Are We There Yet?

OUTLOOK 2026

Thoughtful Investment
Solutions

AUTHORS

John Chatmas
Chief Exicitive Officer

Don Simoneaux
President & Chief Investment Officer

Ben Woodward
Chief Market Strategist

Logan Moulton
President of Investments

Randy Flowers
Vice President of Investments

Sajal Mutter
Junior Analyst

Henry Looney
Investment Analyst

DESIGNED BY:

Taylor Chatmas
Marketing Manager

Contents

Outlook 2026: Are We There Yet?

Letter from the Investment Team 5

Outlook Themes 2026

A Market Changing Seasons 6

The AI Bubble 12

Growth Across an Uneven Ground 18

The Policy of Tolerance 24

Taking the Alternate Route 29

Letter from the Investment Team

It's the classic road trip question, and over the past few years has doubled as the soundtrack of investing. Every bump in the pavement has investors tightening their seatbelts in anticipation of hitting the brakes. We've faced blaring recession warnings, predictions that the Magnificent 7 would skid out, concerns that tariffs would stall out the consumer, mounting deficit worries, calls for an imminent AI bubble pop, and speculation that the Fed's independence was slipping. **Through all of it, the same behavioral chorus kept echoing: surely this must be the end of the road.**

Yet, time after time, the car kept rolling. **Earnings held up, the consumer refused to let off the gas, and the economy proved far more resilient than expected.** The view through the windshield looked foggy more often than clear, but every time the mist lifted, the journey was still underway, and somehow ahead of schedule.

Adding to the collective unease, **risk assets didn't just survive this period, they thrived.** Equity markets pushed to new highs, credit remained durable, and valuations stretched to levels that made investors refresh the GPS wondering if we'd outrun the road. **When prices rise this far and this fast, the instinct to ask "Are we there yet?" becomes almost reflexive** - whether "there" means the top of the AI boom, the peak of valuations, the turn in consumer spending, or the moment when fiscal sustainability begins to fracture.

This question is at the heart of the behavioral dynamic we see in markets today: **investors aren't asking "Are we there yet?" regarding a single topic, they're asking it about everything.** Some fear we've made it to our destination already. Others insist we're miles past it and need to reroute. Most simply feel the pressure of a long, though scenic, ride and just want to know when a turn, any turn, is coming.

As we peer into 2026, the better question isn't whether we've arrived, it's **which destinations are coming into view, and which remain further down the road.** The trek ahead features shifting landmarks. These forces will shape the next phase of the journey, one where progress continues, but the scenery changes, and thoughtfully navigating the open road matters more than ever.

In our 2026 Market Outlook, we explore which concerns are genuinely approaching "there" status, which are still well down the road, and how investors can steer through a market that keeps moving forward even as the chants of "Are we there yet?" from the backseat grow ever louder. On behalf of Waterloo Capital, thank you for reading.

WATERLOO CAPITAL

Part 1

A Market Changing Seasons

A MARKET CHANGING SEASONS

Maybe it's a word you remember from a college class, a CNBC segment, or from someone detailing why you shouldn't put everything in one basket. Wherever you heard it, the last few years within equities made diversification feel more like a nice theory than a real-world advantage, mostly because the weather never seemed to change. When one pocket of the market enjoys endless clear skies, the instinct is to stay outside and enjoy the sunshine rather than carry around rain gear.

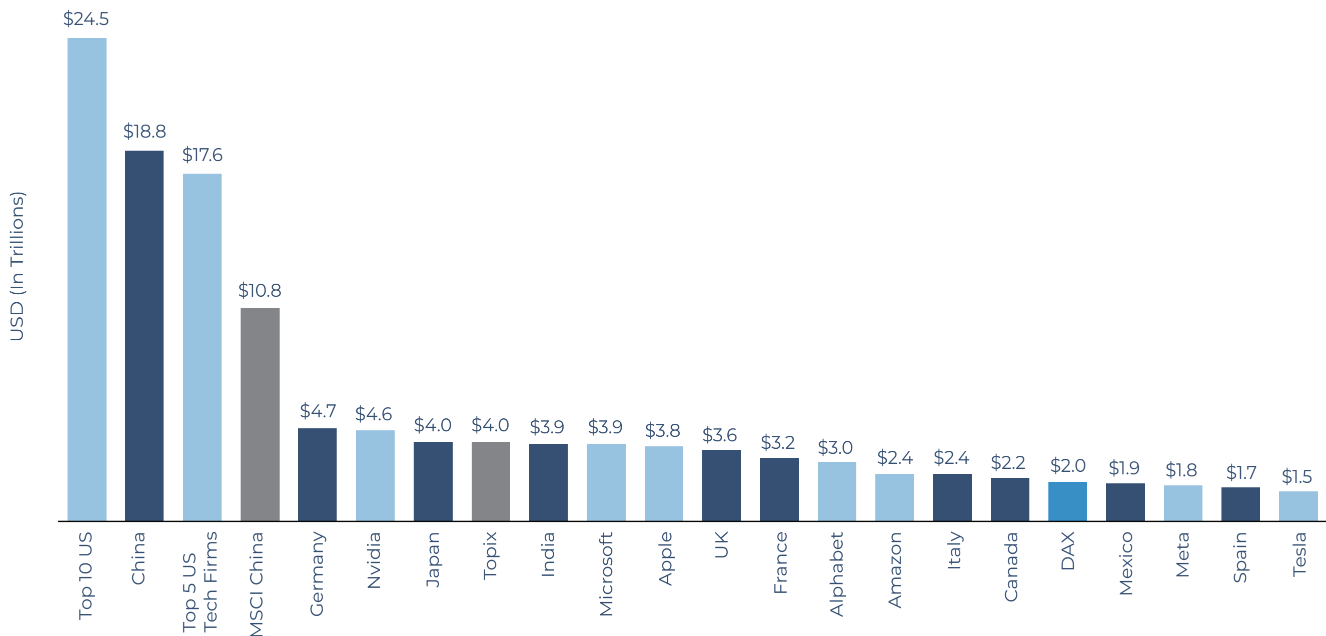
That was the story for much of this cycle. As other parts of the market tried to thaw, US mega cap tech basked in a multi-year heatwave. Foreign equities fell to record low relative valuations, small caps lagged dramatically, and investors continued piling into the same winners. Passive flows amplified the trend, quietly pushing portfolio equity allocations further and further toward a single-season strategy.

The growing outperformance sent the top 5 US tech companies ($17.6T) atop the mountain with a collective value that exceeds the GDP of Japan, India, U.K., France, and Italy combined ($17.1T). What was the point of owning more of other segments of the market when these dominant forces kept going higher? When one area only goes up, everything else feels optional.

But market climates never stay static. They cycle and hibernate until the right series of events puts the importance of diversification back to the front of investors' minds. We started to see that shift as 2024 ended, urging investors not to abandon what had been working, but to cast a wider net within equities. Then early 2025 delivered the first real weather pattern shift in years. Foreign equity markets snapped awake just as US tech cooled. Investors who had allowed their portfolios to drift into one-season strategies felt how uncomfortable a fast temperature change can be.

The Top 10 US Companies Dominate The World Equity Market

Top 5 US Tech Firms Alone Have a Collective Value ($17.6 T) that Exceeds the Combined GDP of the Japan, India, UK, France, and Italy ($17.1 T)



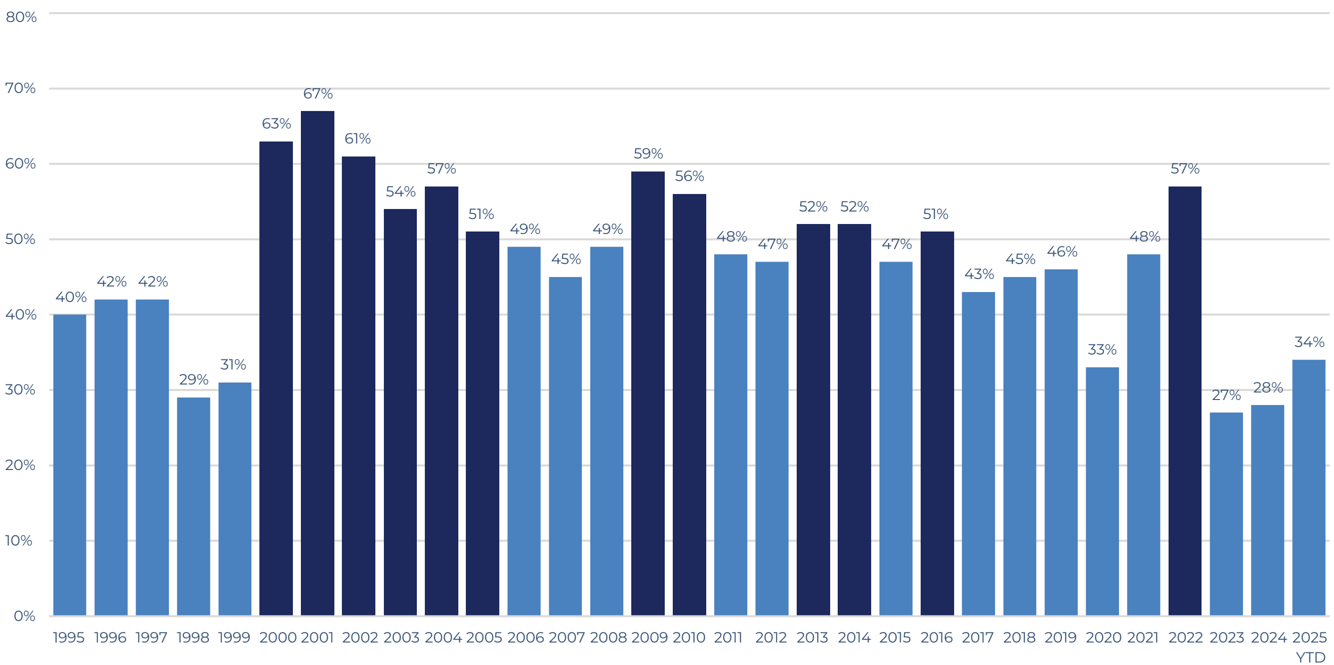
Source: Goldman Sachs, IBES, FactSet. As of October 8, 2025.

In 2026, we are moving out of a one-season equity market, where the same handful of companies dominated, and into a period where more areas are starting to participate. The mega caps remain powerful leaders, but they're no longer the only story. This isn't about abandoning them, far from it, but it does mean recognizing that equity dynamics are evolving and portfolio construction needs to evolve with them.

A MARKET CHANGING SEASONS

The topic du jour across the investment community centers around the overconcentration in the Magnificent 7 stocks. After several years of outperformance, valuations have risen and investors are naturally wondering whether the group is due for a meaningful reset. Investors continue to ask: Are we there yet? Is this the point where they finally break? While sentiment has become more cautious, we do not anticipate a dramatic reversal in 2026. Several, though not all, remain well positioned with deep competitive advantages in AI. These are exceptional businesses. But exceptional doesn't mean boundless. Dominant doesn't mean invincible. And strength doesn't eliminate risk.

What matters more is that the market is beginning to show signs of healthier participation. Breadth has been unusually weak for the last few years, but the improvement recently is telling. In 2023 & 2024 only about a quarter of S&P 500 companies outperformed the index. In 2025, that number has risen to 34%. Mega caps still drive a large share of returns, but more areas are contributing - an encouraging development for investors who have been waiting for a broader set of opportunities to return to the market.



Source: First Trust, Bloomberg, Data as of December 1, 2025

This developing backdrop argues for a steadier, more balanced approach within equities. The question is not whether to own the Mag 7, but how much to rely on them given the homogeneity of performance. Other segments of the market are strengthening and allowing them more room aligns naturally with a healthier diversification framework. AI will remain a formidable force, but the roster of beneficiaries is widening, from companies building the physical infrastructure of AI to firms tied to reindustrialization and cyclical improvement. The leadership within this race is no longer restricted to a single lane.

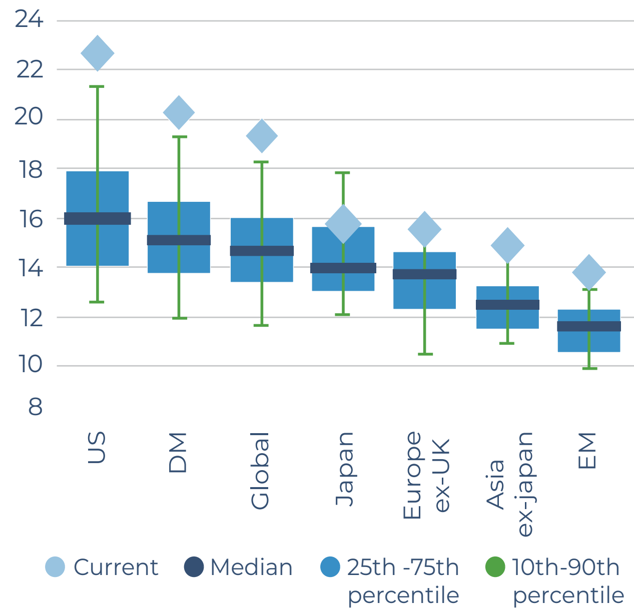
> "Exceptional doesn't mean boundless. Dominant doesn't mean invincible. And strength doesn't eliminate risk. "

A MARKET CHANGING SEASONS

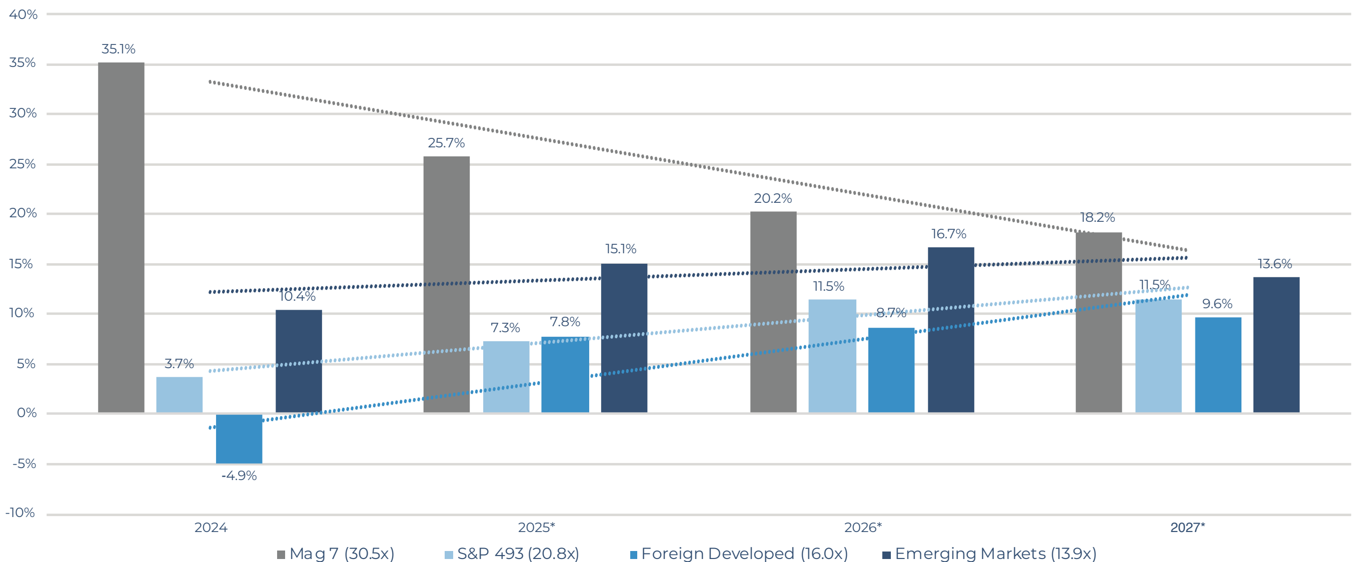
With our call for more broadening, it is important to acknowledge that valuation and earnings trends matter, because what investors pay for growth is just as important as the growth itself. The Mag 7 trade at roughly 30.5 times next year's earnings, reflecting both their quality and the premium investors are willing to pay for it. The rest of the S&P 500 trades closer to 20.8 times, foreign developed at 16 times, and emerging markets sit even lower at about 13.9 times. With valuations elevated across equities, 2026 will be more about earnings growth than multiple expansion.

While the Mag 7 still offer stronger absolute growth, their earnings momentum is beginning to level off. At the same time, expectations for both the broader US market and international equities are improving. The outlook for the coming year is less about replacing the leaders and more about incorporating the growing number of segments now showing signs of renewed strength.

> "What investors pay for growth is just as important as the growth itself."



Source: FTSE, IBES, LSEG Datastream, MSCI, S&P Global, Tokyo Stock Exchange, J.P. Morgan Asset Management. Asia ex-Japan, China, DM, EM, Europe ex-UK andGlobal are MSCI. Japan: TOPX; UK: FTSE 100; US: S&P 500. Valuation is price to 12-month forward earnings, as published by IBES. Range and median calculatedover last 20 years. Data as of 31 October 2025.



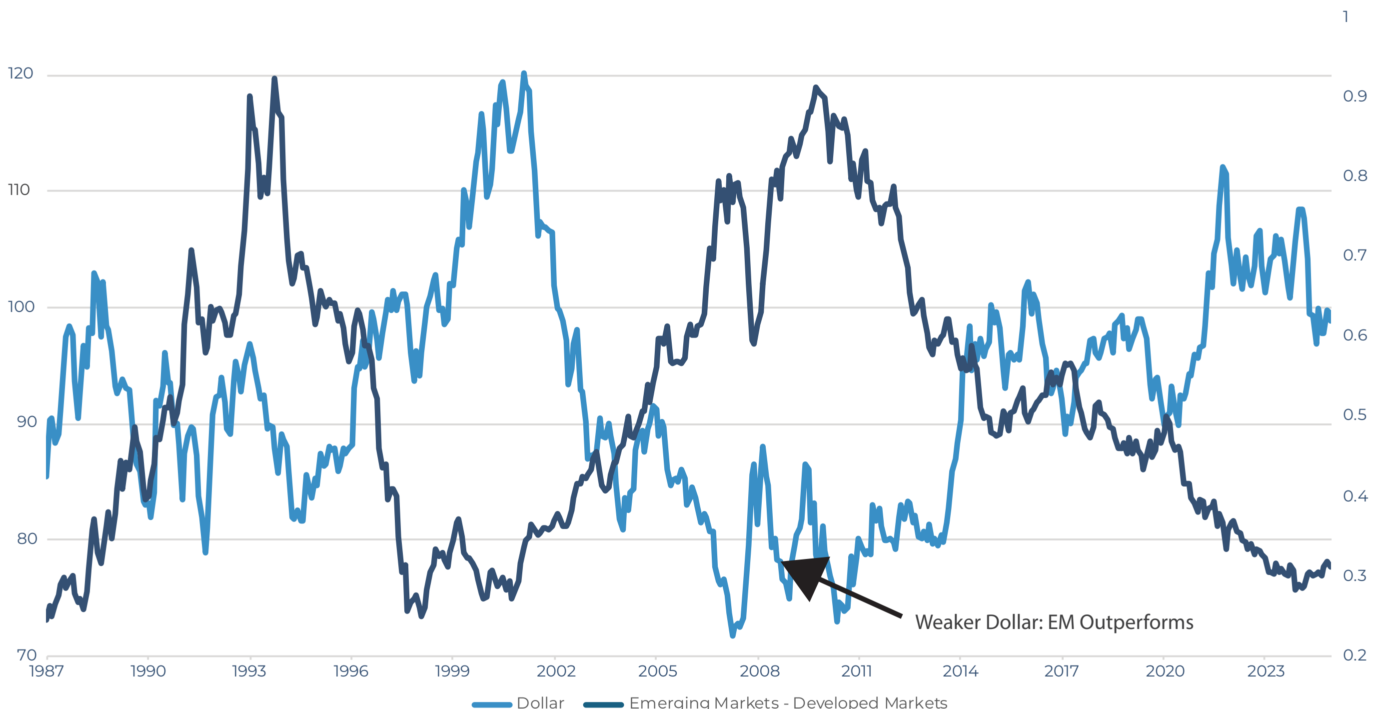
Source: Bloomberg. Waterloo Capital. Bloomberg Magnificent 7 Index, Bloomberg 500 ex Magnificent 7 Index, MSCI EAFE Index, MSCI Emerging Markets Index. Data as of December 9, 2025

Simultaneously, smaller companies have shown early signs of renewed momentum. A stable domestic economy, Federal Reserve tailwinds in terms of lower rates and liquidity, fiscal incentives tied to reindustrialization, and an expanding set of AI-related opportunities all support a better environment for lower capitalization names. These areas will still require selectivity, a rifle's accuracy rather than a broad allocation, but the dispersion creates room for well-chosen companies to benefit as leadership broadens. For investors accustomed to this one-season market dominated by a handful of mega caps, small caps once again offer exposure to drivers that differ meaningfully from large cap technology.

> "When growth outside the megacaps is accelerating at a lower cost, the relative value case becomes harder to ignore."

As leadership broadens at home, the opportunity set abroad is shifting as well. Even after a strong year for international markets, most investors remain meaningfully underweight global equities. We continue to favor US markets at the core of portfolios given our call on domestic exceptionalism, but the magnitude of that tilt should be moderated - especially as the driving force of American markets faces more scrutiny. As global capital flows rebalance, the international landscape should feel a bit less like an afterthought and more like a region riding a steadier breeze, especially in emerging markets where valuations and currency dynamics remain supportive.

Several emerging markets offer compelling structural stories, and parts of Asia appear poised to benefit from the next phases of the AI buildout. The key companies powering semiconductors, cloud infrastructure, and robotics meaningfully expand the opportunity set, as technology already accounts for more than 25% of the market compared with only 9% for their developed European counterparts.



Source: Bloomberg. Waterloo Capital. Data as of December 11, 2025.

A MARKET CHANGING SEASONS

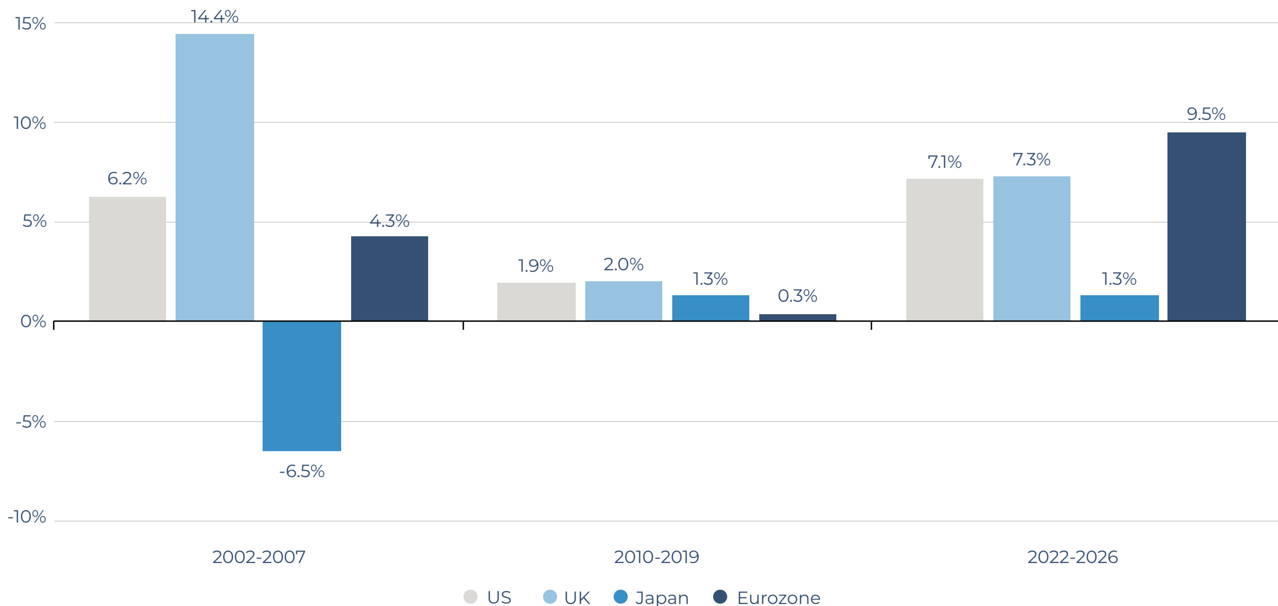
Also, even accounting for the slide in 2025, the US dollar is historically expensive on several measures, and the valuation gap between US equities and international markets, notably emerging, remains wide. If global conditions continue to stabilize, that gap offers additional room for relative value abroad. But the more important shift comes from fundamentals. Even with price outperformance, international earnings were subdued last year, constrained by tariff volatility and stronger local currencies that weighed on exporters. Looking to 2026, the setup is more constructive. Companies should benefit from resilient global demand, fewer tariff surprises, and more predictable global monetary policy as inflation steadies.

Another meaningful shift is emerging on the fiscal side of the coin. Europe, and Germany in particular, is moving away from the tight spending constraints that defined the past decade. Governments across the continent are preparing to deploy significant capital into defense and infrastructure, with several countries planning outlays approaching 5% of GDP. This increased fiscal impulse and initiatives out of Europe should help contribute to European economic growth, narrowing the gap with the US. Much of this has been on the road map, but 2026 is when actual spending begins in earnest.

Japan is also pivoting given multiple positive tailwinds. More stable monetary policy and direct fiscal support from a new Takaichi led government should provide more building blocks for stronger corporate capex and consumer spending in 2026. The corporate governance reforms we wrote about last year should continue unlocking shareholder value via increased dividends and share buybacks. For the first time in years, fiscal policy outside the United States could serve as a sustained source of demand rather than a drag.

Unlike The Post GFC Period, Fiscal Authority Has Been Left Behind Across Regions

Nominal Government Investment, Average Annual Growth Rate



Source: OECD, J.P. Morgan Asset Management. *2022-2026 includes OECD forecasts. Eurozone is a GDP-weighted average of France, Germany, Italy and Spain. Government investment is fixed capital investment by government entities in long-term assets such as infrastructure, buildings, machinery and equipment, intended to support public services and economic devlopment. Data are as of November 13, 2025.

Markets drift through seasons just like everything else. The last few years have felt like an extended summer for mega cap growth, but the early signals of a new season are already visible: broader participation, improving relative valuations overseas, and renewed momentum in smaller companies. In 2026, investors don't need to predict the exact moment when the weather will finally turn, they simply need to be prepared for it. It means building portfolios that can thrive better across seasons, not just during one long, warm stretch. The opportunity set ahead is broader than in recent memory, and portfolios that adapt stand to benefit the most.

Part 2

The AI Bubble: Closer to the Checkered Flag or the Starting Line?

It seems you can't look at the market, skim headlines, or frankly enjoy your holiday dinner without one topic consistently bubbling up. Leaning into that very intentional pun, the question at the center of the conversation is whether we're living through an AI bubble and, if so, how close it may be to bursting.

With every market move, new data center announcement, and capex figure that looks like a couple extra zeros slipped in, the speculation only grows louder that the AI trend is nearing its peak or, worse, has already drifted past it. That collective anxiety is shaping the narrative as we look further into 2026.

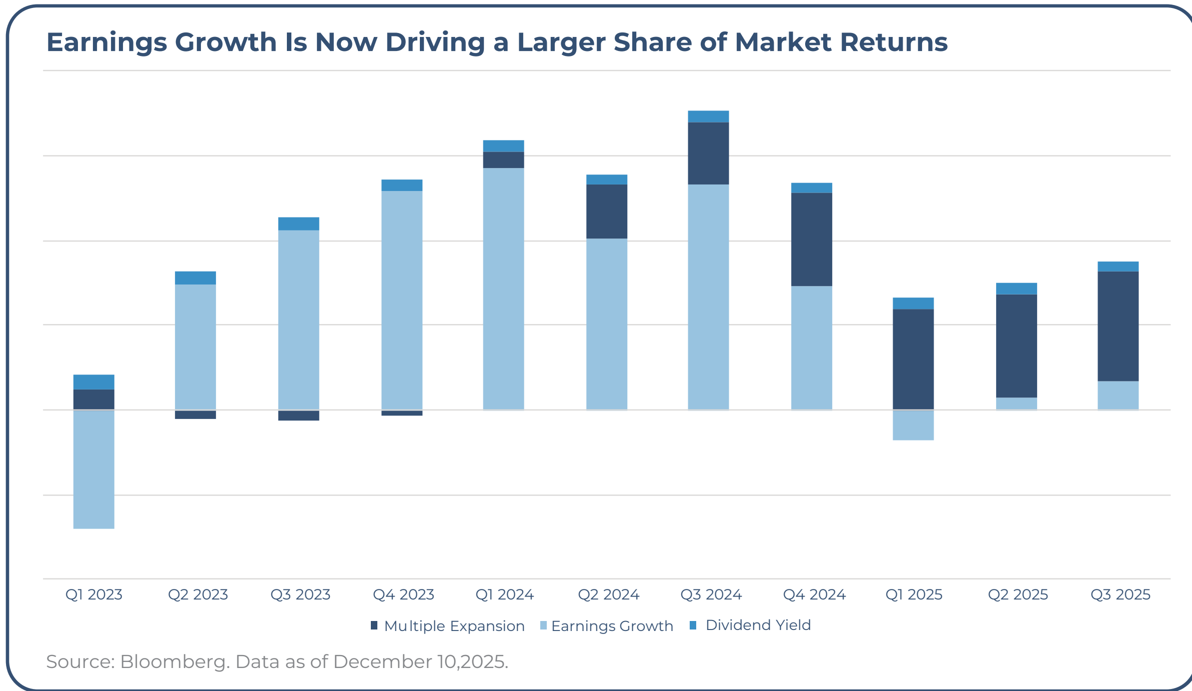
But before we declare we've reached our destination, it's worth checking the map. Leading this investment surge are some of the most profitable and innovative companies ever built, driving what could become one of the largest productivity transformations in modern economic history. There's still enormous greenfield left to explore, and by our estimation, we're nowhere near the end of the race. In fact, we're arguably early in a newly forming secular cycle. While bubble fears make for lively debate and holiday table theatrics, the more relevant question is whether we're approaching the checkered flag or still in the opening laps. And the answer, at least in 2026, is that the AI story appears to have a long road ahead.

Asset Bubble	Index	Peak Date	% Rise to Peak	% Drop from Peak
Roaring Twenties	Dow Jones Industrial Average	Sep 1929	451.20%	-66.30%
End of the Gold Standard	Daily London A.M. Fix Gold Prices	Jan 1980	1729.40%	-54.60%
Japanese Asset Price Bubble	Nikkei 225 Index	Dec 1989	407.90%	-40.60%
Dot-Com Bubble	NASDAQ Composite Index	Feb 2000	538.20%	-56.80%
Chinese Stock Market Bubble	Shanghai Composite Index	Oct 2007	315.90%	-48.20%
Housing/Commodity Bubble	West Texas Intermediate	Jul 2008	380.20%	-48.10%
AI Bubble?	BBG Magnificient 7 Index	???	275.40%	???

Bubbles, as history reminds us, tend to be surprisingly obvious in hindsight, yet strangely invisible while you're in them. They flicker faintly, usually detectable only to a few observers who catch the right angle and rarely become part of mainstream cultural conversation until after they've popped. What we're seeing today is the opposite. The notion that we may be in an AI bubble isn't whispered, it's shouted. It's less the hushed tension of a race nearing its finish and more the noisy energy of one that's still unfolding. To us, that signals a market doing its job, with participants actively assessing the potential risks and adjusting based on evolving information. Consideration is healthy and the heightened scrutiny around AI makes the theme more constructive, not more concerning.

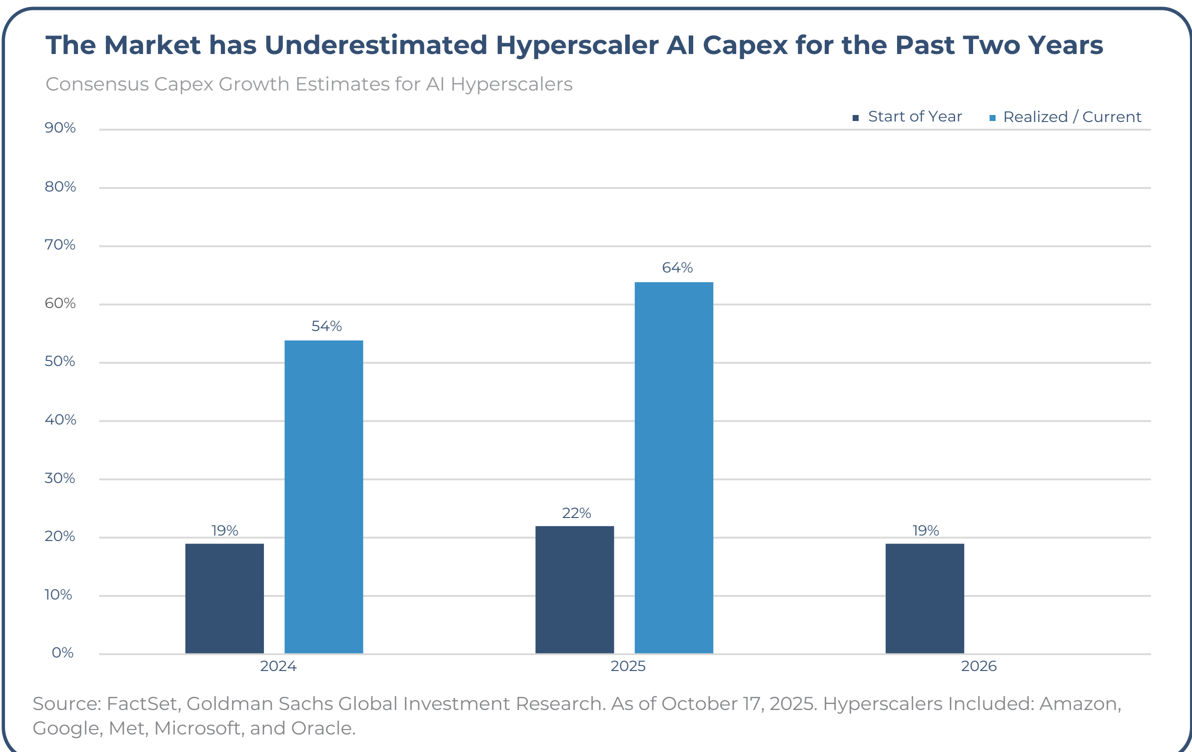
THE AI BUBBLE

When we look back to the road that led us here, what stands out is not irrational exuberance, but instead fundamental strength. While valuations are stretched among these major player AI beneficiaries - as they are across all markets and asset classes - the primary driver recently hasn't been speculation boosted multiple expansion, but earnings growth. At the same time, the technology sector's free cash flow margin is near 20%, more than double its level during the often compared to dot-com era. Bubbles tend to dissolve into nothing, but these companies are delivering real cash flow and investing in infrastructure built for sustained growth.



Source: Bloomberg. Data as of December 10,2025.

That surge of capital deployed to build out an economy capable of supporting AI's enormous demands isn't showing signs of easing off the accelerator. If anything, it's the pace of a field still gaining speed rather than one pulling into the final laps. The Magnificent 7 companies' willingness to spend continues to exceed even Wall Street's expectations. These historical levels of capital expenditure are often cited as one of the key reasons why this market is ready to pop, and the nominal figures certainly come with their fair share of sticker shock.



Source: FactSet, Goldman Sachs Global Investment Research. As of October 17, 2025. Hyperscalers Included: Amazon, Google, Met, Microsoft, and Oracle.

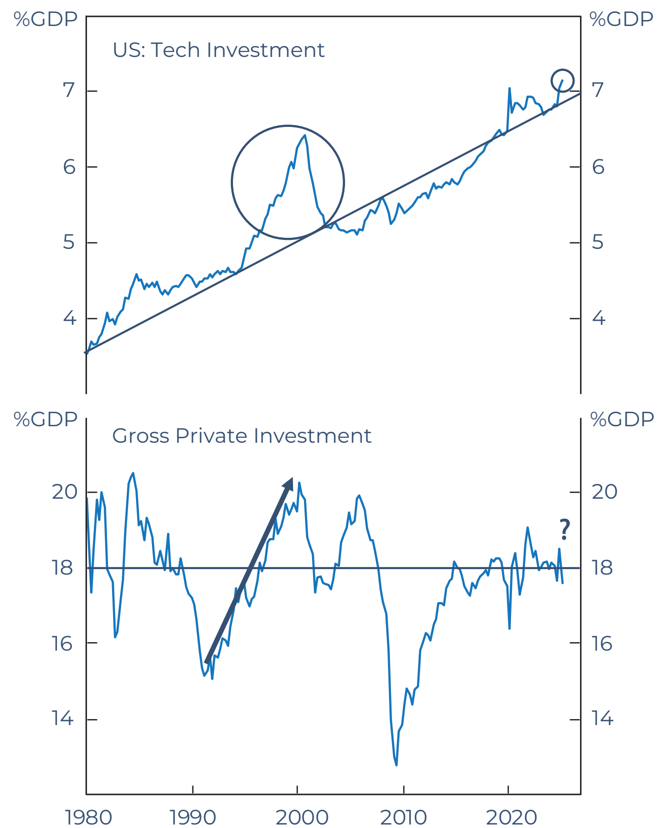
But zoom out and the numbers that appear dizzying out of context begin to align with long-term trends in private investment. Since technology began burgeoning in the 1980's, tech sector spending has steadily increased as a share of the economy. Today we sit just above that long run trajectory, and when we widen the aperture further, gross private investment across the entire economy is still slightly below its 45-year average. Both of those metrics were badly dislocated during the dotcom era. In contrast, the current capex surge looks more like the necessary capital formation required for a genuine secular shift than the excesses of a speculative top.

Of course, even a constructive cycle comes with tradeoffs. The very companies leading this buildout were once rewarded for being asset light. Now, meeting AI's substantial infrastructure demands requires adding leverage and carrying heavier balance sheets, a shift already showing up in widening CDS spreads across major tech names. It doesn't negate the long-term thesis, but it does highlight an important truth: AI's ascent isn't free. This race requires fuel, and that means real capital, real risk, and meaningful balance sheet transformation as a result.

Which brings us to the heart of the matter. The spending is massive, and some portion of it will, without question, prove excessive. But the real question isn't how large the numbers are, it's why they are this large. What are a handful of the world's most sophisticated companies trying to achieve with this wave of capex? Firms invest at this scale when they believe the opportunity ahead is not just meaningful, but transformational.

These titans are racing to build the equivalent of an operating system for the entire economy, where every application, every action, every click eventually runs through their ecosystem. Their business models, and in many ways their futures, depend on securing this position. Whether they are constructing the computational backbone for AI or by deploying it to develop the next generation of AI-enabled products, scale becomes both a competitive weapon and a prerequisite. In this battleground, the victor takes the spoils, and with victory comes the potential for earnings already reshaping their industries.

Technology Capital Expenditures Reflects Structural Change in Overall Investement

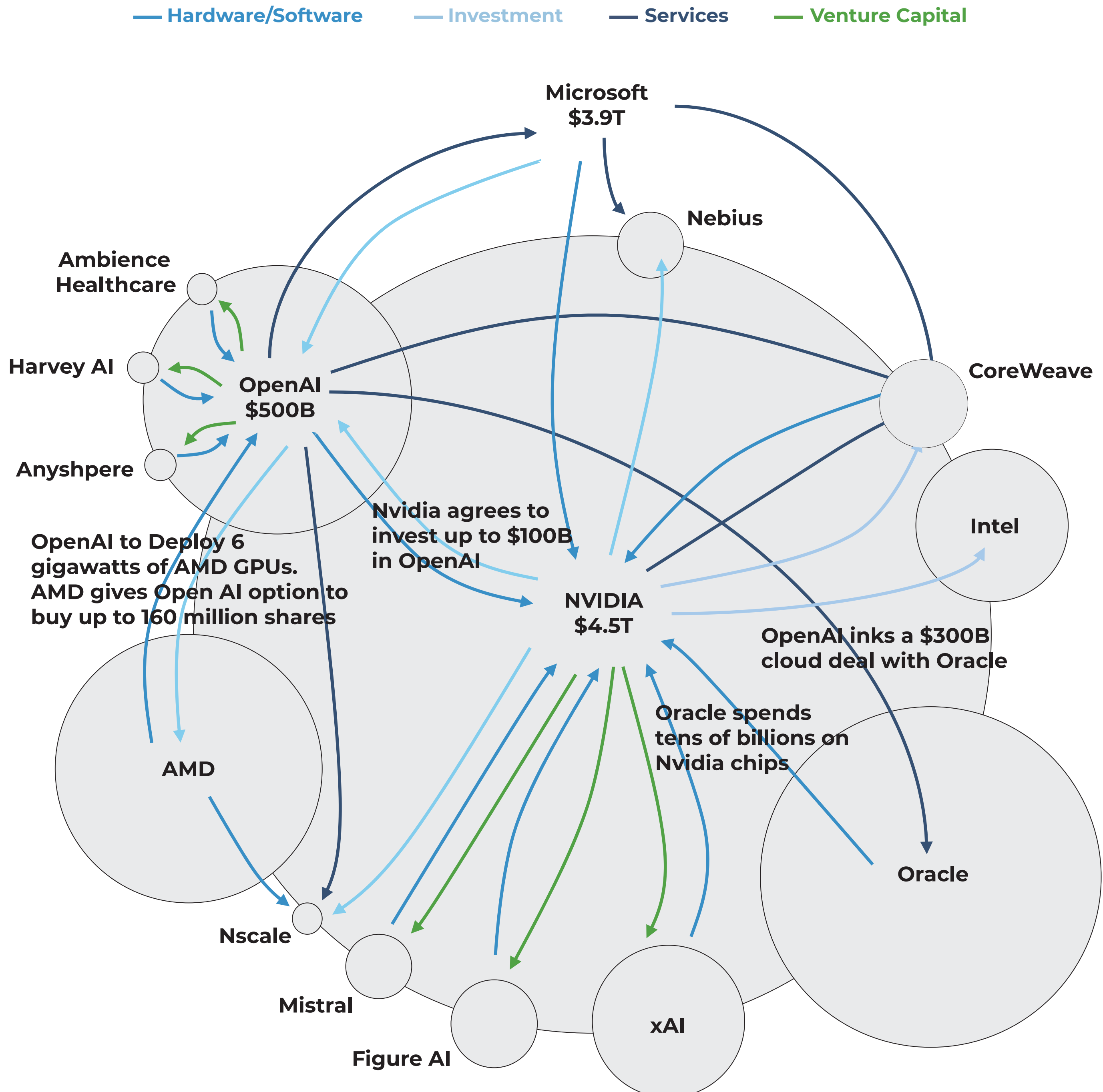


*Private fixed investment in information processing equipment, software and R&D

Source: Alpine Macro, Waterloo Capital

> "This race requires fuel, and that means real capital, real risk, and meaningful balance sheet transformation as a result."

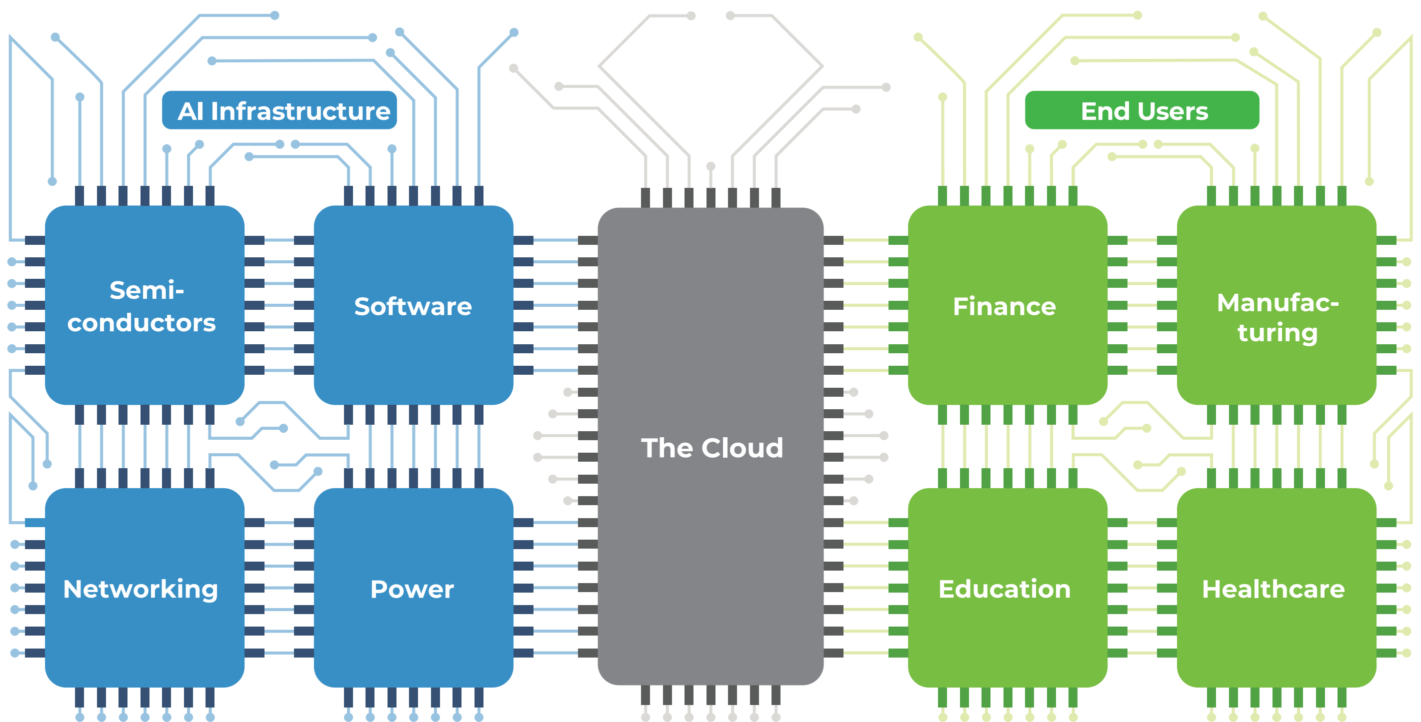
In pursuing this advantage, they've created their own microeconomy by investing in and spending amongst each other. The much discussed circular financing ecosystem is less a smoke-and-mirrors scheme and more the modern form of vendor financing and vertical integration at unprecedented scale. The simplest explanation is the most convincing when it comes to distilling why this sharing of capital is a feature and not a bug: the companies committing their futures to this transformation are likely the best equipped to judge which partners merit investment and which suppliers deserve their spending. That said, this developing interdependence binds their fortunes together, amplifying the contagion effect already evident. In a drafting formation like this, a wobble from one competitor quickly ripples through the pack.



Source: Bloomberg News, Waterloo Capital

This entanglement complicates the process of predicting which individual companies will emerge as the dominant winners. But the good news is that the benefits of their spending extend well beyond the titans themselves. As the AI ecosystem matures, we are likely seeing a transition along the spectrum, from the enablers of the AI revolution to the innovators developing new products and services, and ultimately to the adopters that will use these tools to reshape their business models. Those adopters may prove to be the clearest beneficiaries as they leverage these new capabilities to operate faster, cheaper, and with far fewer constraints than before. They're building systems where processes that once took hours happen in seconds, where tasks that demanded entire teams can be executed by a few, and where outputs that once required massive budgets can be generated instantly.

Beyond Tech - AI's Transformative Potential Across Sectors



Source: T. Rowe Price., Waterloo Capital

As these gains compound, the positive effects will ripple outward, gradually lifting the broader market and economy. That's the element most bubble narratives overlook: this capital isn't merely inflating valuations; it's laying the groundwork for the next phase of economic growth. What's unfolding goes beyond companies spending simply to secure their own positions. It's an incentivized effort to reshape the baseline capabilities of the economy itself, a shift that appears poised to accelerate the trends already taking hold as progress into 2026.

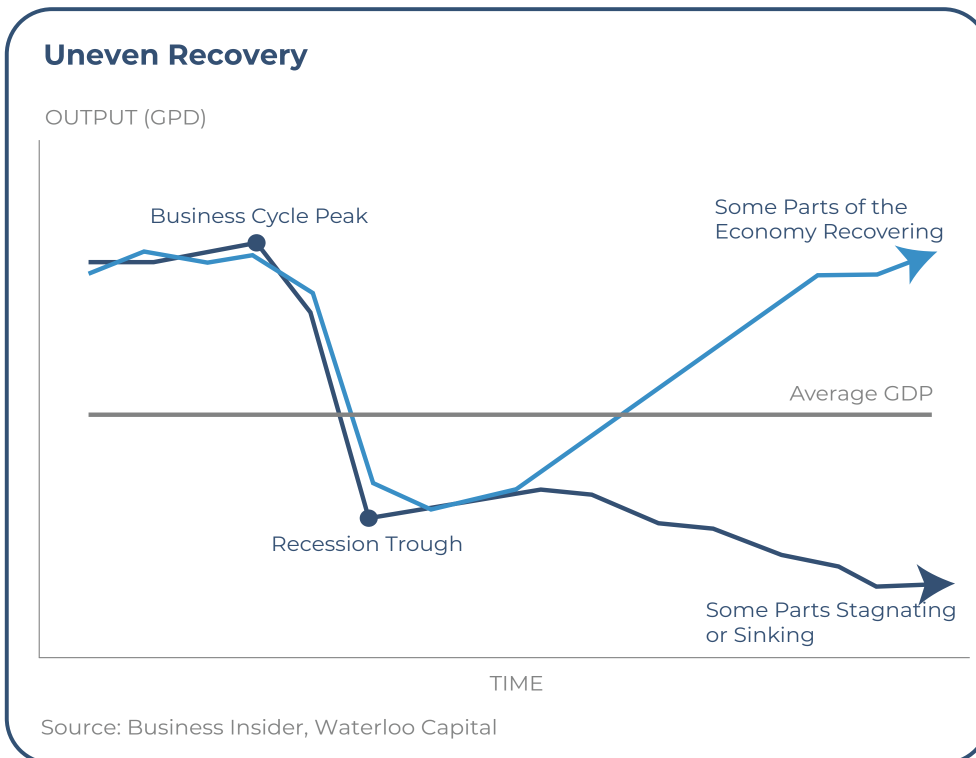
Part 3

Growth Across an Uneven Ground

GROWTH ACROSS AN UNEVEN GROUND

In the face of persistent calls for a material slowdown, economic growth in the United States has remained resilient, even as it has become increasingly uneven. Beneath the headline figures lies an economy no longer moving in unison, but instead diverging along lines of ownership, income, and exposure to assets. One in which prosperity and pressure coexist, where the factors that lift one end of the spectrum weigh on the other. US growth has endured not because it has been broadly shared, but because forces supporting one part of the economy have remained powerful enough to offset weakness elsewhere. This dynamic, reinforced by several tailwinds, will remain central to the momentum of the US economy in 2026.

Looking ahead, the unevenness of this environment becomes clearer at the household level. Inflation continues to manifest through higher prices for everyday goods and services, weighing most heavily on low- and middle-income consumers. Wage growth has moderated and labor market conditions have softened making it difficult for many households to feel confident navigating the year ahead. While a recession in aggregate is not our base case, a meaningful portion of the population is likely to continue experiencing conditions that resemble one.



Source: Business Insider, Waterloo Capital

At the same time, a smaller segment of Americans will be operating from a very different position. Rising prices have coincided with a sustained increase in asset values, particularly across financial markets, allowing wealth to expand even as inflation persisted. As portfolios have appreciated, confidence has followed, supporting continued spending and financial flexibility among higher economic status households. With roughly 87% of the US stock market owned by the wealthiest 10% of individuals, the benefits of asset appreciation remain highly concentrated. For those positioned to participate, the wealth effect continues to support consumption, offsetting rising costs and a weaker headline labor market.

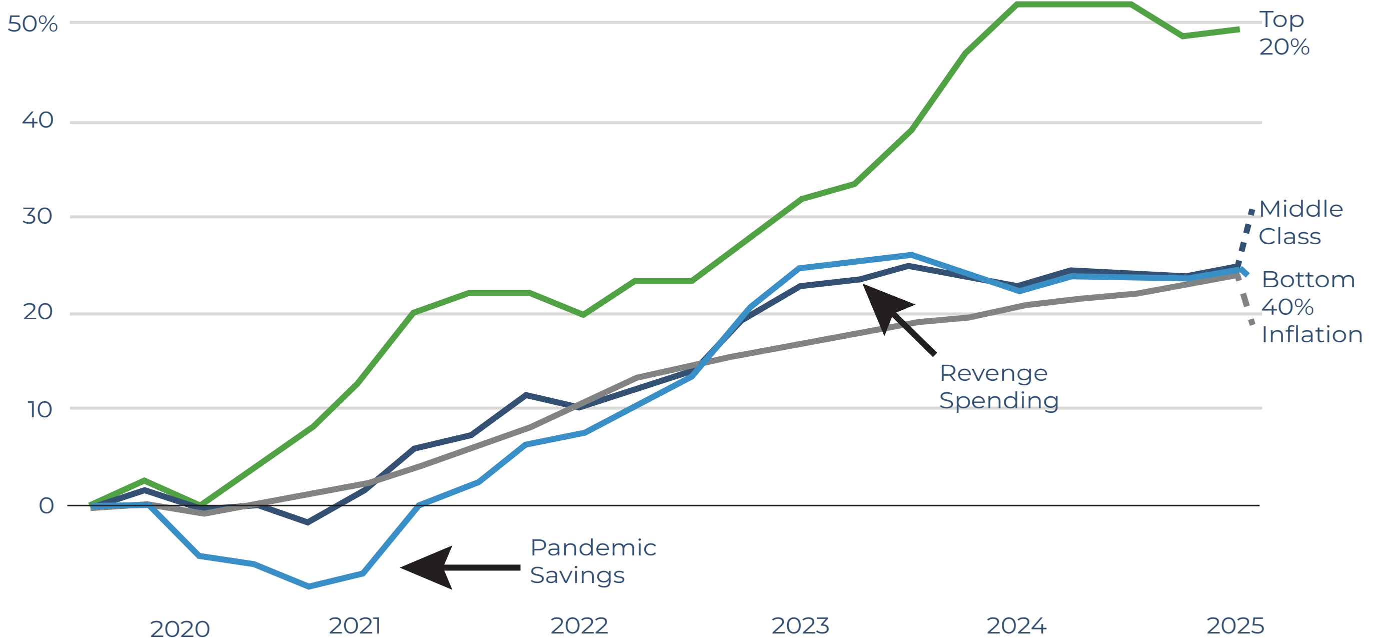
This concentration helps explain why the consumer has not tapped out, and why, in an economy that for most feels like its running on empty, growth should continue even amid widening disparities. The top 20% of U.S. households now account for roughly 40% of total consumer spending, while the bottom 20% contribute less than 10%. With consumption generally responsible for 70% of economic growth, it’s easy to see how this small segment can have a disproportionate impact. As long as higher-income households remain confident and willing to spend, support for continued expansion this year remains intact.

In this environment, financial markets have taken on an outsized role in shaping economic outcomes. Historically, the stock market has tended to lead the economy. Today, that relationship has become more direct. A relatively small group of companies has driven a significant share of market returns in recent years, and those same firms are likely to remain central to economic momentum. As asset values rise, the resulting wealth effect flows through to spending, reinforcing growth through higher-end consumers whose balance sheets are closely tied to market performance.

That said the same wealth effect that has supported consumption also represents a potential point of vulnerability. A meaningful reversal in asset prices, driven by slower investment, tighter financial conditions, or a shift in confidence, could weaken spending at the upper end of the income spectrum more quickly than headline data might suggest. This is not our base case, however the margin for error has narrowed given how concentrated consumption has become.

The US Economy Depends on Consumption by the Rich

Growth in Personal Outlays vs. Inflation



Source: Moody's Analytics

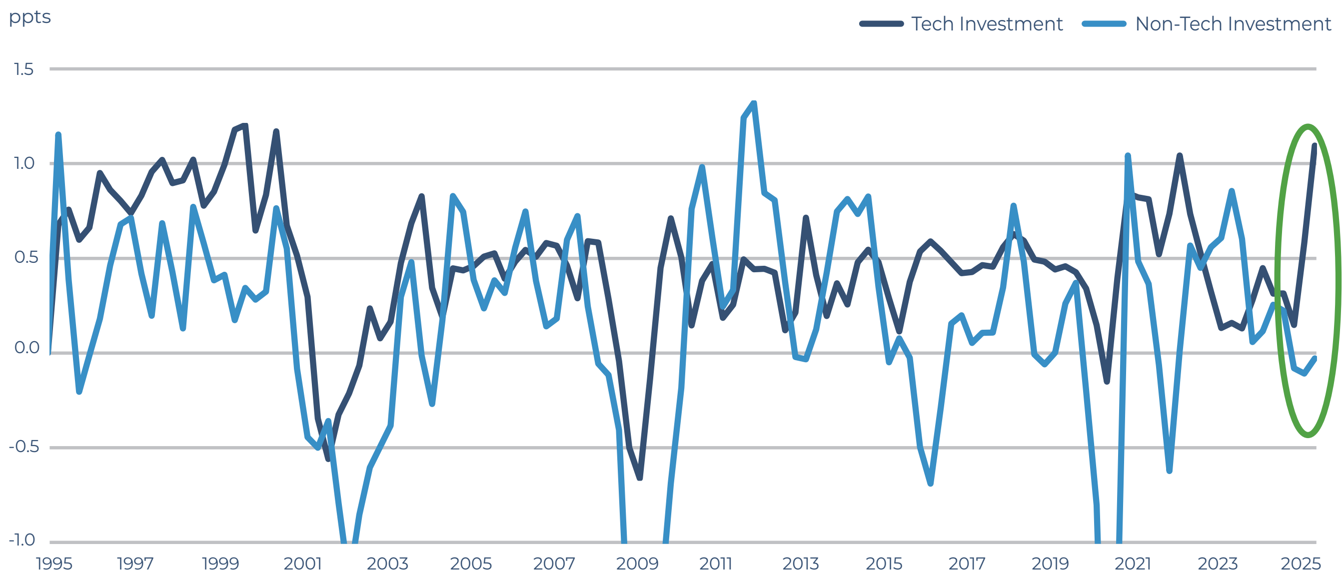
That feedback loop is being amplified by corporate investment. Large US corporations have played a central role in preventing a broader slowdown by committing significant capital to expansion, infrastructure, and artificial intelligence. Investment in AI alone has accounted for roughly half of recent GDP growth, helping transform what was a sluggish economy into one that surged above 4% annualized in the most recent quarter and approximately 2% for the year. Importantly, these investment plans appear secular rather than cyclical. Corporate commitments to AI and long-term expansion show little sign of nearing an endpoint, providing confidence that this source of growth can persist. As a result, we believe GDP growth can remain near a steady 2% this year.

Fiscal policy has added another layer of reinforcement. Recent legislation like the Big Beautiful Bill has added tax incentives to support capital expenditures and moved toward lighter regulation for banks, improving conditions for credit creation. Increased lending capacity has the potential to support activity across Main Street, particularly among small businesses and sectors that have felt recession-like pressure despite operating in a boom. Together, sustained corporate investment and fiscal support form a foundation that allows growth to extend into 2026, even as other policy variables remain in flux.

AI Investment is Powering US Growth

Growth in Other Sectors Has Been Sluggish

Tech vs. all other investment (quarterly contribution to real GDP growth)



Source: Source: US Commerce Department, Haver, and PIMCO Calculations. As of June 30 2025.

One of those variables is trade policy.

Tariffs have been a near constant concern for investors, yet their economic impact has so far been more muted than initially feared. While tariff conditions have become more orderly compared to the volatility of early 2025, corporations tend not to adjust strategy in response to temporary shifts. Pricing decisions, supply chain investments, and capital allocation are driven by expectations of permanence. To date, much of the tariff regime has been defined by delays and short-lived escalations rather than a fully implemented, stable framework, which has helped limit the near-term cost pass through to consumers.

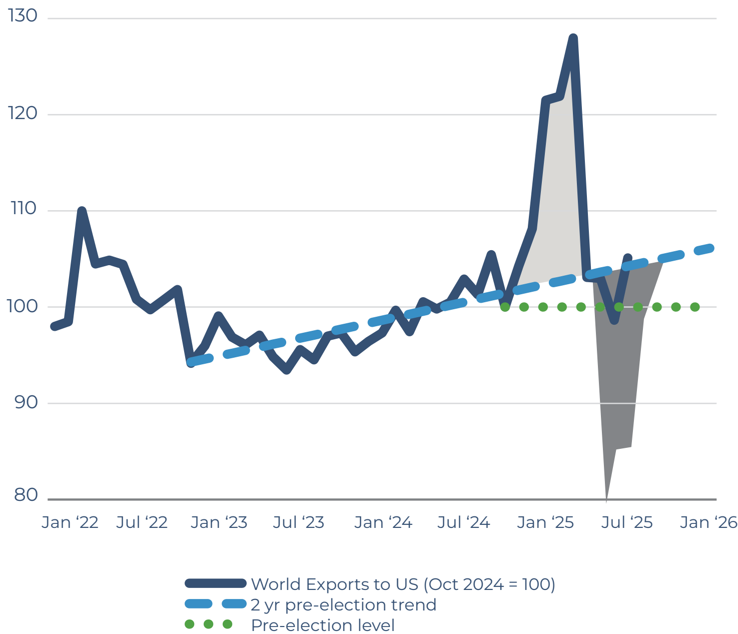
This uncertainty has shaped corporate behavior. Due to this temporary nature, corporations and global suppliers have been hesitant to raise prices aggressively, knowing that doing so risks losing market share to competitors willing to hold the line. The fear of falling behind has outweighed the impulse to pass costs through, forcing companies to absorb more of the burden or seek efficiencies elsewhere. Corporations have repeatedly demonstrated an ability to adapt by renegotiating with suppliers, adjusting sourcing strategies, and cutting costs rather than relying solely on price increases. This competitive tension extends across the supply chain, leaving, for now, the consumer bearing less of the tariff bill.

What may now begin to change is the planning horizon. Earlier in 2025, many US corporations proactively front-loaded imports ahead of the roughly 18% tariff rate, temporarily shielding both margins and consumers from higher costs. That buffer, however, may not last indefinitely, particularly if inventories are drawn down before demand meaningfully softens. According to Goldman Sachs, tariff costs are ultimately expected to be distributed unevenly, with roughly 55% passed on to US consumers, 22% absorbed by American corporations, 18% borne by foreign exporters, and the remainder evaded.

Tariff Effects Are Set to Bite

Front-Loading Payback May Require Meaningfully Below-Trend Activity

World Exports to the US



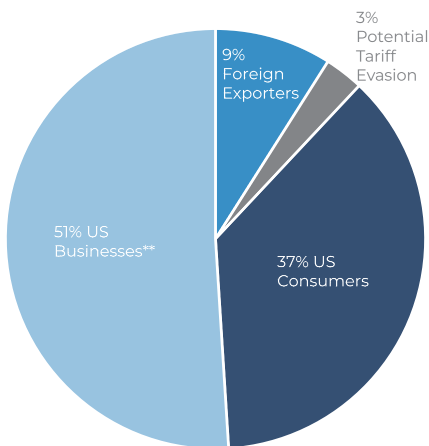
Source: Haver and PIMCO calculations. Data as of August 2025.

The risk, therefore, is less about a sudden inflationary shock and more about gradual pressure. Unlike demand-driven inflation, tariffs introduce cost-driven inflation, where higher input costs are initially absorbed by producers and only later reflected in pricing decisions. If tariff policy stabilizes and remains in place for a sustained period, corporations are more likely to adjust structurally, increasing the likelihood that consumers begin to absorb a greater share of those costs over time. Still, compared to the 2018–19 trade war, the current environment appears more manageable, as companies better understand the landscape. Advances in technology and artificial intelligence have further enhanced these efficiencies, helping offset some cost pressures.

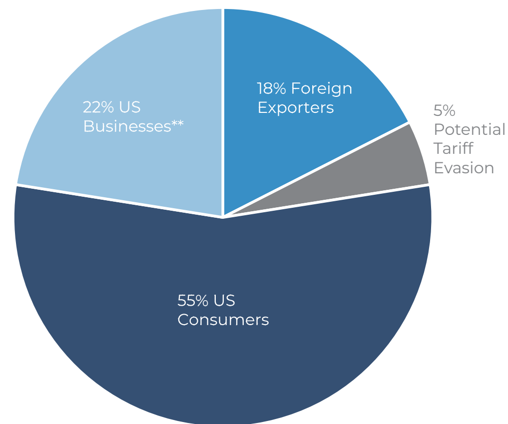
"Corporations front loaded imports, shielding margins and consumers from higher costs. That buffer may not last indefinitely."

Tariff Effects Seen So Far Imply that US Consumers Will Eventually Absorb Over Half of Tariff Costs

Division of Tariff Costs As of August 2025



Eventual Division of Tariff Costs* by 2025E



* Tariffs in effect from February to October.
** The share of tariff costs borne by US businesses is a net amount. Some businesses probably absorbed a larger share of tariff costs, while other businesses that competed with imported goods likely raised their prices.

Source: Goldman Sachs Global Investment Research. Based on Estimates Derived from PCE Data Through August and Import Price Data Through July

None of these forces point to a smooth or frictionless path forward, yet together they help explain why a narrow set of powerful drivers has kept the growth story intact despite the risks. We expect the artificial intelligence investment cycle to continue playing a central role in generating GDP growth. If sustained, the wealth effect from years of equity market performance should support spending among higher-income households, reinforcing divergence in the economic experience across wealth classes. Conversely, a sharp decline in equity markets would pose a meaningful risk to expansion, reflecting our view that the stock market increasingly functions as a proxy for the economy itself. That risk is partially mitigated by supportive fiscal policy, which makes sufficiently large enough shocks less likely in the near term. Tariffs remain an area of uncertainty, particularly given the limited impact to date as implementation has been delayed. Ultimately, this economy does not look or feel the same for everyone, but the power of these underlying forces that have already shown resilience through shifting conditions is precisely why we remain confident that the next chapter of growth is still being written.

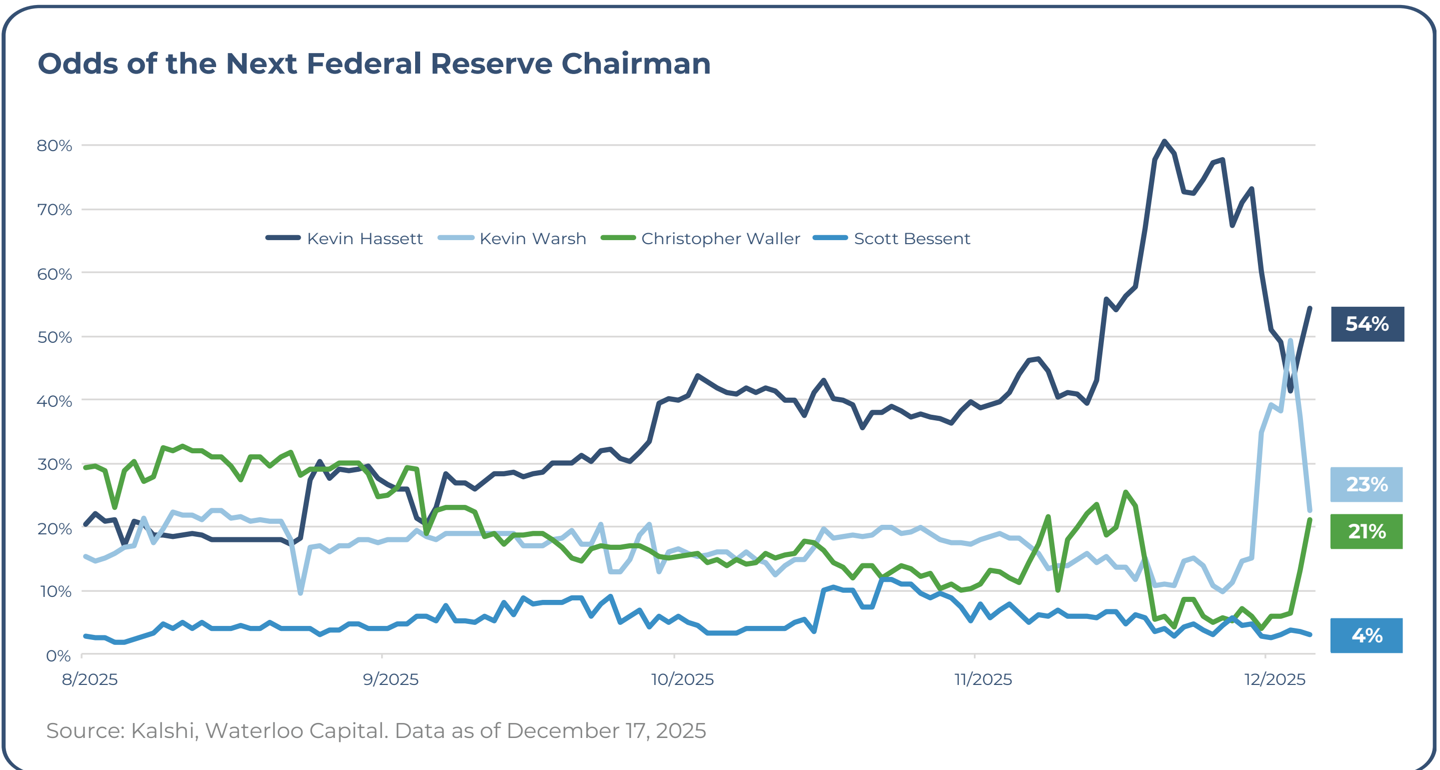
> **"Growth has held up not because it has been broadly shared, but because the forces supporting one part of the economy have remained powerful enough to offset weakness elsewhere. This dynamic, along with several reinforcing tailwinds, will remain central to the momentum of US economic growth in 2026."**

Part 4

The Policy of Tolerance

The same Federal Reserve Chair appointed by President Trump during his first term, and later scolded during his second, is now entering the final miles of his tenure, set to step down in May 2026. Few Fed leaders have governed across as many extremes as Jerome Powell, spanning crisis-era policy during Covid, the fastest rate hiking cycle in decades, and now, a rare pivot toward rate cuts during a non-recessionary expansion.

As the baton handoff to a new Chair approaches, scrutiny of the Federal Reserve's independence has grown louder. With another political appointee waiting in the wings and policy already leaning towards accommodation, investors are questioning whether the Fed is nearing a point where monetary dovishness risks undermining credibility in 2026.



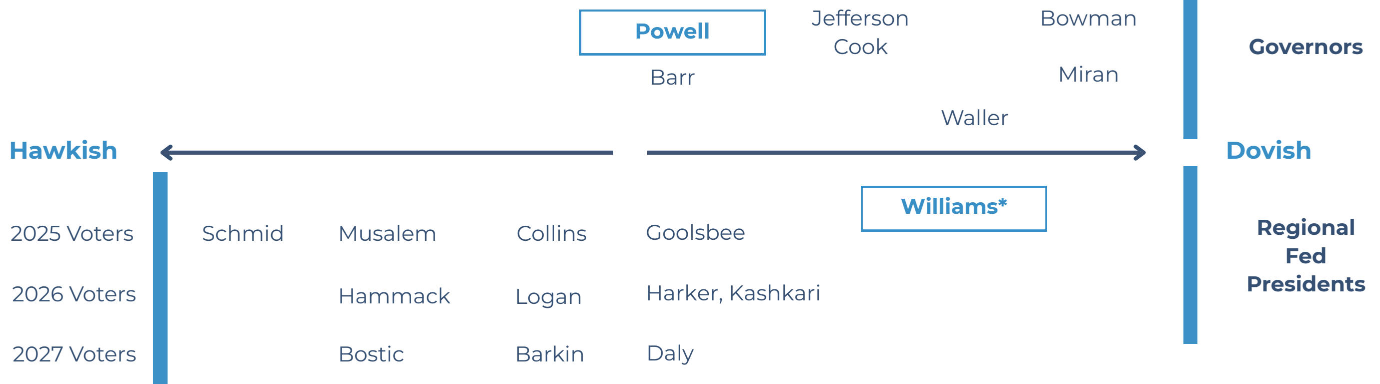
Source: Kalshi, Waterloo Capital. Data as of December 17, 2025

In our view, that framing misjudges the timing.

The dovish turn is not something that lies ahead, it is already behind us. That exit was missed miles ago. A central bank that has delivered 6 rate cuts, including one outsized move, into an economy growing near 4% last quarter with inflation well above target has already made clear how it plans to drive the rest of the trip.

A potential handoff to a more politically charged, or rhetorically dovish, Chair does not suddenly transform the Fed's stance, nor does it imply an imminent loss of independence. Political pressure exists at the margins, but it has not replaced the committee driven process. Monetary policy remains set by a collective, not an individual, and recent meetings have shown dissent on both sides of the debate. That matters. It suggests the institution is not operating in lockstep, even as its overall bias has tilted more dovish.

The December dot plot reinforces this with the 2025 projections offering the clearest window into the current voting members. A majority of policymakers signaled that policy is already near an appropriate level. 12 participants indicated rates are in a good spot, only 1 projected lower rates, while 6 saw the need for modestly higher rates. Taken together, this distribution suggests that much of the dovish adjustment has already been delivered. With easing front loaded, the bar for additional cuts in early 2026 is higher, not lower, and further action will likely require clearer evidence of economic deterioration rather than precaution alone.

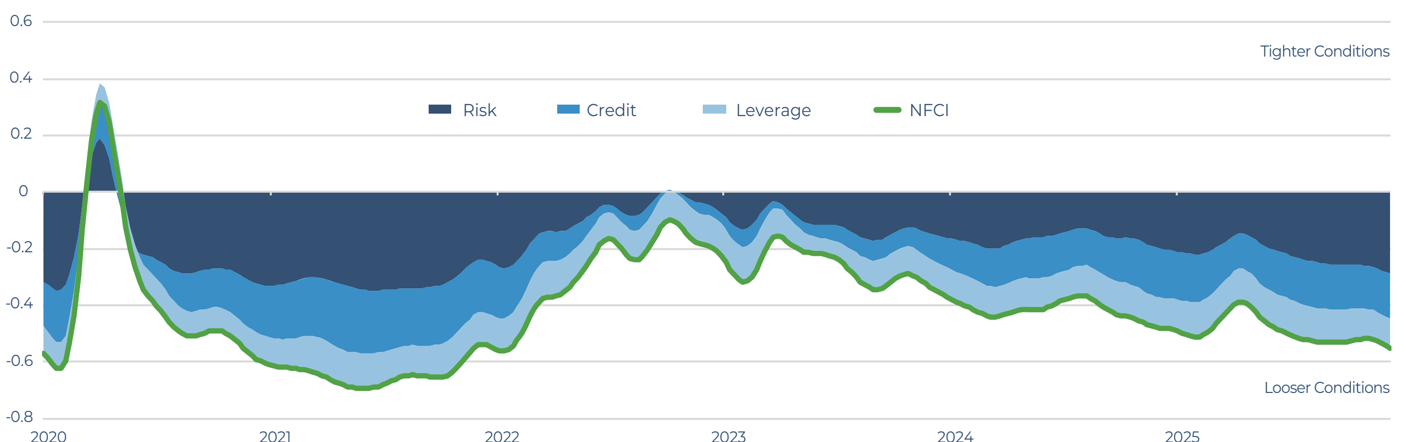


*Federal Reserve Bank of NY President always votes
Source: Renaissance Macro Research

The Federal Reserve operates under a dual mandate of price stability and maximum employment. In theory, that mandate is symmetric. In practice, it rarely is. Recently, policy justification has leaned more heavily on perceived labor market risks. We agree that earlier rate cuts were reasonable, particularly given how distorted the employment data has been by revisions, the government shutdown, and other sources of noise that made real time decision making unusually difficult. Chair Powell has even acknowledged that headline labor data may be understating underlying weakness. Within today's framework, the Fed's greater concern is not acting too soon, but waiting too long.

Looking ahead, however, a growing share of labor market softness appears driven by forces beyond the reach of rate policy, including immigration dynamics, slowing government hiring, tighter corporate cost discipline, and productivity gains from AI. Rate cuts may help at the margin, but they are not an immediate cure for structural labor supply and demand changes. That is what makes 2026 different as the Fed may be cutting into a labor slowdown it cannot fully influence, while simultaneously keeping inflation risks alive.

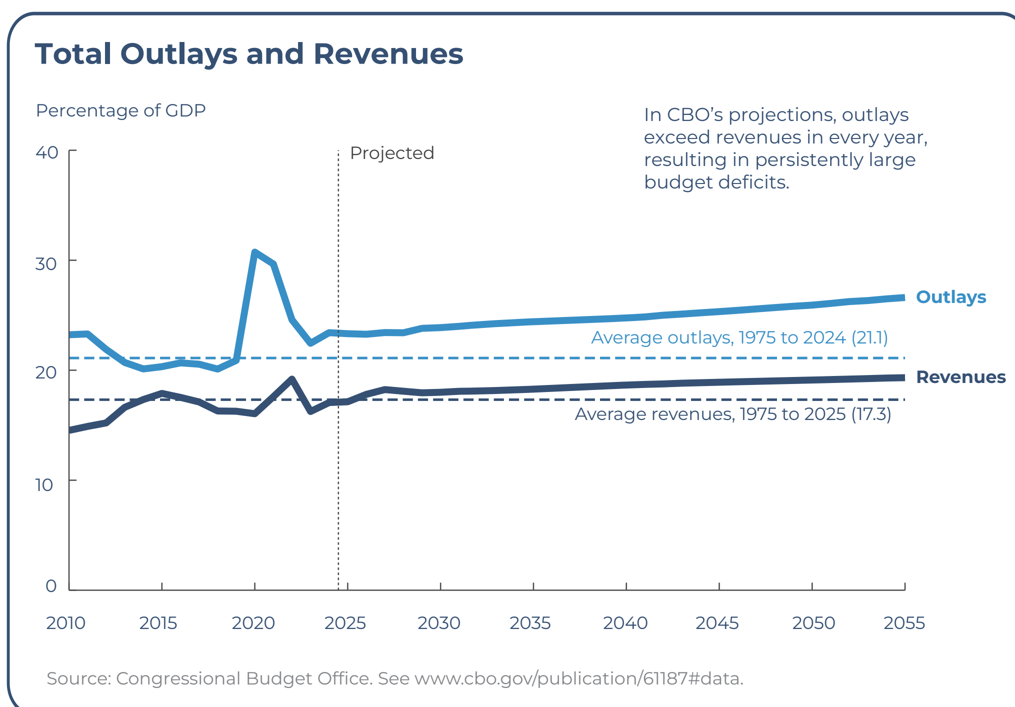
With much of the easing already delivered, in our view, the logical next step would be patience. Inflation remains elevated, growth remains resilient, and financial conditions are already loose by historical standards. A true wait-and-see approach would allow policymakers to assess the cumulative impact of prior cuts before risking further imbalance. With easing frontloaded, the burden of proof for future cuts should rise.



Source: Federal Reserve Bank of Chicago. Data as of December 12, 2025.

"That said, what we think is prudent policy and what the Fed is likely to pursue are not necessarily the same."

Even as the Fed continues to assert 2% inflation is the goal, its actions and communication suggest a growing tolerance with the number closer to 3%, particularly if the alternative is a recessionary outcome triggered by a policy mistake. The decision to wind down Quantitative Tightening while growth and financial conditions remain expansionary reinforces that mindset. This is a Fed inclined to insure against downside risk rather than wait for perfect data.



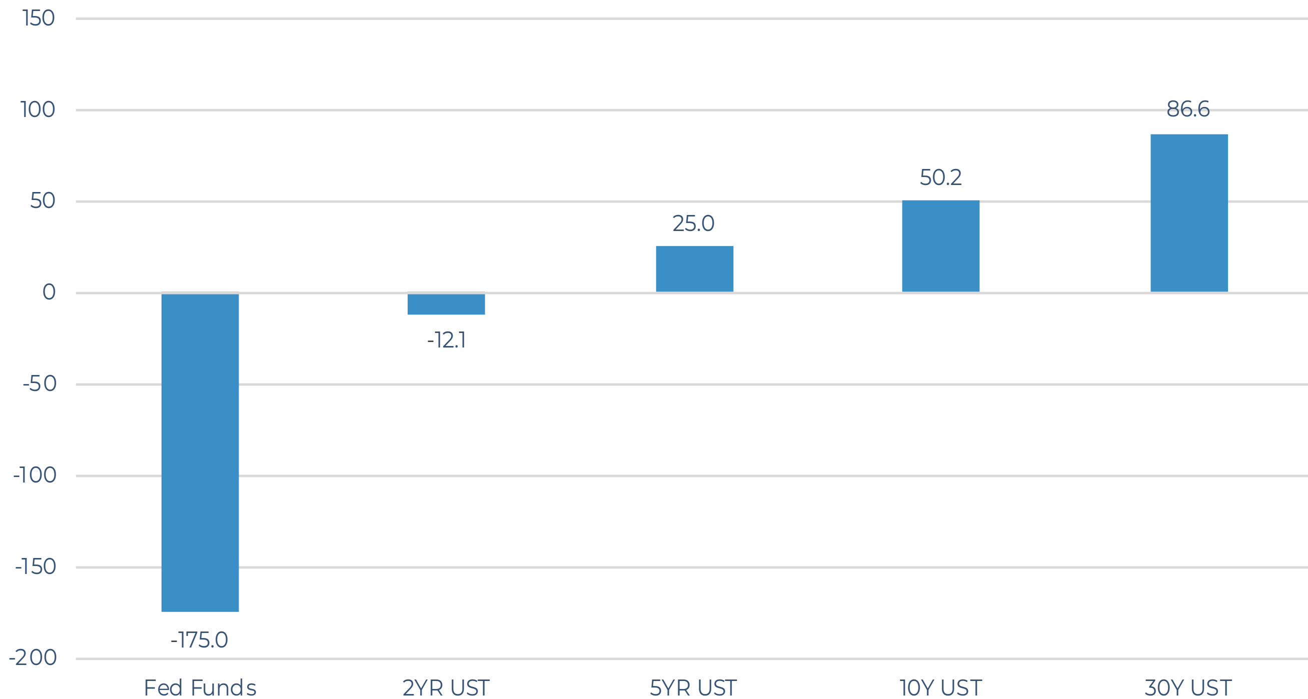
A big driver of that tolerance is structural. US debt and deficits are historically large, narrowing the range of realistic policy choices. Interest costs are projected to approach $1 trillion this year, nearly triple 2020 levels. Policymakers can try to grow their way through that problem or inflate their way out of it. In reality, the outcome is usually some combination of both.

A more tolerant Fed makes that possible. Allowing the economy to run somewhat hotter supports growth and sustains revenue, while permitting inflation to settle modestly above target can gradually erode the real burden of the outstanding debt. Neither approach is a cure, and neither solves the problem outright. But together, they provide marginal relief. When interest rates lag nominal growth, the math simply works better.

This does not require explicit coordination between monetary and fiscal authorities. It has emerged naturally given elevated debt levels and the high economic costs of forcing inflation back to target. Independence still matters, but it is not absolute. That is why tolerance has become such a durable feature of monetary policy. Even with solid growth and inflation above target, the Fed is likely to remain biased toward accommodation and quick to react if the labor market falters. Patience may make sense in theory. In practice, this Fed has shown a clear preference for moving early rather than risking a repeat of past mistakes.

For markets, this distinction is critical. A Fed that is more tolerant of an environment defined by higher inflation and solid growth has very different implications across asset classes. Inflation that settles into a middle ground can support nominal revenue growth and earnings, which is generally constructive for equities so long as policy remains supportive. That same backdrop becomes far more problematic when the Fed is tightening aggressively, as it did in 2022. In this cycle, the Fed's posture matters as much as the level of inflation itself. Hard assets and inflation-sensitive exposures, such as gold, are likely to continue benefiting in 2026 as liquidity improves and inflation risk persists. Fixed income, by contrast, faces a more uphill climb.

Fed rate cuts generally support fixed income, but they will not guarantee price appreciation. The Federal Reserve exerts its influence primarily at the front end of the yield curve while longer-term yields are driven by inflation forecasts, growth expectations, and term premium. Over the past year, all three have moved higher. Despite 6 rate cuts, longer term yields have risen rather than fallen, a clear signal that markets are pushing back against the idea that easier policy alone can anchor the curve.



Source: Bespoke, Bloomberg, Waterloo Capital. Data as of December 19, 2025.

Investors are demanding greater compensation to hold long duration assets as inflation risks remain more skewed to the upside, growth has proven resilient, and uncertainty around policy and supply has increased. The rising term premium, especially, reflects that reality.

Debt and deficits set the backdrop for this adjustment. The volume of issuance required to fund persistent deficits raises supply at the long end, while marginal demand has become more price sensitive. As a result, yields adjust higher. This dynamic does not require a fiscal crisis to be relevant, it simply raises the floor for how low long-term yields can fall, even in a cutting cycle.

The result is a fixed income environment that looks materially different from prior easing cycles. Returns will be driven by income rather than duration. Bonds still play an important role, but the path to capital gains is far narrower when inflation is tolerated and the term premium is rising. In that context, we favor an underweight to duration. It is not a call for sharply higher rates, but an acknowledgment that the structural tailwinds for long bonds remain weak.

> Whether or not one agrees with every decision, the pattern is clear. The Fed has chosen to err on the side of accommodation and speed, a bias we expect to continue in 2026. For investors, the challenge is no longer just predicting the next cut, but understanding what a more reactive Fed means for asset prices, particularly in a fixed income market that is no longer willing to follow policy rates lower without demanding compensation.

Part 5

Taking the Alternate Route

TAKING THE ALTERNATE ROUTE

After a long stretch of open highway, the ride has felt smooth. Traffic has moved steadily, the road has been well paved, and progress has been easy to measure. Yet despite the calm, many investors are uneasy. The concern is not that the road is no longer passable, but that it has become increasingly crowded, with fewer ways to maneuver if conditions change.

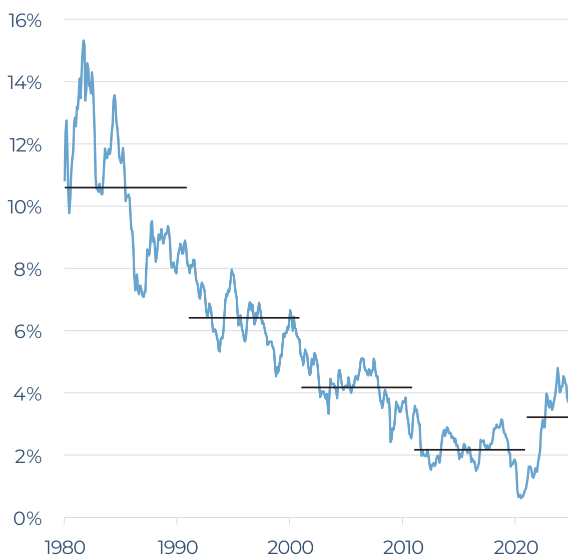
Public equity markets heading into 2026 feel much like that highway. Returns have been stronger than usual, volatility has remained muted, valuations sit near peak, and retail investor participation has broadened. On the surface, the journey appears orderly. Beneath it, however, the road has narrowed. More capital, more portfolios, and more outcomes are increasingly concentrated in a small group of large public technology companies. Most investors are not speeding recklessly, but they are traveling together, exposed to the same turns ahead.

Periods of stability and concentration often persist longer than expected, until they falter. Market cycles rarely provide advance notice. Today's imbalance is not necessarily a signal that conditions are about to change, but it does raise an important question: how resilient are portfolios if they do? That question has become harder to answer. Rotating away from large-cap public technology exposure can mean replacing one crowded trade with another, accepting greater volatility, or risking the opportunity cost of missing continued gains. At the same time, traditional public-market diversifiers have been less effective than history would suggest.

The familiar 60/40 portfolio helps explain the challenge many investors face today. Bonds have long served as the stabilizing ballast in client portfolios, providing income, diversification, and protection during equity drawdowns. Over the past decade, however, public bond returns have averaged under 2% annually and, more recently, have struggled to provide the diversification investors have historically relied on as stock and bond correlations have risen. The traditional off ramp has narrowed just as traffic has increased.

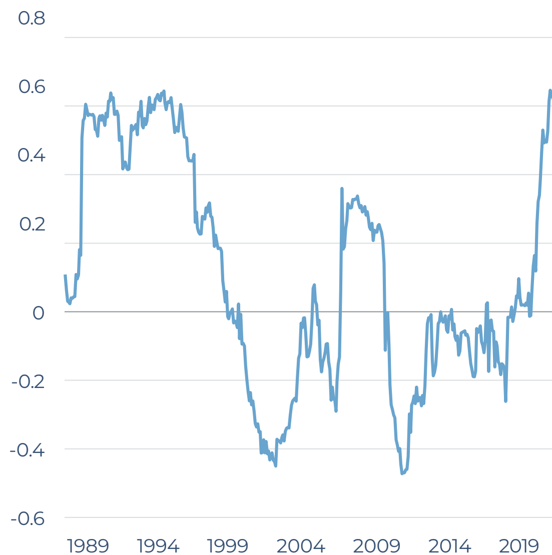
Fixed Income Bull Market Ends

10-yr US Treasury Yield & 10-yravg.



Stocks and Bonds are Correlated

Rolling 3-Year Correlation
S&P 500 and Bloomberg Agg

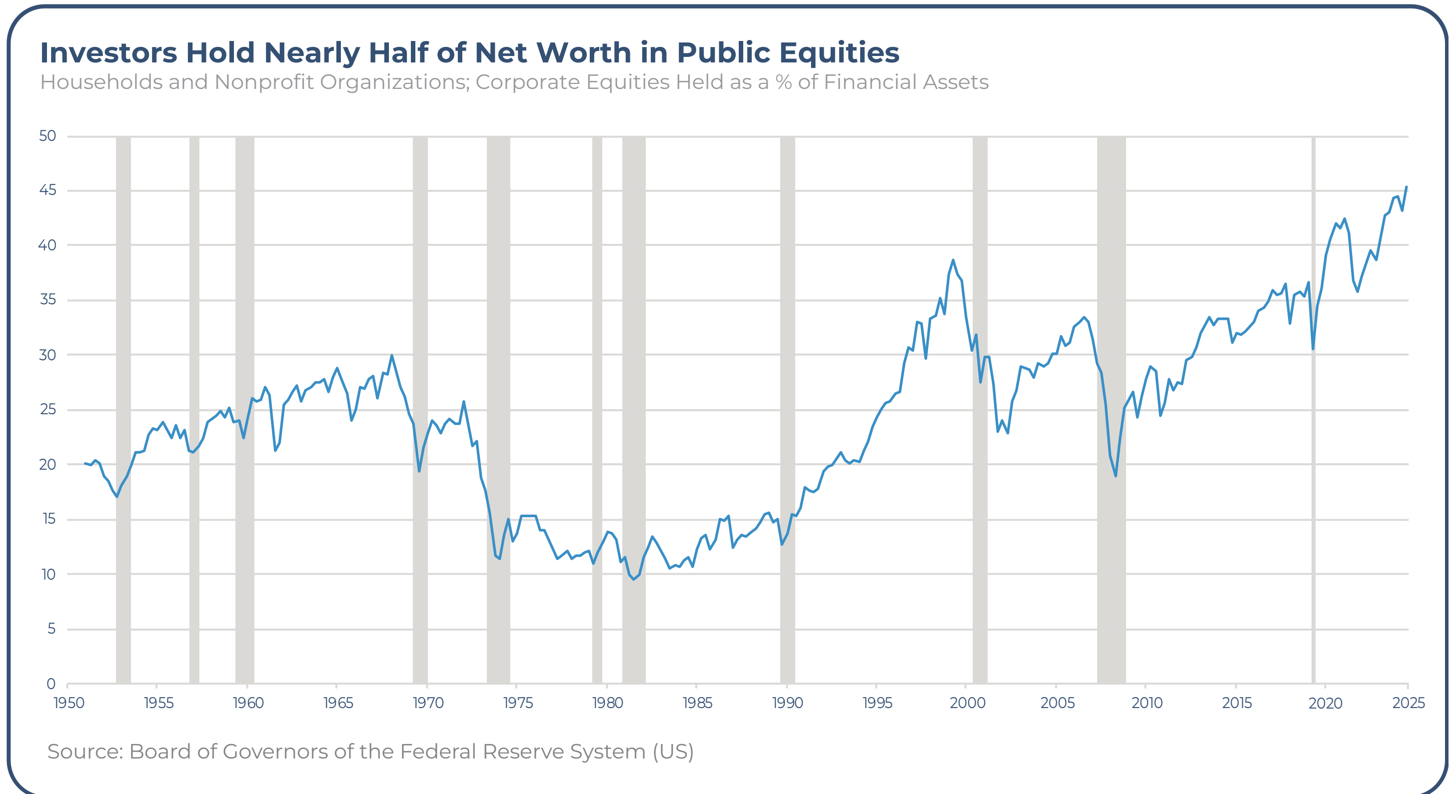


Source: Bloomberg Finance L.P., as of March 31, 2025.

The challenge, then, is not predicting the turns in the road, but recognizing when it makes sense to reduce reliance on a single route. Rather than waiting for conditions to shift, investors can begin charting an alternate path. Broadening portfolios beyond crowded public equity markets and into a wider set of investments can reduce concentration risk, introduce new drivers of return, and help portfolios keep moving forward without depending entirely on one road whose destination remains uncertain.

TAKING THE ALTERNATE ROUTE

This reassessment starts from a position of concentration. Entering 2026, individual investors hold a higher proportion of their net worth in public equities than at almost any point in history. Federal Reserve data shows public equities now represent nearly half of household financial assets, comparable to periods preceding prior market drawdowns, including the late 1990s and mid-2000s. Historically, household equity exposure tends to peak during periods of optimism and stability, not stress.



When starting points are stretched, portfolio construction matters more than prediction. This is where diversification becomes practical rather than theoretical. Harry Markowitz famously described diversification as "the only free lunch in investing," demonstrating that combining assets with imperfect correlations can reduce risk without sacrificing long-term return potential. Today, that logic increasingly points beyond traditional stock and bond portfolios and toward investments with fundamentally different drivers of return.

The question is not whether stock markets will correct in 2026, but whether portfolios are built to withstand a wide range of outcomes when prediction is difficult. After years of public equity-driven returns, many portfolios remain highly sensitive to a narrow set of risks, leaving them vulnerable to shifts in sentiment and momentum. In this environment, diversification is less about reallocating within equities and more about incorporating assets designed to behave differently as conditions change.

Wherein response to that uncertainty, taking an alternate route becomes compelling. Each investor embarking on this journey resembles a different kind of driver. Risk tolerance, income needs, and time horizon all shape how they navigate the road. While there are many routes to the same destination, the key is alignment between the vehicle and the journey, between investment choices and long-term objectives.

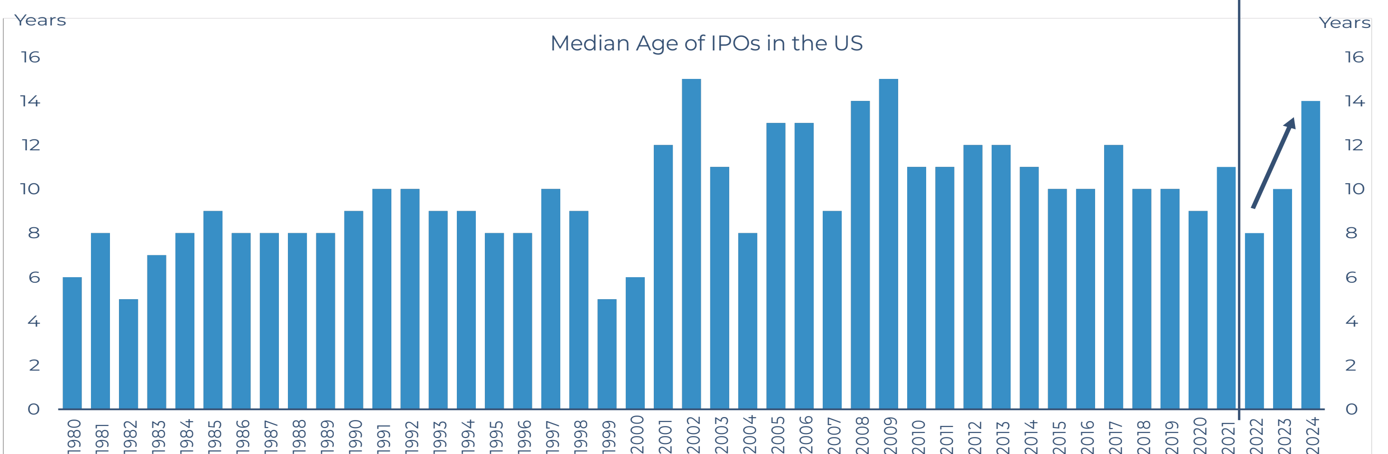
In investment terms, those vehicles extend beyond traditional public equities. They include private equity and venture capital, private credit, real assets such as infrastructure and income-producing real estate, hard assets like commodities, structured products, and hedge funds. Each offers a distinct profile of return potential, stability, and control. As we move into 2026, the question is no longer whether to leave the crowded highway, but which alternate routes best suit the journey ahead.

Asset Class	Diversification Merit	Role in Portfolio
Private Equity & Venture Capital	Expanded opportunity set; lower correlation to public equities	Growth enhancement and long-term return amplification
Private Credit	Yield with lower duration risk and stronger covenants	Income generation and downside mitigation
Real Assets	Inflation hedge; cash flow resilience	Ballast amid inflation and equity volatility
Hard Assets	Distinct drivers tied to supply–demand and geopolitics	Inflation hedge and shock absorber in stress periods
Hedge Funds	Potentially low beta and diversified sources of alpha	Crisis buffer and active risk management

For investors seeking to complement public equity exposure with differentiated growth opportunities, private equity and venture capital offer a faster lane. These markets provide access to thousands of companies that traditionally would have been public, expanding the opportunity set beyond public exchanges and offering return drivers less tied to daily market sentiment.

After a period of rain and overcast conditions, the backdrop for 2026 appears to be improving on the margin. Lower policy rates, improving financing conditions, and a renewing IPO window support a healthier deal environment and more credible exit paths for sponsors. At the same time, secondary markets in private equity offer opportunities to buy interests at discounts to prior valuations, effectively improving entry points for new capital.

While those benefits are present, this alternate road is unlikely to be smooth. Higher return potential does not imply quicker realization. These strategies are inherently illiquid, with capital typically locked up for years and highly dispersed outcomes across managers and vintages. Elevated valuations in certain growth segments, longer holding periods, and execution risk all argue for selectivity and rigorous manager due diligence. For investors willing to accept these constraints, private equity and venture capital can complement public equity exposures, but they are best approached as part of a disciplined, long-term roadmap rather than a shortcut.



Source: Jay Ritter, University of Florida, Apollo Chief Economist

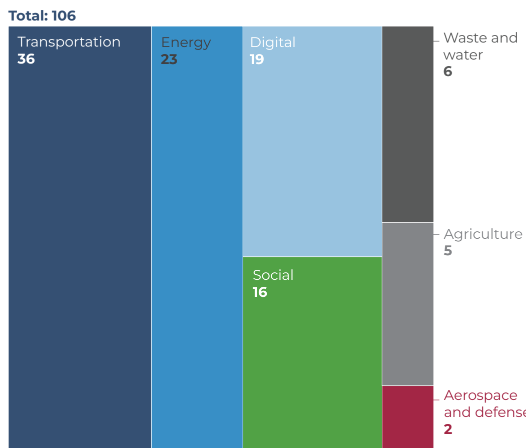
Private credit occupies a steadier middle lane between equity risk and traditional fixed income. It encompasses non-bank lending through privately negotiated loans, offering direct exposure to borrower cash flows and often stronger structural protection than public bonds.

Private credit enters the year on steady footing as higher base rates and tighter bank lending standards continue to support elevated spreads and provide attractive opportunities. Strategies such as direct middle-market lending, asset-based lending, specialty finance, and real estate debt benefit from floating-rate structures, senior secured positions, and active underwriting, which can help reduce interest rate sensitivity and enhance downside protection.

As monetary policy transitions toward continued accommodation, private credit's contractual income profile and reduced duration risk offer a compelling complement to traditional fixed income. In an environment of ongoing market volatility and evolving rate expectations, these features position private credit as a potential source of income stability and portfolio diversification for investors who want to keep moving forward without flooring the accelerator.

Cumulative Infrastructure Investment is Expected to Reach as High as $106 Trillion by 2040

Total infrastructure investment projected through 2040, by sector, $ trillion



Note: Figures do not sum, because of rounding.
Source: Food and Agriculture Organization; Global Infrastructure Hub; International Energy Agency; International Monetary Fund; Organisation for Economic Cooperation and Development; Prequin; United Nations; World Bank; World Economic Forum; McKinsey

Real assets are the infrastructure of the journey itself: the roads, bridges, power lines, and buildings that make economic activity possible. They represent investments in physical, economically essential assets, such as infrastructure, real estate, and natural resources whose values are tied to long-term demand and often supported by contractual or usage-based revenue models. These characteristics provide a degree of inflation protection and reduce risks born from high public market valuations.

This year, infrastructure may prove to be a standout sector within real assets, supported by significant and sustained investment in AI buildout, data centers, and decarbonization initiatives. These structural forces are directing capital toward energy generation and transmission, digital infrastructure, transportation networks, and regulated utilities – the essential services that keep the broader economy moving.

Hard assets, particularly commodities and select cryptocurrencies, function as guardrails within a portfolio, helping smooth out the bumps when growth, inflation, or geopolitics surprise. Broad commodity exposure, along with targeted allocations to energy, metals, agriculture, and digital assets, can provide a differentiated return stream relative to traditional equities and bonds. Performance in these areas is driven more by supply–demand dynamics, geopolitical developments, and physical constraints than by earnings multiples.

Heading into 2026, the case for hard assets is straightforward: inflation remains above target in many economies, policy tolerance for higher inflation has risen, and the energy transition continues to reshape commodity demand. Precious metals appear well positioned, supported by persistent inflation pressures, elevated geopolitical risk, and ongoing demand for perceived stores of value. Select cryptocurrencies may benefit from growing institutional adoption and their role as speculative "digital risk" assets. At the same time, investors must weigh meaningful drawbacks: commodities and crypto can be highly volatile, prone to sharp drawdowns, and often require derivatives, futures, or specialist vehicles to access efficiently, introducing complexity and potential roll or basis risk.

For investors willing to accept these trade-offs, measured allocations to hard assets can complement real assets and traditional inflation hedges. Rather than serving as the primary vehicle on the trip, commodities and cryptocurrencies are often most effective as part of the toolkit that helps portfolios navigate unexpected potholes in inflation, policy, or geopolitical stability, without relying solely on equities and bonds for risk management.

TAKING THE ALTERNATE ROUTE

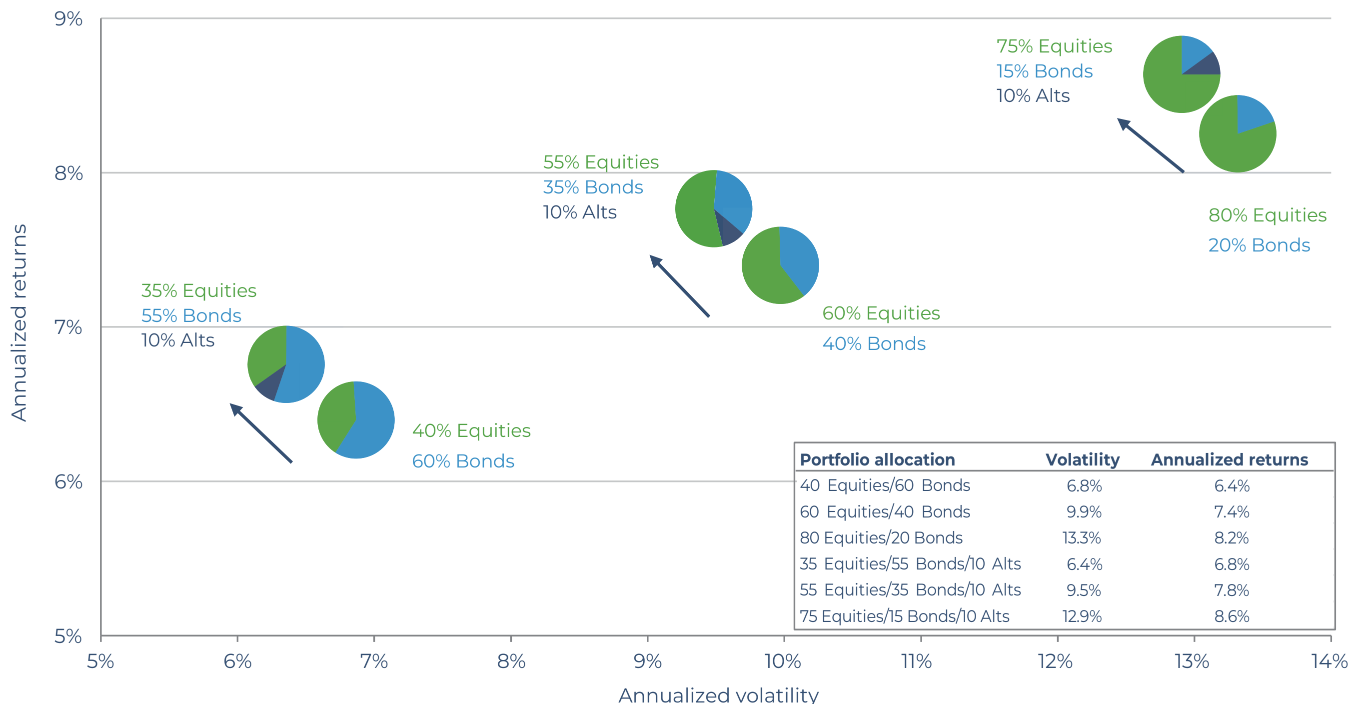
Hedge funds resemble skilled drivers who can shift lanes, tap the brakes, or change speed as conditions evolve, rather than committing to a single, unhedged route. They encompass a broad set of actively managed strategies designed to generate returns with lower dependence on broad market beta, using tools such as dynamic exposure management, short positions, derivatives, and cross-asset allocation to manage risk and capture relative value opportunities.

The current backdrop of greater market dispersion, policy divergence, and macro uncertainty creates a more fertile environment for many hedge fund approaches. Market-neutral, global macro, relative value, and event-driven strategies may be well positioned to take advantage of volatility, dislocations, and shifting economic conditions, potentially reducing portfolio-level volatility and providing diversification when traditional assets move in tandem. However, the opportunity set is highly manager-specific: wide dispersion of returns, higher fees, limited transparency, and occasional liquidity constraints all argue for careful selection, alignment of terms, and ongoing oversight.

Market leadership shifts, valuations evolve, and risks that once seemed remote can quickly move to the forefront. Simply owning more equities, or even more diversified equities, is no longer enough on its own. In an environment where correlations change and traditional buffers weaken, portfolio resilience increasingly depends on how different return drivers work together, not just how much exposure investors have to any single one. Diversification remains the only free lunch in investing. But in today's market, it is earned not by staying in the same lane, but by thoughtfully combining alternative paths that can carry portfolios through whatever lies ahead.

Alternatives and Portfolio Risk/Return

Annualized volatility and total return, 1Q98 - 2Q25



Portfolio allocation	Volatility	Annualized returns
40 Equities/60 Bonds	6.8%	6.4%
60 Equities/40 Bonds	9.9%	7.4%
80 Equities/20 Bonds	13.3%	8.2%
35 Equities/55 Bonds/10 Alts	6.4%	6.8%
55 Equities/35 Bonds/10 Alts	9.5%	7.8%
75 Equities/15 Bonds/10 Alts	12.9%	8.6%

Source: Burgiss, Bloomberg, FactSet, NCREIF, PivotalPath, Standard & Poor's, J.P. Morgan Asset Management.
The alternatives allocation includes hedge funds, real estate and private equity, with each receiving an equal weight. Portfolios are rebalanced at the start of the year. Equities are represented by the S&P 500 Total Return Index. Bonds are represented by the Bloomberg U.S. Aggregate Total Return Index. Volatility is calculated as the annualized standard deviation of quarterly returns. past performance is not a reliable indicator of current and future results.
Guide to Alternatives. Data are based on availability as of November 20,2025.

DISCLOSURE

Investing involves risk, including the possible loss of principal and fluctuation of value. Past performance has no guarantee of future results.

This newsletter is not intended to be relied upon as forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The opinions expressed are as of the date noted and may change as subsequent conditions vary. The information and opinions contained in this letter are derived from proprietary and nonproprietary sources deemed by Waterloo Capital to be reliable. The letter may contain "forward-looking" information that is not purely historical in nature. Such information may include, among other things, projections, and forecasts. There is no guarantee that any forecast made will materialize. Reliance upon information in this letter is at sole discretion of the reader.

Please consult with a Waterloo Capital financial advisor to ensure that any contemplated transaction in any securities or investment strategy mentioned in this letter aligns with your overall investment goals, objectives and tolerance for risk.

Additional information about Waterloo Capital is available in its current disclosure documents, Form ADV, Form ADV Part 2A Brochure, and Client Relationship Summary report which are accessible online via the SEC's investment Adviser Public Disclosure (IAPD) database at www.adviserinfo.sec.gov, using SEC # 133705.

Waterloo Capital is neither an attorney nor an accountant, and no portion of this content should be interpreted as legal, accounting or tax advice.

2801 Via Fortuna #250, Austin, TX 78746 • (512) 777-5900 • www.WaterlooCap.com