Morgan Stanley Wealth Management

December was a decent month for stocks and bonds were essentially flat after an otherwise good year: the S&P 500 gained 0.1 percent while the Dow Jones Industrial Average gained 0.9 percent. International stocks rallied more robustly with the MSCI EAFE and MSCI Emerging markets both up 3.0 percent in December. The Barclays Aggregate Bond Index declined 0.1 percent. We think Lisa Shalett, Morgan Stanley's Chief Investment Officer summed up last year as well as we could in her GIC Weekly from January 5th, writing "2025 entered the history books with the S&P 500 Index up 16.4%, for its third consecutive year of double-digit gains, as it finished near its all-time closing high of 6,932 reached on Christmas Eve. The last eight weeks were more of a sideways churn than a "Santa Claus rally," with the generative artificial intelligence (GenAI) story showing signs of entering adolescence. That said, the overwhelming historical narrative of 2025 will likely be the economic resilience produced by the AI capex boom. The AI ecosystem—reflecting expansion beyond the "Magnificent Seven" to include the semiconductor industry—and the rest of the technology and communications industries, along with utilities, drove roughly 70% of the S&P 500's price gains and earnings growth. They also accounted for nearly one-third of annualized US GDP growth and nearly 100% of the contribution to growth from capital investment."

But that's water under the bridge as they say, so what do we think about 2026? Does the GenAI rally continue? Do the promised productivity gains materialize for corporations utilizing new AI systems? For starters, we like to anchor from Morgan Stanley's official 2026 year-end targets as we make our team's forward full-year predictions. The Morgan Stanley Global Investment Committee's 2026 year-end targets are as follows:

2026E US GDP Growth		2026E US Inflation	Federal Funds Rate	Two-Year/10-Year US Treasury Yield
Real	1.8%	2.8-3.0%	3-3.25%	2.60%/4.05%
Nominal	4.5%		July vs. October Consensus	2s10s slope to 145 bp

2026E Rest of World		2026E US Dollar		2026E/2027E S&P 500 Earnings		Price/Earnings Multiples	
GDP	3.2%	1H	-6%	MS & Co.	$317/$356	Current	22.3x
		2H	+6%	Consensus	$307/$340	Forecast	22x
Inflation	2.0%	DXY @ 100		MS & Co. Growth: 17% Consensus: 14%		Fair Value	17.8x

Source: Morgan Stanley Wealth Management GIO, Bloomberg.

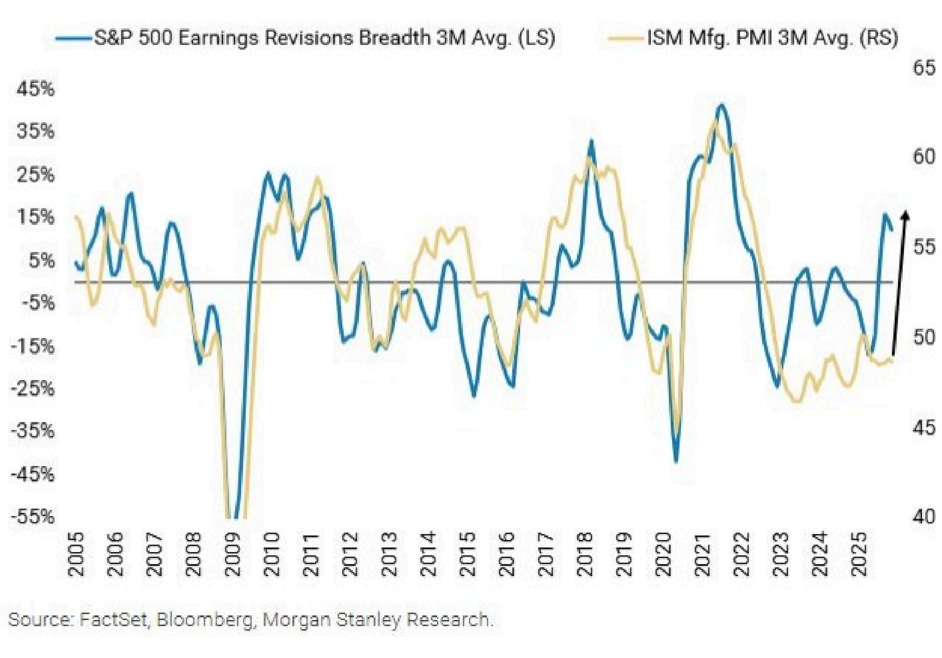
The data above implies the S&P 500 will end 2026 with a gain of about 15 percent, dividends included, over the starting level of 6,858. If the US 10-Year Treasury ends the year at 4.05 percent, that would be slightly down from the current 4.17 percent and imply a total return on the order of 6.25 percent for 2026.

As we often state in these missives, markets don't care that much about how good or how bad things are currently. Rather, they move because of a differential in reality and expectations. Good news that is worse than expected makes markets fall. Bad news that is better than expected makes them rise. With that in mind, we make our predictions based on where we think markets will be positively surprised and where they will be disappointed in 2026.

- **Prediction 1: Real GDP Growth surprises to the upside and exceeds 2.0 percent; there is no recession in 2026.** We are not predicting anything on the order of the third quarter's 4.3 percent clip for the full year, but we do think the combination of already low oil prices and continuing domestic AI capex spending portends another positive GDP surprise for the full year. We were planning to make this call on oil and GDP before the Venezuela situation materialized. Many have suggested the removal of Maduro may put additional downside pressure on oil prices, but our team thinks that's more of a 2027 and later phenomenon as it will take a long time to rebuild Venezuelan infrastructure. Regardless, it likely adds some fuel to the idea that GDP growth will exceed 2.0 percent in 2026 and that there will not be a recession this year. AI Capex spending is likely to persist and because of its scale acts similarly to a government-bond-backed Keynesian stimulus. Large corporations with good credit borrow money to build AI facilities, providing a debt-financed burst of economic activity that filters down through the economy. Goldman Sachs predicts 2.1 percent and we think that sounds about right to us. That's a positive for stocks and likely benefits Wall Street and Main Street alike.

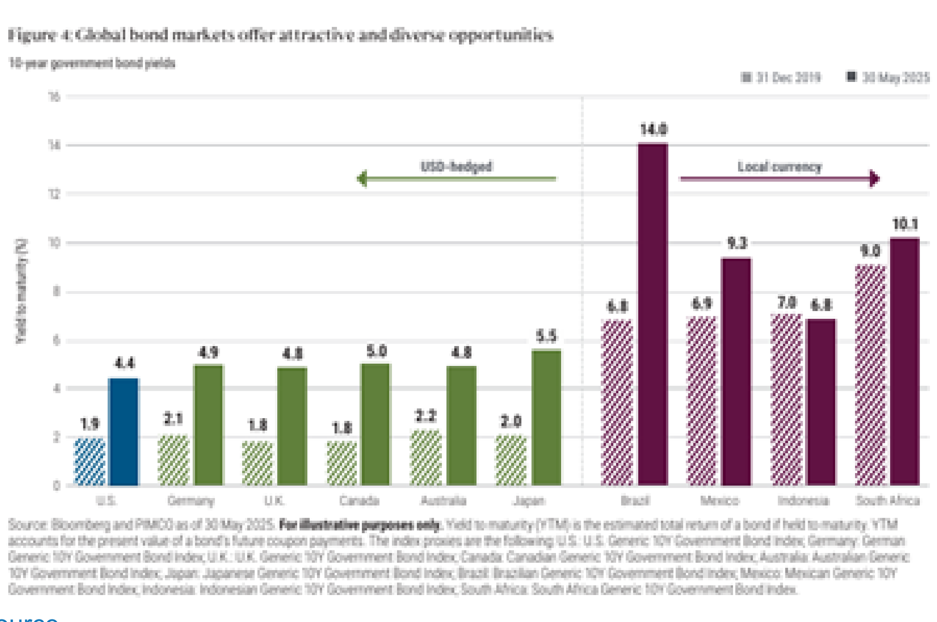
Source: Bloomberg, Morgan Stanley Research.

- **Prediction 2: Despite the fact that it's very expensive, the S&P 500 rises by double digits for the 4th consecutive year**. Many are forecasting earnings growth to slow in 2026, but Morgan Stanley's US Chief Equity Strategist, Mike Wilson, holds the out-of-consensus view that EPS growth may surprise to the upside – ending in the high teens. There is no version of that happening that does not bode well for domestic equity markets. While stocks are by no means inexpensive, better-than-expected earnings make markets rise. We agree with Mike and think also think that the rally could extend beyond just the Mag 7 to Consumer Discretionary, Financials, Industrials, Healthcare and Small-Caps particularly. While no one can forecast market returns with precision, we generally agree with Morgan Stanley's 15 percent call (which is among the highest of major Wall Street banks) on the S&P 500 and remain optimistic about equity markets generally. We think markets will broaden again in 2026 much as they did last year with an even higher percentage of stocks rising.



Source: FactSet, Bloomberg, Morgan Stanley Research.

- **Prediction 3: Bonds have another positive year, but the yield curve steepens significantly causing longer term maturities to provide coupon only returns.** We are more sanguine on domestic bonds than Morgan Stanley and the market consensus. Our team thinks long rates do not fall much this year if at all. We also think corporate bond spreads widen in 2026 despite the good economy as a simple consequence of increased demand for debt to finance additional AI capex. We think bond investors should look internationally to improve yield rather than only to credit bonds. We agree PIMCO's core thesis that "yield curves will re-steepen over our secular horizon, as investors continue to demand more compensation to hold longer-term bonds relative to cash and short-term bills." We think the Barclays Aggregate Bond index has positive year, but only provides approximately the coupon return of around 4.0-4.5 percent. In other words, we think the 10-year ends the year about where it is now, short rates come down, and very long rate might even squeak higher. Corporates may fare slightly worse if spreads widen. Long rates generally are set by the market not the Fed. While we do think the Fed will likely cut rates twice this year, their doing so may have the unintended effect of causing longer rates to rise if market participants are concerned that the long-term effect of those cuts will not produce additional economic growth and instead create only additional liquidity/inflation down the road. None of this should be read to mean we don't favor bonds in portfolios – we do. On a risk-adjusted basis, high-quality bonds are probably the "cheapest" market out there right now. Returns of 4-5 percent with very little risk remain attractive as part of a diversified portfolio in an increasingly volatile world.



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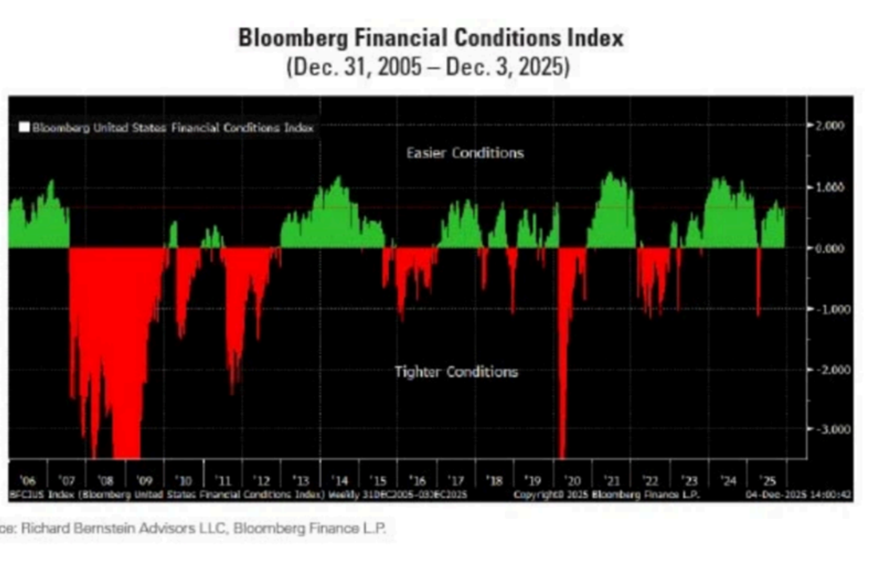
- **Prediction 4: The dollar continues to weaken, and international stocks and precious metals continue to rise.** Our team thinks the dollar continues to weaken and gold and international stocks continue to benefit. Why do we think the dollar weakens further? First of all, the Fed is likely to cut rates as we explained above. All else held equal, rate cuts weaken the dollar. The Trump administration is highly likely to appoint a more dovish Fed chair and wants lower rates for two purposes: first, to reduce interest cost on the national debt and second, to further weaken the US dollar which supports the Administration's trade agenda. Furthermore, the Administration's tariff policies make foreign central banks desire less dollar holdings. They also make foreign corporations and investors have fewer dollars on hand to purchase US investment assets. As we have pointed out before, the other side of a trade deficit is a capital account surplus. Gold is likely the primary beneficiary of foreign central banks diversifying away from the dollar. As the much-feared tariff-inflation never materialized this year, we fully expect the Trump Administration to continue with tariffs through some mechanism even if it faces a setback in the Supreme Court early this year – possibly as soon as this Friday.

Source: Morgan Stanley Wealth Management GIO, Bloomberg

- **Prediction 5: Inflation remains sticky and above the Fed's long-term target of 2.0 percent.** Unlike last year when we bucked widely held tariff-inflation narrative, we are very much in line with consensus inflation predictions in 2026. As we have said repeatedly in these notes, we think the 2.0 percent stated Fed target has become a floor for inflation rather than a cap. We think inflation remains sticky not because of tariffs but because the economy runs hotter than expected (see prediction 1) and the fed cuts rates despite already abundant liquidity (see chart in point 6 below). We are not forecasting a return to the Biden-era inflation of 6.5 percent experienced in 2022, but rather holding with our general call of a multi-year phenomenon where any disinflation that might accrue from technological productivity gains (AI and robotics) is immediately vacuumed up through the fiscal impulse of politicians eager to redistribute wealth downstream by borrowing – it seems to be the case that these technological marvels also have a tendency to concentrate wealth very much at the top and voters may prefer candidates that promise to disperse said wealth concentration. We think inflation falls maybe a little more than Morgan Stanley is predicting and ends the year closer to 2.5-2.6 percent than Morgan Stanley's 2.8-3.0 percent target, but in general, MS research has the right idea.

Source: Morgan Stanley Wealth Management GIO, Bloomberg

- **Prediction 6: Stock market volatility will rise and the S&P 500 will experience at least one large drawdown in excess of 15 percent.** Lastly, despite our overall optimistic take on 2026, we do think the US market experiences at least one correction in excess of 15 percent this year and that the speed of that correction will be alarming. It might even happen in a matter of days. We agree with Richard Bernstein at RBA advisors that markets remain in a liquidity-driven speculative state where stocks trade more on scarcity than underlying economic trade-offs – consider buying the one house for sale in a hot market where you are bidding against a ton of other buyers versus buying a house as a rental property in a depressed market because you can make a much higher yield on it than other investments. US equity markets are like the former now.



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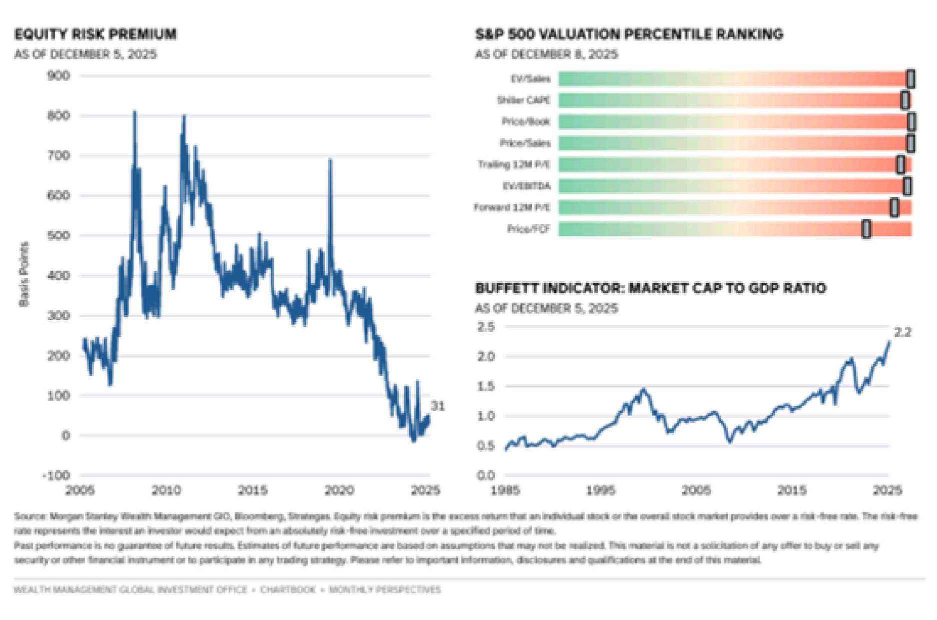

For obvious reasons, a highly speculative state invites the possibility of extreme price swings over short spans of time. Expect market swings to be bigger and faster as the amplitude of volatility magnifies in speculative markets. Any correction will likely hit the Mag 7, AI related stocks, Bitcoin, and other widely held/popular investments more profoundly than the overall market – you can't sell something you don't own. That's basically what happened in April of this year and why diversified portfolios held up so much better than those concentrated in the Mag 7 and other popular thematic investments during the Liberation Day sell off. We feel pretty confident some random trigger event will cause a similar quick reversal in 2026. As Bernstein says, "historically, it's been prudent to keep portfolios simple and boring as speculation reaches a crescendo because boring suddenly becomes beautiful when speculation subsides." We agree with that completely and continue to favor maximal diversification in an increasingly uncertain world dominated by security prices at the peak of their normal valuation range. The chart above provides all the evidence one needs to remain cautious in their optimism in 2026.

We wish you and your family the happiest of New Year's and look forward to continuing to work with you in 2026. As always, if you have any questions or concerns, or need anything at all, don't hesitate to reach out to any member of our team

Sincerely,