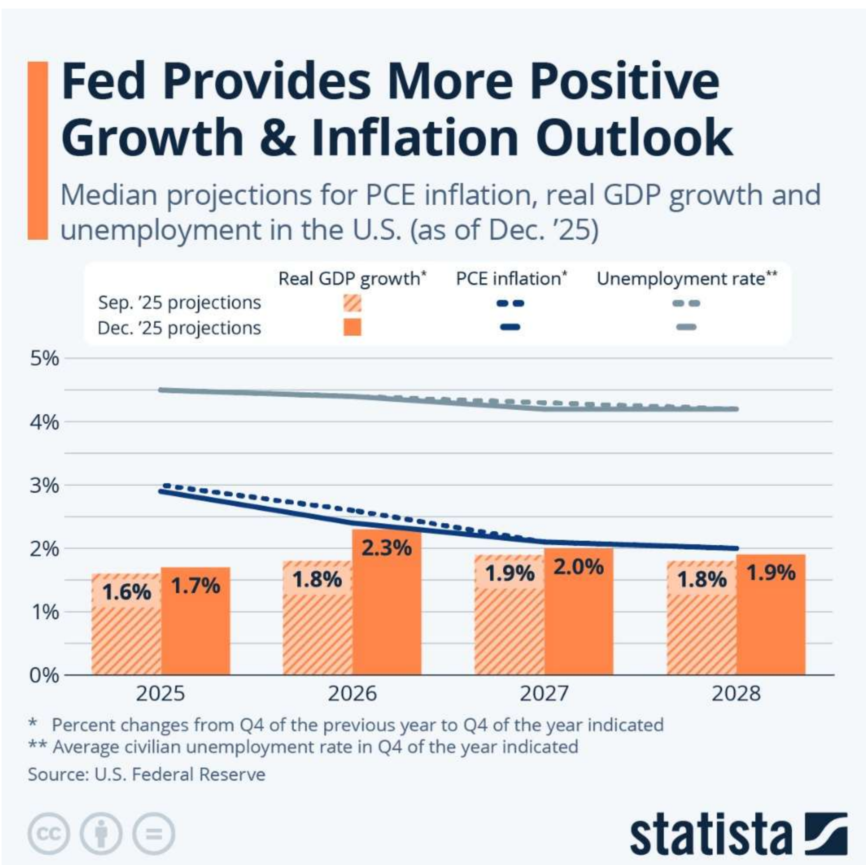
With apologies to the late, great "Artist Formerly Known as Prince", in our opinion the constant comparison between the internet tech stock bubble at the end of the Millenium, and the current market leadership in AI-related stocks is an oversimplification. While there are some similarities between that period and now, we believe that there are some very important differences.



Unquestionably, both eras are fueled by a belief that we are undergoing a transformative technological change – the Internet then and Artificial Intelligence now. Historically during such periods of great change, we have seen participants overestimate future demand for these innovations. At the end of the Internet Boom, thousands of miles of optical fiber were laid underground that went unused for years after markets collapsed in 2000. It's only natural that with new data centers popping up like mushrooms across the country, concerns about “over-building” would emerge. In both eras, excessive speculation around unprofitable companies have pulled investors into companies like Pets.com (then) and quantum computing stocks (today).

However, we believe that the differences between now and then are more striking and substantial. During the Dot.Com era the companies propelling the market higher were mostly very young and often unprofitable. Today’s leaders such as the Magnificent 7 are some of the largest, most profitable companies ever. Back then, most of the capital spending was financed by debt, vendor financing and speculative IPOs. Today the investment in data centers is predominantly coming from the operating cash flows of some of the best-capitalized companies in the world. Recently questions have been raised about the growing use of debt financing to fund capital expenditures, but the mere fact these issues have garnered so much attention is reassuring. Tech stock valuations are elevated on a historical basis, but not outrageous considering the consistent growth at these companies. And they are nowhere near the insane levels reached at the end of the Dot.Com era, when the NASDAQ traded over 60 times earnings.

So where do we stand in this debate? While there are some red flags recently regarding debt financing and valuations are slightly stretched, we think that labelling this an “AI bubble” is unwarranted. After all it’s difficult to create a true bubble when so much media attention is being focused on the subject. But we do not believe that ALL stocks associated with the AI Revolution will necessarily end up as great investments, and so we continue to focus on companies with strong market positions, solid balance sheets, and reasonable valuations.



Turning away from the AI question, what’s been going on with the US economy and broader financial markets? Heading into year end, despite tariff concerns, geopolitical risks, and an extended federal government shutdown, the US economy continues to show remarkable resiliency with full year GDP growth on course for over 2% growth. Consumer spending has been surprisingly strong, although the bifurcation between upper end and lower end households remains an issue. The operative word that retailers use to describe customers during earnings calls was “choiceful”. Although the government shutdown has left a bit of a void in recent economic data, inflation appears to be under control, although there are concerns that the full impact of tariffs has yet to be passed through to consumers. The jobs market continues to be a bit of a mixed picture, with job creation slowing at the same time unemployment levels remain at historically low levels.

Third quarter earnings provided another quarter of positive upside-surprises, with over 85% of companies beating expectations. Analysts were estimating S&P 500 earnings per share growth of 7% but the actual numbers came in a little bit under 15%. Technology companies continued to lead with over 30% earnings growth, but the Financial and Industrial sectors posted solid returns as well. The only sector with negative growth was Energy, as low oil prices weighed on earnings.

The Federal Reserve continues to struggle with the risks of allowing inflation to run above their 2% target rate versus a softening labor market. Minutes from their December meeting reveal a deeply divided committee, and the situation is further complicated by Chairman Powell's lame duck status. Despite three 25 basis point cuts in the Fed Funds rate, critical 10-year Treasury yields remain stubbornly above 4% with 30-year mortgage rates north of 6%.

Let's Go Crazy

No matter how you look at it, the markets have put in a remarkable performance the last three years, averaging roughly 23% annually. So, after such an amazing run, would it be crazy to expect another great year?

There aren't very many historical precedents for the hot streak that we're currently on. Since 1926 there have been only seven previous such streaks, and the performance in the "Fourth Year" is mixed with the market extending its double-digit run 3 times, with negative returns 3 times, and one year finishing essentially flat. The point is that markets are not preordained to fall just because we've had a nice run.

Heading into 2026, the US economy presents a mixed picture with surprisingly strong GDP growth in the last two quarters of the year, while the labor markets remain soft. With the benefits of business tax incentives from the Big Beautiful Bill, and a substantial increase in household tax refunds this tax season, we believe that the broader economic picture should improve heading into the summer of 2026. Companies continue to be cautious about adding to their headcount, given impacts of AI-driven productivity improvements, but we don't see the unemployment rate rising much further either.

Interest rates continue to present an interesting conundrum for the Fed, and we would be surprised if they cut the overnight rate more than once in the first part of the year. And with the announcement of the next Fed Chairman eminent, we doubt that the markets expect much more until the new Chair takes over in May. Longer-term rates continue to trade in a range between 4 to 4.25%, and it will be critical for the new Chair to avoid further cuts unless inflation data supports the move. A loss of confidence in the independence of the Fed could send long-term rates higher, threatening both the equity markets and the broader economy.

Looking at Equities, we believe that the long-awaited broadening of the markets away from the Magnificent 7 may finally come to pass. This doesn't necessarily mean that those leaders will decline, just that other parts of the market exposed to the wider growth in the economy may finally catch up. We continue to like the prospects for Financial and Industrial companies and also believe that with more regulatory certainty the Healthcare sector provide attractive opportunities. International stocks had a great 2025 outperforming the S&P and with our expectations for a weaker US dollar they should continue to perform well in the coming year.

We still prefer to concentrate our Fixed Income investments in the short-to-middle maturity range, as we anticipate a steeper yield curve in 2026. And given the historically low incremental yield premium above treasury bonds, we are keeping our exposure to credit risk from corporate bonds low as risks outweigh reward.

Overall, we look for 2026 to be a year where the markets will be driven by earnings growth given already high price-to-earnings multiples. Current consensus estimates for S&P 500 earnings growth are around 12% and we wouldn't expect that index returns will be much above that level. Markets are clearly challenging the assumptions around the "AI Revolution", but we consider that a healthy development not a reason for concern.

Once again, I thank you for placing your trust in me and our team here at Pinnacle, and I look forward to helping you achieve your financial goals in the year ahead.

Don Garcia

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