THE BOSTON FAMILY OFFICE
INVESTMENT SERVICES

Market Update
Fourth Quarter 2025

Equity Markets:

Global equity markets finished the fourth quarter higher, with the S&P 500 gaining 2.7% for the quarter and 17.9% for the year. Domestically, strong corporate earnings and additional interest rate cuts supported the advance, though volatility surfaced as investors contended with delayed economic data following the government shutdown and renewed concerns about a possible bubble in the AI-trade. As illustrated in the table to the right, foreign stocks outperformed by a wide margin in 2025, an infrequent occurrence of late.

Equity Markets (Total Return)	4Q'25	2025
Dow Jones Industrial Average	4.0%	14.9%
S&P 500	2.7%	17.9%
S&P 400 Mid-Cap	1.6%	7.5%
S&P 600 Small-Cap	1.7%	6.0%
MSCI All-Country World	3.4%	22.9%
MSCI Foreign Developed Markets	4.9%	32.0%
MSCI Foreign Emerging Markets	4.8%	34.3%

US Bond Markets (Total Return)	4Q'25	2025
Bloomberg US Treasury	0.9%	6.3%
Bloomberg US Municipal	1.6%	4.3%
Bloomberg US Corporate Investment Grade	0.8%	7.8%

Source: Bloomberg

Companies Successfully Navigated a Meaningful Hurdle in 2025: Tariffs

The market's strong advance for the year was achieved in the face of several challenges, including the broad tariffs announced by President Trump in April that initially threatened to disrupt global trade and quickly drove the S&P 500 close to bear market territory. As trade negotiations progressed and deals introducing lower effective tariff rates were reached, markets stabilized and resumed their rally higher.

Many of the multinational companies we own acted quickly to mitigate tariff pressures by adjusting sourcing, streamlining costs, and, in some cases, pledging increased investment in the United States to foster goodwill with the administration. These actions offset much of the initial potential impact, and corporate profit margins for S&P 500 companies remained near record highs despite the trade headwinds.

Artificial Intelligence – Growth Persists

Artificial intelligence remained a central theme for investors throughout 2025 as the broader AI ecosystem continues to develop rapidly. Early in the year, newly launched Chinese AI models drew attention by claiming performance comparable to ChatGPT at significantly lower cost. This prompted questions about potential competitive pressures on leading U.S. AI-focused suppliers, though concerns eased as these firms reported strong earnings and guidance that underscored robust growth.

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Later in the year, the combination of higher valuations and increasingly complex and interwoven financing structures along with very large, long-term spending commitments from OpenAI led some investors to question whether markets may be entering an "AI bubble."

It is helpful to distinguish between a demand bubble and a valuation bubble. A demand bubble would typically be characterized as a temporary surge in demand that largely pulls forward from the future only to eventually trail off, something we do not believe is occurring. Instead, the major "hyperscalers"—Alphabet, Microsoft, Amazon, Meta, and Oracle—are investing heavily to build the initial infrastructure to develop the AI ecosystem and several have indicated that their capital expenditures will remain elevated well beyond 2026 as the buildout continues, suggesting that underlying demand for compute and AI services remains strong.

Valuation bubbles, however, are more difficult to assess, because the appropriate levels will depend on how the generative AI ecosystem evolves over many years. A useful example of how quickly it, and investor perceptions are changing comes from Alphabet. In early 2025, worries that ChatGPT could undermine Google's search business weighed on the stock for some time, yet by mid-year sentiment had reversed as Google's Gemini platform became significantly more competitive, contributing to Alphabet's strong performance relative to other mega-cap technology names.

At the same time, OpenAI's substantial multi-year commitments to secure compute capacity have raised questions about whether it will fully utilize or fund all its contracted resources, and some investors have scrutinized how much reliance hyperscalers should place on that order backlog when planning future spending. We believe the associated risk is partially mitigated by the fungible nature of compute capacity, which can likely be reallocated to other customers if OpenAI does not fully meet its obligations.

Despite AI's prominence, five of the so-called "Magnificent Seven" underperformed the S&P 500 in 2025, indicating a healthy broadening of market leadership beyond a narrow group of mega-cap technology companies.

The "K-Shaped" Economy

Inflation moderated over the course of 2025 and the labor market showed signs of cooling, creating room for the Federal Reserve to begin cutting interest rates again after a nine-month hiatus. Even so, many households continued to struggle with affordability, with consumer confidence slipping to multi-year lows and delinquencies in credit cards and auto loans drifting higher—though still not to levels that would currently be considered systemically concerning.

By contrast, higher-income consumers have benefited from a pronounced wealth effect as strong equity and asset returns have boosted investment portfolio values. Economists increasingly describe this dynamic as a "K-shaped" economy, in which the upper "arm" reflects more robust growth in wealth and income for higher-income and asset-owning consumers while the lower "arm" illustrates the persistent financial struggle for lower-income consumers.

Looking ahead, consumers are positioned to receive meaningfully larger tax refunds this year, supported by provisions in the recently enacted "One Big Beautiful Bill," which should provide a much-needed windfall for many lower income households.

Fixed Income & Monetary Policy

As discussed last quarter, the Federal Reserve began reducing interest rates in September and followed with two additional cuts in the fourth quarter, bringing the federal funds target range down to 3.50%–3.75% by the end of the year. In December, the Fed also announced that it would purchase short-term Treasuries as needed to maintain an ample reserve supply on an ongoing basis, reinforcing its commitment to smooth market functioning.

Looking into 2026, Chair Jerome Powell's term as head of the Federal Reserve Board ends on May 15, 2026, although his term as a Board governor continues through January 31, 2028. President Trump is in the process of selecting a successor to nominate for Senate confirmation, and his publicly expressed dissatisfaction with the pace of rate cuts has heightened concern that the next chair could face more explicit political pressure to maintain a lower-rate policy stance and pivot away from its historical data-driven approach.

Lower interest rates typically support higher equity valuations, and President Trump has often pointed to stock market performance as a measure of his administration's success. Nonetheless, markets currently expect only two additional rate cuts in 2026- well short of what Trump is looking for implying that investors still assume the Fed will retain a largely data-driven framework despite the political backdrop.

Looking Ahead

Looking forward to the year ahead we remain broadly optimistic on the underlying fundamentals based on what we've heard from many companies – namely continued strength within the AI ecosystem and the prospect for continued strength in margins across the economy. That said, we would be remiss not to highlight national and global events that we are watching that could spark periods of volatility.

President Trumps's military operation in Venezuela to capture President Maduro renewed conversations on Trump's desire for the U.S. to acquire Greenland. The people of Greenland and Denmark strongly oppose President Trump's overtures. We don't think the U.S. will attempt to take Greenland by force – however, President Trump has not ruled this out. If this were to happen, we think the market would suffer from meaningful volatility. Meantime, the negotiations related to Greenland are mostly a source of headline risk rather an immediate threat to market fundamentals, in our view.

Similar, the prospect of China's interest to reunify with Taiwan re-entered the peripheral narrative in the investment community, with China's President Xi Jinping reportedly directing China's military to be prepared for a potential operation by 2027. As it relates to equity markets, this risk is top of mind for investors in the AI ecosystem because Taiwan Semiconductor Manufacturing Company (TSMC) is the leading producer of the world's most advanced chips, most of which are still manufactured in Taiwan even as the company ramps up new facilities in the United States.

The government shutdown last fall ended with a continuing resolution that temporary funds the government until January 30, 2026. At that time, the matter of whether to renew Affordable Care Act subsidies was punted to a later discussion. Early this month the House passed a bill that provides a three-year extension to those subsidies with the legislation now moving to the Senate.

Mid-term elections will occur this fall which will determine which party controls Congress for the next two years. Given the president's low approval rating, it appears likely that Republicans will lose seats, increasing the probability of a divided government, a configuration that has historically been associated with relatively stable and predictable policy outcomes—often a constructive backdrop for equity markets.

We also expect a ruling from the Supreme Court on the legality of Trump's tariffs soon. If the Supreme Court deems these to be illegal, we expect equity markets to respond favorably as it will further support corporate margins. If this transpires, however, we expect the Trump administration to pursue avenues to keep the tariffs in effect, thus the outlook is uncertain and handicapping the ultimate outcome is challenging.

As is often the case, these global events will likely shape near-term sentiment, but history reminds us that companies and investors adapt. In that spirit, we enter 2026 with a constructive but balanced outlook—mindful of risks, yet confident in the resilience of the markets.

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