FIRST FINANCIAL TRUST
YOUR FUTURE FIRST

EQUITY MARKET UPDATE

As of 12/31/25 | Volume 14, Issue 12 | FFTAM.com

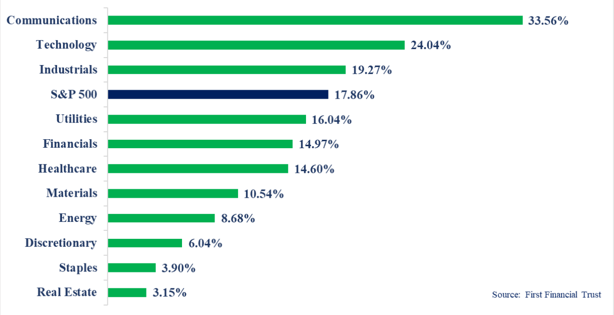
Stocks finished the year with another positive monthly return. The market has been up eight months in a row. For the full year, equities were up double digits for a third consecutive year. Earnings growth was better than expected, but valuations are elevated as we enter the new year. Historically, that has been a headwind for future performance; however, investors seem willing to put those fears aside as they believe earnings growth will be robust again in 2026, along with expectations that the Federal Reserve will continue lowering interest rates.

Performance

In December, major market indices delivered mixed results, with the Dow Jones Industrial Average leading the pack with a total return of +0.92%. In contrast, the S&P 500 remained nearly flat with a return of +0.06%, while the Nasdaq Composite declined by -0.47%. At the sector level, Financials and Materials were the strongest performers, rising +3.07% and +2.22% respectively. These gains were offset by sharp declines in the Utilities sector, which fell -5.12%, and Real Estate, which dropped -2.19%.

For the full year, the market showed robust growth driven by large-cap and technology-heavy indices. The Nasdaq Composite was the top performer with a +21.17% total return, followed by the S&P 500 at +17.86%. Small-cap stocks significantly underperformed, finishing the year up 5.99%. Performance was largely fueled by the Communication Services and Information Technology sectors, which posted annual returns of +33.56% and +24.04% respectively. Conversely, Real Estate and Consumer Staples saw the weakest growth, ending the year with modest gains of +3.15% and +3.90%.

Year-to-Date Sector Returns



Source: First Financial Trust

Individual stock performance in 2025 was dominated by NVIDIA and Alphabet, which collectively contributed almost one-third of the S&P 500's overall return. Market breadth for the year remained positive, as 329 stocks within the S&P 500 advanced; however, only 159 of those companies produced a return better than the overall index.

Economic Data Summary

Given the seismic shift to global commerce from President Trump's tariff agreements, along with changes to tax laws, economic data has been difficult to clearly interpret. The government shutdown made matters worse since many of the usual reports were not released. As we enter the new year, economic data is back on its regular release schedule. Collectively, the data is mixed, but there are signs that the US economy is attempting to reaccelerate from the soft patch witnessed during the summer and fall months. Consumer spending is firm, but it continues to come primarily from higher-income households that have record amounts of their net worth tied up in the stock market. Lower-income households are polling weak in consumer sentiment surveys, and they have become very sensitive to the affordability of basic goods and services, which has started to shape political messaging for government officials as mid-term election campaigns kick off. Labor, which has been the bright spot for the past two years, has visibly slowed. December jobs data was noticeably weak compared to one year ago with non-farm payrolls growing 50,000 jobs. The unemployment rate decreased to 4.4%. Wages were up 3.8% from one year ago and continue to move toward the Fed's target. Initial jobless claims are very mild, while continuing claims have increased. This tells us the labor market is tight, but competition to recruit and retain employees has obviously waned. Lack of immigration is also weighing on employment growth. Collectively, this indicates that getting a new job is becoming harder for people on unemployment as the JOLTs report and U6 data show fewer open positions and more people working part-time.

Consumer inflation remains stubborn, with prices increasing 2.7% from one year ago. Core inflation that removes food and energy is also 2.6%. PCE data, the Fed's preferred measure of inflation, showed total prices climbing 2.8%, while prices ex-food and energy also rose 2.8%. However, that data is stale since it was a September report that was previously delayed due to the government shutdown. The stickiness of inflation has created a large debate among investors about how much room the Fed has to lower interest rates, especially if tariffs push prices higher in future months as pre-tariff inventories are worked out of the system. Investors are also awaiting a ruling from the Supreme Court on whether President Trump overstepped his authority on applying widespread tariffs without authorization or ratification of new deals from Congress. The President has already lost the case in both the lower and appellate courts.

Despite wage growth and relatively low unemployment, clouds are forming over select segments of the consumer population. Personal income and spending data for September is the most recent data released. It showed no growth in spending on an inflation-adjusted basis. An increasing number of retail and restaurant CEOs are describing a "k-shape" economy in which wealthy households continue to prosper while lower- and middle-income families are cutting back. Consumers have increasingly funded their expenditures with the use of debt. Credit card balances are at record amounts, and debt delinquency has climbed from one year ago in both credit cards and auto loans, especially among people with lower credit scores.

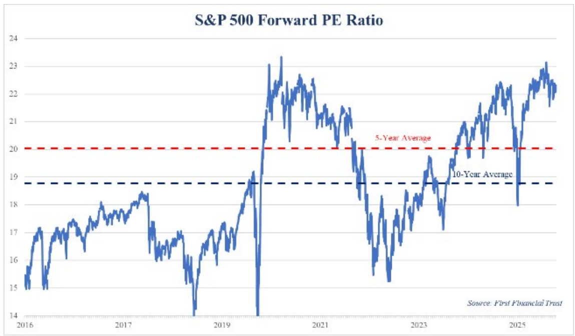
Business investment is anemic outside of artificial intelligence. According to a recent *Wall Street Journal* article, spending on AI infrastructure has accounted for half of the GDP growth in 2025. Meanwhile, the ISM Manufacturing PMI Index was 47.9. This index has contracted 35 of the last 38 months. Employment data (44.9) contracted once again. Manufacturing jobs have fallen in 31 of the last 35 months, something that historically happens only during deep recessions. New orders (47.7) contracted for the third straight month. Unfortunately, prices paid (58.5) remained very hot, adding to fears that inflation from tariffs could be lurking under the surface of more widely followed economic metrics. Service is the engine powering the economy. The ISM Service PMI Index (54.4) was very healthy. Service employment (52.0) expanded, which has been rare the past year, providing evidence that labor conditions have tightened. Meanwhile, new orders (57.9) exploded to the upside, a very encouraging look at future activity. However, just like its manufacturing cousin, prices paid for services (64.3) remained very hot, although this was a significant improvement from the 70.0 reading we got in October.

Collectively, the data shows the Fed is winning the battle with inflation, although as stated above, President Trump's tariff agenda has inserted a high degree of uncertainty for future prices. The President has begun to exempt several food-related items from tariffs to help with affordability. He also delayed by one year the implementation of tariffs against furniture-related products. Many are wondering how many products the President will try to reclassify under other sections of the trade code should he lose the Supreme Court case.

The FOMC lowered interest rates to a range of 3.50% to 3.75% at their December meeting, but Fed minutes from the previous meeting showed a major diversion between voting members on whether additional cuts are needed. Finally, President Trump has softened his messaging on appointing a new Fed chair from his decision has been made to he is now considering four final candidates. This decision will likely be announced in the next few weeks since current Chairman Jerome Powell's term expires in May. Market odds are heavily tilted towards the current Director of Economic Council, Kevin Hassett.

Valuation & Earnings

The valuation of the S&P 500 currently stands at 22.3x forward earnings estimates. This is more than one year ago (21.5x), and it is also above the 5-year (20.0x) and 10-year (18.7x) averages despite the higher interest rate environment. Therefore, the equity risk premium that compensates investors for the excess risks associated with stocks compared to bonds remains thin.



Source: First Financial Trust

We are on the brink of another earnings season. Analysts expect fourth-quarter profit growth of 8.3% compared to one year ago. If that comes to fruition, it would mark the 10th consecutive quarter of earnings growth. Nine of the eleven sectors are projected to report year-over-year growth, led by the Information Technology and Materials sectors. On the other hand, two sectors are predicted to report a year-over-year decline in earnings, led by the Consumer Discretionary sector. Wall Street now expects full-year 2025 earnings growth of 12.3%. They are even more bullish on 2026 with first- and second-quarter profit growth of 13.1% and 14.6%, respectively. For full year 2026, the expectation is for earnings growth of 15%. Technology is still expected to be the best grower of earnings, but the spread between tech and other sectors is thought to narrow. If true, it is likely a rotation could occur where investors trim from the more expensive big tech names to rotate towards other areas of the market where growth rates are improving at much lower valuations, like financials, industrials, and materials. We would caution that above-average profit growth in these other sectors is coming from select industries or individual names that are skewing overall results.

With the market currently trading above valuations of the past decade, stocks are vulnerable to headline risk from major economic reports, the Fed, and geopolitical events. The S&P 500 has experienced three straight years in which returns exceeded profit growth, resulting in significant PE multiple expansion. However, analysts are quick to remind investors that the S&P 500's forward PE ratio expands ~90% of the time when EPS growth is above the long-term average and monetary policy is accommodative. This makes quarterly earnings reports and forecasts, along with Fed meetings, must-watch events.

Conclusion

For months, we have written about the large difference in valuation between the big tech companies at the top of the index and everybody else. Many may not be aware that the ten largest tech companies now represent more than 40% of the market, a level of concentration rarely seen in history. Currently, if you equal-weight the names inside the S&P 500, the forward PE ratio drops from 22.3x to 17.2x. In December, we saw a major rotation away from higher valuation tech names at the top of the index, such as Broadcom, Microsoft, and Apple, to reinvest in areas with improving profit growth at lower valuations, primarily financials, industrials, and healthcare. Today, the median stock inside the S&P 500 trades at a 3-turn discount to the cap-weighted PE ratio; therefore, the incentive to buy non-tech positions is high. Most analysts are recommending cyclical areas of the market in anticipation of an economic re-acceleration fueled by lower taxes, looser regulations, and accelerated depreciation from the One Big Beautiful Bill, along with softer monetary policy from the Fed, and lower capital ratios for big banks. While these trades are attractive, defensive areas of the market are being completely ignored despite three straight years of major underperformance. In a market where all participants appear to be playing offense, some nibbling on defensive positions within the portfolio serves as cheap insurance for what is likely to be a volatile year.

Scan the QR Code to subscribe to our Monthly Equity Market Update. It will be delivered to your email inbox.