January 2026

The "Valuation" Debate Is Too Narrow

One of the more common investing mistakes we see is becoming overly reliant on a single data series. This is especially true when that one data series is amplified by a social media environment that rewards shallow research over depth. Today, we hear "the market is expensive," and yes, for one data series, the S&P 500, it is overwhelmingly true across most well-respected valuation measures. Possibly the most well-respected of them all, the Shiller CAPE, just hit ~39 at year-end 2025, the highest level since 2000. **[Reference Page 2 in Slide Deck]**

The mistake comes when investors leap from "U.S. mega-cap stocks are priced for perfection" to "everything is priced for perfection." That assumption distorts portfolios and, over the past decade, led many investors to sit out of large portions of the global equity market. And while it's true that the S&P 500 has appeared historically expensive for much of that time, avoiding equities altogether came at a cost - an enormous, missed opportunity for long-term wealth creation. Many other asset classes and equity market segments have not been valued at historical extremes **[Pages 3 & 4]**. The opportunity set looks meaningfully wider once you stop treating SPY as "the market." And while the returns of these less commonly cited stock sectors may not have kept up with the S&P 500 over the last decade, they produced attractive results well in excess of bonds and money market funds **[Page 5].** This has allowed investors to participate in equity markets against a far less concerning valuation backdrop.

Broadening the valuation lens doesn't mean dismissing risk; it means **being precise and thoughtful about where risk is concentrated**. In today's market, that risk is most acute in the most expensive segments, particularly U.S. mega-cap growth (which is the dominant weight of the S&P 500 **[Page 6]**), where current prices leave little margin for disappointment. In those areas, future returns depend far more on actual earnings growth than on continued optimism or multiple expansion (more on this below).

A Potential Earnings Tailwind: The New Tax Law's Business Incentives

One of the few tangible ways premium valuations can ultimately be justified is through stronger (i.e., growing) after-tax earnings and cash flow, and that's where recent tax policy becomes relevant. The 2025 tax law, formally titled the *One Big Beautiful Bill Act* and signed on July 4, 2025, includes several provisions designed to increase after-tax corporate cash flow, which can translate into higher earnings power, greater reinvestment capacity, or both.

The most investor-relevant mechanisms are straightforward:

- **Faster write-offs for business investment (accelerated depreciation / bonus depreciation).** When firms can expense more of a capital investment sooner, taxable income and tax bills fall today, cash flow rises, and that can support buybacks, capex, or debt paydown.

- **More favorable treatment of domestically conducted R&D (immediate expensing).** The ability to expense qualifying R&D sooner reduces near-term tax drag and can raise the ROI on incremental innovation and AI-related spending.
- **Incentives aimed at encouraging domestic investment.** Multiple summaries of the law emphasize the intent to improve after-tax cash flow when investment occurs in the US, which can be earnings-supportive if it leads to productivity gains or margin improvements over time.

These provisions can support earnings at the margin, but they do not eliminate the risk that arises when expectations move too far ahead of fundamentals. That distinction matters - valuation risk does not disappear simply because earnings tailwinds exist.

When Hype Can Cause Real Problems

Wall Street is currently projecting above-average earnings growth (15% versus a long-term average closer to 7.7%) with forecasted margin levels near multi-decade highs. These optimistic forecasts, particularly regarding earnings and margins, increase risk when valuations are already elevated **[Pages 7-9]**. Historically, the most severe bear markets have occurred when disappointment is compounded, as valuations compress while revenues and margins decline, creating a damaging "double adjustment." This has driven the sharpest market drawdowns, with the Great Recession of 2007-2009 (>50% sell-off in the S&P 500) being the most recent example.

The Macro Backdrop Is Getting Less Forgiving

The challenge is that the economic data are not obviously consistent with the level of optimism embedded in current earnings and margin forecasts.

- Unemployment has drifted higher, with the unemployment rate at 4.6% in November 2025, a higher level than a year prior, alongside negative changes in monthly non-farm payrolls. **[Pages 10-11]**.
- Consumer sentiment is depressed. The University of Michigan's December 2025 sentiment index was 52.9, far below its level a year earlier (74.0) **[Page 12]**.
- Delinquencies have been rising in key pockets of consumer credit, particularly in transitions into serious delinquency for credit cards, auto loans, and mortgages **[Page 13]**.
- Leading indicators look soft. The Conference Board's LEI messaging has been consistent, pointing to slowing activity into early 2026 **[Pages 14-15]**.

This is why we keep coming back to "margin for error." When valuations are elevated, Wall Street forecasts are exceedingly rosy, and the macro backdrop is deteriorating at the edges, the market has less tolerance for disappointment. The margin for error, where forecasts are not met, begins to shrink.

When that margin for error disappears, attention quickly shifts from earnings forecasts to policy response. Slowing growth, rising deficits, and heavy debt loads limit policymakers' room to maneuver.

This is especially true if economic weakness emerges before inflation has fully receded. In that environment, *how* deficits are ultimately addressed becomes just as important for investors as *whether* they are addressed at all.

Deficits, Debt, And the Path of Least Resistance

At some point, the deficit conversation stops being theoretical and becomes a constraint. There are two main policy responses available:

1. **Reduced spending AND higher explicit taxation**. This is politically difficult and economically painful in the near term. Neither major political party appears confident about running on this platform.
2. **Financial repression and debt monetization**. This will be reflected in policy choices that keep real interest rates suppressed relative to inflation, allowing inflation to do more of the work over time by reducing the real value of future U.S. government obligations. We anticipate this being achieved through (A) reductions in the Federal Funds Rate and (B) the FED's simultaneous printing of money and purchasing of longer-duration treasuries on the open market (Quantitative Easing, or "QE").

Historically, the second path is the one of least resistance, and if policymakers take it, the investment implications cannot be ignored. Some might argue that elements of pathway #2 are already emerging **[Page 16]**.

Historical Parallels from the 1970s

We have seen this setup before - inflationary pressures that do not fade quickly, combined with growth that proves weaker than expected (1970s). In that environment, "traditional" portfolios may underperform, and real assets may matter more.

In stagflationary episodes, **commodities have often been among the relative winners**, in part because they are the inputs into everything else **[Page 17]**.

Against today's backdrop, the commodity case is not just macro, it is structural AND valuation-driven:

- An ongoing AI buildout requires substantial real-world infrastructure investment, including power, metals, and other raw inputs.
- Energy remains the base layer of the economy, and years of underinvestment have consequences.
- Re-shoring and supply-chain redundancy, major post-COVID themes, tend to be commodity-intensive.
- Relative valuations matter. The broad commodities index trades at roughly 50-year lows relative to the S&P 500. Aside from the 1970s, we observed a similar relative valuation extreme in 2000

(though not as pronounced as now), after which commodities delivered far superior 10-year forward returns **[Page 18]**.

That's why the "commodity trade" continues to look like a durable, multi-year theme rather than a one-quarter bet. This category spans across industrial metals, oil, natural gas, and related real-asset exposure, with potential benefits extending to the companies that produce and develop these resources.

Core Real Estate, A Better Setup After a Sideways Stretch

Commodities are not the only real assets that tend to benefit when inflation proves more persistent than expected. When the purchasing power of money is being repriced, capital often rotates toward assets tied to tangible utility, real cash flows, and replacement costs.

Core real estate has historically fit that description, serving as a reasonable place to allocate capital during periods of persistent inflation, owing to the combination of rent growth and long-term price appreciation **[Page 19]**.

After several years of sideways-to-negative results across much of the real estate market **[Page 20]**, valuations have adjusted meaningfully. Assuming inflation remains sticky and the economy avoids a deep shock, that reset improves the forward return profile. This is not a "real estate always wins" claim; it is a valuation and mean-reversion claim.

A Weaker Dollar Narrative, Tailwind for International Stocks

If debt monetization and suppressed real rates become the default response, the **US dollar's medium-term outlook can weaken**. This can be a positive theme for international stock indexes, which continued to outperform the S&P 500 in 2025, amid a declining US dollar strength index **[Page 21]**.

International stocks also enter 2026 with a valuation argument that is simply easier:

- Many non-US markets trade at **materially lower multiples** than US large cap, meaning investors are paying less for the same concept, a share of corporate profits **[Pages 22 & 23]**.

If the dollar weakens while valuation spreads remain wide, it's a strong fundamental setup for continued non-US relative outperformance.

Breaking It Down: The Heightened Risk for US Index Fund Investors

The flip side of that currency-related opportunity warrants direct attention. While parts of the global market benefit from a weaker dollar and more forgiving valuations, the same conditions leave far less room for error in US-centric portfolios.

Here's why the margin for error looks low in US headline indexes:

- **Valuations are extreme by several historical yardsticks**

- **Leading indicators point to slowing**, which historically is not when you want to be paying peak multiples.
- **We're entering a midterm election year**, which has *often* been a weaker year in the presidential cycle, with multiple market history summaries showing lower average returns in "year two" **[Page 24]**.
- **We've already had three strong years in a row** for the S&P 500. Prior to the 2023-2025 episode, this had happened only four times since 1926. In only two of those four instances did the S&P 500 post a positive return in the fourth year.
- **Banks still carry meaningful unrealized losses on securities portfolios**. While these losses are smaller than at the 2023 peak, they remain substantial in dollar terms. This poses a heightened risk for a new "SVB style" bank crisis, which ultimately drove all stock markets lower. Such an outcome is not far-fetched if loan delinquencies continue to creep higher and long-term treasury rates move the wrong way (up) **[Page 25]**.
- **Markets are pricing a sustained productivity growth spike**, but long-run productivity has historically mean-reverted around a low-single-digit trend, roughly ~2% in many long-term summaries **[Page 26]**.

This combination does not mean "sell everything." It means you should be cautious about assuming that owning the most expensive segment of global equities is the same thing as "diversification."

Portfolio Takeaway: Broaden The Opportunity Set

If 2026 delivers anything like a sticky-inflation, slower-growth regime, the winners may look more like:

- Real assets and commodities,
- Select real estate exposure,
- International equities, especially where valuations are less demanding, and
- US equity styles and segments not priced like US mega-cap growth stocks, which still have high anticipated earnings growth **[Page 27]**.

Taken together, this newsletter and its supporting visuals reinforce a simple conclusion. Risk today is concentrated where expectations and valuations are highest, while opportunity increasingly exists in assets and markets priced for more modest outcomes. In past periods marked by sticky inflation, constrained policy choices, and slowing growth, diversification across real assets, select real estate, and attractively valued international equities has mattered more, not less. This is not a call to time markets, but a reminder that starting valuations shape future returns. A disciplined, valuation-aware approach remains the most reliable way to compound wealth when margins for error are thin, and opportunities/risks are unevenly distributed. This approach generally served us well in 2025 in delivering attractive risk-adjusted returns.