

Investment Commentary

As we close the books on 2025, the fourth quarter served as a reminder that market progress is rarely linear. Investors navigated a complex landscape defined by a federal government shutdown, shifting interest-rate expectations, and a maturing narrative surrounding artificial intelligence. Despite these moving parts, equity markets displayed remarkable resilience, finishing the year near record highs.

During the quarter, the Federal Reserve reduced the federal funds rate by 50 basis points (0.50%). However, policymakers signaled a "cautious descent" for 2026, suggesting that future cuts may be less aggressive than the market currently anticipates. Meanwhile, the euphoria surrounding AI shifted toward a more discerning phase, with investors prioritizing companies capable of converting infrastructure spending into tangible near-term profits.

Equity Market Performance

The fourth quarter saw the S&P 500, Nasdaq, and small-cap indices reach new territory. The S&P 500 gained 2.7% in Q4, bringing its year-to-date return to 17.7%. The Growth stock index followed suit, rising 2.5% for the quarter, also finishing the year up over 17%.

While headline growth was steady, the most notable development was the broadening of market leadership. Large-cap value stocks—represented by the Dow Jones Industrial Average and the Russell 1000 Value—led the quarter with gains of roughly 4.0%. Small-cap stocks also found support as the Russell 2000 rose 2.2% for the quarter, buoyed by the easing interest rate environment. Small-cap stocks and the S&P 400 MidCap Index did not keep pace with the largest companies for the full year but still gained 12.6% and 7.5%, respectively, in 2025.

International equities notably outperformed domestic markets during the quarter and for the year. Both developed and emerging market indices gained nearly 5% in Q4, ending the year with returns exceeding 30%. This strength was bolstered by a weakening U.S. dollar, driven by a combination of trade tensions and a global rotation of capital into undervalued overseas markets. Stock valuations are also generally more attractive overseas.

"Data Fog" of the Government Shutdown

A defining challenge of Q4 was the lack of traditional economic guideposts. The government shutdown that began October 1st delayed critical reporting on employment, inflation and GDP. In the absence of official data, markets were forced to rely on corporate earnings and private-sector surveys, which naturally induced higher volatility.

The available data suggests an economy that is "cooling but not breaking." While unemployment rose to its highest level in four years, consumer spending remained steady despite persistent affordability pressures. Interestingly, GDP grew at an annualized rate of 4.3% in the third quarter (reported in Q4), marking the strongest back-to-back quarters since 2021. This paints a picture of a late-cycle economy that is slowing to a sustainable pace rather than rolling over.

The Fed: A Flexible Pause

Uncertainty regarding Federal Reserve policy led to significant swings in sentiment. By quarter-end, the message from the Fed was clear: while the threshold for additional rate hikes is extremely high, further cuts will be data-dependent and unlikely to arrive in rapid succession. This "patient" stance contributed to late-year volatility and will likely remain a primary market driver as we enter 2026.

AI Investing: From Hype to Harvest

The AI narrative evolved significantly in the final months of the year. Early in 2025, enthusiasm was broad and often indiscriminate. However, Q4 saw investors begin to ask tougher questions regarding capital expenditures and balance-sheet strength.

The market is shifting its focus from solely valuing the potential of artificial intelligence to prioritizing companies that can consistently demonstrate sustainable earnings growth derived from this technology. This shift led to increased rotation within the Tech sector, reflecting a healthy maturation of this transformative trend.

Fixed Income: Stability Re-emerges

After several years of historic volatility, the bond market found its footing in Q4. Short-term rates drifted below 4% following the Fed's cuts, while long-term yields remained relatively stable.

Both investment-grade and high-yield bonds gained approximately 1% during the quarter. This contributed to a total annual return of 6.1% for the Bloomberg US Government/Credit 1–5 Year Bond Index. (The short-intermediate bond space is where most of our client portfolios are positioned.) While yields remain relatively attractive for income-focused investors, tight credit spreads necessitate a highly selective approach to corporate credit.

Diversification Matters Again

One encouraging development as we exit 2025 was

the reemergence of diversification as a meaningful portfolio tool. With market leadership broadening beyond a narrow group of mega-cap growth stocks, asset allocation and sector balance once again contributed to returns during the 4th quarter, rather than detracted from them.

Equity dispersion increased during the year, rewarding fundamental security selection. At the same time, the stabilization of fixed income markets restored bonds' role as both a source of income and a potential ballast during periods of equity volatility. This environment reinforces the value of maintaining diversified portfolios aligned with long-term objectives rather than reacting to short-term market narratives.

The successes of 2025 have effectively "raised the bar" for the coming year. With valuations higher and expectations elevated, much of the recent "good news" has already been priced into the market.

However, several tailwinds remain: resilient corporate earnings, technological tailwinds, and a consumer base that has proven sturdier than expected.

We'll end on the note that our focus remains on disciplined long-term positioning and prudent portfolio risk management to navigate whatever the new year may bring. As always, we remain committed to helping clients stay focused on long-term goals amid an ever-changing market landscape.

Warm Regards,

Clear Point Advisors

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