

# Optimism Amid Volatility

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## Review of 4Q 2025

The S&P 500 rose 2.30% in the fourth quarter of 2025 and was up 18.12% on a year-to-date basis including dividends reinvested into the index. During the quarter the U.S. economy continued to slow, driven by the forty-three-day government shutdown and a drop in overall economic activity. Tariffs continued to cause disruptions in trading patterns, creating volatility and uncertainty globally that affects supply chains. But consumers continued to spend in the face of higher prices from tariffs and falling consumer confidence due to a weakening labor market. Core inflation rates rose sharply following the tariff announcements in April and have risen about 0.5-0.7% in 2025 depending on the index.

### U.S. GDP Estimates

| 2024 Act. | 2025E | 1Q 2026E | 2Q 2026E | 3Q 2026E | 4Q 2026E | 2026 Est. | 2027 Est. |
|-----------|-------|----------|----------|----------|----------|-----------|-----------|
| 2.8%      | 2.0%  | 2.0%     | 1.9%     | 2.3%     | 2.5%     | 2.4%      | 2.6%      |

Source: Pinnacle Financial Partners

The FOMC continued to reduce the Federal Funds rate by 0.75% in 2025 as they prioritized weakness in the labor market over the threat of persistent inflation. The decreases in the Federal Funds target have been partially offset by higher long term Treasury rates, reflecting continued risk funding the U.S. government and deficits. Since the FOMC began cutting in September of 2024 the 10-year Treasury yield has risen from 3.65% to 4.17%. The higher long Treasury rates means there will be little relief for mortgage rates and other fixed rate lending instruments.

The Trump administration has said the price effect of tariffs are a one time increase in the price level. We believe that there is

growing evidence that manufacturers and retailers are, in some cases, slowly leaking the tariff pricing effect into finished goods. This is happening on an ongoing basis because while they know the overall effect of tariffs imposed on each country, they are blending the various tariff effects with their production and raising prices slowly. We expect the core inflation index to climb an additional 0.2% before declining in the second half of 2026. The payback for tariffs will take years as manufacturers build new factories to on shore manufacturing. Manufacturing jobs have continued to decline in 2025 with approximately 50,000 jobs lost. So far, tariffs have been a failed strategy for the Trump administration. They created a headwinds for economy and were the primary cause of slower GDP growth in 2025.

Currently, the risk of a recession remains about 45%. So far, the FOMC has been proactive in cutting interest rates even with little clarity and incoming data to support the cuts. This has relieved some of the recession risk in our view. As a result of the government shutdown, we are just now getting economic releases for September. This data should have been released in mid to late October, and some of the releases for October have been cancelled, including unemployment and job creation data and CPI. We will not catch back up on the data releases until the middle of January 2026. The U.S. economy has been remarkably resilient to date, but the risk over the next 30 days will be if the data released show even weaker fundamentals for the economy.

## Economic Outlook

Still, we are optimistic. 2026 will be a better year for the U.S. economy than 2025. The headwinds of tariffs and DOGE are behind us now. We believe that the FOMC has cut rates enough to provide a soft landing for the U.S. economy and that GDP growth should rise from 2025 levels in 2026 and 2027. The administration has back peddled somewhat on specific tariffs related to beef and bananas and other food costs. We believe that businesses have acclimated somewhat to the tariffs as the administration continues to move forward with a second round of country specific trade negotiations. We do see an opportunity for a reduction in tariffs and trade barriers which could provide a path to higher GDP growth in 2026 and 2027.

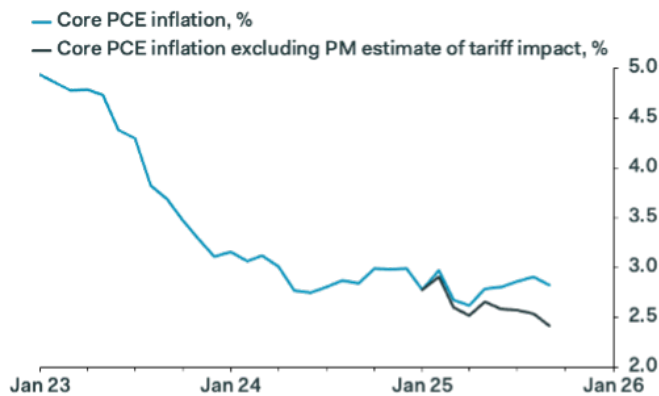
The November CPI report was better than expected and shows that inflation fell from 3.0% a month ago to 2.7%. There were gaps in the data, however, and it's further distorted by the shutdown, so this reading is not a reliable one. It did show that coffee prices

were up 18.8% and steaks 14.7% year-over-year. Egg prices have dropped 13.2%, televisions 7.3%, and pork chops were down 6.3%. On an overall basis we expect core personal consumption expenditures to peak in the first quarter of 2026 and slowing to recede. We do expect Core PCE inflation to slowly decrease over the next year or so and reach the low 2% range by 2027.

The third quarter GDP growth revision from 3.8% to 4.35% was a positive surprise and showed that consumers are still spending in the face of higher prices for goods. Both the Conference Board and University of Michigan confidence surveys show consumer confidence continues to fall. This is being caused by the weak labor market and those who fear losing their jobs and reducing their spending. Retailers have stated that consumers continue to trade down to maximize their spending. As we discussed last quarter, the cost of living has risen dramatically since the 2020. Housing prices are up 47%, rental prices are up 29%, grocery prices are up 30%, transportation costs have risen 34% and vehicle costs are up 37.3% during this same period. U.S. wages have risen approximately 25.7%, which has partially offset the increases. Inflation and the cost of living are the top issues for U.S. consumers and will be the principle political issue for the upcoming mid-term elections in 2026. Year-over-year spending growth in spending on goods and discretionary services slowed in November to the slowest pace since 2022.

We have lowered our fourth quarter GDP estimate to reflect the weakness in growth due to government shutdown. First quarter 2026 GDP should reflect a partial recovery of the lost growth. Our GDP forecast for 2026 is currently 2.3% which is only modest growth from the 1.9% expected in 2025, but our estimates could move higher as we enter the new year. We expect GDP growth to bottom out in the first half of next year, and growth estimates for 2027 should rise if the FOMC continues to lower rates methodically and does not get behind the curve.

### Core PCE Inflation Excluding Tariffs



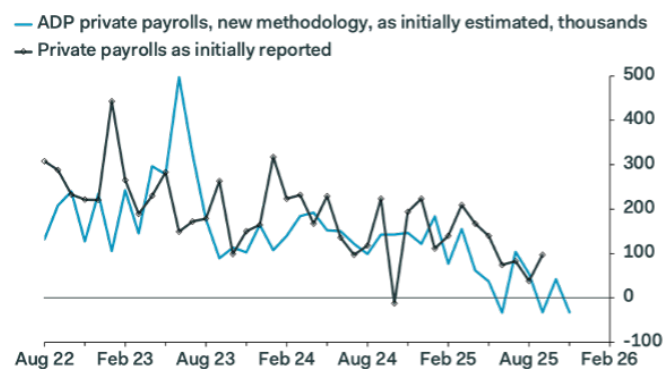
Source: Pantheon Economics

If the administration is successful in reducing tariff barriers and focusing on additional government deregulation, which should be accretive to U.S. productivity and growth and a positive development for all. We also expect the drag on fiscal policies such as DOGE as other spending cuts will be behind us as we enter

2026 which should also be an added tailwind. The passage of the "Big Beautiful Bill" in July will also mean that taxpayers will receive larger than expected tax refunds in the spring of 2026 because of a higher standard deduction and other reduced taxes on tips and overtime. The benefit to corporations is tremendous as we expect capital expenditures to grow quickly due to the 100% depreciation of these expenses lowering their tax bills versus capitalizing these expenses and depreciating them over time.

The artificial intelligence revolution continues to help the U.S. weather the softness in GDP growth in 2025. It also is contributing to greater worker productivity in which is deflationary. While we see the level of capital expenditures leveling off somewhat, we expect AI capex to rise by 34% in 2026. It is still the most important area of growth for the U.S. economy as we move forward and should provide a 0.3% boost to 2026 growth.

### ADP and Private Payrolls



Source: Pantheon Economics

The labor market continues to weaken in the quarter. We now expect unemployment to rise from 4.6% at year end and peak around 4.9% in the third quarter of 2026. No matter where you look, the labor market is suffering. The unemployment rate for 20-25 years old rose 0.3% and now stands at 9%. This continued weakness poses a threat to our overall outlook and is the single biggest factor when people discuss recession risk for the U.S. economy. Several high-profile companies have announced reductions in force.

We have seen shelter costs, which drove much of the rise in inflation rates during the Biden years, moderate as rental rates have continue to fall. Single family prices have also begun to moderate and fall in certain markets. In the Southeastern U.S., the intense price growth we saw is slowing as market prices and inventory are becoming more balanced. While mortgage rates fell in 2025, rates are still too high for existing homeowners to sell. Trump has made housing a priority for 2026, and we will see if he is successful in unlocking the market.

## Jolts and Indeed Job Postings



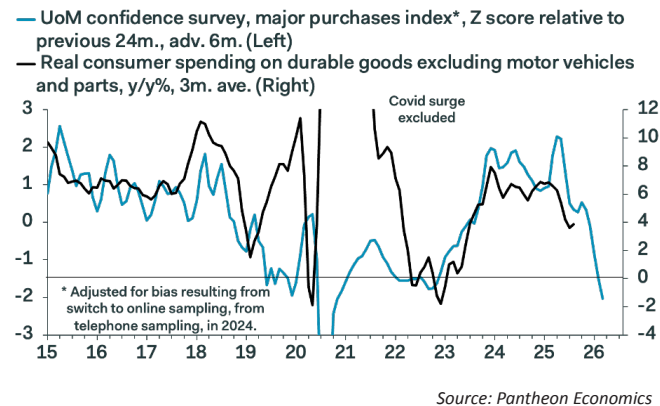
Retail sales continue to be held up by wealthier American's (homeowners), but overall spending growth has slowed from 5.7% in 2024 to an estimated 3.6% in 2025. Overall consumers are much more cautious as they deal with increased costs for essentials and are delaying major purchases. The one area consumers continue to spend freely on is experiences such as travel and entertainment. We have seen negative trends in 4Q in clothing, home furnishings, home exercise equipment, and vehicles and parts.

## Unemployment Rate

| 2025 Est. | 1Q 2026E | 2Q 2026E | 3Q 2026E | 4Q 2026E | 2026 Est. | 2027 Est. |
|-----------|----------|----------|----------|----------|-----------|-----------|
| 4.2%      | 4.2%     | 4.3%     | 4.4%     | 4.6%     | 4.5%      | 4.4%      |

Source: Pinnacle Financial Partners

## University of Michigan Confidence Survey



We expect the FOMC to cut the Federal Funds rate by a total of 0.50%-0.75% in 2026. We expect them to wait until June before any cuts, but if the labor market weakens further in early 2026, they may have to cut sooner. The FOMC continued to cut in October and December with little incoming data to support their decision as a preemptive move to support the economy. The FOMC will be looking for further clarity on the overall economic situation. Jay Powell's term as chairman ends in May of 2026. President Trump has promised to nominate his successor by year end. We would not be surprised if committee just sits tight until the new chairman is sworn in. A risk for the markets in 2026 will be if the Trump chosen Federal Reserve chairman lacks credibility to allow the FOMC to have independence from political pressure.

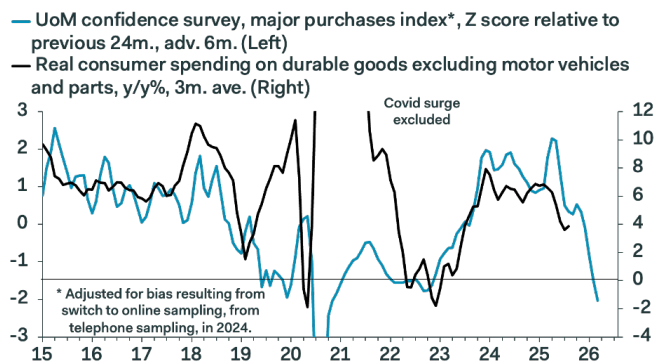
We expect the neutral rate on Federal Funds to be around 2.75%-3.00%. This would equate to a 5.75%-6.00% prime rate. The volatility within the Treasury market has made predicting the number of FOMC cuts difficult, at quarter end the Federal Funds Futures expect the FOMC to cut rates by 0.58% by December of 2026. We believe these Federal Funds cuts are essential to stimulate the U.S. economic growth, support the labor market and encourage borrowing and spending access to labor is necessary for higher GDP growth. The FOMC needs to look past current economic results and be accommodative because the current economic expansion could be at risk if they do not continue to loosen financial conditions. We'd like the president to use the more than \$200 billion in tariff funds for reinvestment and economic stimulation to ensure continued growth.

The FOMC also ended their quantitative tightening campaign during the quarter, and this will provide a better backdrop for M2 growth in 2026. The FOMC's balance sheet peaked at almost \$9 Trillion in May of 2022. The FOMC's qualitative tightening campaign causes approximately \$2.5 Trillion in assets to roll off, which made M2 contract in 2023. As of December 1st, 2025, they will no longer let maturities roll off, and the bonds will be reinvested. Historically M2 has grown at about the same rate of GDP growth. This should provide some additional liquidity to the economy and banking system, helping the capital markets operate more smoothly.

Tariffs have caused Core PCE inflation to rise by 1.0% causing 2026 inflation projections to rise above 3.0%. If you exclude the price effect of the tariffs, Core PCE inflation would have fallen this year. While we do not expect the FOMC to cut rates again until the second half of 2026, we feel the FOMC needs to do more to reign in longer term treasury rates. New mortgage rates are in the 6% area, which is 2.0% above the effective rate of all outstanding mortgages. If the administration and the FOMC want to help the consumers and housing market they need to work together to lower mortgage rates, the affordability of single-family homes is currently the highest on record.

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## Conference Board Expectation Index



Source: Pantheon Economics

## U.S. Core PCE YOY

| 2025 Est. | 1Q 2026E | 2Q 2026E | 3Q 2026E | 4Q 2026E | 2026 Est. | 2027 Est. |
|-----------|----------|----------|----------|----------|-----------|-----------|
| 3.4%      | 3.0%     | 2.8%     | 2.5%     | 2.4%     | 2.4%      | 2.3%      |

Source: Pinnacle Financial Partners

## Portfolio Strategy

At quarter end the S&P 500 traded at 25.4x earnings up from 24.3x up in the third quarter. The index is currently estimated to be trading at 22.06x 2026 earnings. We expect the markets in 2026 to remain volatile. Strong earnings growth driven by AI will moderate allowing other areas of the market to perform better. S&P 500 street earnings are expected to grow by 15% in 2026. We expect 2026 S&P 500 returns to be in the high single digit area as price to earning remain historically high and will compress in 2026. The economic backdrop will create volatility and opportunities for investors.

The best performing sectors for the quarter were healthcare, up 8.41%; communications up 8.11%; and financials up 2.95%. The worst performing sectors for the quarter were real estate, down 2.84%; utilities down 2.34%; and energy down 1.57%.

The best performing sectors year to date were communications, up 32.71%; information technology, up 24.30%; and industrials up 19.71%. The worst performing sectors for the year were real estate, up 4.12%; consumer staples, up 4.34%; and consumer discretionary up 6.40%.

The S&P 500 sectors currently trading below the S&P 500 at the end of the fourth quarter were energy (27.7x), financials (19.0x), and utilities (19.2x).

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