

## 2026 Forecast: Still Wary

Last year, we thought economic growth would slow. Verdict: GDP data say we were wrong, employment data say we were right. Last year we thought the stock market would decline. Verdict: it did in March and April, sharply, but the S&P 500 ended the year with an impressive 16.4% gain. Overall, we'd say our negativity was unwarranted.

But to be clear, we are not pessimists. We expected – and continue to expect – amazing new technologies to roll out. Like always, we believe it is innovation that leads to higher standards of living. We are also very supportive of deregulation and fewer bureaucrats, policing crime and rooting out fraud, stopping illegal immigration and the drain on societal resources this seems to come with, keeping tax rates low, using tariffs in an attempt to reduce other countries' trade barriers and unfair trade practices against the US, and cutting government spending in any way possible.

In other words, our pessimism was not driven by policies or the actual events of 2025. We did not worry about tariffs causing inflation or a collapse in global trade. Nor did we think closing the border would collapse consumption and growth. Moreover, we completely disagree with fears of “debasement” and the end of American Exceptionalism.

But two things did concern us last year. 1) COVID stimulus – from easy money and irresponsible deficit spending – was wearing off. No way should we be able to lockdown the economy and never have a recession. So far, the main price was higher inflation and more inequality and that price has been paid by those with lower incomes. The overall economy has continued to grow, but as stimulus faded we expected things to slow more than they have. And 2) The fact that by any measure the stock market was over-valued.

So, what about 2026?

First off, if anyone thinks they know exactly what will happen, they are kidding themselves. We woke up on January 3<sup>rd</sup> to the arrest of Nicolas Maduro, the self-proclaimed President of Venezuela. No one expected this, but it will have far-reaching effects on Russia, China, Cuba, the oil market, and global politics.

In November, the US will elect a new Congress which could have a massive impact on fiscal policy for years to come. The Federal Reserve will likely cut interest rates – our base case is two or three more 25 basis point cuts in 2026 – but with a new Fed leader coming in it could be more than that.

What we do know is that things will change. And many of those things will be positive for growth. The OBBBA restored 100% expensing for most business investment. And although the law didn't cut marginal income tax rates, it did keep them from rising.

In addition, deregulation, the shrinking of the bureaucracy (January to November federal employment was down 271,000), and hundreds of billions of dollars in cuts to climate-related subsidies are removing wasteful spending and obstacles to productivity growth.

And while it is still too early to say with conviction, the actions against Maduro in Venezuela are likely to begin a process of pushing back against captured global institutions. We fully understand the arguments many are making about the Constitutionality of Trump's arrest of Maduro. We won't debate them other than to say Congress dithers while China, Russia, and Maduro thumbed their noses at the US. China and Russia actually like that Maduro was a criminal and dictator, they were supporting him. And they were doing it in our hemisphere with little pushback until now.

A global elite, who stand for open borders and “reimagining” the economy and support things like the “Great Reset,” are now on notice. Undermining freedom one institution at a time with seemingly free reign is over. At least for now. We see this as a good thing. Why? Because any reasonable person, looking at the history of our world, realizes that the founding of the US was one of the greatest things to ever happen. Freedom reduces the power of authoritarians and dictators don't like this, but freedom is the greatest generator of wealth. It seems we are getting more of it. Which is appropriate in our country's 250<sup>th</sup> year.

One worrisome development is a significant economic slowdown in Europe. We won't go into all of it, but Germany and the UK are having economic problems. The German economy contracted from April to September, while the UK economy grew just 0.1% in Q3 (0.4% annualized). Much of this weakness is in manufacturing as electricity prices have soared because of climate-change-related energy policy.

Which brings us to the forecast for 2026. We could forecast just about any GDP growth rate imaginable. On the one hand we have all the ingredients of a boom – better tax environment, deregulation, less wasteful government spending, interest rate cuts, lower inflation, and an A.I. boom. On the other hand, the M2 money supply is only up 4.3% in the past year. With 2.5% inflation, that leaves just 1.8% for real GDP growth.

At the same time, the US has an extremely bifurcated economy with high income households benefiting from rising asset values and the wealth effect, while lower income households have been hammered by inflation. More and more purchases, even for meals out, are being paid for with Buy Now, Pay Later (BNPL). Car lenders are stretching out payment time periods. Delinquencies for most loan-types

have been rising and this month student loan collection processes will start up again.

If the stock market were to get hit, then wealth effect spending could drop at the same time lower income households are already hurting. This could subtract from consumption and slow growth sharply.

And that brings us to the stock market. Yes, we have been bearish on the market because our models (as well as every other model we know of) say the market is overvalued. This does not mean every stock is overvalued. It means the indexes are trading at multiples which historically are unsustainable. How did we get here? Since the bottom of the economy during COVID in 2020, corporate profits are up 96.2%, S&P 500 reported earnings are up 140% (they won at the expense of small business closed during COVID), while GDP is up just 55.8%. But the total return for the S&P 500 is up 189.5%! The stock market has outperformed earnings and economic growth and is trading at valuation metrics at the high end of the historical scale. Profits are also at a record level of GDP.

Many argue that AI and robots will boost profits significantly but the math on these predictions is somewhat suspect. We are not saying AI won't change the world, it will, but the near-term projections seem over-rated.

Our capitalized profits model discounts earnings with the 10-year Treasury yield to calculate fair value. As of the third quarter, using a 4.0% 10-year Treasury yield and corporate profit growth of 10%, the S&P 500 is worth just 5,000. Our forecast for 2025 was a year-end target of 5,200. We know, we were way too low...the S&P 500 is trading at 6,900. In other words, we think the market is over-valued by roughly 25%.

This 25% figure can be affected dramatically by the level of the 10-year yield and profits. With the Fed cutting rates

this year, a 10-year yield of 3.5% is not out of the picture. If that were to happen and profits also grew 10%, the market would still be overvalued by 17.5%. If AI boosted profit growth to 20% and the 10-year fell to 3.5%, the fair value of the S&P 500 would rise to 6,200. In other words, we can't reasonably summon a forecast of a rising stock market in 2026.

Of course, with the list of positive events taking place on the monetary and fiscal front this year (and the potential for AI to lift profits faster than we think), we can't just blindly follow the model right now. As a result, our forecast for year-end 2026 is 6,000.

Something to always remember though is that we invest in a market of stocks not just a stock market. Markets may struggle, but investments can do well. Be picky. Broaden out. Don't concentrate investments and increase risk unnecessarily.

To conclude, we expect real GDP and inflation to both grow roughly 2% this year. That's 4% overall growth and a slowdown from recent years. The 10-year should trade in a 3.5% to 4% range as the year progresses. Gold and silver have some fundamental forces pushing them higher, but the inflation they apparently see is unlikely to show up in the year ahead.

On political risks: if the GOP loses the House in November, reforms will be harder to push further. If tax rates remain low, while spending and regulation continue to be cut, the future is brighter. As a result, the election is a risk.

The bottom line is that good things are happening, but risks abound. Blindly buying the market because it keeps going up would be a mistake. Pay attention and be nimble. This coming year could be a roller coaster.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-5 / 9:00 am	ISM Index – Dec	48.4	<b>48.6</b>	<b>47.9</b>	48.2
<i>afternoon</i>	Total Car/Truck Sales – Dec	15.8 Mil	<b>15.9 Mil</b>		15.6 Mil
<i>afternoon</i>	Domestic Car/Truck Sales – Dec	12.4 Mil	<b>12.6 Mil</b>		12.2 Mil
1-7 / 9:00 am	ISM Non Mfg Index – Dec	52.2	<b>52.4</b>		52.6
9:00 am	Factory Orders – Oct	-1.2%	<b>-1.4%</b>		+0.2%
1-8 / 7:30 am	Initial Claims – Jan 3	211K	<b>219K</b>		199K
7:30 am	Int'l Trade Balance – Oct	-\$58.7 Bil	<b>NA</b>		-\$52.8 Bil
7:30 am	Q3 Non-Farm Productivity	+4.8%	<b>+5.4%</b>		+3.3%
7:30 am	Q3 Unit Labor Costs	+0.3%	<b>-0.8%</b>		+1.0%
2:00 pm	Consumer Credit – Nov	\$10.0 Bil	<b>\$8.8 Bil</b>		\$9.2 Bil
1-9 / 7:30 am	Non-Farm Payrolls – Dec	60K	<b>65K</b>		64K
7:30 am	Private Payrolls – Dec	65K	<b>85K</b>		69K
7:30 am	Manufacturing Payrolls – Dec	-5K	<b>-10K</b>		-5K
7:30 am	Unemployment Rate – Dec	4.5%	<b>4.5%</b>		4.6%
7:30 am	Average Hourly Earnings – Dec	+0.3%	<b>+0.3%</b>		+0.1%
7:30 am	Average Weekly Hours – Dec	34.3	<b>34.3</b>		34.3
7:30 am	Housing Starts – Dec	1.325 Mil	<b>1.321 Mil</b>		NA

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