

Equity Research
Economics

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Economic Outlook 2026

Glass Half Full: Positives > Negatives



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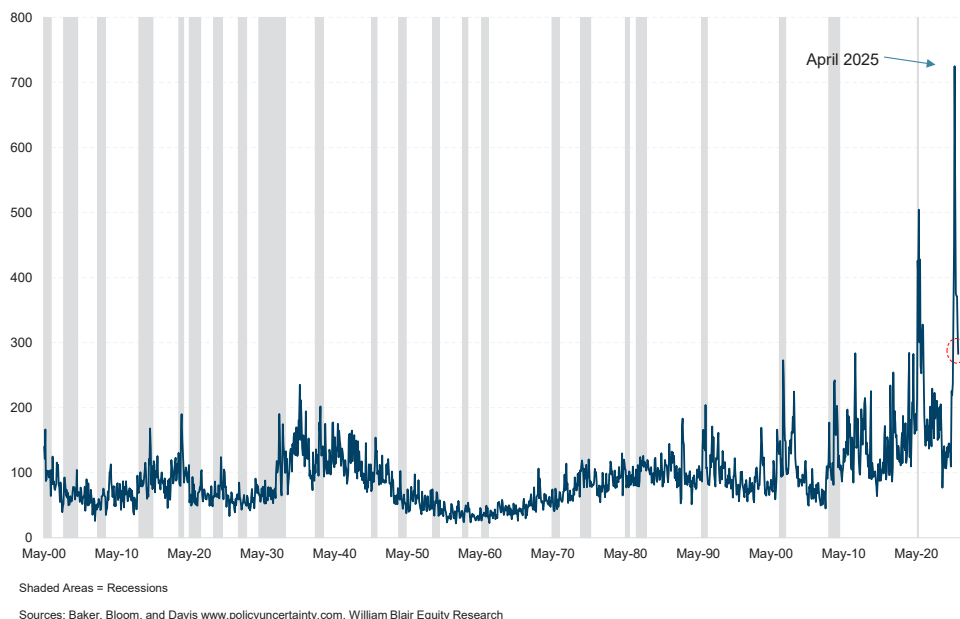
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Closing Out a Year of Heightened Uncertainty, With Rising Growth Prospects

One Word to Describe 2025—Uncertainty

It is fair to say that President Trump has been the great “disrupter in chief” this term. If President Clinton was famous for his ability to compartmentalize, President Trump’s innate—and no doubt tactical—ability seems to be to “flood the zone,” in an effort to simultaneously provoke and destabilize his opposition. As a result, economic policy gauges of uncertainty (exhibit 1) in 2025 are at their highest level since 1900. Thankfully, we believe this uncertainty will diminish in 2026.

Exhibit 1
U.S. Economic Policy Uncertainty Index
(News-based gauge of uncertainty across national media)



So Many Goals, so Little Time

Although Trump is a second-term president, there is seemingly a strong sense of urgency to achieve the administration’s goals, and time is fleeting. Those goals still equate to reordering the global economic and financial trading system to relevel the playing field; forcing NATO members to accelerate defense spending in accordance with their agreement; generating peace in the Russia-Ukraine conflict, as Trump produced a ceasefire in Israel-Palestine and simmered tensions with Iran; lowering government regulation and taxes; increasing energy production; and tightening border security to reduce illegal immigration.

The president is also attempting to achieve these goals unilaterally by slicing the Gordian knot in unconventional ways, including attempting to squeeze every bit of executive power he can to avoid or circumvent institutional hurdles—so much so that the Supreme Court is now considering whether too much control has been usurped from Congress (i.e., the power to impose taxes and raise revenue). While a negative decision on tariffs for the president would be a setback, it

seems his administration will likely find alternatives. The market, however, could view such a setback as a potential positive stimulus for growth—if tariffs were a tax raise, a reversal would be a tax cut.

Ironically, Trump seems to have had the least success in the one area that shares the greatest bipartisan support: reducing fraud, waste, and abuse, while reducing the size of the government and making it much more efficient. Unfortunately, this has largely been unsuccessful. It was always the case that if DOGE's mandate included only discretionary spending—where there was not that much waste to cut—its scope for success was incredibly limited.

AI Investment Boom Counters Policy Uncertainty

Despite this uncertainty, the financial markets and the aggregate economy have been resilient. Such resiliency, however, was in no small way helped by the unfolding surge in AI-related investment, outside of which capital investment remained weak. The result is that economic growth this past year is expected to have increased by 2.0%, supported by an estimated 2.5% increase in consumer spending and a 4.0% rise in nonresidential business fixed investment. At the time of writing, the S&P 500 has risen by 17% year-to-date, though the equal-weighted index is up just 9%. Earnings growth this past year is also estimated to have increased by 12%, with more than a third of that increase driven by technology and communication services.

Positioned for Economic Growth

Looking toward 2026, despite some mounting trepidation about the labor market, it is quite likely that economic growth will broaden and possibly accelerate, but with the corollary of still high inflation. Growth will be driven by a combination of fiscal and monetary stimuli; consumer spending supported by the benefits from the One Big Beautiful Bill Act (OBBB); and continuing AI-related capital investment, including in the energy sector. Additional drivers include a manufacturing sector that is emerging from a three-year recession, deregulation across the financial sector and potentially housing as well, and a reduction in the uncertainty that has caused many companies to delay and/or reduce capital expenditures in 2025.

Still, sticky or potentially accelerating inflation is likely to result in fewer rate cuts than the market currently anticipates. And the main risks for the outlook center on financial market volatility, the potential for rising unemployment, and geopolitical tensions.

Domestic Policy Uncertainty Eases, Foreign Policy Risks Remain Elevated

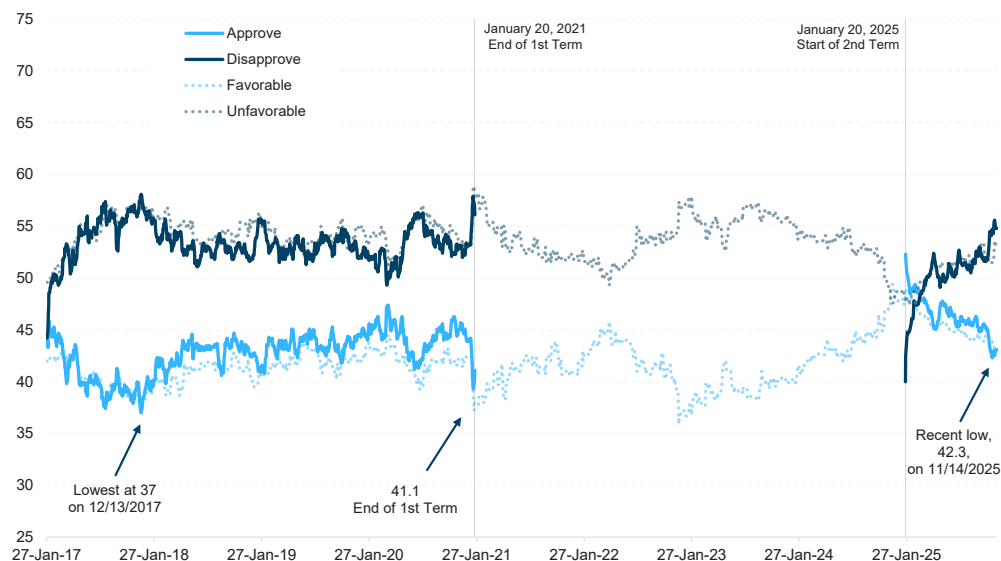
The heightened degree of domestic policy uncertainty emanating from the White House over the past year should ease through 2026, although foreign policy pressure is likely to be maintained. The shock and awe from the most controversial policies on the Trump platform (e.g., tariffs, DOGE, and deportations) have already largely been instigated, with many of these policies now in consolidation mode or starting to get bogged down by opposition.

Historically, following the midterm elections, second-term presidents find less traction on domestic policy (having already pushed their domestic agenda) and tend to turn their focus toward fortifying their legacy, embarking on foreign travel, and achieving non-domestic policy objectives, where they retain a relatively free hand. We expect President Trump to continue to follow this trend with his continuing efforts to counter Chinese economic and military power and remodel the global economic trading system toward his world view.

Heading into the 2026 midterm elections, Republicans will defend a slim majority in the House of Representatives and a larger, though still narrow, edge in the Senate. One-third of the Senate and all the House seats are up for (re)election, raising the prospect of a split Congress during the final two years of President Trump's term. Historically, midterms serve as a referendum on the incumbent party in the White House, which almost always loses congressional seats. At present, the Democrats seem to have another advantage. According to Real Clear Politics, President Trump's approval rating recently fell to 42.3, its lowest point since he left office following the January 6, 2021, Capitol attack, when it stood at 41.1% (exhibit 2). The current Trump administration has faced strong opposition on several public policy fronts, and Democrats will harness that discontent to mobilize their base and appeal to swing voters.

Though sentiment could shift between now and November 2026, current electoral ratings and prediction markets suggest Republicans will likely retain control of the Senate, while Democrats have a strong chance of flipping the House.

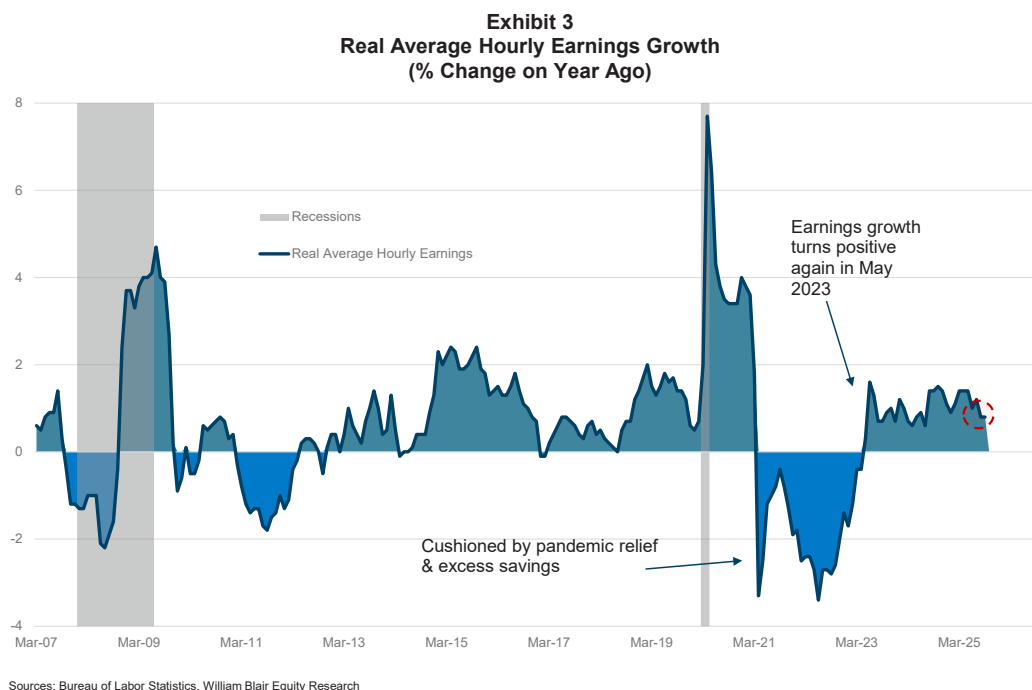
Exhibit 2
RCP President Trump Job Approval and Favorability
Average of National Polling Data, %



Sources: Real Clear Politics, William Blair Equity Research

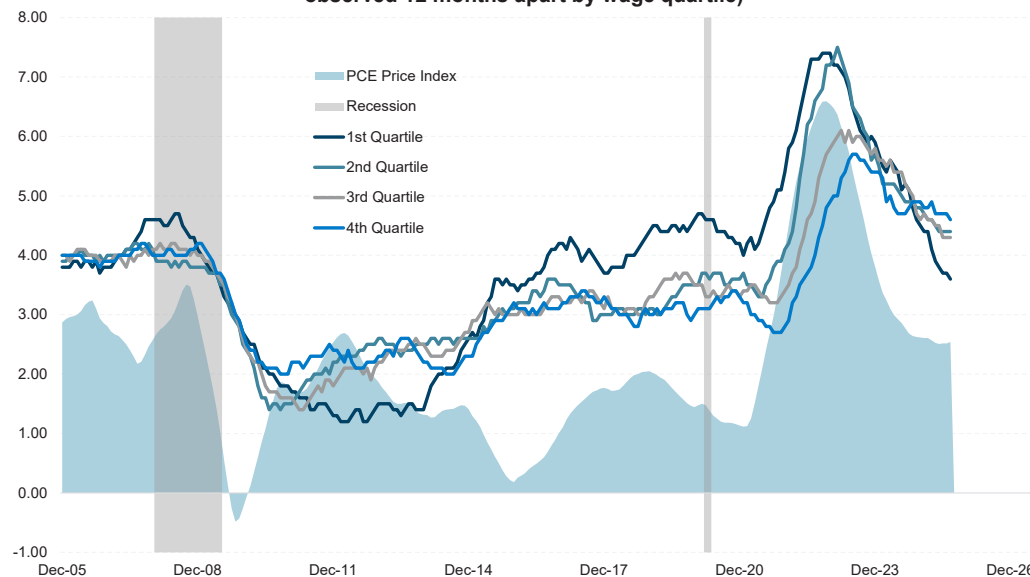
Solid Consumer in 2026 With Help From the OBBB (and Potentially Tariff Dividend Checks)

In contrast to the current market narrative for a collapsing K-shaped consumer, we see a scenario where the aggregate consumer remains relatively solid in 2026, with a pace of spending growth roughly in line with, if not above, the estimated 2.5% pace in 2025. Consumers are currently experiencing robust real wage growth that is still above the historical average (exhibit 3).



Wage growth for the lowest income quartile (the lower leg of the K) has decelerated sharply, though this follows an unprecedented pandemic-related surge over the last few years. Growth today is still positive in real terms, but below the historical average. Meanwhile, the highest income cohort (the top of the K) is still benefiting from both well-above-average real wage growth and an appreciation of asset wealth, as the owners of both real estate and financial assets whose values have been rising (exhibit 4).

Exhibit 4
Atlanta Fed's Wage Growth Tracker by Quartile
 (12-month moving average of median percent change in the hourly wage of individuals
 observed 12 months apart by wage quartile)



Sources: Atlanta Fed, William Blair Equity Research

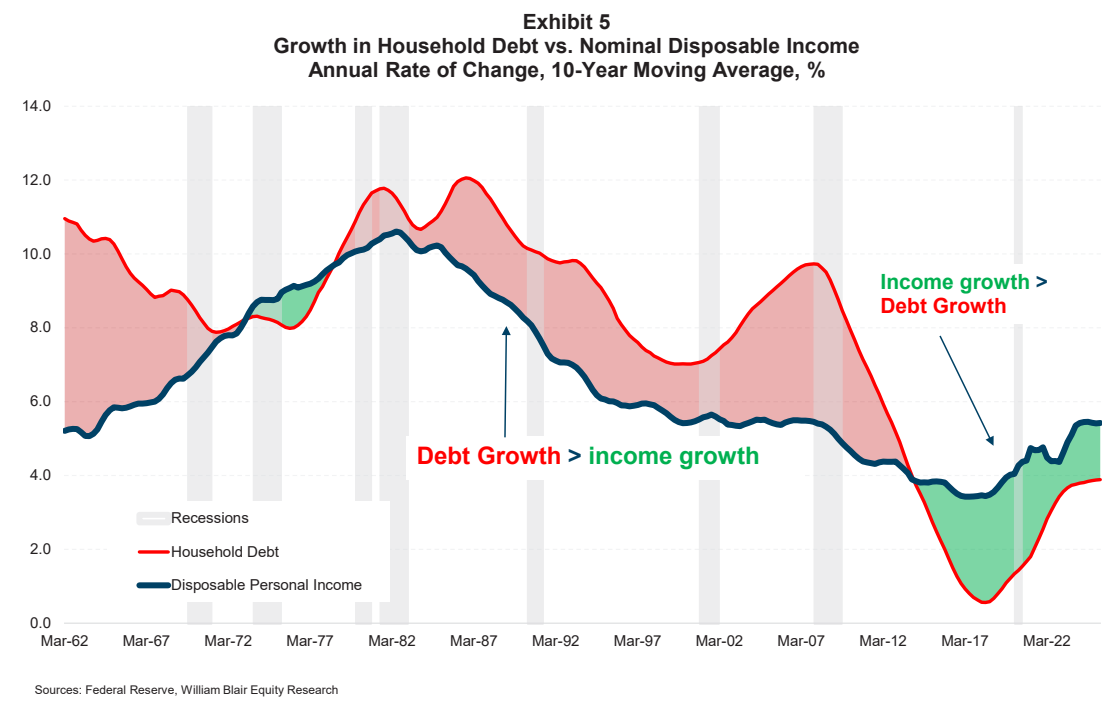
As we move into 2026, households will also receive a helpful boost from the OBBB, in the form of significant tax refunds following those changes to tax legislation in 2025. This includes the OBBB's removal of taxes on tips, on overtime, and on auto loan interest payments. Childcare tax credits were also increased, as were the caps for SALT deductions.

[As discussed by Dylan Carden](#), our fellow research analyst from the consumer team, these benefits will be broad, but not as broad as the \$7,300 in rebate checks that were issued between March 2020 and March 2021 to 170 million individuals, with the largest upfront benefit going to the lowest-income households. Consumers are expected to receive a weighted average payout that could be as high as \$700.

Furthermore, these benefits could be supplemented by another round of stimulus checks. The Trump administration has proposed so-called "tariff dividend" checks of \$2,000, which would be issued to workers with incomes less than \$100,000. However, any such stimulus would require a vote in Congress, and if passed, the amount would likely be lower than \$2,000. Their issuance could also depend on the Supreme Court's decision on the legality of the tariffs themselves.

Households in Good Standing

Widening the scope a little, we continue to see the aggregate consumer as in relatively good shape and resilient in 2026, even though higher inflation will continue to weigh on family finances. Balance sheets are far from being stretched, and income growth continues to easily outpace debt growth (exhibit 5).



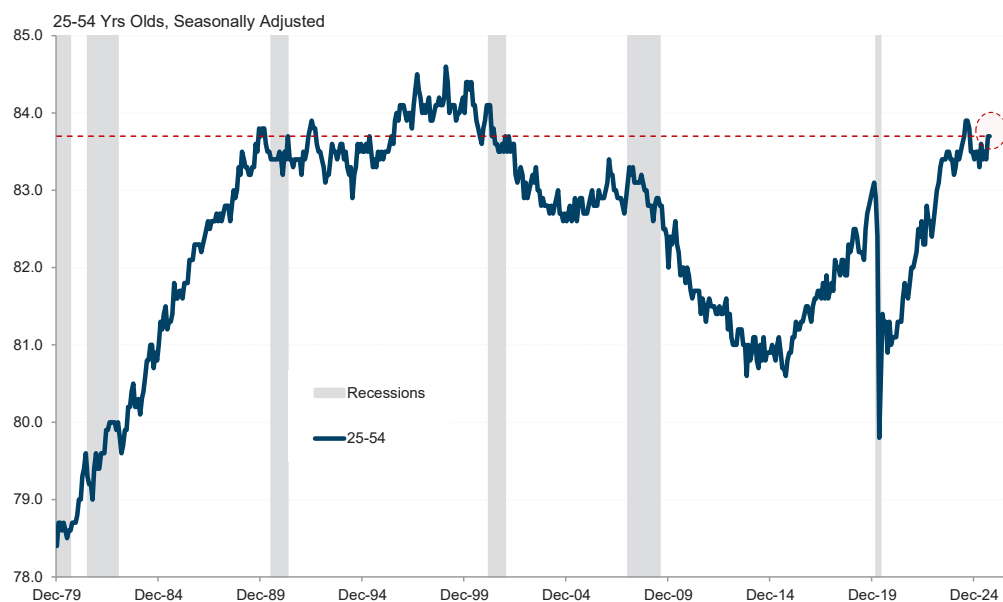
Such low debt ratios mean that households are better placed to manage any potential weakness than was the case following the global financial crisis, when they not only lost their jobs, but also were carrying far higher levels of debt, which many were forced to default on. This debt deleveraging turned what could have been a mild recession into a major financial crisis. For both the corporate and household sectors, the lower debt they are carrying today means they would be both more receptive and responsive to lower interest rates if the need arose.

Employment Outlook

In addition, the labor market is structurally tight. An aging workforce, lower birthrates, deglobalization, and anti-immigration policies are combining to shrink the pool of available labor, with the result that companies are more reluctant to shed workers who have been so hard to find in the first place. This structural tightness is also acting as a major driver of what we see as an unfolding productivity boom, aided and abetted by the AI innovation wave.

This structural labor market tightness is showing up in a labor force participation rate for prime-aged workers still hovering near the highs of the late 1990s. This is effectively the opposite of the hysteresis impact we witnessed post-GFC, when workers remained unemployed for longer because they lost their skills, confidence, and contacts. High levels of participation today are therefore encouraging and would be consistent with both shorter durations of unemployment and a lower unemployment rate—in effect, we could be experiencing some reverse hysteresis.

Exhibit 6
Labor Force Participation Rate for Prime Age Workers, %

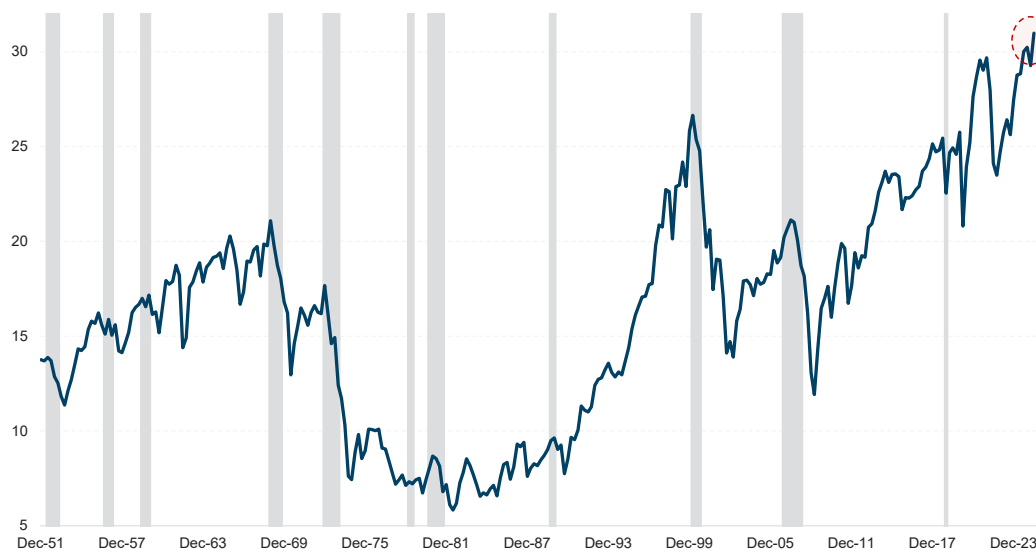


Sources: Bureau of Labor Statistics, William Blair Equity Research

Households in 2026 are most at risk from three main areas.

1. ***If Congress decided not to extend the hotly debated enhanced premium tax credits for the Affordable Care Act***, which are due to expire on December 31. If this provision is not extended, premiums are set to spike for an estimated 22 million enrollees. Members of Congress have agreed to come to a solution for these by mid-December, and two bills are already in play to resolve this issue. Many members of the GOP, including the president, would prefer to direct payments to consumers or health savings accounts. Democrats, however, would prefer a clean extension and for premiums to be made permanent. Failure to pass an extension would see premiums more than double from current levels, which would act as a significant drag on consumption and tangibly change the economic outlook for 2026.
2. ***Any sharp corrections in the stock market***, where households' exposure to the equity market as a share of total financial assets has never been higher (exhibit 7). We have also been seeing evidence of a wealth effect playing out, whereby the beneficiaries of this appreciation are increasingly treating unrealized capital gains as "banked" savings, allowing them to lower their actual rate (and level) of savings.

Exhibit 7
Household Direct & Indirect Holdings of Equities as Share of Total Assets, %



Sources: Federal Reserve, William Blair Equity Research

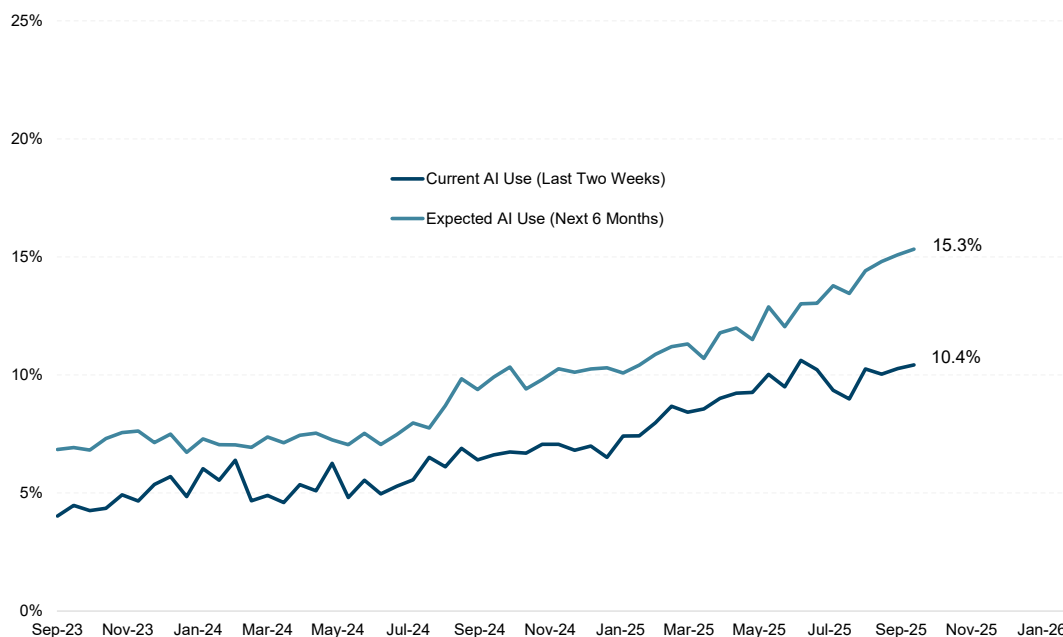
3. ***If recent softening in the labor market turns to widespread layoffs.*** Trends in the labor market often feed on themselves, where some layoffs beget more layoffs. However, it is hard to see what the catalyst for this might be in the face of the structurally tight labor market and strong earnings growth, in addition to the anticipated boost to consumer incomes through the first half of 2026.

What About the Labor Threat From AI?

Listening to comments from the corporate sector during the latest earnings periods, as well as examining the available employment data, suggests that much of the softening we have seen in employment growth has been due to the combination of a more limited supply of workers and the uncertainty related to fiscal policies coming out of Washington, with seemingly little yet due to AI.

Furthermore, the productivity growth we are seeing today also looks to be more related to post-COVID capital deepening, which companies undertook when workers stayed home during the restrictions. Exhibit 8, for example, shows that AI adoption rates are still as low as 10%, and many of the companies that are adopting AI are (for the moment) doing so to work alongside workers, rather than to replace them.

Exhibit 8
AI Use - National Average, %



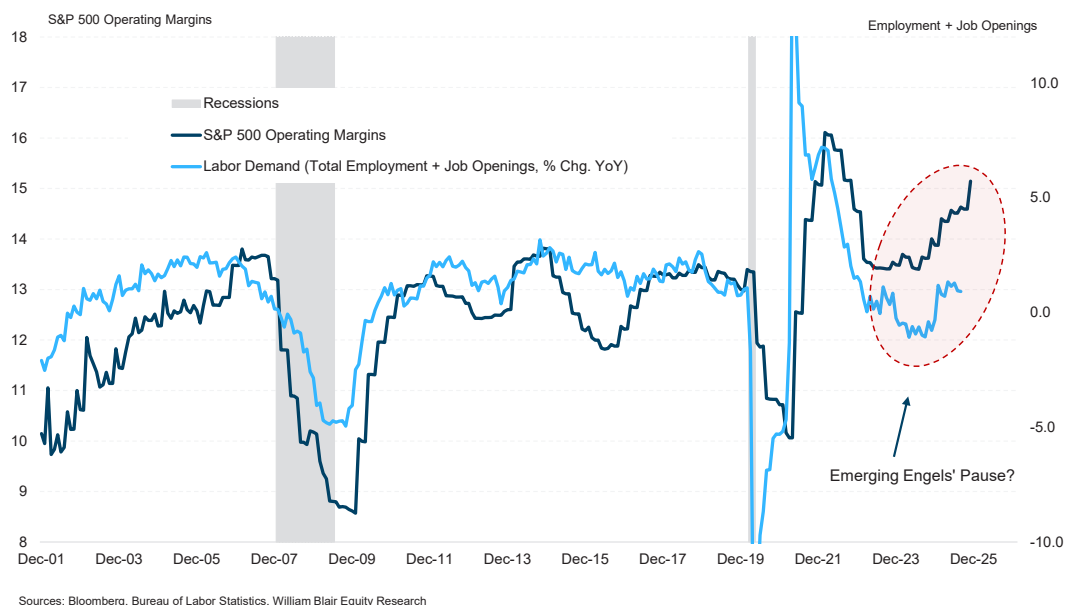
Sources: Census Bureau, William Blair Equity Research

It is also worth highlighting that there is little historical evidence showing productivity/innovation booms to be the direct catalyst for an economic collapse, even though they can be highly disruptive across impacted industries and indirectly led to the 2001 recession, due to the irrational exuberance that built up in the stock market and its subsequent bust.

An example that could hold some salient lessons for today is Engels' pause from around 1790 to 1840 in Britain. In the early stages of the industrial revolution, GDP per capita rose sharply yet consumption stagnated. During this period, despite rising productivity growth, workers' real wages were flat—i.e., the owners of capital captured the profits being created rather than the workers, increasing societal tensions though not causing a recession.

There is a fear today that this scenario could play out again in the coming years as we move from the enabling phase of the AI revolution to the adoption phase (exhibit 9). Governments, as a result, will clearly need to watch this closely. However, there are also many differences with today's scenario compared to this past episode, including the fact that workers' rights barely existed then; the speed of adoption and knowledge transfer is far faster today, which should help reduce any lag between productivity gains and wage growth; and, while AI primarily affects cognitive and routine tasks, it is also likely to create new high-skilled jobs and industries far faster than historical industrialization did.

Exhibit 9
S&P 500 Operating Margins vs. Labor Demand Growth, %

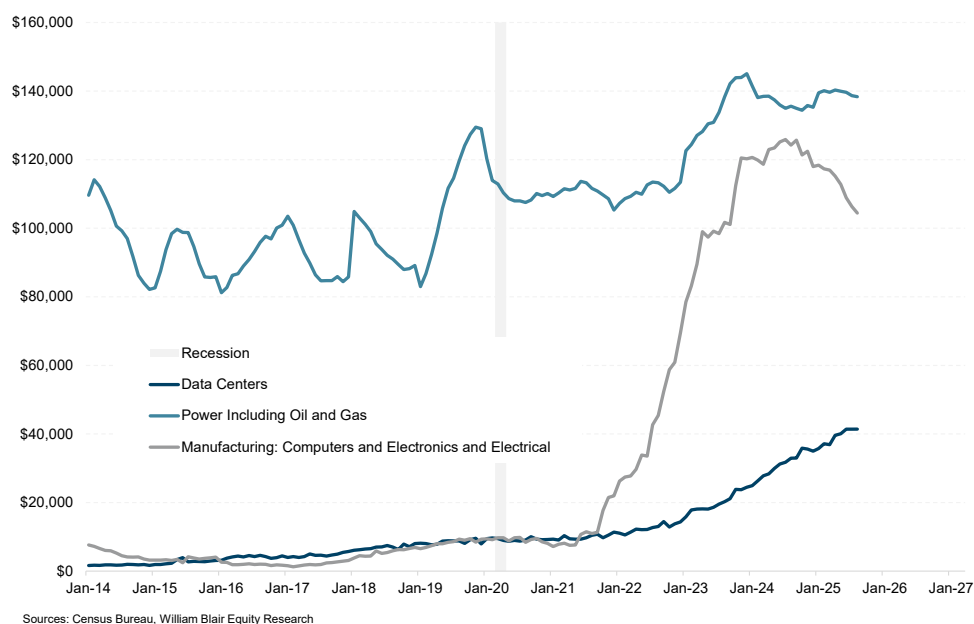


Capex Momentum: More Than Just Data Centers

We expect corporate capital expenditures to remain elevated through 2026, supported by AI and rising energy demand, in addition to a broadening of capital investment across the economy. This momentum is likely to be supported by recent presidential executive actions and tax incentives included in the OBBB, which tangibly lower effective corporate tax rates for capital-intensive businesses. In addition, the push to reshore manufacturing and secure critical supply chains will also require significant upfront capital investment.

Since the release of ChatGPT and similar tools, data center construction spending has surged to nearly \$40 billion annually, more than triple the figures reported in late 2022 (exhibit 10). In 2014, data center projects represented roughly 5% of all office construction, but have now increased to more than 40%. [Estimates](#) from McKinsey indicate that global companies will need to invest a further \$5 trillion-\$7 trillion in the coming five years to meet AI-industry demands.

Exhibit 10
Value of Private Construction Put in Place for Select Structures
(Millions, SAAR)



Data Centers and Beyond

The boom in generative AI and advanced models has compelled companies to rapidly scale their physical infrastructure, purchase the latest chips, and secure reliable energy sources to sustain the power-intensive systems. AI-related capital expenditure has been a major driver of economic growth this year, yet overall spending still falls short of the levels during the late-1990s tech boom. Unlike past infrastructure booms, this investment cycle is shorter lived, fast depreciating (with chips needing to be replaced every two to three years), and dependent on continuous hardware upgrades. These would suggest that the data center buildout is still ramping up and 2025 is not the peak.

Construction is also booming beyond just data centers, with more capital flowing into computer and electronics factories today than all other manufacturing facilities combined (exhibit 10). This alongside growing investment in power generation suggests that focusing solely on data centers would underestimate the total economic effects of AI-related capital expenditure.

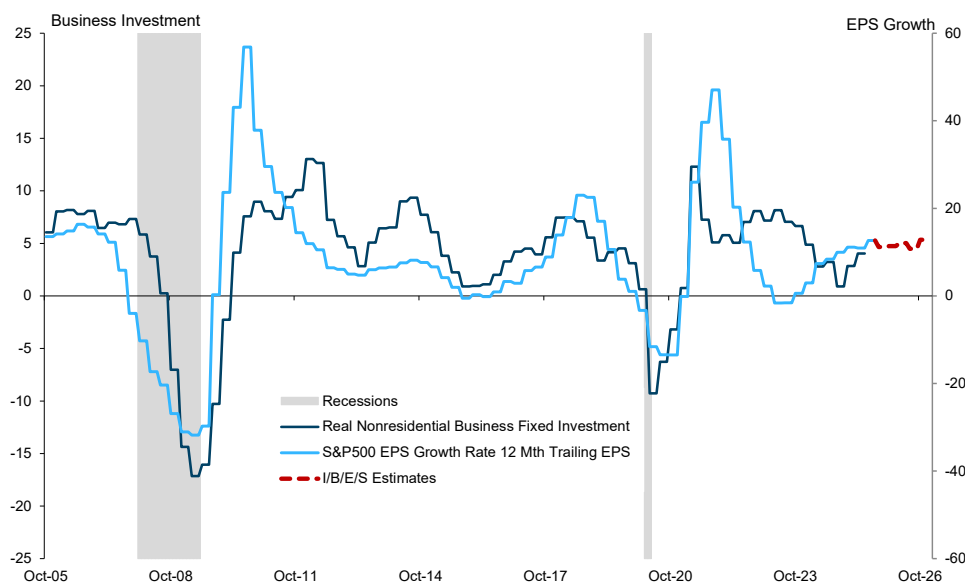
The Need for Power

As outlined [here](#) by our colleagues Jed Dorsheimer and Neal Dingmann, upgrading the power grid is critical, as existing capacity alone cannot meet the energy-hungry data center power needs. Hyperscale demand will grow with rising compute requirements, but limited transmission infrastructure and grid interconnection capacity remain major constraints. This is pushing construction toward regions with existing infrastructure and abundant natural gas. If the sector insists on powering all workloads with green energy, it will likely have to scale back its AI ambitions, with natural gas—and increasingly nuclear—providing the reliable capacity needed in the near term.

Strong Earnings and Less Uncertainty

Lastly, the combination of continued strong earnings growth and diminished policy uncertainty as we move away from the initial shock-and-awe phase of the first year of the Trump administration should also help support a continued broadening out of capital investment (exhibit 11).

Exhibit 11
Business Investment and Earnings Growth
S&P 500 EPS 12 Months Rolling vs. Real Business Fixed Investment, % Change YoY



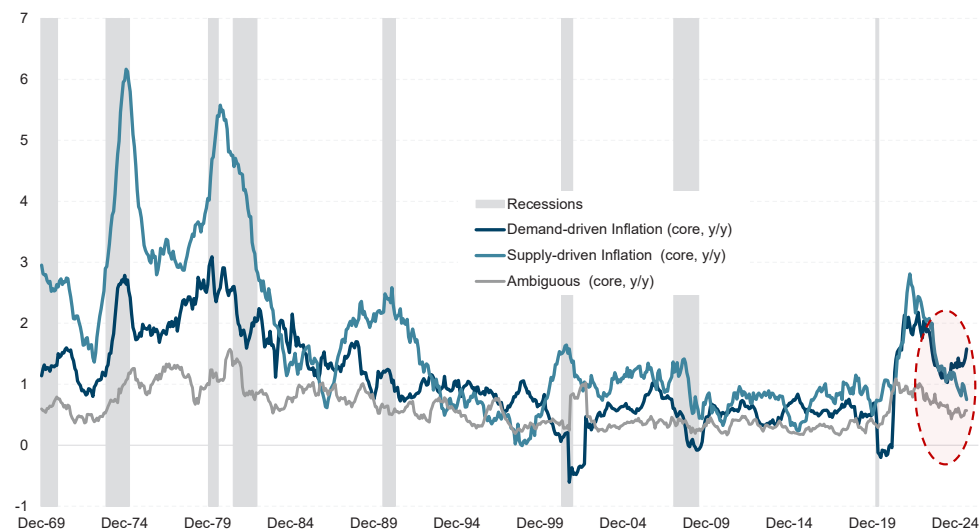
Sources: LSEG I/B/E/S, William Blair Equity Research

Inflation: The Key Vulnerability in 2026

This time last year, inflation (CPI) was expected to fall from 2.9% to 2.5% by the end of the year. That has not happened. Inflation is still stuck at 3.0%. While some of this can be blamed on tariffs, the reality is that the inflationary tariff impact has so far been relatively limited as many companies have found ways to mitigate passing price increases on to the end-consumer. Rather, the sticky inflation is also being driven by a combination of still solid aggregate demand, shelter prices that have decelerated less rapidly than envisioned, and goods prices that are no longer deflationary due to structural changes to the supply side of the economy.

While we believe that the inflation regime has now changed to one where pricing has become much more susceptible to supply-side shocks than over the previous two decades, disaggregated data from the San Francisco Fed into supply and demand buckets shows that recent cyclical price stickiness looks to be driven more by demand-side factors than supply (exhibit 12). If this really is the case, it would be consistent with less room for further Fed easing in 2026 and also help support the more hawkish stance being taken by some members of the FOMC.

Exhibit 12
Supply-Driven and Demand-Driven Contributions to Annual Change in PCE Inflation Rate
(Percentage Points)

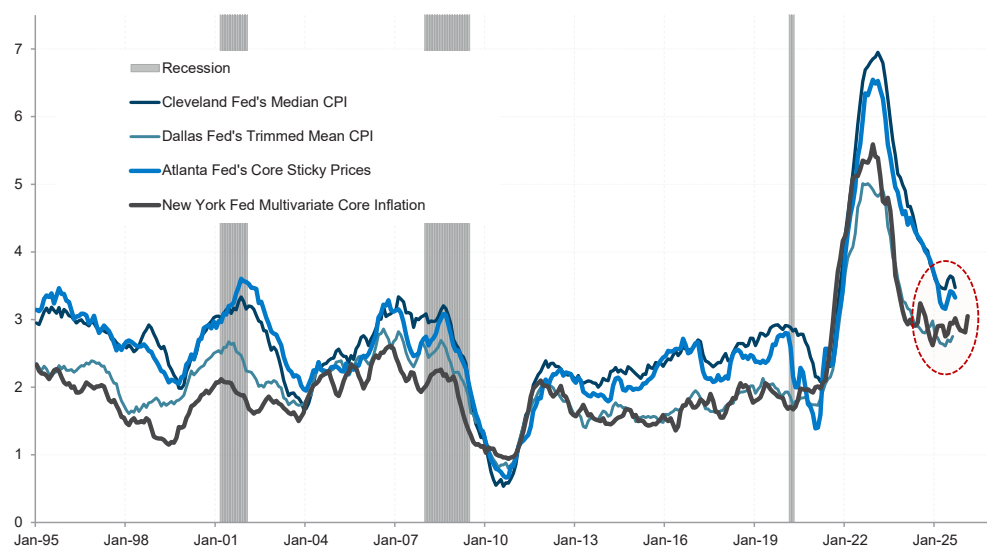


- Demand-driven categories are identified as those where an unexpected change in price moves in the same direction as the change in quantity in a given month.
 - Supply-driven categories are identified as those where unexpected changes in price and quantity move in opposite directions.

Sources: San Francisco Federal Reserve, William Blair Equity Research

A look at various core measures of inflation shows that progress on inflation has stalled (exhibit 13). The New York Fed's multivariate gauge of inflation—which has a good history of forecasting changes in pricing over the coming six months—is signaling a modest reacceleration of core PCE inflation in the coming months.

Exhibit 13
Federal Reserve Inflation Gauges
% Change on Year Ago



Sources: Federal Reserve, William Blair Equity Research

This is consistent with our view that inflationary pressure will remain elevated at least through the first half of the year, supported by extremely accommodative financial conditions, fiscal stimulus, and, to a lesser extent, tariffs. In addition, the structurally tighter labor market—due to demographics, deglobalization, and ongoing immigration restrictions—is also likely to keep wage inflation elevated. A recent study from the San Francisco Fed, for example, estimates that net migration in 2024 increased by 2 million and dropped to just 515,000 in 2025.

While AI will undoubtedly help dampen pricing pressures in the coming years, the reality is that we are still mainly in the more investment-driven enabling phase of this process, compared to the more disinflationary adoption phase, which we hope will have a greater disinflationary impact in future years.

Fed Policy: Less Room to Maneuver Than Market Expects

For central banks, the combination of accelerating demand-driven inflation and the return of structural supply-side vulnerabilities (shortages of labor and more variability in access to materials, and consistent with a major inflation regime change) indicates that they no longer have the same leeway they had in the past to keep rates lower for longer, nor to “look through” inflationary supply shocks quite as easily as they did back then either.

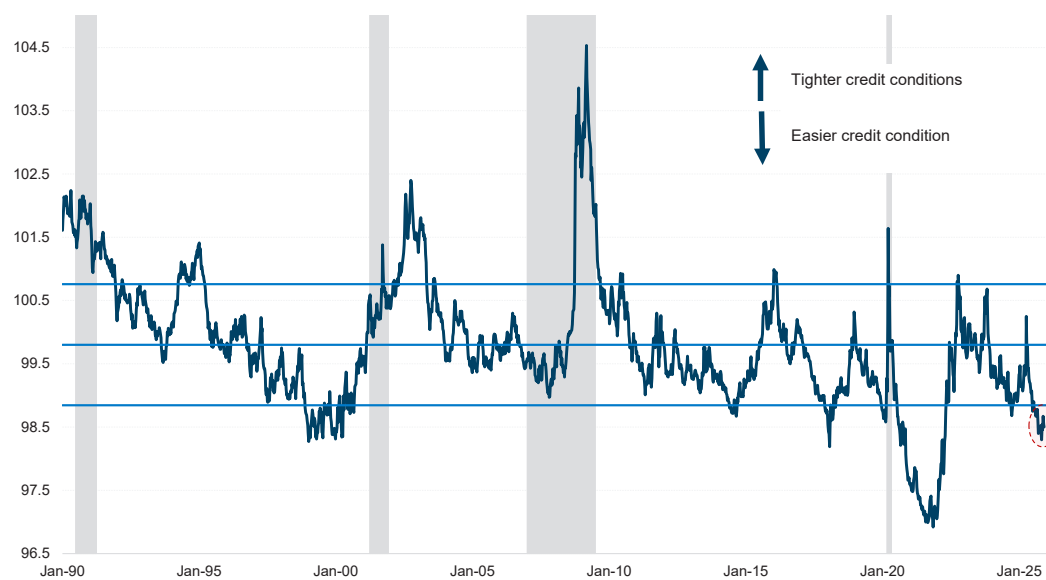
At the last FOMC meeting, Chair Jerome Powell led us down the garden path by clearly messaging that the Fed did not intend to lower rates again in December. Since then, lagged employment data and conversations with the corporate sector seem to have convinced a majority of officials to vote for a rate cut at the December meeting.

Looking beyond that, market expectations are for the Fed to continue to cut rates through 2026, bringing the funds rate down to the Fed’s median estimated neutral rate of 3% (100 basis points lower than today’s levels).

Were we voting members of the committee, we would plan on one more cut to bring rates to 3.75%—or still slightly above our estimate for the neutral rate at 3.25%-3.5%. As we are not, our views are superfluous here, particularly in light of the likely appointment of Kevin Hassett as the next Fed chair beginning in May, which clearly raises the probability that rates will fall by more, probably closer to 3.25% by year-end.

Yet, in our view, the combination of sticky inflation, a modest reacceleration in growth, continued supply-side constraints, AI infrastructure building that is likely to be more inflationary than disinflationary, financial conditions that are indicative of an already extremely accommodative policy rate (exhibit 14), and the likely resumption of QE would be consistent with a rate that should remain modestly restrictive.

Exhibit 14
Goldman Sachs U.S. Financial Conditions Index



Sources: Bloomberg, William Blair Equity Research

Long Rates: Could Be Forced to Take Up the Slack

We believe the 5-year real rates against 30-year nominal yields (as shown in exhibits 15 and 16) are good gauges for the emergence of what we see as a growing theme of fiscal dominance. In such a scenario, the fiscal policymakers and central bankers swap roles, with central banks pivoting toward reducing the interest cost of the federal debt versus directing economic growth and fighting inflation. The result is that real short rates, over which the central banks retain control, are low or falling, while nominal long rates, where the banks hold less control, are free to adjust higher.

If we are moving toward a period of less monetary independence, such a scenario should start to show up here with a steeper yield curve, or a wider spread between real five-year rates and nominal long-term yields.

Exhibit 15
30-Year Nominal T-Bond Yield and 5-Year Real Yield, %

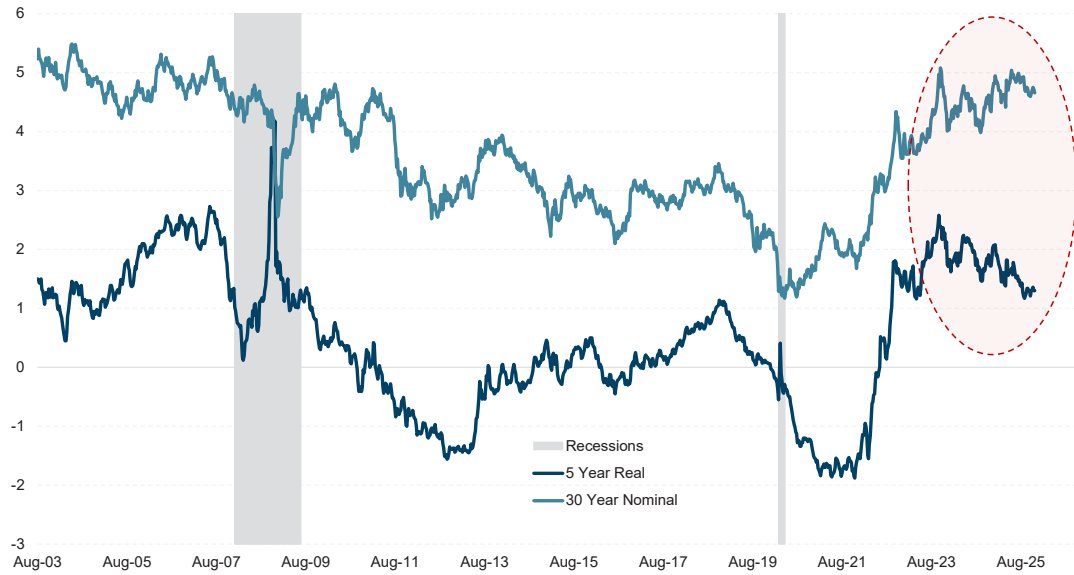
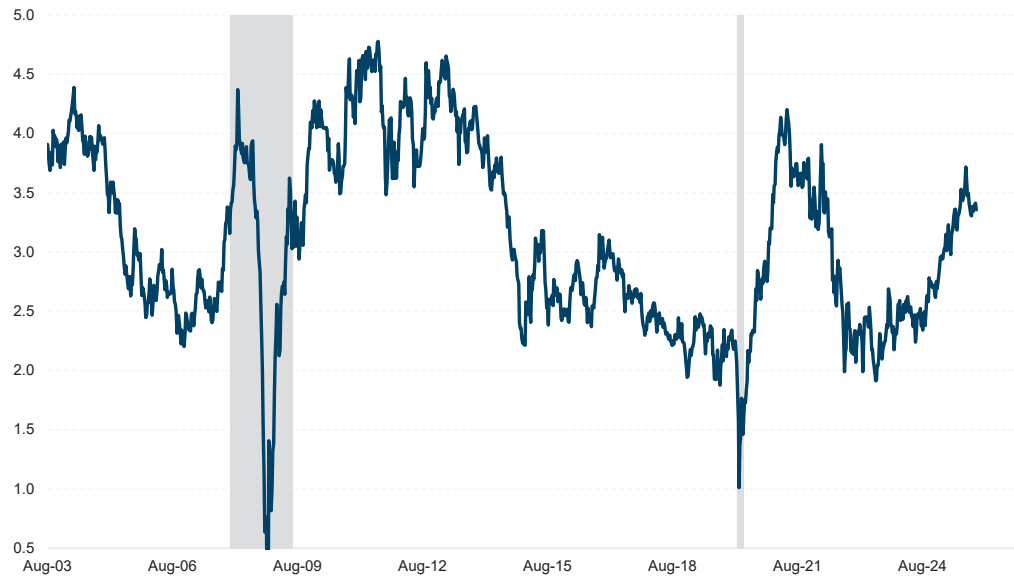


Exhibit 16
Fiscal Dominance Proxy
(30-Year Nominal T-Bond Yield – 5-Year Real Yield)

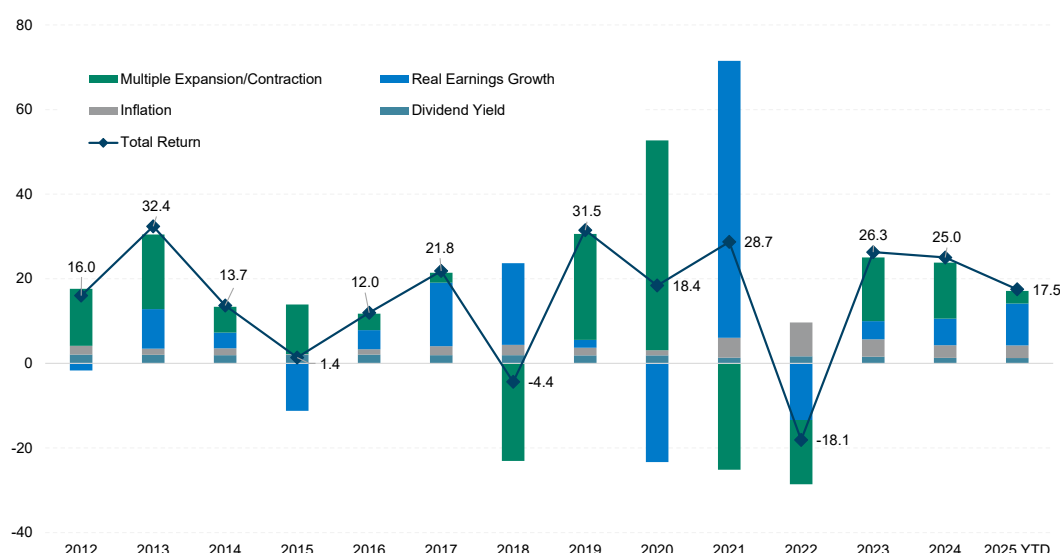


Equity Investment Landscape

Broader Earnings Growth and Investment in the Real Economy Should Support Broader Market Participation

With the P/E multiple for the S&P 500 heading into 2025 already at 25x, there was little room for further multiple expansion to drive returns by this past year. As exhibit 17 highlights, this proved to be the case, with the market multiple contributing only slightly to the 17.5% total return so far this year. Rather, the biggest contributor to the total return was real earnings growth, with a more modest contribution from inflation and multiple expansion than in the previous two years.

Exhibit 17
Composition of Equity Market Return
(Percentage Point Contribution to Annual Equity Market Total Return)

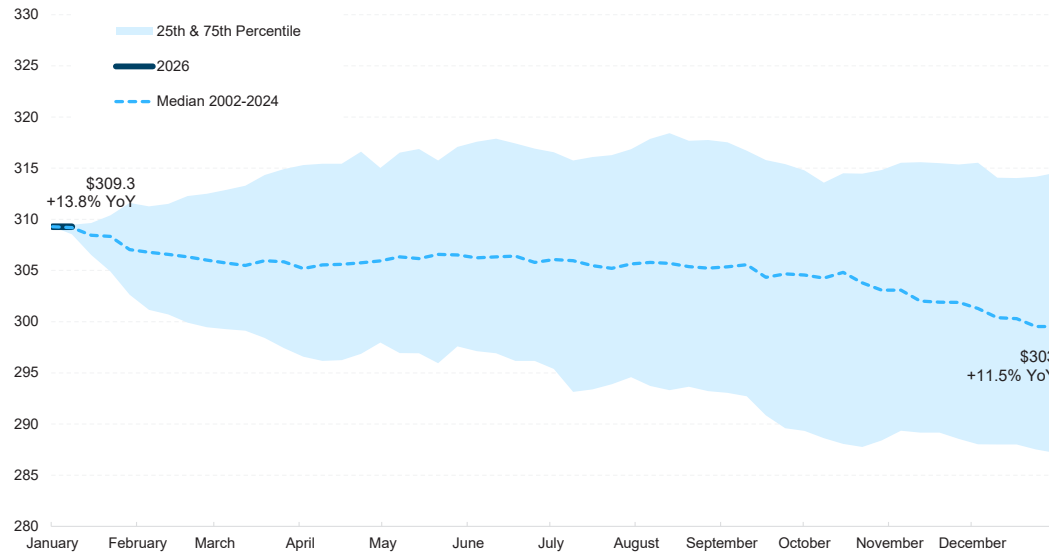


Sources: Bloomberg, Bureau of Labor Statistics, S&P, William Blair Equity Research

Looking toward 2026, we are likely to see a similar story. The market multiple is already at 26x trailing earnings and is in the 90th percentile (from 1988 to present), once again suggesting that market returns will need to depend more on nominal earnings growth, dividends, and buybacks.

Current I/B/E/S estimates are for earnings in 2026 to increase 13.8%. If, however, earnings follow the normal trend pattern whereby estimates are tempered over the course of the year, historical data since 2002 suggest a reading closer to 11.5% (exhibit 18). This is exactly in line with the 11.6% average 12-month trailing earnings growth rate in non-recession quarters since 1988, and above the average of 8.4% for the entire period.

Exhibit 18
Progression of S&P 500 2026 EPS Estimates, 2026 vs. Median 2002-2024
 (Rebased to Estimate at 21 November 2025 of \$309.3 per share)

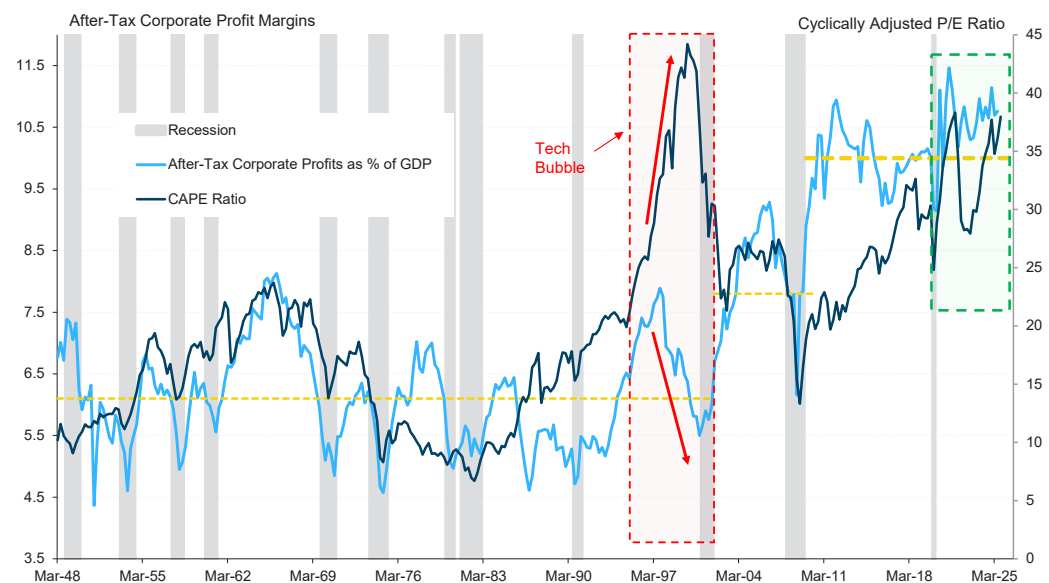


Sources: LSEG I/B/E/S, William Blair Equity Research

Valuations Not as Stretched or Irrational as During Late 1990s

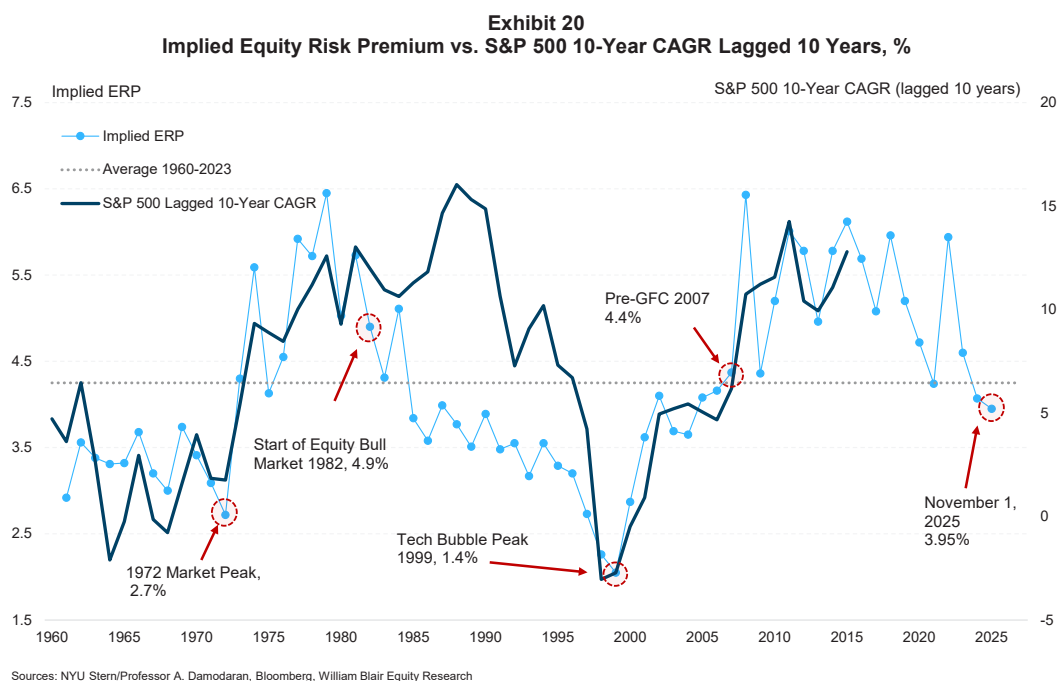
In contrast to the late 1990s when expectations were far ahead of reality, corporate profit margins today are much higher and have not sharply diverged from P/E ratios (exhibit 19).

Exhibit 19
Corporate Profits Margins vs. Shiller CAPE Ratio



Sources: BEA, Robert J. Shiller, William Blair Equity Research, Shaded Areas = Recessions, NIPA = National Income & Product Accounts, profits for all U.S. corporations.

Another way to look at market valuation through a broader prism than just the PE ratio is the implied equity risk premium (ERP). The implied ERP takes into account not just earnings, but also earnings expectations, expected cash flows via dividends and buybacks, and level of interest rates. This ERP is depicted below using the model created by New York Stern School of Business Professor Aswath Damodaran; it is also one that our exhibit shows has proved to be a decent predictor of future 10-year returns (exhibit 20).



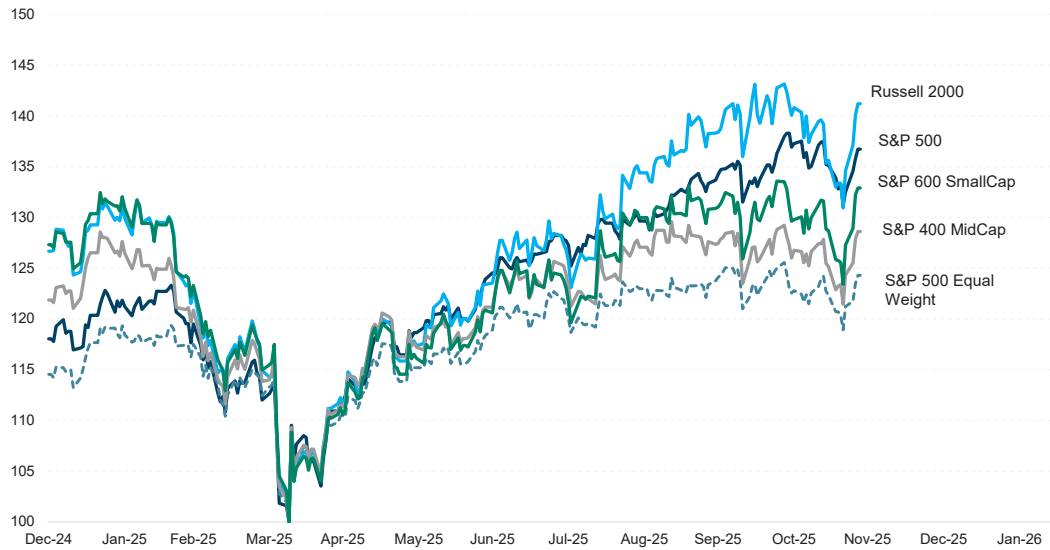
Damodaran's ERP model tells a similar story to what we are seeing elsewhere in the market—namely that the market is highly valued (particularly so relative to the last 20 years), but only a little below the historical average from 1960.

Expectations are also not nearly as outlandish as they were in the late 1990s, when investors were caught up in the thrall of the internet and seemingly buying into the premise of (likely next Fed Chair) Kevin Hassett and James Glassman's book *Dow 36,000*. The book argued that because stocks always outperform over the long run, there was little justification for any risk premium whatsoever, and if that risk premium were removed, a properly valued Dow would reach 36,000 by 2002-2004. In the end, that milestone was not reached until November 2021.

Why We *Still* Find Smidcaps Attractive Heading Into 2026

We continue to like the smidcap area of the market heading into 2026, just as we did heading into 2025. As it stands, the Russell 2000 is up 12.6% year to date, against the 16.5% increase in the S&P 500. Both the S&P 600 index and the smidcap index, however, have increased by only 5.5% and 5.8%, respectively. The equal weight S&P 500 is up 9.0%. Nevertheless, these indices have done much better on a relative basis since the April tariff announcement lows, with the Russell 2000 leading the pack, and the equal weight S&P 500 the laggard of the bunch (exhibit 21).

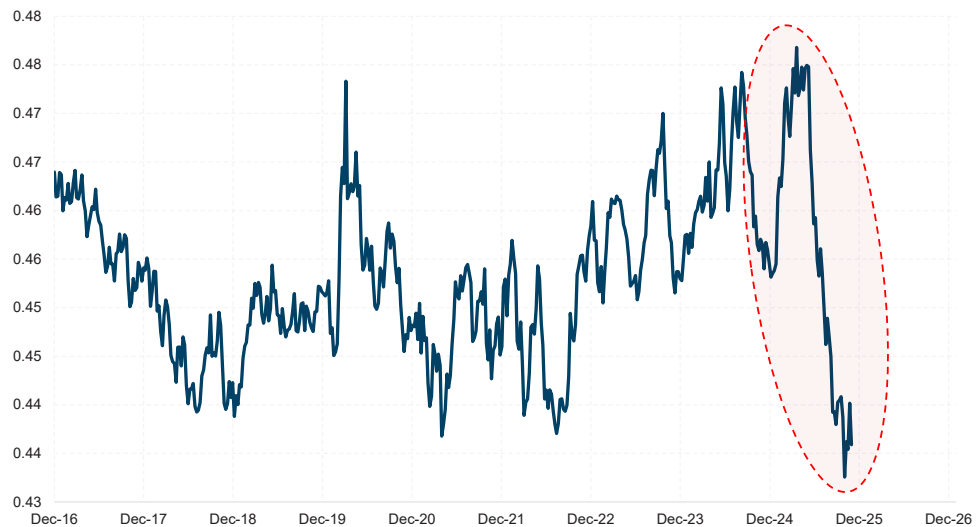
Exhibit 21
Stock Market Performance by Size
(Rebased to 100 at 8 April 2025)



Sources: Bloomberg, William Blair Equity Research

Exhibit 22 shows that the rally from those lows has also largely been driven by the lowest-quality stocks, supported by the Fed's shift back to an easing stance.

Exhibit 22
It's Been a Tough Year for Quality Stocks!
Relative Performance of S&P 500 Quality Stock Index to S&P 500

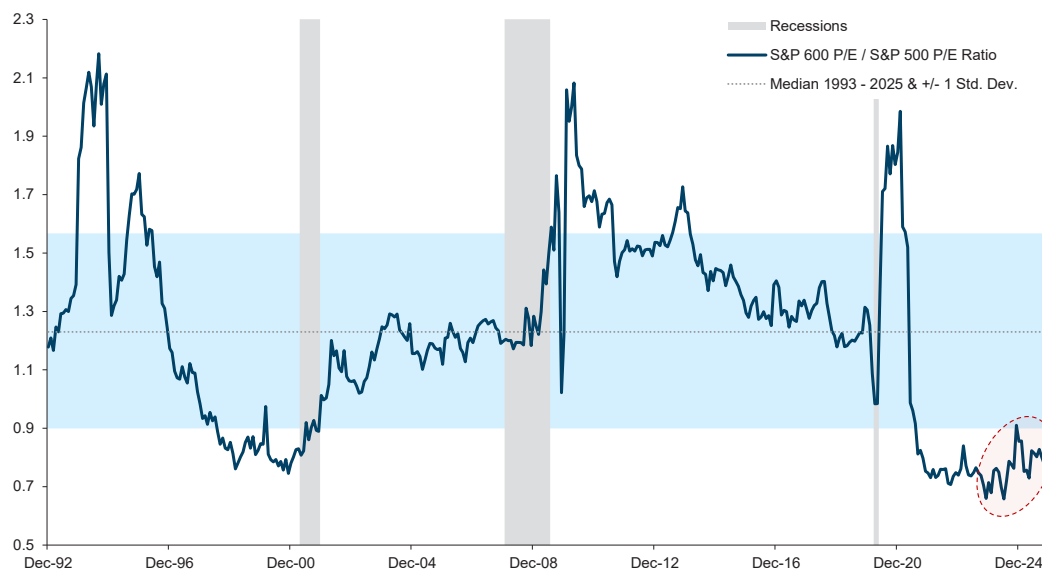


The S&P 500® Quality Index is designed to track high-quality stocks in the S&P 500 by quality score, which is calculated based on return on equity, accruals ratio and financial leverage ratio.

Sources: Bloomberg, William Blair Equity Research

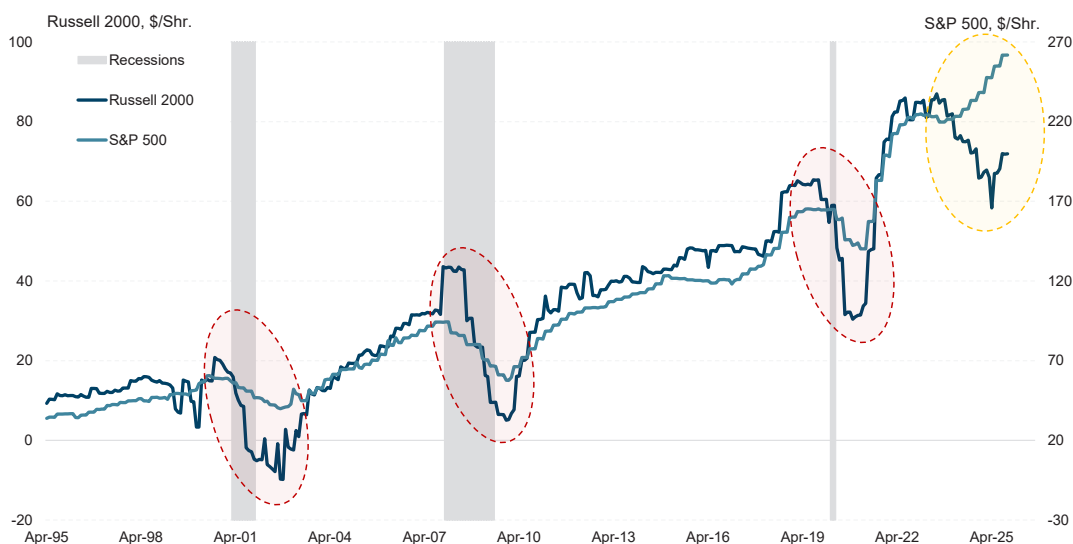
As we move into 2026, we believe that investors will likely be drawn back to both smidcap and quality stocks. We see this as a transition from stage one, being the smidcaps rally (a rally based largely on actual and expected rate cuts), to stage two, a rally based on attractive valuations (exhibit 23), an earnings recovery out of a small-cap recession (exhibit 24), a broadening out of economic growth in the real economy, increasing capital markets activity (including IPOs), a steeper yield curve (historically associated with better relative performance of the smaller stocks), and an increased desire on the part of investors for diversification at a time when the stock/bond correlation remains positive.

Exhibit 23
Relative P/E Ratio: S&P 600 / S&P 500
Based on 12-Month Trailing EPS



Sources: Bloomberg, Capital IQ, FactSet, William Blair Equity Research

Exhibit 24
Russell 2000 12-Month Trailing EPS vs. S&P 500 12-Month Trailing EPS



Sources: Bloomberg, William Blair Equity Research

Conclusion

President Trump burst into the White House in 2025 with the notion that radical change was called for, and one seemingly clear strategy to increase the chances of success was to flood the zone—i.e., throw as much as possible out there at once, minimizing the time and space for opponents to react. While this has so far proved successful across many of his chosen policies, one of the unintended side effects was to blindside the business community, which was reluctant to hire and invest amid so much uncertainty.

As we head into 2026, most of the biggest shock-and-awe policies seem to have now been announced. We are now moving into stage two, which is more about assessing those areas of success or failure, consolidating gains, granting exemptions where needed, and making companies feel comfortable in their decision-making process. Growth in investment will also be supported by the ongoing investment spending associated with the emergence of AI; the OBBB, which tangibly reduces the effective corporate tax rate for capital-intensive companies and gives lower-income consumers a significant income boost during the first half of the year; and the need to invest to both renew the capital stock and increase productivity to offset the emerging structural labor shortage.

With both consumer and corporate sector investment likely to be solid in 2026, and possibly even aided by the handing out of \$2,000 “tariff dividend” checks, inflation is likely to remain sticky at 3% or possibly even accelerate moderately. As we are still in the buildout phase of the AI innovation boom, with continued low adoption rates, many of the expected disinflationary benefits are likely to be further out in the future. This is not the current view of the market, which continues to see inflation falling to 2.5% or lower, coupled with downside pressures on employment, helping give the Fed room to lower rates a further 100 basis points by year-end 2026.

Where the Fed ends up next year is more uncertain than usual, given the ending of Powell’s term as Fed chair in May and the likely appointment of Kevin Hassett as his replacement. If this results in a more dovish Fed at the short end of the curve, it suggests the main interest rate risk for 2026 resides firmly at the long end of the curve—where the Fed has less control.

Equity market performance in 2025 has been largely driven by the continued outperformance of a handful of mega-cap tech stocks. However, with policy uncertainty decreasing, earnings growth likely to broaden, and valuations already full for many of those mega caps, and a positive stock-to-bond correlation, investors should be looking for wider sector and size diversification. This should also benefit the small- and midcap higher-quality stocks, which have been largely overlooked over the last few years and where valuations remain attractive.

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DOW JONES: 47850.90

S&P 500: 6857.12

NASDAQ: 23505.10

Additional information is available upon request.

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