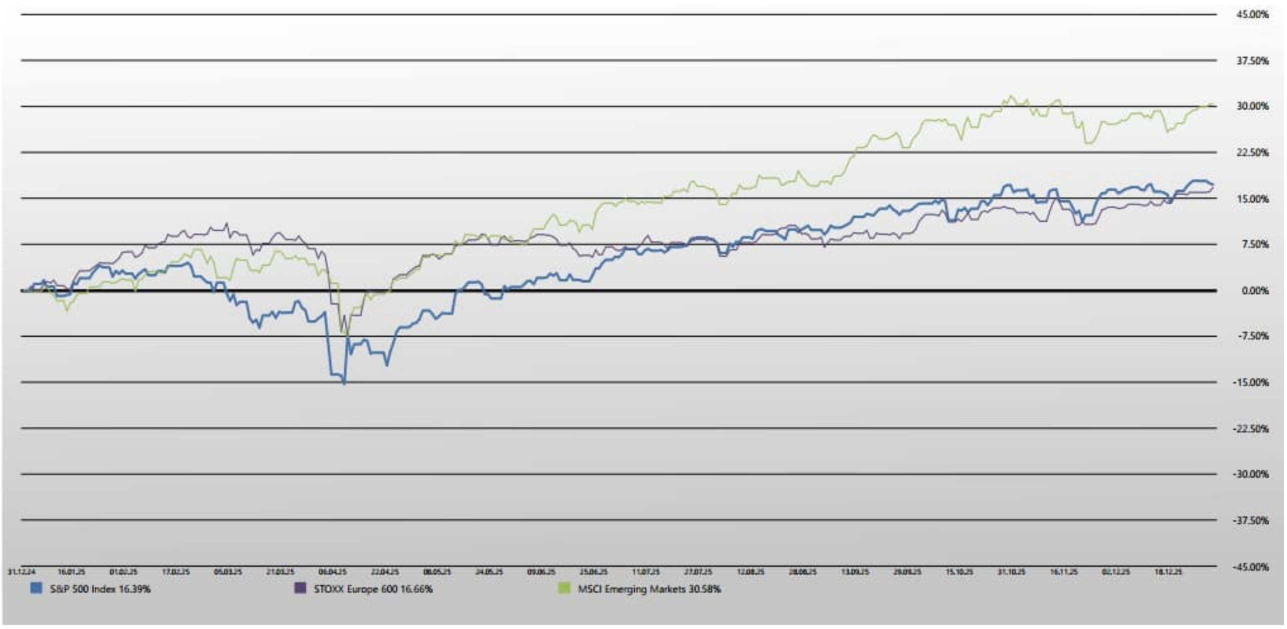
Kestrel Wealth Management

Quarterly Financial Market Update, December 2025

Some spikes in volatility did not derail the global equity markets from their overall uptrend during the last quarter of the year. Cuts in benchmark interest rates by central banks and continuing investments in the Artificial Intelligence (AI) segment more than offset concerns over equity valuations, the US shutdown and ongoing geopolitical tensions. Furthermore, some economic data recently released were not as bad as one could have feared. That said, the current environment is particularly murky. We believe this fog is likely to persist over the next months, with investors torn between good corporate earnings, fear of stagflation and a moribund international law.

In 4Q 2025, global stocks posted a return of 3.4%, led by European shares (6.5%). US and Emerging Markets equities generated a return of 2.7% and 4.8% respectively.

Equity Index Performance, rolling 12 months (%)



Source: Kestrel Wealth Management

In October and November there were two periods of sharp rises in volatility, as expressed by the VIX Index, jumping twice from a 16%-level to about 25%. These periods emerged due to fears of a potential AI bubble burst in the near future. Adding to investors' nervousness were the opposite evolutions of the US economy and inflation, casting doubts over the next moves from the US Federal Reserve (Fed).

When it comes to AI, although the "easy money" period might be behind us, the underlying fundamentals should remain supported by the ongoing adoption of this technology in several aspects of our day-to-day life. Indeed, if AI is similar to an industrial revolution, as were computers, the Internet etc. in the past, then its impact on the world, on the economy and on corporate earnings is far from being over. AI infrastructure spending is also expected to rise further this year (for example, UBS estimates that investments on data centres dedicated to AI is likely to approach USD 570 bn, up from 420 bn last year).

Partially offsetting the positive growth prospects from AI is an overall subdued economic environment in terms of labour and economic activity. Since June 2025, the US unemployment rate is on the rise (up from 4.1% to 4.6% over the period). The economic activity, especially on the manufacturing side, also presents weaknesses. At a level of 47.9 for the latest reading and down from 48.2, the ISM Manufacturing Index still indicates an economic contraction. We do not expect a sharp change, either way, in those readings over the next months.

To us, the main question lies with the evolution of inflation in the US. With the tariffs implemented throughout the year by the Trump administration, the inflation rate has increased continuously, albeit slowly, to reach 3.1% in September. However, the data surprisingly decreased to 2.7% in November (no data was released for October because of the shutdown). Looking forward, the consensus expects inflation to be in the 2.9%-3% region, still above the Fed's target of 2%. Despite this and if the US economy remains below average, then the Fed should not be finished with its accommodating monetary policy and will cut its benchmark interest rate a bit further, in our opinion. This would in turn support the equity markets. However, we keep in mind that the full impact from tariffs remains to be seen over the months to come.

The Fed will remain an essential element for the future movements of the financial markets overall. Not only its decisions and comments on the benchmark interest rates will be scrutinized, but also its Chairman, Mr. Powell. President Trump has been very displeased by the lack of responsiveness (according to him) in reducing rates. However, as the Jerome Powell chairmanship ends in May, the announcement of his replacement will quickly make the headlines, offering President Trump the opportunity to have a partisan at the helm of this institution. Should this happen, the question of the Fed's independence will also quickly be headline news.

The geopolitical environment could be a source of uncertainty, again, for investors. Over the past months there were some positive developments in the Gaza strip with a ceasefire. In Ukraine, the pressure is mounting on its President to reach some kind of a truce with Russia. Depending on the terms, this could be a positive development.

Simultaneously however, this has exacerbated the fracture in the relationship between the US and its European allies over the security in the continent. Furthermore, President Trump is undermining the sovereignty of countries and the international law with his actions in Venezuela and his harsh comments about Greenland. Besides, the American military involvement in Venezuela might give the final, little push for China to act against Taiwan. Venezuela is a major source of oil for the Middle Kingdom. Moreover, as President Trump views the Western Hemisphere as his own preserve, President Xi could do the same with the Eastern Hemisphere.

Given the many and varied uncertainties that lie ahead, it is essential to consider not only share valuations but also earnings growth prospects. Thus, a bit of caution is warranted on equities in our opinion. The equity valuation is fair in today's context, in our opinion, but we do not believe there is room for significant upward revisions to earnings either. For example, the consensus expects earnings per share to be USD 299.65 in the next twelve months for companies in the S&P 500 Index, representing an 11%-rise from the past twelve months. Putting this expected growth in relation with an estimated forward price-to-earnings ratio of 23.2x, we are comfortable with our neutral stance on stocks overall.

With regard to bonds, our strategy remains unchanged. We continue to favour the Investment Grade segment, i.e. high-quality debtors, in corporate bonds. In a sluggish economic environment, we are not taking any exposure to bonds from low-quality issuers with weak balance sheets. Over the last quarter, the yield curve steepened. The yield on 2-year US bonds fell by 14 basis points, while the yield on 10-year bonds remained stable. Against this backdrop, bond prices remained broadly unchanged.

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