PENOBSCOT
FINANCIAL ADVISORS

MARKET COMMENTARY

Q4 2025

MARKET REVIEW

The fourth quarter of 2025 capped a strong year for global markets. Equities and bonds continued to advance, supported by resilient corporate earnings, cooling inflation and signs that the labor market was softening at a manageable pace. While economic growth moderated from earlier in the year, conditions remained supportive for risk assets, even as elevated valuations and policy uncertainty tempered optimism.

U.S. equities posted gains during the quarter, with large-cap stocks outperforming smaller peers. Leadership was mixed, with value outperforming growth as investors favored more predictable cash flows and balance sheet strength. Companies tied to artificial intelligence and cloud infrastructure remained influential, but were no longer the sole drivers of performance. Earnings generally exceeded expectations, driven more by margin discipline and cost controls than by accelerating revenue growth.

International equities again outperformed U.S. markets during the quarter, extending a trend that persisted throughout much of the year. Performance was supported by a weaker U.S. dollar, moderating inflation, and improving conditions across several regions. Developed markets benefited from improving economic momentum, while emerging markets were aided by stabilizing trade and renewed capital flows.

Bond markets steadied during the quarter as inflation pressures eased and labor market data softened. The Treasury yield curve steepened, with short-term rates declining on expectations for policy easing in 2026, while longer-term rates moved higher amid ongoing concerns about rising government spending and debt. Credit markets remained supported by low default rates and generally healthy corporate balance sheets, while commodity performance was mixed, with energy prices drifting lower and gold continuing its historic run amid dollar weakness, fiscal uncertainty, and geopolitical risk.

Overall, economic data reinforced a picture of gradual cooling rather than contraction. By year-end, markets appeared more discerning, marking a transition toward an environment where fundamentals, diversification, and risk management matter more than narrative momentum alone. As uncertainty persists and growth becomes more uneven, markets may prove less forgiving of excess optimism, underscoring the importance of discipline.

LOOKING FORWARD

AI: DISCOVERY & DIFFUSION

The economic impact of new technologies comes less from the initial breakthrough and more from how widely and effectively those innovations are adopted. Discovery creates possibility, but diffusion determines scale, driving productivity gains, lowering costs, and embedding new tools into everyday economic activity.

So far, the artificial intelligence narrative has been dominated by the discovery phase, with investment and value creation concentrated among a small number of large companies building models, chips, and infrastructure. For the theme to become more durable, the benefits of AI will need to diffuse broadly across the economy. That diffusion would ideally show up through measurable productivity improvements, widespread implementation of practical use cases, and a gradual shift in costs from a narrow group of developers and infrastructure providers toward a much larger base of end users. Over the next year, progress along these dimensions may help clarify whether AI is transitioning from an innovation story to an economy-wide growth driver.

FEDERAL RESERVE INDEPENDENCE

Concerns around Federal Reserve independence have moved closer to the foreground, as the Trump Administration has increasingly used public pressure and messaging to challenge the traditional separation between monetary policy and politics. For investors, this introduces an additional variable into interest rate markets, where rate expectations may no longer be driven solely by inflation and employment data.

This comes at a time when the Federal Reserve is already navigating a difficult backdrop of weakening employment alongside sticky inflation, with added uncertainty around the implications of tariffs on prices and artificial intelligence on employment. Altogether, these overlapping unknowns raise the probability of a policy misstep and suggest interest rate volatility may persist in the year ahead.

K-SHAPED SIGNALS

Recent market dynamics continue to reflect a K-shaped recovery, with equity markets near highs while measures of consumer sentiment remain depressed. Economic strength has become increasingly uneven, with a disproportionate share of spending coming from higher income households whose wealth is closely tied to financial markets.

As a result, the relationship between markets and the broader economy has begun to feel inverted. Rather than markets responding to underlying economic conditions, pockets of the economy are becoming more dependent on market performance itself. This dynamic can help explain why headline growth remains resilient even as many households report financial strain, and it leaves the broader economy more sensitive to market volatility than in past cycles.

SHIFTING TRADE DYNAMICS

Global trade dynamics continue to evolve as geopolitics plays a more central role in economic policy. Supply chains that were once optimized primarily for efficiency are increasingly being shaped by national security concerns, strategic alliances, and domestic political priorities.

For investors, these dynamics add another layer of complexity to the outlook. Trade policy can influence inflation, corporate margins, and growth in uneven ways. Increased geopolitical fragmentation and more frequent trade interventions raise uncertainty for businesses, complicating long term investment and supply chain decisions. As a result, markets may remain sensitive to geopolitical developments, with trade headlines acting as intermittent catalysts for volatility.

OUR TAKE

As we enter 2026, we continue to see meaningful opportunities across markets. Analyst sentiment is largely bullish, driven by expectations for continued earnings growth, easing interest rates, and the potential for productivity gains as new technologies are more broadly adopted. As with any year, there is also a long list of risks that could challenge these assumptions and require thoughtful risk management within portfolios.

One of the most important opportunities and risks remains artificial intelligence. The past several years have rewarded companies directly involved in AI discovery, including chipmakers, platform providers, and firms building the underlying infrastructure. These businesses are innovative, profitable, and strategically important. They are also increasingly dominant within U.S. equity benchmarks, with roughly one third of the S&P 500 concentrated in just seven technology related stocks. History suggests that periods of extreme concentration often carry hidden fragility. Rather than betting on continued leadership from a narrow group, we believe the next phase of value creation is likely to come from AI diffusion, as these technologies are adopted across industries such as health care, manufacturing, logistics, and financial services. This view underpins our decision to remain modestly underweight the most crowded areas of U.S. equity markets to support broader diversification.

Geographic diversification remains another key opportunity. International equities continue to trade at meaningful valuation discounts relative to U.S. markets, and many regions are earlier in their economic and policy cycles. While international investing involves risks related to currency movements, geopolitics, and regulation, it also reduces reliance on a single economic or political system. In an environment where global trade relationships and policy frameworks are evolving, we believe maintaining exposure outside the United States remains an important source of both diversification and potential return.

Monetary policy represents a more subtle but potentially consequential risk. Confidence in the independence of the Federal Reserve has long helped anchor inflation expectations and support the U.S. dollar’s role in global markets. While the Fed has proven resilient to political pressure historically, any meaningful erosion in investor confidence could have broad implications for bonds, equities, and currencies. Combined with uncertainty around trade policy and fiscal discipline, this reinforces our view that portfolios should retain explicit inflation protection through allocations to international equities, inflation protected securities, and gold.

A less visible but increasingly important dynamic is the growing sensitivity of the U.S. economy to financial market performance. Consumer spending accounts for roughly two-thirds of economic activity, yet a rising share of that spending is being driven by higher income households whose wealth is closely tied to asset prices. This creates a feedback loop in which strong markets support consumption, but market volatility can translate more quickly into economic weakness. In this environment, we believe it is prudent to lean modestly defensive within U.S. equities, favoring sectors with more stable demand such as Consumer Staples, Health Care, and Utilities.

Periods of elevated uncertainty are not inherently negative for long term investors. In fact, they often create the conditions for attractive future returns. What matters most is not predicting which concern will dominate the headlines next, but maintaining a portfolio structure that is resilient across a wide range of outcomes. We will continue to monitor these risks and opportunities on your behalf and make adjustments as conditions evolve, always with the goal of keeping portfolios aligned with long-term objectives. As always, we appreciate the trust you place in us and remain focused on helping you navigate changing market conditions with discipline and perspective.