

ECONOMIC OUTLOOK

Summary

The economy has recently shown encouraging signs of strength. ISM manufacturing hit 52.6, snapping a near-year streak of contraction and signaling renewed momentum in the industrial sector. Services remained solid at 53.8, reflecting continued strength in a segment representing roughly 70% of economic output. Third-quarter productivity jumped to an annualized rate of 4.9%, coming in well ahead of the 3.3% estimate and marking genuine efficiency gains across the private sector. These positive developments suggest an economy gaining traction.

The labor market, however, tells a different story. Net of revisions, the three-month rolling average for employment growth has been negative for three consecutive months. Job Openings and Labor Turnover Survey (JOLTS) data showed job openings fell to 6.54 million, the lowest reading since late 2020 when pandemic restrictions still constrained activity. The job openings rate of 3.9% marks the first time this metric has fallen below 4% since 2017, excluding the pandemic period.

The relationship between productivity and employment is complex. Efficiency gains can drive expansion, but they can also decouple from labor demand. We are currently seeing the latter, with companies generating more output with fewer workers. Artificial intelligence (AI) adoption likely plays a significant role in this dynamic, fundamentally altering production functions. Simultaneously, changes in immigration policy are constraining labor supply, affecting both hiring patterns and workforce composition. While separating their individual impacts is difficult, both factors clearly contribute to the current divergence.

The upcoming January employment report, with estimates of around 70,000 jobs added, will provide critical perspective on whether recent weakness is a temporary soft patch or a durable trend. Even if realized, that figure would mark the second-highest reading in six months. However, recent reports have consistently missed expectations and included negative

revisions, suggesting labor market weakness runs deeper than headline numbers indicate. While the data fog from the government shutdown has largely cleared, visibility into economic conditions remains slightly limited.

Kevin Warsh's nomination to lead the Federal Reserve arrives amidst these unfolding dynamics. He inherits an economy where inflation sits above the Fed's 2% target while labor market conditions weaken, creating a challenging backdrop that will test traditional policy frameworks. The economy is growing, driven by productivity gains and consumer resilience, but the character of that growth is shifting. Whether productivity and employment eventually realign, or whether we are witnessing a fundamental transformation in how the economy operates, will be the defining question for the economy and the Federal Reserve in 2026.

Positives

ISM manufacturing jumps into expansionary territory for the first time since Feb '24 (52.6)

Inflation remains relatively stable with no change to the Consumer Price Index (2.7%)

UofMich Consumer Sentiment rose to the highest value since August '24 (57.3)

Negatives

The three-month average employment growth has been negative since September (-22k)

Job Openings are now at the lowest level since 2020 (6542k)

Tourism to the U.S. declined with a drop in foreign visitors of 6% year-over-year

EQUITY OUTLOOK

Summary

After strong performance in 2025, equity markets got off to a strong start in January. The S&P 500 Index rose 1.4% and the rotation from growth to value was notable. The Russell 1000 Growth Index lost 1.5% while the Russell 1000 Value Index climbed 4.5%. The Russell 2000 small-cap index gained 5.4%, which also illustrated a broadening out of markets in general. International stocks participated in the rally as well. The developed international MSCI EAFE Index rose 5.2% and the MSCI Emerging Markets Index jumped 8.9%.

Narrow leadership in equity markets has often been thought of as unhealthy and unsustainable. Many market observers have been hoping for broader participation as a signal of strength. Last year saw breadth improve somewhat relative to the previous Magnificent 7 led 2023 and 2024. While a single month does not necessarily make a trend, the strong breadth in January may be a healthy signal for what is to come.

Equity markets have recently been navigating events with the potential to create some rougher waters. The most recent Federal Reserve meeting went pretty much as expected and President Trump picked Kevin Warsh as his nominee for the next Fed Chair. There were also some major geopolitical events/tensions throughout the month. These events created short-term noise that was quickly quieted while the market focused on fundamentals.

We entered fourth-quarter earnings season with fairly elevated expectations. With just over half of the market capitalization of the S&P 500 having reported, results have been mostly impressive. It is worth noting, once again, that valuations are historically stretched by almost every measure. However, if earnings momentum keeps improving, perhaps equity valuations can become more reasonable without having a market pullback.

Positives

Strong corporate-earnings growth

Tax refunds, World Cup and America 250

Improving market breadth

Negatives

Historically stretched valuations

Elevated geopolitical tensions

FIXED INCOME OUTLOOK

Summary

The new year started with 10-year Treasury note yields near the upper end of a prolonged trading range. Unexpectedly, the Japanese bond market became the catalyst for a breakout. With stubbornly high inflation and increasing fiscal concerns, the Japanese 10-year rose 42 basis points (bps) in Q4 and another 28 bps in mid-January. As the largest foreign holder of U.S. Treasuries, concerns that Japanese investors would repatriate funds pushed the U.S. 10-year to 4.30% before settling at 4.24%, up 7 bps for the month. The 2-year rose 5 bps to 3.52%.

Late in the month, at the Federal Open Market Committee (FOMC) meeting, members held rates steady after three consecutive cuts. Their statement upgraded the economic outlook, noting the economy “expanded at a solid pace last year and is coming into 2026 on a firm footing.” Chairman Powell stated risks are largely balanced as both upside inflation risk and downside employment risk have diminished.

On the last day of the month, President Trump announced his nomination of Kevin Warsh as Fed chairman. Fears have seemingly eased as the markets showed little reaction to the news. Returning to the Fed, where Warsh was once a governor, raises concerns for those who cherish the status quo as he has previously recommended significant changes in the Fed’s footprint on the economy. Warsh has advocated for balance sheet reduction through regulatory reform alongside rate cuts—moves some view as offsetting, though potentially non-inflationary with productivity gains.

Investment-grade corporate issuance hit \$217 billion in January, the fifth-highest monthly total ever and 29% above the four-year January average, according to JP Morgan research. As usual at the beginning of the new year, financial companies comprised 64% of issuance. Mergers and acquisitions (M&A) activity contributed \$18 billion in what may become the largest M&A issuance year in over a decade. Despite heavy supply, credit spreads tightened 5-6 bps to levels last seen in the late 1990s. Intermediate corporate bonds returned 0.22%

versus 0.01% for Treasuries. The Bloomberg Intermediate Government/Credit Index returned 0.11%.

We expect one or two additional Fed rate cuts this year as the strong economy makes more than that unlikely even under the new Fed chair. Higher long-term yields prompted us to extend duration slightly relative to benchmarks. We believe credit spreads will remain well supported despite record issuance and maintain our overweight in high-quality corporate bonds.

Positives

Yields moved above recent trading range but have stabilized near 4.25%

The yield curve is the steepest since early 2022 allowing for more return from the roll

Inflation expectations remain well anchored

Tariff and housing impact on inflation should be waning

Negatives

Inflation may become more problematic if economy remains robust

Corporate bond issuance continues to be heavy due to technology cap expenditures

Unknowns

Legality of tariff policies

Confirmation of the new Fed chair