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Economic and Market Outlook

Dec. 31st, 2025

Don't Get Greedy

*Bulls make money, Bears make money
Pigs get slaughtered*

- Old Market Proverb

Section I. Introduction

The above quote means that if we get too greedy we will suffer the consequences. We have experienced great growth in value from our investment decisions over the last couple years. By any measure, the stock market at the moment is richly valued. For reasons sighted later in this report we feel now is an appropriate time to lower our exposure to equities.

The Shiller CAPE ratio, also known as the Cyclically Adjusted Price Earnings ratio, is at 39.8 as of December 1st 2025. The only time it was higher was during the dot-com bubble when it reached 44.2. (Chart #1) This does not mean we run for the hills. But it is important to take some profits in our big winners.

Section II. The Federal Reserve and Interest Rates

The Federal Reserve has now cut rates three times in 2025. Remember that cutting rates is usually a sign that the economy is slowing, but in this case it is due to concerns that the employment picture is weakening and that it is time to move to less-restrictive monetary policy.

Usually Federal Reserve Chair Jerome Powell and the other Fed governors refrain from making remarks that specifically pertain to the stock market. The Federal Reserve's primary job is to oversee the nation's monetary policy, with the goals of maximizing employment and stabilizing prices. But in response to a question about market valuations, Chair Jerome Powell said *"We do look at overall financial conditions, and we ask ourselves whether our policies are affecting financial conditions in a way that is what we're trying to achieve. But you're right, by many measures, for example, equity prices are fairly highly valued."*

Rates in most European 10-year bonds are steady because of a strengthening European economy. The U.S. 10-year bond still remains relatively more attractive to international investors for its yield and AA+ credit rating, though the spread is narrowing. The U.K. 10-year yields 4.5% (AA), German 10-year yields 2.85% (AAA), France 10-year yields 3.57% (AA), Italian 10-year yields 3.51% (BBB) and Swiss 10-year yields 0.32% (AAA). These compare to our 4.12% 10-year yield.

Section III. Inflation

As discussed, the other side of the Fed's mandate is inflation. After making great progress in moving the inflation rate closer to the Fed's target rate of 2%, the past few months have seen a slight increase. Even though the last CPI reading was lower, many economists were skeptical of its accuracy. Much of the increase has been the blame of tariffs.

The tariffs that were enacted earlier in the year started to show up in the inflation numbers this summer. Since tariffs are a tax, they will increase the prices of goods on a short-term basis. But like any other tax, as long as the tax is not increased, the acceleration in prices due to the tax will be short-lived. "Our expectation has been that inflation will move up this year, basically on good prices from tariffs," said Powell. He stated that the Fed doesn't expect tariffs to lead to persistent inflation, but the effect of the tariffs may take some time to work their way through the supply chain.

Currently the Consumer Price Index (CPI) is up 2.7% on an annual basis, and core CPI, which excludes food and energy, which is up 2.6%. Both readings are for November 2025. CPI has decreased since our last report by 0.2%. Core CPI decreased by 0.5%. While the CPI reading peaked in June of 2023 at 9.1%, the core rate actually peaked in September of 2023 at 6.6%. This is still above the Federal Reserve's 2% target. As expected, the move from 3% to 2% will continue to be slow and difficult.

Average hourly earnings are up 3.5% year-over-year in November and overall inflation is up 2.7% as previously stated. This is a positive for the economy because it means real wages are rising.

The Federal Reserve prefers to use a measure called the Personal Consumption Expenditures (PCE) Price Index to gauge inflation. The reading for PCE in September was 2.8% and the core rate was also 2.8%. Inflation in the Euro Zone was running at 2.1% on an annual basis in November.

Section IV. The Bull Market

As we stated in our December 31, 2024, report, we expected some types of correction or consolidation in the market from time to time. Corrections are part of normal volatility, and are healthy for the market. Within the first four months of the year, the S&P 500 index had a correction of 18.9%, reaching a level of 4982.77, on a closing basis. It has since rebounded to 6900. Remember that a bear market is defined by a pullback of at least 20%. Therefore the bull market is still intact.

Bull markets do not die of old age. We are approaching 38 months in this bull market. Since World War II there have been 13 bull markets and the average gain was 164%, and on average they lasted 57 months. It is also true that recent bull markets have generated higher returns over longer periods of time. On average, the last five bull markets since 1980 have seen stocks advance about 240% over a period of 70 months.

Bull markets end because of Black Swan events or because of recessions in the economy. By definition, Black Swan events cannot be predicted. For reasons cited later in this report, we do not see a recession coming in the near future.

To be clear, in the short term we fully expect more corrections or consolidation in the market from time to time. Corrections of less than 10% are part of normal volatility. In addition, corrections are historically quick and sudden pullbacks while Bear Markets are slow and rolling like a dripping leaky faucet.

In the December 31st report we also forecast a 6% - 9% return for this year. As of this writing, the S&P 500 is up 17.4%. The average return on the S&P 500 for the last 10 years is around 11%, and over last century the stock market is up on a yearly basis 76% of the time.

Despite recent market fluctuations and uncertainties, the momentum behind AI-driven technologies remains strong. The energy demands of AI will create other opportunities. As companies across industries continue to embrace AI to drive innovation and efficiency, investors are presented with unique opportunities to capitalize on the transformative power of artificial intelligence. The AI revolution is not just a fleeting trend but rather a fundamental shift that is poised to reshape industries and create new opportunities for growth and innovation. In our view this could be the next economic revolution.

Section V. The Recession Model

As we have discussed in past reports, earnings and the economy are the true long-term influences on the stock market. Recessions, or fear of recessions, are the major reason we experience corrections of more than 10%. Corrections of less than 10% are just part of normal volatility and tend to happen multiple times each year.

The official arbiter of recessions in the U.S. is the National Bureau of Economic Research (NBER). They determine when our economy enters and exits recessions. The problem is that usually by the time they declare the official start date of the recession the economy is probably coming out of or already done with that recession, in other words no predictive value.

At Clutinger, Williams & Verhoye, we have developed what we view as a recession indicator, which tracks 5 data sets on a monthly basis. If 3 of the 5 indicators are negative and the S&P 500 is below its 40 week moving average, it is a very strong indication that a recession is near or may already be underway.

Indicator number one compares the current monthly unemployment rate to its 12 month moving average. As of November, the unemployment rate was 4.6% and the 12 month moving average was 4.22%. By being above the moving average this indicator has stayed negative.

Indicator number two is represented in Chart #2. This represents the year over year percentage change of Advance Real Retail and Food Service Sales. This is one

method to measure the strength of the consumer. Currently the reading is 1.2% for September, so this indicator remains positive since our last report.

Indicator number three is represented in Chart #3. This shows the year over year change in Industrial Production. This indicator has remained positive. It currently sits at 2.52% for November 2025.

For indicator number four (Chart #4), we look at Total Nonfarm Payrolls divided by the Civilian Labor Force Level on a year-over-year percentage change basis. This indicator stands at -1.33% showing a slight weakness in employment. Therefore, this indicator is negative.

Indicator number five (Chart #5) represents the Average Weekly Hours of Production and Nonsupervisory Employees-Manufacturing on a year-over-year percentage basis. Currently the reading is 1.23%, so this indicator remains positive.

Currently three of the five indicators are positive and the S&P 500 Index is 10.21% above its 40-week moving average as of December 26th. The S&P 500 is above its 40-week moving average so this model is not giving a recession warning sign. We will be closely monitoring these indicators in the coming months.

The above indicators are only updated on a monthly basis. To offset this situation, we also track two other indicators. They are both indicators that are updated more frequently (on a weekly or daily basis) and we consider them as early recession indicators. Both are somewhat volatile, so we track three-month moving averages. These two indicators are separate and independent of the first five and either one can indicate the possibility of recession on its own.

The first one is the Aruoba-Diebold-Scotti Business Conditions Index, which is updated on a daily basis and published by the Philadelphia Federal Reserve. The 91 day moving average is at -0.01 currently. The divining line for entering and exiting recessions is -0.8.

The second indicator for recessions is the Chicago Fed Business Activity Index. It is reported weekly and the divining line for entering recessions is -0.7. The three month moving average stands at -0.21.

In summary, the two "early warning signs" are not predicting recession at this time.

Section VI. Market Psychology

For decades we have measured market psychology using price and volume data in the short and long term from the Dow Jones Industrial Average as well as a 17 week moving average of advancing and declining stocks on the New York Stock Exchange.

Currently, 7 out of 12 of our price/volume indicators are positive. The S&P has returned to 6,900. But that doesn't necessarily mean the end of the rally. The market needs corrections from time to time in the short term to stay healthy and growing over the long term.

Our advance/decline line has been positive for the last twelve weeks and sits at 50.6%, and is reflecting the recent pullback while expressing there may still be some room to the upside by not being overextended.

Our technical model measures the first and second derivative of price and volume for the market. We have developed this model to recognize patterns and spot buy and sell signals from reviewing years of historical data. This model is providing negative signs and may be signaling an intermediate term correction is in the near future.

Section VII. The Economy

Indexes that measure manufacturing data are mixed. The Philly Fed Manufacturing Index has turned negative, slipping to -10.2 in December of 2025. The Empire State Manufacturing Index fell to -20.0 in March, but after reaching positive territory in October and November, its December reading was -3.9. The national ISM manufacturing index was 48.2% in November and the ISM services index improved to 52.6% (above 50 is considered growth, above 55 is considered exceptional growth).

Multiple Wall Street and Federal Reserve predictions for Gross Domestic Product (GDP) have stayed around 1.7% for 2025. GDP for the second quarter was 3.8%, up from -0.5% level in the first quarter. GDP came in at 4.3% for the third quarter. GDPNow is estimating a GDP of 3.0% for the fourth quarter.

Section VIII. Conclusion

The market has had a strong year. This can primarily be attributed to the expectations of the Federal Reserve being less restrictive with their monetary policy, as well as the highly weighted influence of tech stocks benefitting from the growth of Artificial Intelligence technology in the indexes. While the market-weighted S&P 500 index is up 17.4% year to date, Yahoo Finance calculates that an equal-weighted return for the index is about 10.5%.

We continue to be optimistic moving forward. As previously stated, we expect a positive, but more muted, return for 2026. As stated earlier, after moves like we have just experienced over the past few months, short-term corrections would not be surprising and are usually healthy for the market. However, we feel that the indicators show that keeping a longer view of the market will be rewarding.

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Chart 1

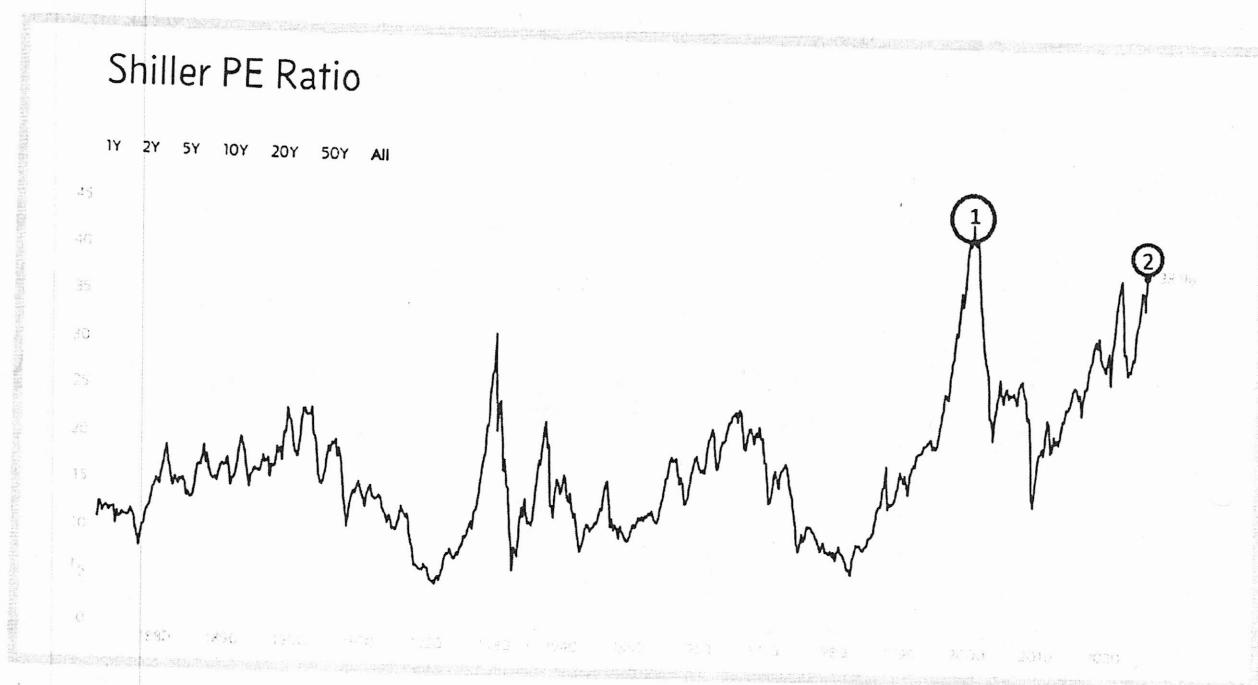


Chart 2

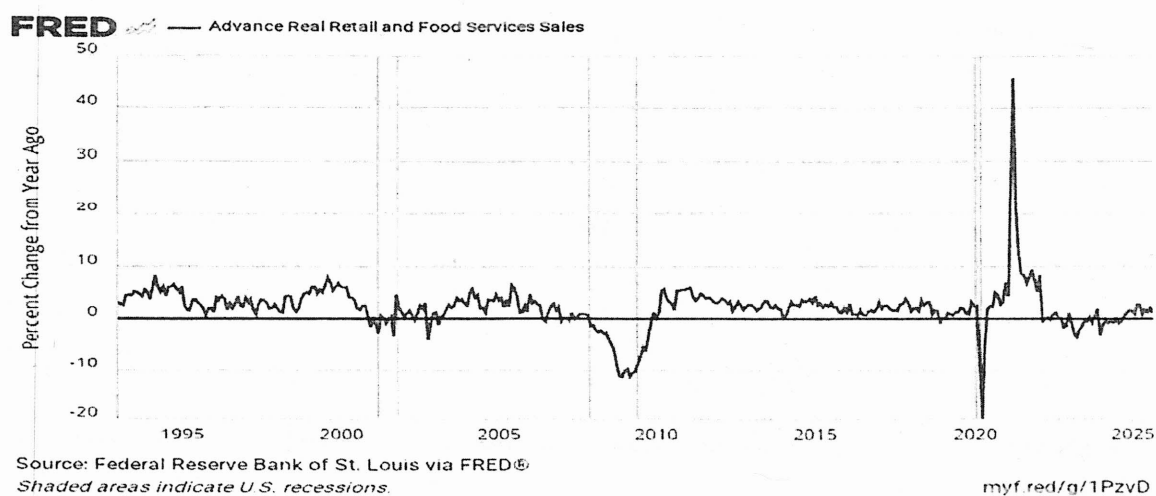


Chart 3

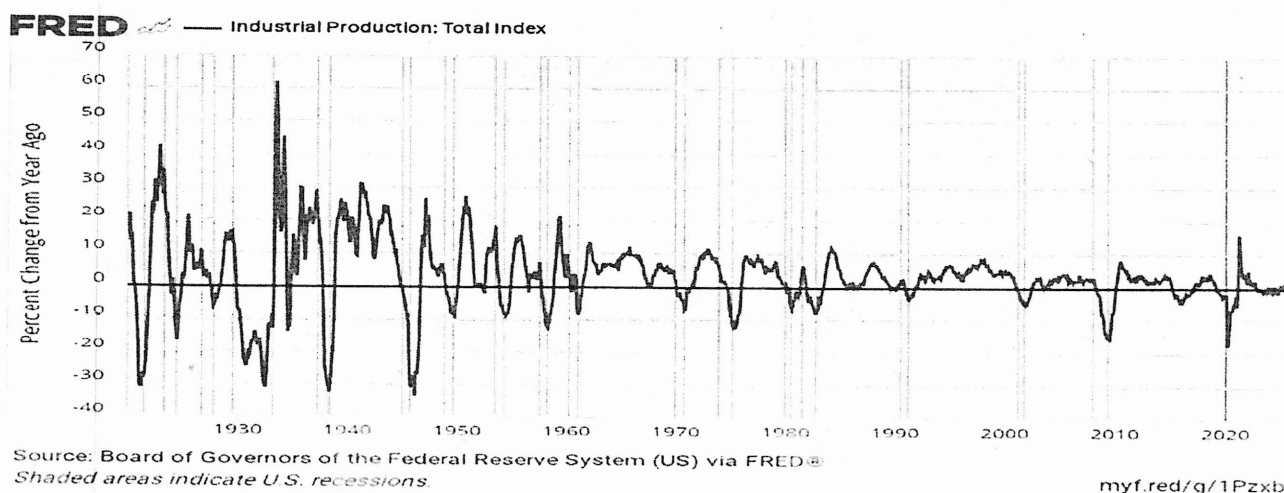


Chart 4

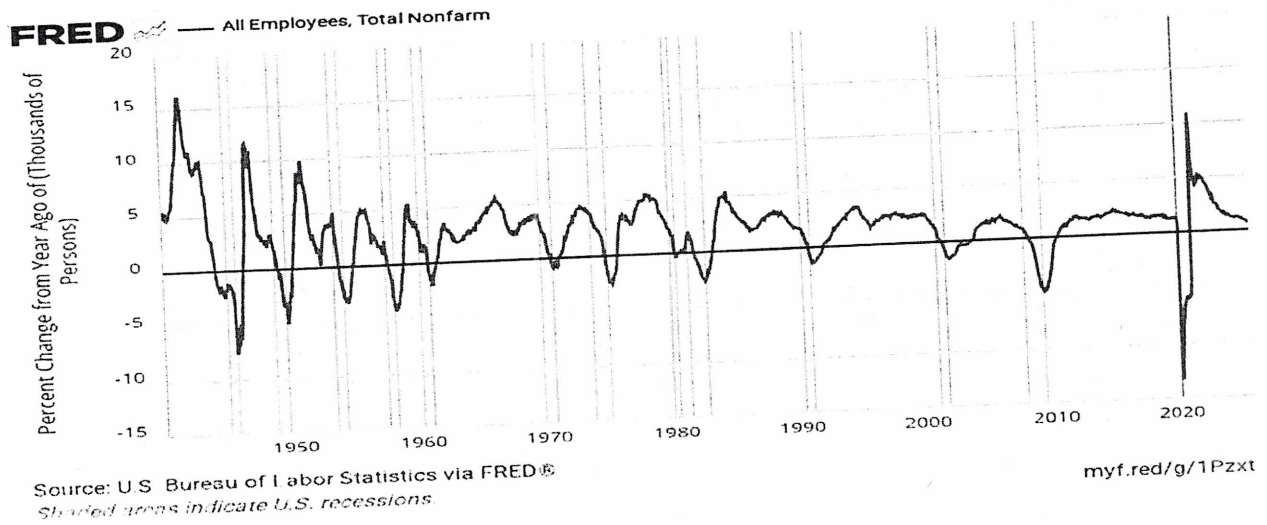


Chart 5

