

Reality Check: Asymmetric Risks & Shifting Economic Fundamentals

The Reber Report Q4 2025

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Now that everyone is back from extended holiday breaks and a new trading year has kicked off in earnest, it feels like a good time to reflect on the current state of the economy and markets, examine some factors that I think will drive near-term performance, and what that means for your investments in 2026.

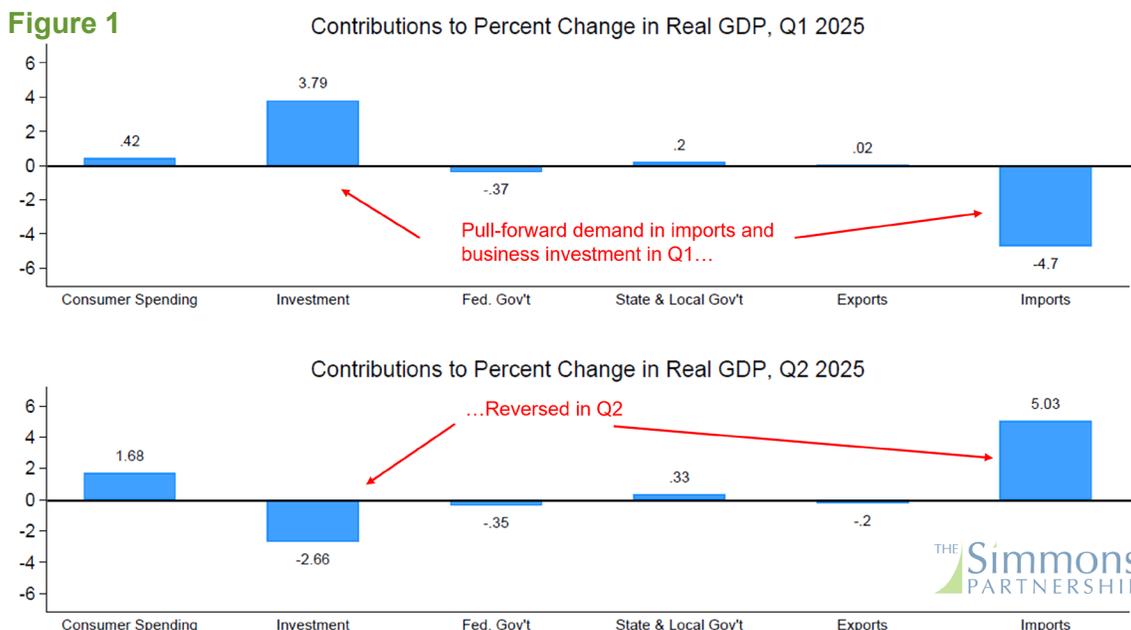
Over the past year, markets and the economy have been defined by a handful of consistent themes: tepid economic growth, persistent inflation, weakening labor markets, stretched equity valuations, and geopolitical uncertainty. I expect many of those themes to continue to drive the narrative throughout much of the coming year.

The economy and markets may face an inflection point in 2026. Financial markets continue to reflect optimism embedded in elevated equity valuations, yet the underlying economy is sending mixed signals. Economic growth has been uneven and AI capital investment has been masking weakness elsewhere in the economy.

I believe the U.S. consumer holds the key to where we go this year. Yet, with persistently weak consumer confidence driving sentiment trends to record lows and workers facing the weakest job market in over a decade, it's hard to envision a situation where consumption can drive meaningful growth over the next year. But don't discount the Fed or the temptation of fiscal stimulus in an election year.

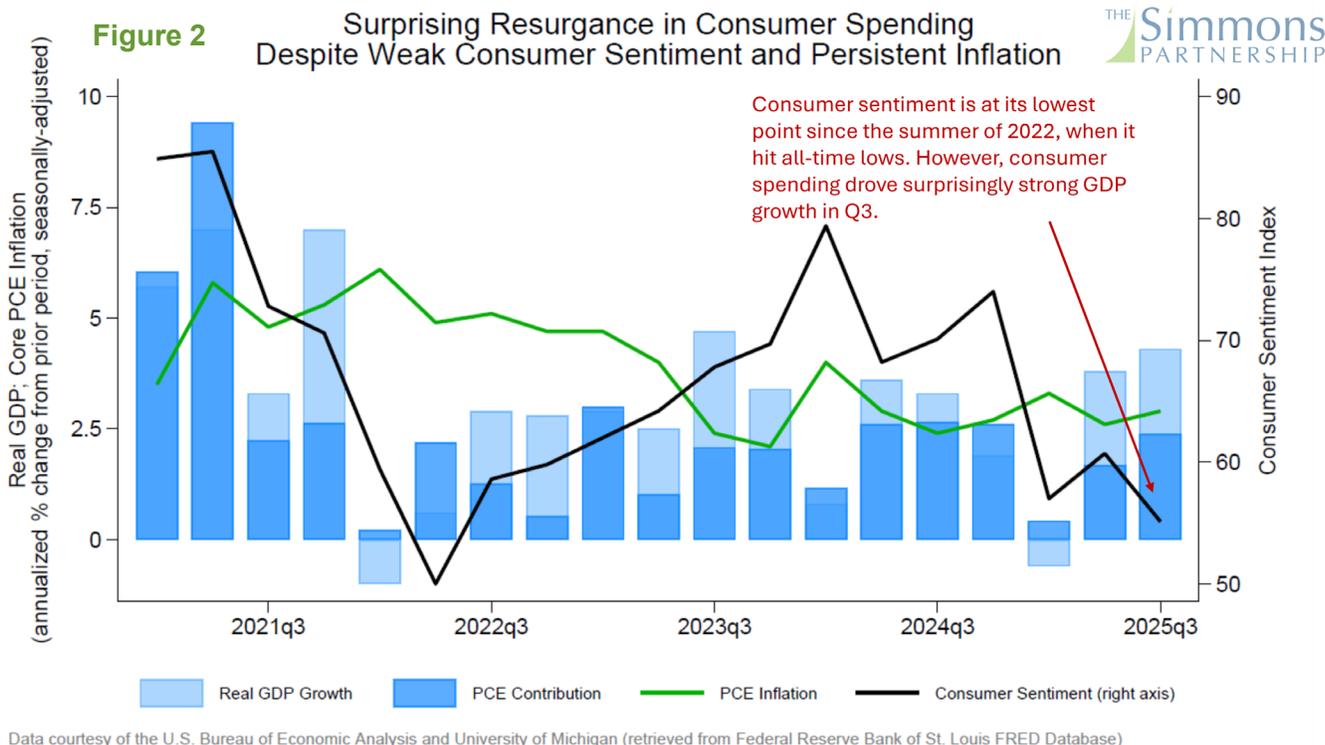
Uneven Economic Growth: Consumers Will be Key in 2026

Economic growth was a mixed bag throughout the first half of 2025, with headline numbers often belying the more nuanced reality buried in the details. In the first quarter of 2025, GDP contracted for the first time in three years driven by a rare surge in imports, as consumers and businesses tried to get ahead of tariffs. However, that temporary spike in imports and business investment in Q1 led to a dearth of imports and a drawdown in business inventories in Q2, such that the effects were all but netted out.

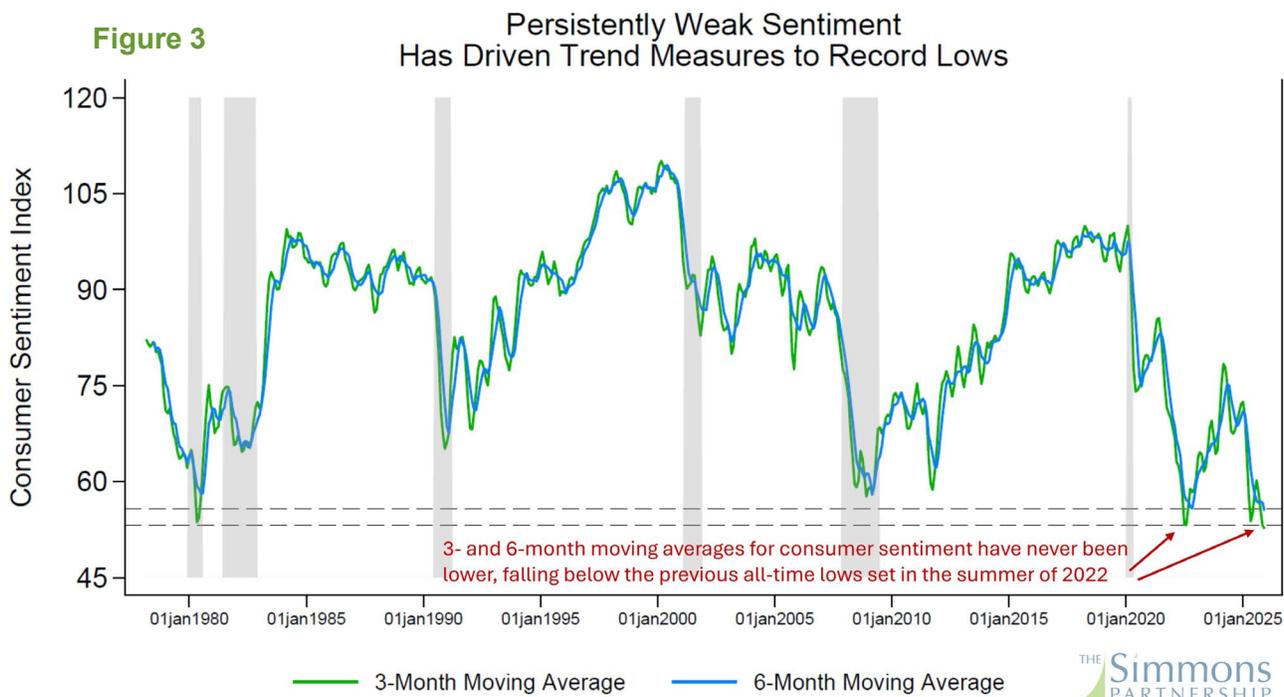


Data courtesy of the U.S. Bureau of Economic Analysis (retrieved from Federal Reserve Bank of St. Louis FRED Database)

The shutdown-delayed initial estimate of GDP growth for Q3 (released at the end of December) surprised significantly to the upside, indicating the economy grew at an annualized rate of 4.3% in the quarter, driven by consumer spending, exports, and government spending.



Assuming these estimates are not revised downward in the coming months, the Q3 GDP report was a testament to the resilience of the U.S. consumer, who is facing otherwise weak growth, persistent inflation, and the worst job market in over a decade. Rightfully so, consumer sentiment is the lowest it has been since the summer of 2022, when inflation was nearly 5% but real GDP grew at an annualized rate of 7%. Notably, the three- and six-month moving averages of consumer sentiment have never been lower, highlighting the strong downward trend in sentiment since 2024 (see Figure 3).

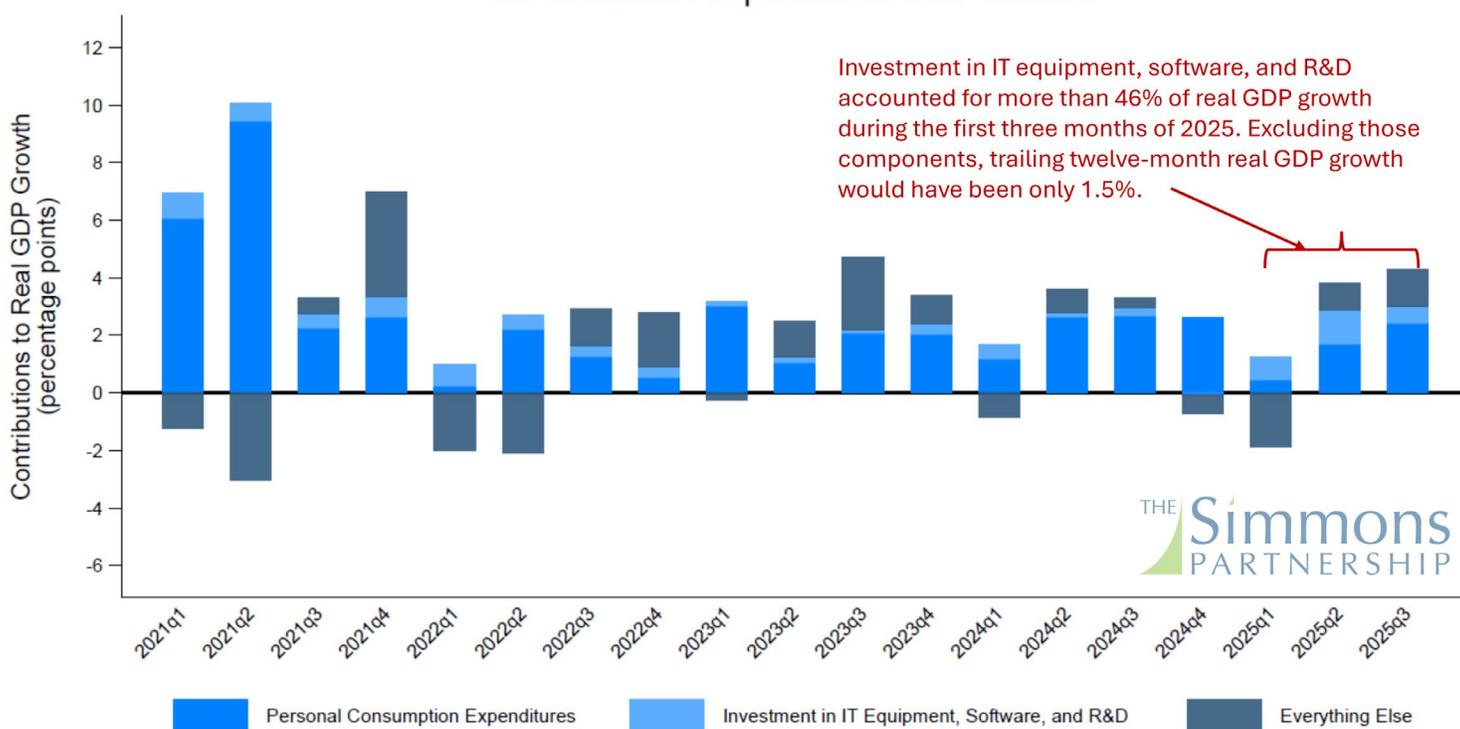


AI investment has been masking weakness elsewhere in the economy. Putting aside the recent uptick in consumer spending and the noise of tariffs, an outsized proportion of economic growth has been driven by capital investment in artificial intelligence. To provide some perspective, investment in AI-related infrastructure (IT equipment, software, and R&D) accounted for more than 30% of GDP growth in Q2 and more than 14% of GDP growth in Q3. In dollar terms, the U.S. economy grew by \$438.5 billion in the first nine months of 2025—\$202 billion of that (or 46%) was attributable to AI-related investments. Over the past twelve months, real GDP grew by 2.3%; removing AI-related capital investment, that rate would have been just 1.5% (see Figure 4).

This impressive rate of capital investment and the sheer amount of wealth that has piled into the stocks of AI hyperscalers (even at the current lofty valuations) means that **economic and financial fortunes are increasingly reliant on continued enthusiasm around the promise of AI.** Determined to deliver on that promise at any cost, firms have now started financing additional investment with debt, leveraging their bets and increasing risk. However, the future benefit of this capital investment—both in terms of financial return for firms and the promise of improved economic productivity—is uncertain. It is unlikely that all (or even a large portion) of these AI investments will pay off sufficiently to meet current expectations.

Figure 4

AI-Related Investment Continues to Drive an Outsized Proportion of GDP Growth



Data courtesy of the U.S. Bureau of Economic Analysis (retrieved from Federal Reserve Bank of St. Louis FRED Database)

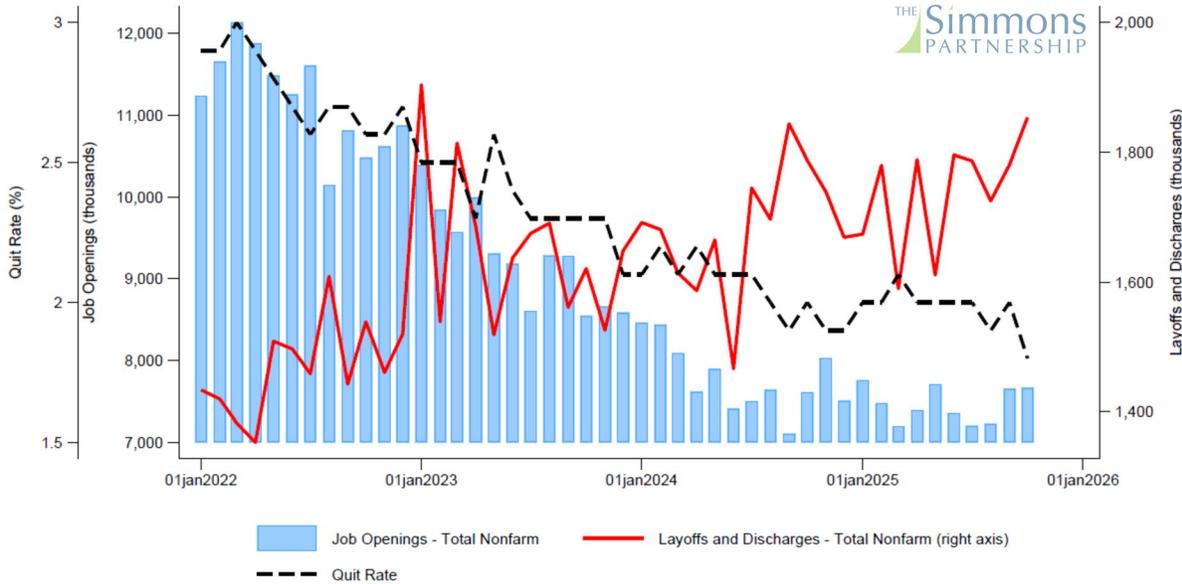
The economy cannot thrive on AI alone. For a country where consumer spending has historically been the primary driver of economic growth, it has been encouraging to see consumption tick up over the past two quarters. However, if there is going to be more durable economic growth in the year ahead, we need to see the consumer return in a more consistent and sustainable way. **Short of measurable improvements in labor market conditions, inflation, and consumer sentiment, it’s hard to envision a situation where consumption continues to drive meaningful economic growth over the next year.**

Weakest Labor Market in Over a Decade

As was the case throughout most of last year, the labor market continues to signal weakness in the economy. Unemployment is rising, job growth is anemic, wage growth is stagnant, and layoffs continue to rise as employers wrestle with uncertainty and seek to right-size their workforces in the shadow of the post-pandemic hiring boom.

The headline (U-3) unemployment rate now stands at 4.6%. A broader measure (U-4), which includes discouraged job seekers who have dropped out of the labor force, is at 4.9%. Both measures are up half a point from where they were at the end of 2024. **Moreover, the number of job openings in the economy has steadily declined since the beginning of the year, as firms have scaled back hiring and layoffs have increased.** Meanwhile, people who have jobs are hanging on to them—the quit rate fell to its lowest level since 2020, suggesting workers lack confidence in their ability to switch jobs in this hiring environment.

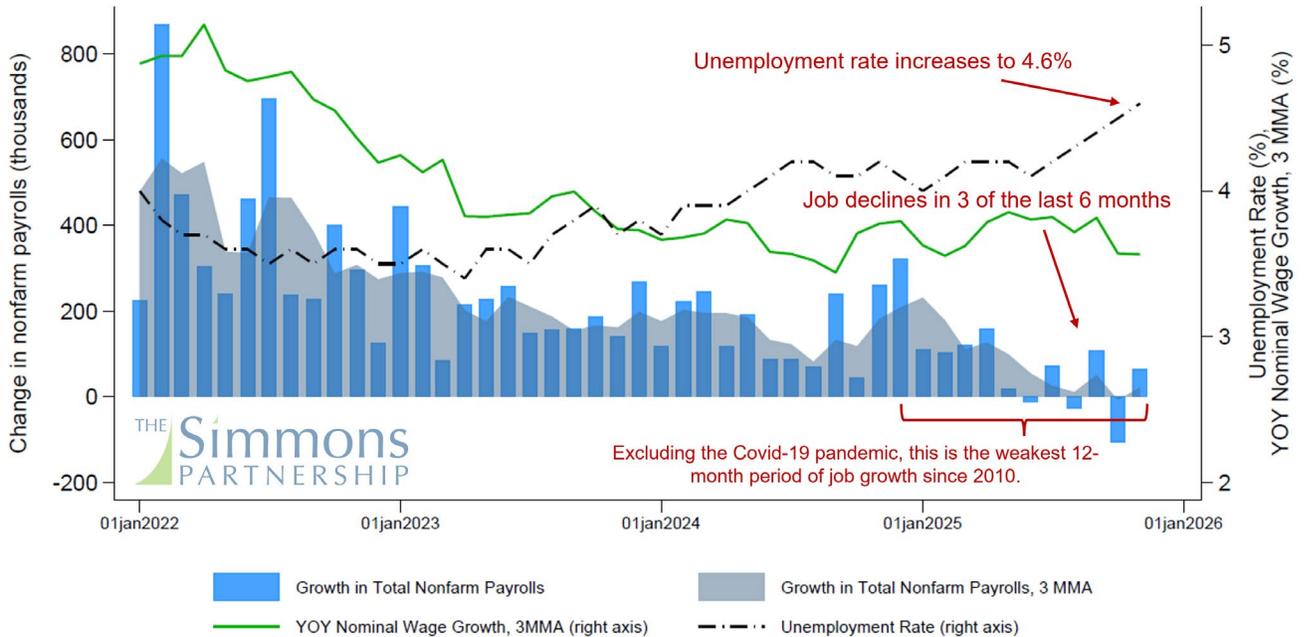
Figure 5 Job Openings Slump While Layoffs Continue to Rise, Lowest Quit Rate Since 2020



Data courtesy of the U.S. Bureau of Labor Statistics (retrieved from Federal Reserve Bank of St. Louis FRED Database).

Excluding the Covid-19 pandemic, this has been the worst trailing twelve-month period of job growth since 2010. Since the beginning of the year, the U.S. economy has created a mere 610,000 jobs. To put that in perspective, that's 18,000 fewer jobs than were created in the entire fourth quarter of 2024 and 86,000 fewer jobs than were created in the single month of July 2022.

Figure 6 Weakest Labor Market in Years: Fewer Jobs, Rising Unemployment, Stagnant Wage Growth



Data courtesy of the U.S. Bureau of Labor Statistics (retrieved from Federal Reserve Bank of St. Louis FRED Database).

Relative to the past 15 years, this current pace of job creation is abysmal. Over the past twelve months, the number of jobs in the economy has grown at a rate of only 77,000 jobs per month, on average. Between 2020 and 2024, the economy created roughly 119,000 jobs per month, on average—that includes March 2020, when nonfarm payrolls shrank by a staggering 20 million jobs in a single month (no, that’s not a typo). Some economists would argue this is an unfair comparison because the post-pandemic job market was uncharacteristically strong. However, in the years between the financial crisis and the pandemic (2011-2019), the economy created roughly 190,000 jobs per month, on average.

But let’s break it down further. It’s actually pretty straightforward to calculate the breakeven rate of job growth—that is, the number of jobs that need to be created in a given period to keep the unemployment rate constant. For a given unemployment rate, the breakeven rate of job growth is:

$$BE \text{ Employment Growth} = \text{Labor Force Growth} \times (1 - \text{Unemployment Rate}).$$

Where labor force growth is simply the product of population growth and the labor force participation rate. [In a recent publication](#), the Congressional Budget Office estimates that the civilian noninstitutionalized population age 16 and older—those people that could be included in the labor force—will grow by approximately 2.64 million in 2026 (or about 220,000 per month, give or take). With an average labor force participation rate of about 62.5%, that means **the economy needs to add about 131,000 jobs per month to maintain the current 4.6% unemployment rate. That’s a far cry from the 77,000 jobs per month we’ve added on average over the past year.**

In fairness, [new research out of the Dallas Fed](#) suggests that the recent reversal of immigration flows and cyclical changes in labor force participation has caused the monthly break-even rate of employment growth to decrease dramatically from a peak of approximately 250,000 jobs in 2023 to about 30,000 jobs now. While I agree that changing demographic factors are important, I am skeptical of the conclusion. For one, the CBO report I cited already accounts for those shifting demographic trends. Moreover, even if we accept the 30,000 per month threshold at face value, that is only the level necessary to maintain a constant unemployment rate—it says nothing about the level of job creation necessary to sustain production, income, and consumption at a level consistent with a robust economy. **Any way you slice it, the current labor market is one of the weakest in over a decade.**

Equity Markets: Asymmetric Risks, Limited Margin of Safety

Equity markets just wrapped up their third consecutive year of double-digit returns—a run that has been unusually narrow in both leadership and narrative. Since 2023, the market cap-weighted S&P 500 index has returned more than 81% (a compounded annualized return of about 21.5% per year), while the equal-weight S&P 500 has returned just 38%.

Figure 7



The outperformance of the cap-weighted index was of course fueled by enthusiasm around artificial intelligence, with gains concentrated in a handful of mega-cap technology companies. **The top eight stocks by market cap—all technology firms—now dominate the S&P 500, making up nearly 38% of the benchmark index. That’s more than the weighting of the financial, healthcare, industrial, energy, and utilities sectors combined.** As such, well-intentioned, passive ETF and index fund investors just hoping to be in “the market” are probably less diversified than they realize, with an outsized proportion of their wealth allocated to just eight firms, in one country, and one industry.

As I have noted here previously, nearly every valuation measure we follow suggests the broad market is overvalued, with most metrics more than two standard deviations above their long-term averages. For example, the total value of the S&P 500 to U.S. GDP is now more than 2.4 standard deviations above its historical trend (see Figure 8)—well above anything we’ve seen in the past 75 years.

At any sign of softness, retail investors (and some professionals) continue to preach their “buy the dip” mantra as if an immediate rebound is ordained—further proof that this FOMO rally has moved beyond logical valuation into a purely emotional state. Any recollection of sustained market drawdowns has apparently been erased from our societal memory.

Figure 8 Buffett Indicator: U.S. Stock Market Value to GDP



Chart courtesy of currentmarketvaluation.com

Meanwhile the cyclically-adjusted earnings yield—the inverse of the often-cited cyclically-adjusted price to earnings (CAPE) ratio—is trading below its Depression-era level of 3% for only the third time in history (the other two being the late 1990s tech bubble and the Covid-19 pandemic) (see Figure 9).

Figure 9

Earnings Yield Falls Below Depression-Era Levels for Only the Third Time in History



Data courtesy of Robert Shiller (<https://shillerdata.com/>). Shading denotes NBER dated recessions.

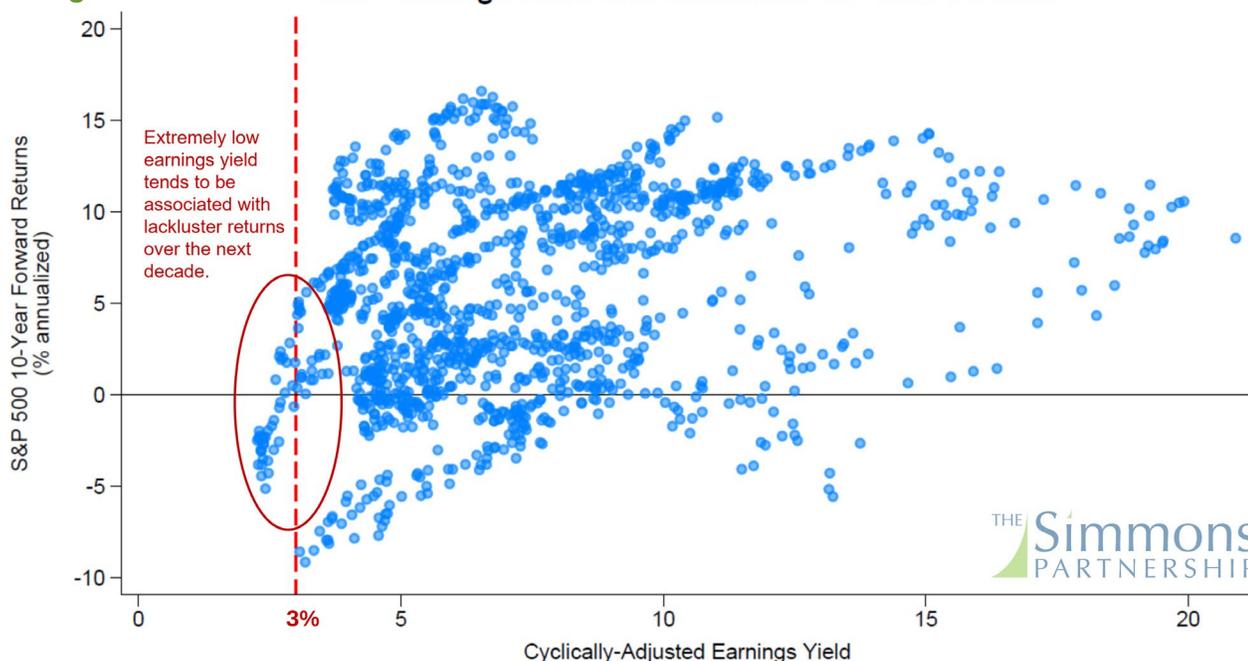
Looking at earnings yield rather than a P/E ratio is perhaps a more intuitive way of looking at market valuation. It both illustrates how historically overvalued markets currently are and signals information about investors' expectations for future earnings growth, macroeconomic conditions, and discount rates—conveniently it also allows us to compare equity returns with bonds, CDs, and cash.

At these levels, the market is pricing in above-trend real earnings growth, productivity gains that more than offset future cost pressures, structurally higher profit margins, and a benign macroeconomic and policy environment with durable economic growth, solid labor markets, stable prices, and low interest rates. Given the current macro environment, we believe such expectations are overly optimistic: not impossible, but unlikely.

When the earnings yield falls to historically low levels, markets are pricing in future growth as if it's a certainty. **Earnings yields at these levels tend to be associated with lackluster forward 10-year returns.** In fact, over the past 125 years, earnings yields below 3% have been followed by 10-year annualized returns between -5.1% and 2.8% (see Figure 10). When markets are priced to perfection, returns become increasingly dependent on outcomes exceeding already optimistic expectations, such that even modest shortfalls in growth can have an outsized impact on returns.

At current valuations, investing in the broad market offers limited margin of safety and, therefore, asymmetric risk. Unless valuations continue to expand, the potential return for these overvalued stocks is limited while there is significant downside risk from multiple compression, even without a recession. **Investors who continue to pile into the momentum trade or passive market cap-weighted funds that track the broad market, are accepting the likelihood of historically low long-term returns in exchange for elevated valuation risk.**

Figure 10 Low Earnings Yield and Lackluster 10-Year Returns



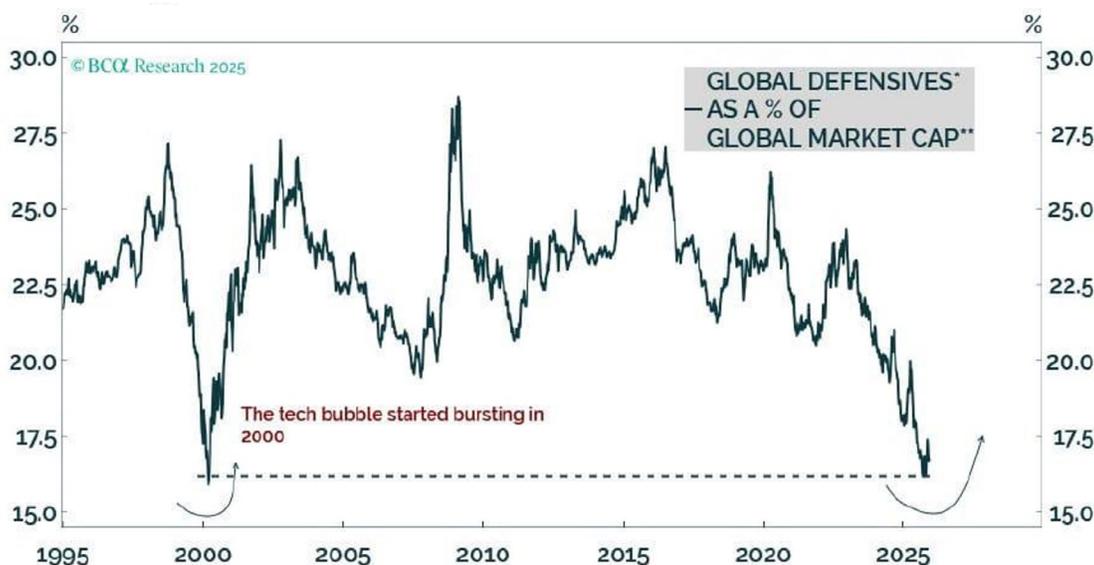
Data courtesy of Robert Shiller (<https://shillerdata.com/>).

This is not to say that all stocks are overvalued—we continue to find good companies with strong balance sheets and cash flows at attractive multiples that the market has largely ignored. For example, the combined market capitalization of stocks in defensive industries (e.g., consumer staples, utilities, healthcare, energy, etc.) has recently hit dot-com era lows (see Figure 11) and we believe some stocks in those industries offer fair expected returns with a greater margin of safety.

Nor is this meant to imply that a recession or even a bear market is imminent. Just because equity valuations are straining historical norms doesn't mean overvalued stocks cannot move higher from here—bubbles can continue to defy reason as long as speculative funds continue to flow in.

Nevertheless, current conditions suggest pairing smart, selective offense with defensive hedges. We continue to stay true to our value-oriented investment process, but we are tactically hedging our equity exposure and keeping extra cash on the sidelines to cushion downside risks and take advantage of good values in equity markets as they arise.

Figure 11 Market Cap Share of Global Defensive Stocks is at Dot-Com Era Lows



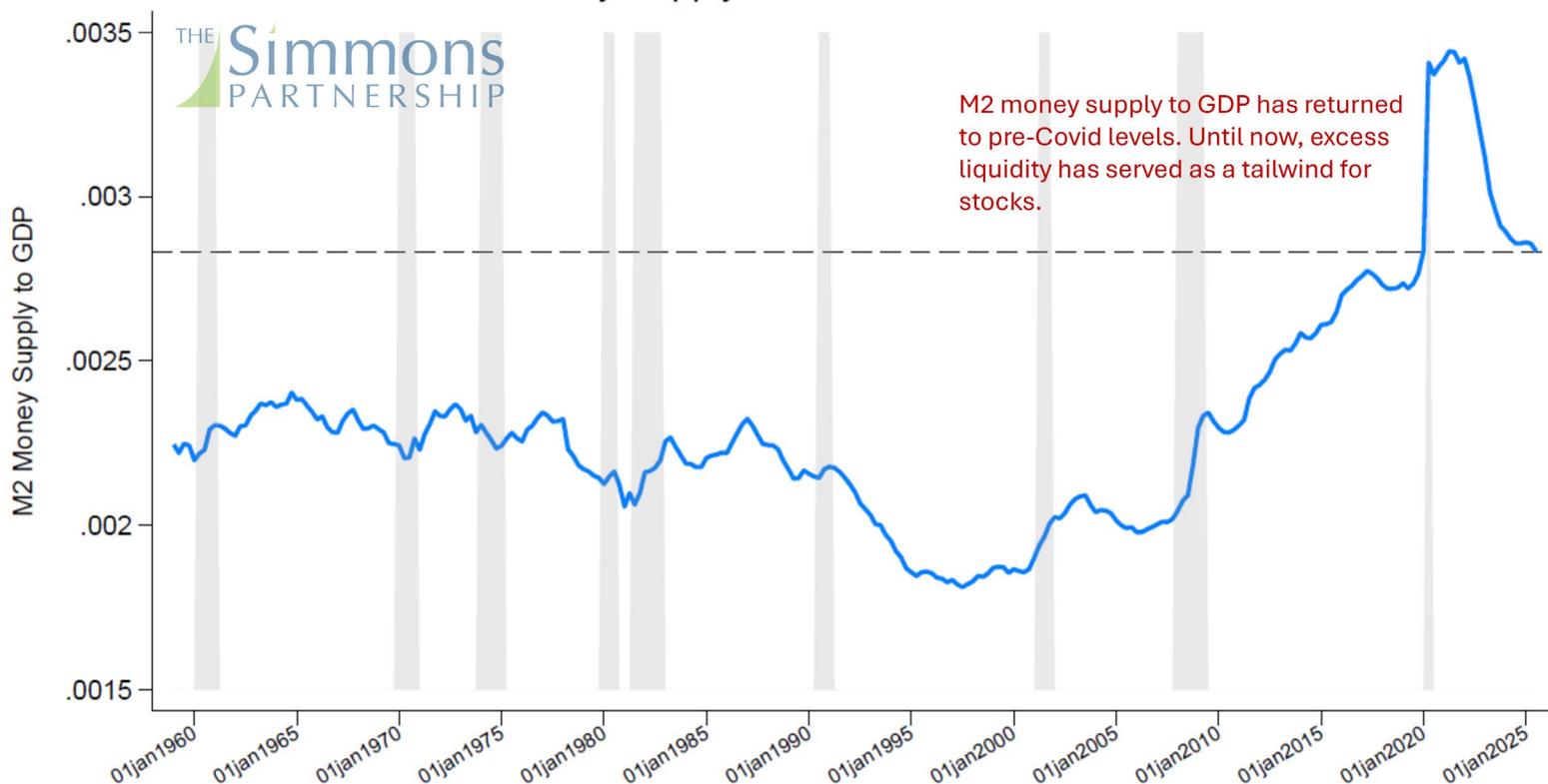
Source: BCa Research and Cypress Capital

Liquidity and Leverage Drive Late-Cycle Momentum

The U.S. economy has largely grown into the extraordinary amount of cash that was pumped into the system during the Covid-19 pandemic, which up until now has served as a tailwind for asset prices. M2 money supply as a share of GDP has returned to pre-Covid levels for the first time in six years (see Figure 12). Short of additional liquidity being injected into the system, we would expect a bit of normalization in equities as markets become driven less by liquidity and more by fundamentals.

Figure 12

Money Supply to GDP at Pre-Covid Levels



Data courtesy of the U.S. Bureau of Economic Analysis and Federal Reserve Board of Governors (retrieved from Federal Reserve Bank of St. Louis FRED Database). Shading denotes NBER-dated recessions.

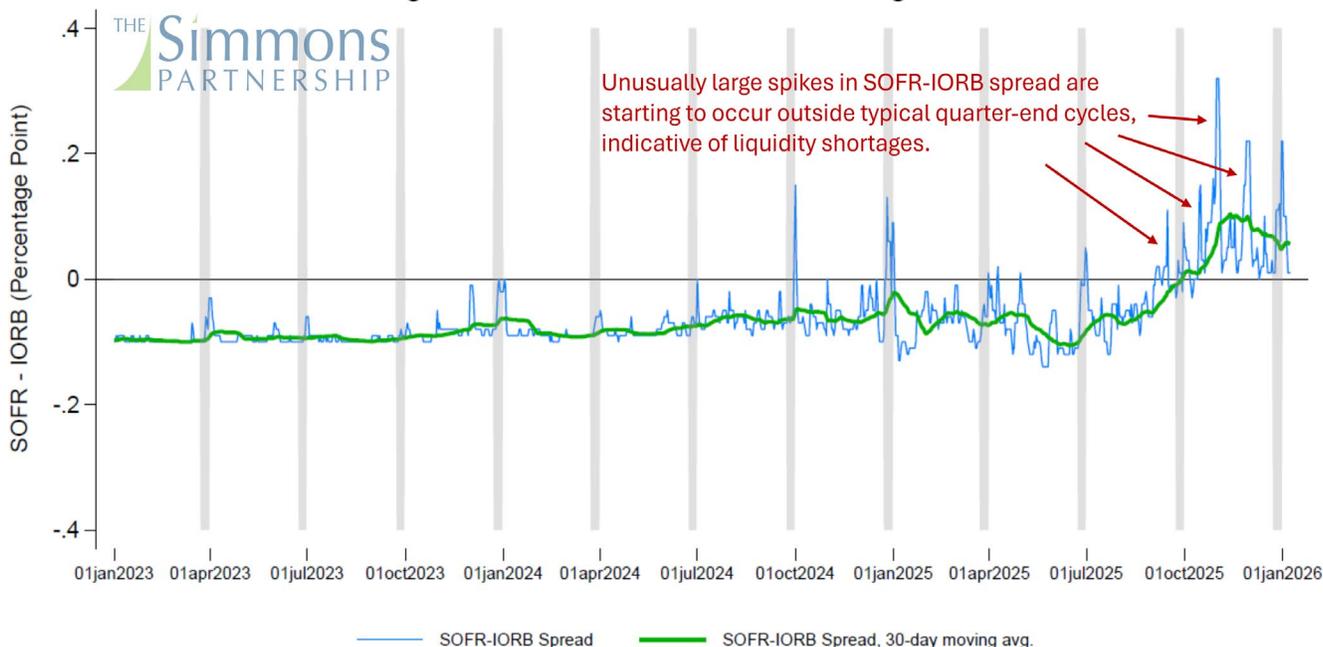
However, concerned about downside risks to the labor market, the Fed has gradually shifted toward more accommodative monetary policy with three consecutive 25 basis point rate cuts between September and December of last year. While the Fed formally ended its policy of quantitative tightening on December 1st—whereby it sought to reduce market liquidity by allowing maturing securities to roll off its balance sheet without reinvesting the proceeds—by mid-December they were once again forced to inject \$40 billion of securities purchases to ease pressure in overnight lending markets.

Recent tremors in short-term rates are worth monitoring, as equity markets tend to get a bit wobbly when short-term funding markets are stressed. [As I pointed out in a LinkedIn post last fall](#), the spread between two important short-term rates, the Secured Overnight Financing Rate (SOFR) and the Interest Rate on Reserve Balances (IORB)—which is negative when market liquidity is abundant—has turned positive and has been expanding since the Fed cut rates at the end of September, indicating liquidity shortages.¹ This contributed to a brief pause in the equity rally last fall.

As highlighted in Figure 13, these temporary liquidity events are fairly common at the end of calendar quarters (grey bars), as financial institutions take advantage of short-term funding markets to window-dress their balance sheets. What's worth watching are the large and increasingly common spikes in spreads that are happening outside these windows, which point to more structural liquidity strains.

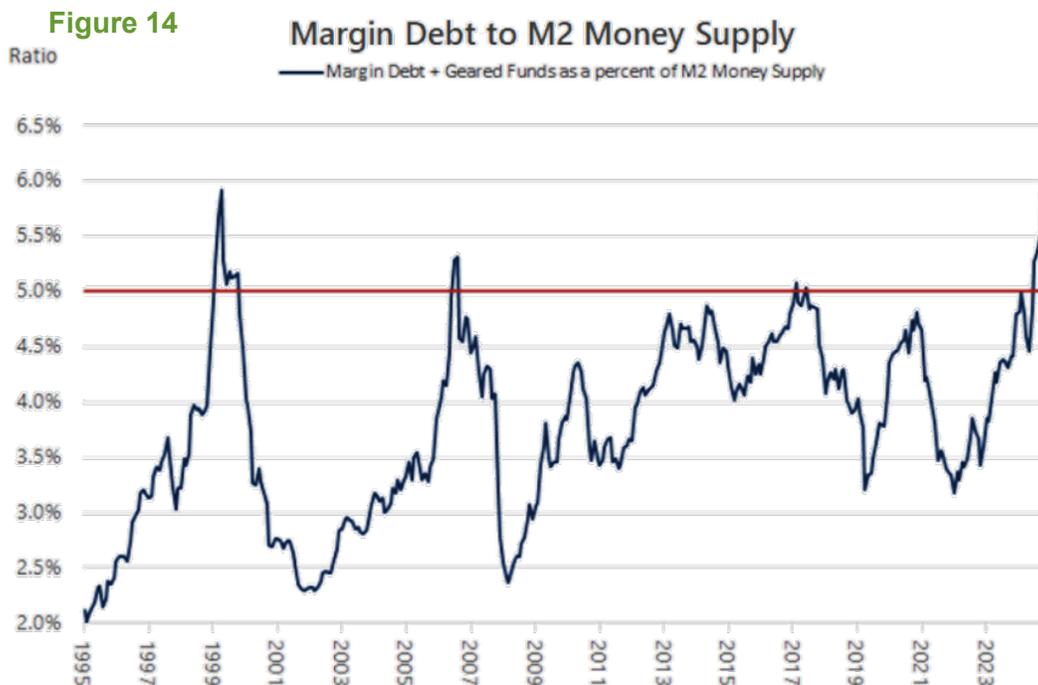
¹The Secured Overnight Financing Rate (SOFR) is a key short-term rate that reflects the cost of overnight borrowing using U.S. Treasuries as collateral. SOFR is important for individual and commercial borrowers because it is commonly used as the benchmark rate against which other variable rates—such as adjustable-rate mortgages, HELOCs, credit cards, etc.—are set. The Interest Rate on Reserve Balances (IORB) is a key short-term rate administered by the Fed, which reflects the rate the Fed pays banks on their reserves held at the central bank.

Figure 13 Signs of Stress in Short-Term Funding Markets



Leverage—the use of borrowed funds, derivatives, or leveraged ETFs to control larger investment positions with less capital—has been another source of momentum and is further evidence that this extended bull market is long in the tooth. Margin debt has increased significantly as a share of the money supply. This is a late-cycle phenomenon, as investors’ appetite for risk increases with their fear of missing out, speculative intensity rises, and investors abandon fundamentals to chase prices higher on sentiment. **While this increased leverage serves to further amplify asset prices on the way up it will unconditionally exacerbate drawdowns when the tide eventually turns, as falling prices trigger margin calls, which triggers forced selling, which drives prices lower in a vicious cycle.**

Similarly, the increasing use of derivatives by investors and leveraged ETFs to speculate on inflated asset prices has also served to further drive stock prices higher. As is always the case, leverage cuts both ways serving to enhance both gains and losses.²



² For example, when an investor purchases a call option to speculate on a stock, the counterparty to that transaction (typically a market maker) is inherently short the stock. To hedge their short call position, the market maker will buy 100 shares of the stock (1 call option controls 100 shares of the underlying stock). At scale, those stock purchases drive up the price of the underlying shares. When stock prices fall, long call positions are closed out, triggering counterparties to sell the stock, driving stock prices lower, and so on.

What does this mean for your money?

The economy is not as strong as top-line GDP growth and equity prices would have you believe. The impressive rate of AI capital investment over the past few years has been masking weaknesses elsewhere in the economy. Excluding the boost from AI-related investment, economic growth has been disappointing. If there is going to be more durable economic growth in the year ahead, we need to see the consumer return in a more consistent and sustainable way. However, while consumer spending has ticked up recently, the median U.S. consumer is struggling with affordability and facing the weakest labor market in over a decade. With rising layoffs and unemployment, anemic job growth, stagnant wages, and persistently high inflation, it's hard to envision a situation where consumption drives meaningful economic growth over the next year.

Given current economic conditions, record equity valuations, and the level of liquidity and leverage currently in the market, it's also hard to imagine another year of double-digit equity market returns.

However, with the political environment in D.C. and current Fed Chairman Powell's term set to expire in May, it is virtually certain that his successor will be considerably more dovish. Additional rate cuts could be the catalyst that moves markets higher in the second half of the year. **While I currently see no economic reason for equities to have another banner year, as the old market adage goes, don't fight the Fed.** Additionally, as a consequence of the OBBA, a significant portion of consumers are likely to see larger than usual tax refunds in 2026, which may also serve as a de-facto fiscal stimulus in the first half of the year.

While market valuations remain stretched, we believe there will be enough support from monetary and fiscal policy this year that investors need to stay long equities in 2026. **However, we expect the market rally to broaden out this year and believe investors should diversify beyond the AI momentum trade and rotate into overlooked sectors and regions. We do not believe investors should be passively investing in market cap-weighted strategies.** Investors need to pick their spots—buy good companies with strong balance sheets and cash flow at attractive multiples—and actively manage risk through diversification, active hedges, and keeping cash on the sidelines to cushion downside risks and take advantage of good values as they arise.

Sophisticated investors require more sophisticated investment strategies.

If you ever get the feeling that the advice you're getting is being read from a script, we'd love to talk to you.

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