Chemung Canal Trust Company

Capital Bank
A Division of Chemung Canal Trust Company

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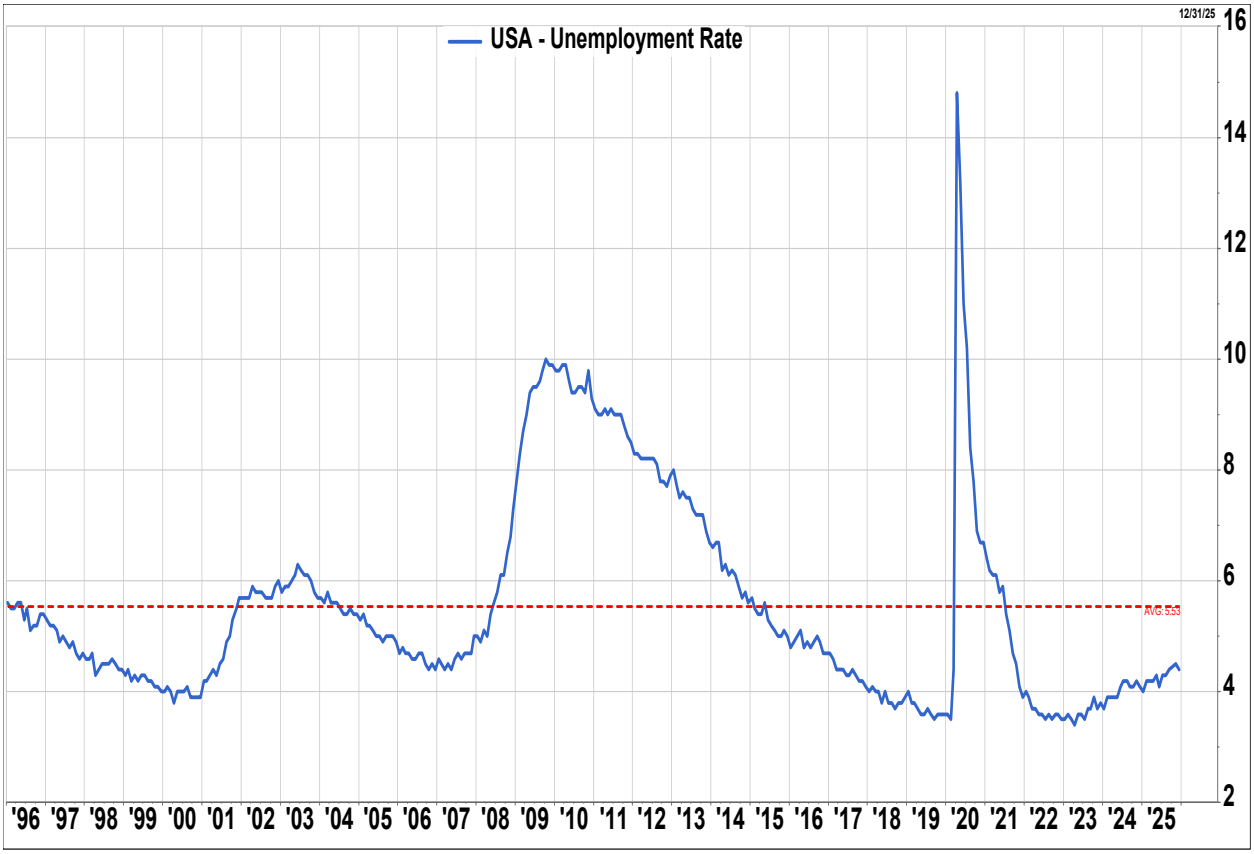
2026 First Quarter

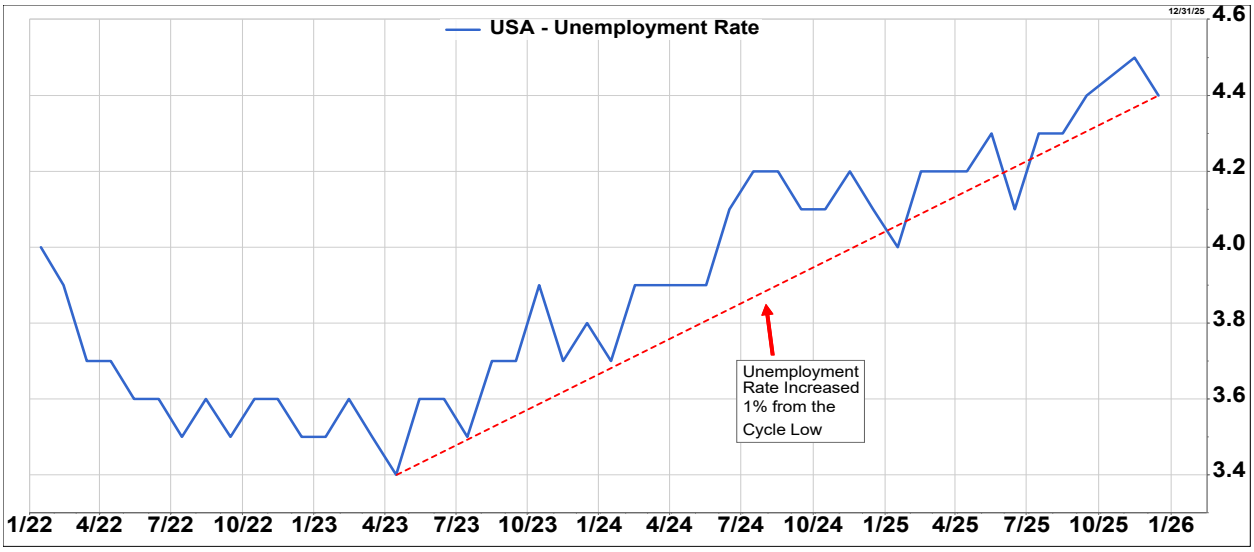
Investment Outlook

2025 Economic Review:

Policymakers and market participants alike found 2025 to be an unusual year in many respects for the economy. The unemployment rate ended the year at 4.4%, after briefly touching 4.5% in the November data release. At 4.4%, there is nothing particularly notable about the current unemployment rate. This is more than 1% below the average unemployment rate over the last three decades and would indicate a labor market that is relatively healthy.

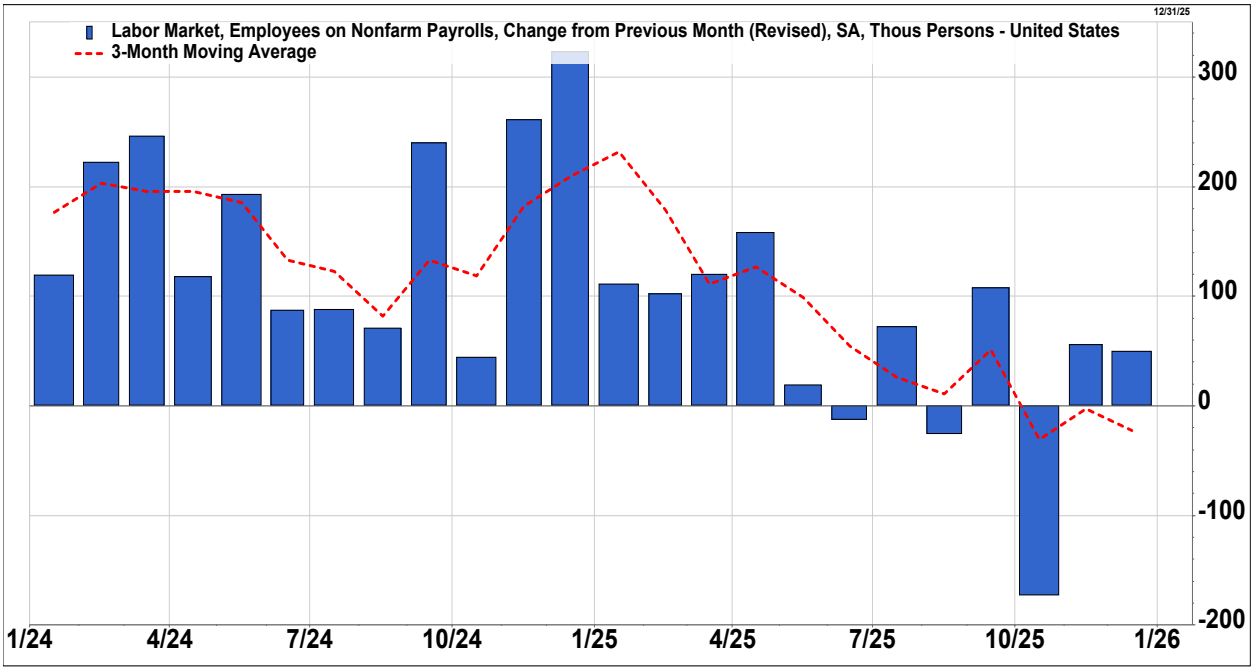


The absolute level of the unemployment rate is not causing much angst, but the direction of travel is certainly causing some concern. The unemployment rate has now increased by 1% from the cycle low of 3.4% that was experienced in April of 2023. Generally, whenever there is a 1% increase in the unemployment rate, it is likely that the economy is headed toward, or already in a recession.



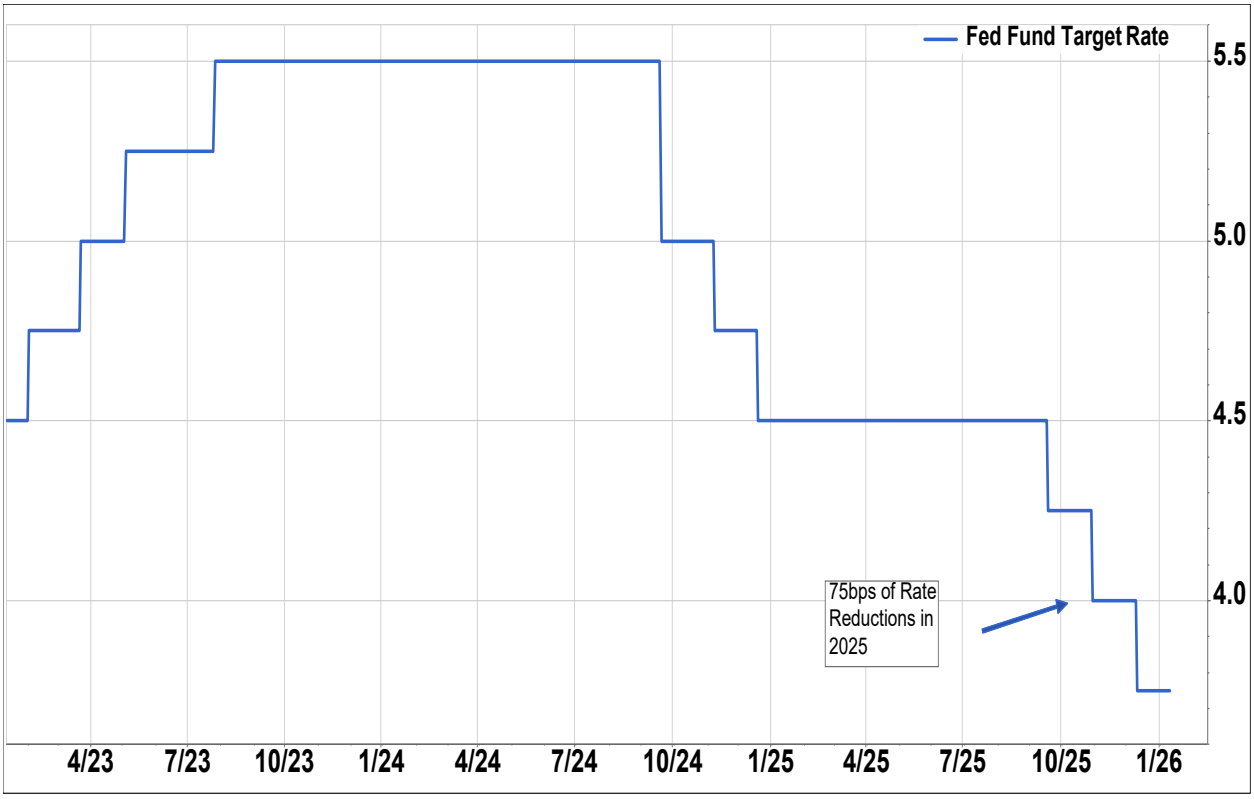
The confounding detail here is that normally after a 1% increase, the labor market would be much weaker than what we are currently experiencing. The job market is essentially back to parity between the number of unemployed persons compared with the number of job openings. This represents a significant departure from the peak degree of imbalance experienced during 2022, but the economy has still not returned to the long-run average of 0.7 jobs available for every unemployed person.

In total, the U.S. economy added 584,000 jobs during 2025, an average of about 49,000 new jobs created per month. This was a tepid result compared to 2024, when more than two million new jobs were created, which amounts to 168,000 jobs per month. Despite the lackluster job numbers, the more concerning occurrences were the three negative payroll reports that started in June. The economy had not experienced a negative payroll report since December of 2020.



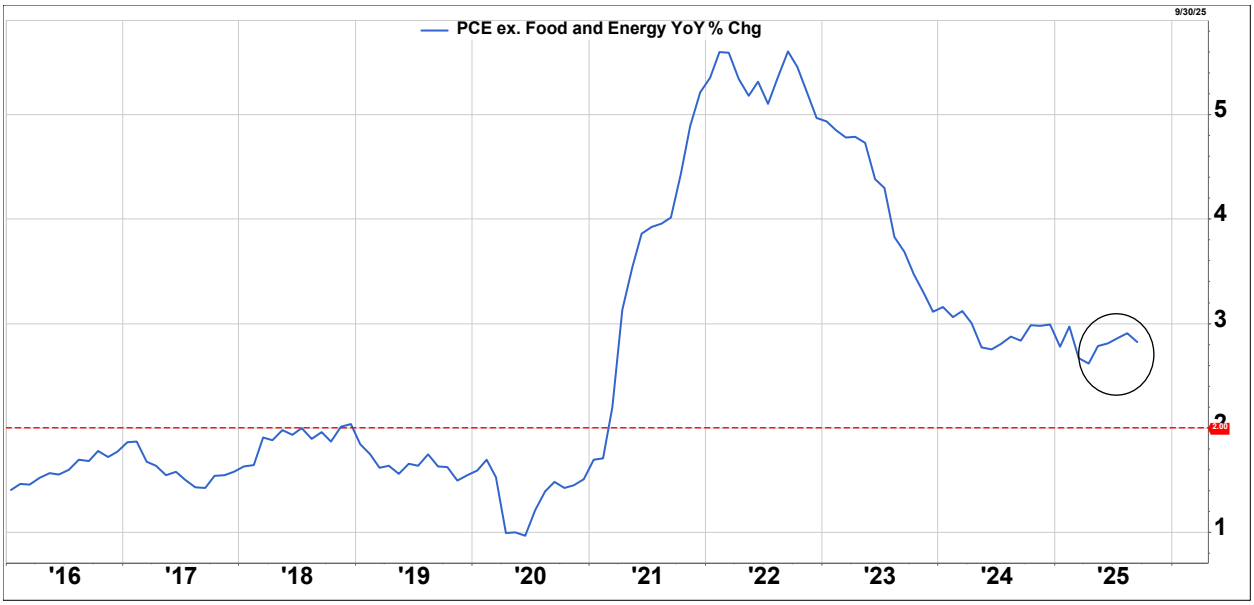
In what may be a mere coincidence, jobs growth had two distinct periods during 2025: pre-tariffs and post-tariffs. Before Liberation Day in April, the U.S. economy had added almost 500,000 jobs, or approximately 122,000 jobs per month. Following the broad imposition of tariffs, only 93,000 jobs were created for the remaining eight-month period, which amounts to just 12,000 jobs per month. It could be a mistake to attribute this change entirely to trade policy. There are a variety of factors that influence the health of the labor market. It also can't be ignored that the change in tariff rates was the single most significant catalyst during the year.

The weakness in the labor market did not go unnoticed by the Federal Reserve. In no uncertain terms, the Fed shifted their focus away from their inflation battle and increasingly moved to support job creation. In total, the Fed lowered their policy rate by 0.75%, in a series of three 0.25% rate cuts during the second half of the year. These followed a full 1% rate reduction in 2024.



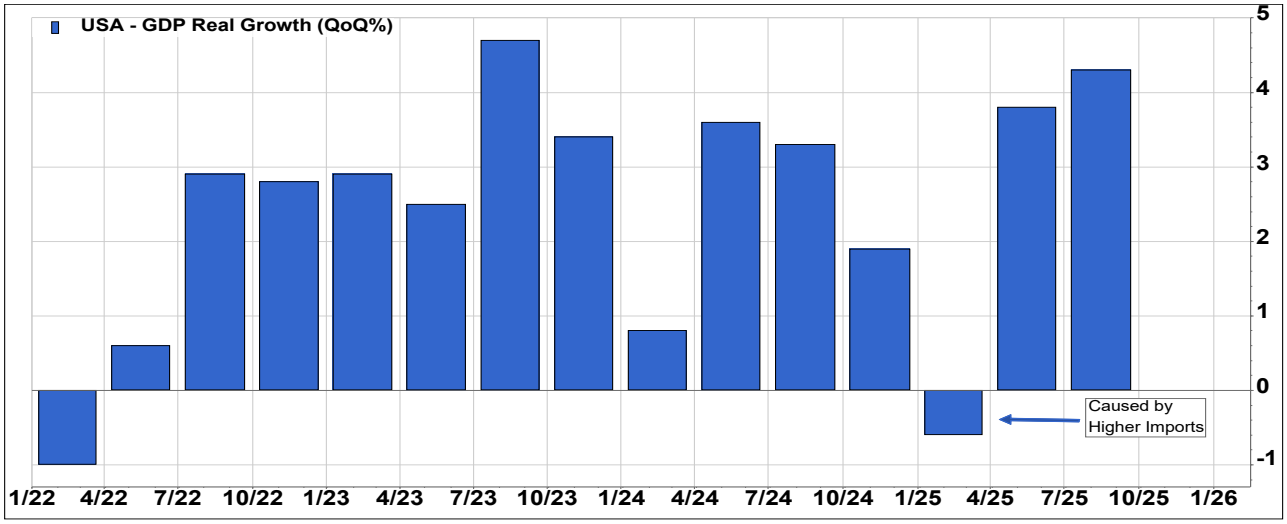
The complicating issue for the Fed was that inflation had not approached its 2% target during the year. If the Fed were to be too aggressive in easing monetary policy to support the labor market, there was a serious risk that inflation could move higher.

As if achieving the Federal Reserve's two opposing mandates wasn't difficult enough, tariffs made the interpretation of the inflation data even more opaque. Core PCE inflation, the Fed's preferred measure, began the year around the 3% mark and initially trended down to the 2.6% low point in April. As with the jobs numbers, it appeared that the inflation story also changed with the tariff announcement.



Following the initial moderation, core PCE trended back up to 2.9% before finally settling in at 2.8% in the September report. The difficulty with inflation readings after the imposition of tariffs is determining what portion of inflation is directly related to these price hikes, and how much of the inflation is related to the natural supply and demand balance within the economy. That is an extremely difficult question to answer and one that is dynamically changing with the passage of time. Importers initially were absorbing a large portion of the tariff duties, but over time, began passing these costs on to the end consumer in the way of higher goods prices. While the numbers are murky at best, the Budget Lab at Yale University has estimated that 60-80% of tariff costs were passed through to consumers. Regardless of the exact figures, the point remains, the interpretation of inflation data has become far more difficult for the Federal Reserve in this new tariff regime.

To the surprise of many, the U.S. economy has emerged from the changes in trade policy remarkably unscathed from a growth perspective. The only slight disruption to the largely healthy trend was the first quarter's negative GDP growth print.



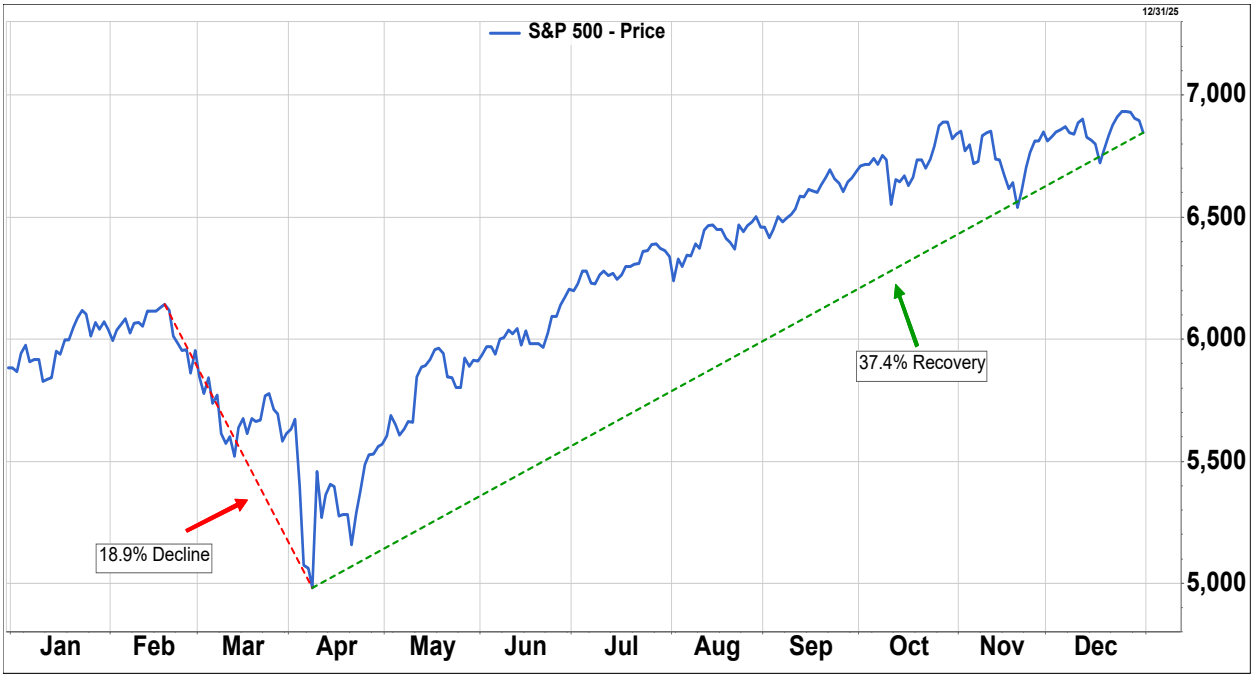
Any negative GDP report rings alarm bells for investors, but the report in the first quarter requires some context to explain the cause. There are several inputs to the computation of GDP, and notably in this case, they are exports and imports. Exports are additive to GDP, while imports detract. The high likelihood that tariffs would be imposed was a hallmark of President Trump's successful campaign, so it was no surprise that tariffs would be arriving soon, in some shape or size. Businesses with global supply chains acted in a rational manner and began to import goods at a higher than normal rate, in an attempt to avoid paying import duties in the future. The result was a large import balance that effectively caused the GDP decline in the first quarter of 2025. The more predictive portion of GDP, consumption, was still positive for the quarter. The second quarter report showed a complete reversal, with the trade portion of GDP accounting for a large proportion of the growth. This is a timely reminder that all economic data cannot be taken at face value. Sometimes, only after looking through the details does the full picture become clear.

The Stock Market in 2025 – A Very Good Year

The Standard & Poor's 500 Index in 2025 accomplished a feat that has occurred only four other times in its history: three consecutive years of gains of 15% or more.

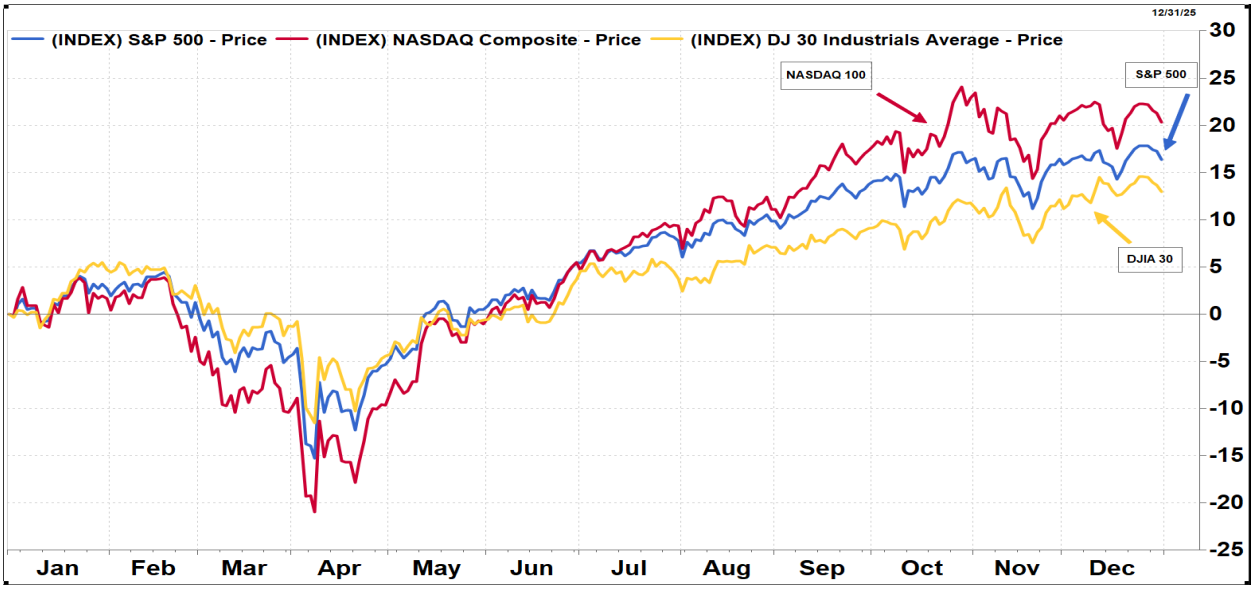
The Index rose 16.39% on a price-only basis last year, overcoming the uncertainties of the President's tariff policies, geopolitical turmoil, the longest federal government shutdown in history, and growing concerns over the possibility of an Artificial Intelligence (AI) bubble.

As was the case with much of the economic data, stock prices also experienced a bout of historic volatility in April as President Trump announced his so-called Liberation Day tariffs, levying import taxes on goods from virtually every nation across the globe and threatening to upend the established global trading system. But stocks rebounded sharply when the President walked

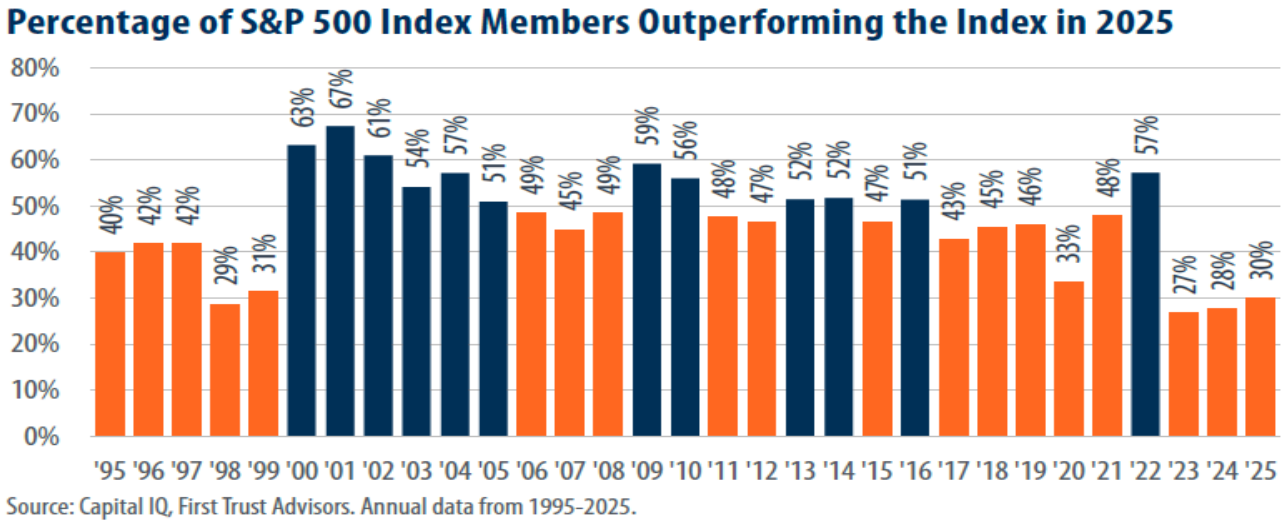


back his most severe threats a week later, and both the S&P 500 and Nasdaq were again hitting new highs by June. Since then, stocks have marched persistently higher, driven by strong corporate earnings and an easing in monetary policy by the Federal Reserve.

As has been the case for most of the last three years, AI was the main driver behind the market's rise in 2025 – and accounted for much of the S&P's earnings gains. The technology-heavy Nasdaq rose 20.36%, making it the best performer among the three major U.S. stock market indices. The blue-chip Dow Jones Industrial Average, the index least exposed to AI and technology in general, rose 12.97%, trailing the other two benchmarks.



It's fair to point out that as generous as the S&P 500's return appears, it continues to be a historically narrow market advance. For the third straight year, 30% or fewer of the S&P's constituent stocks were able to outperform the Index, and 2025 marked the fourth narrowest market going back to 1995.

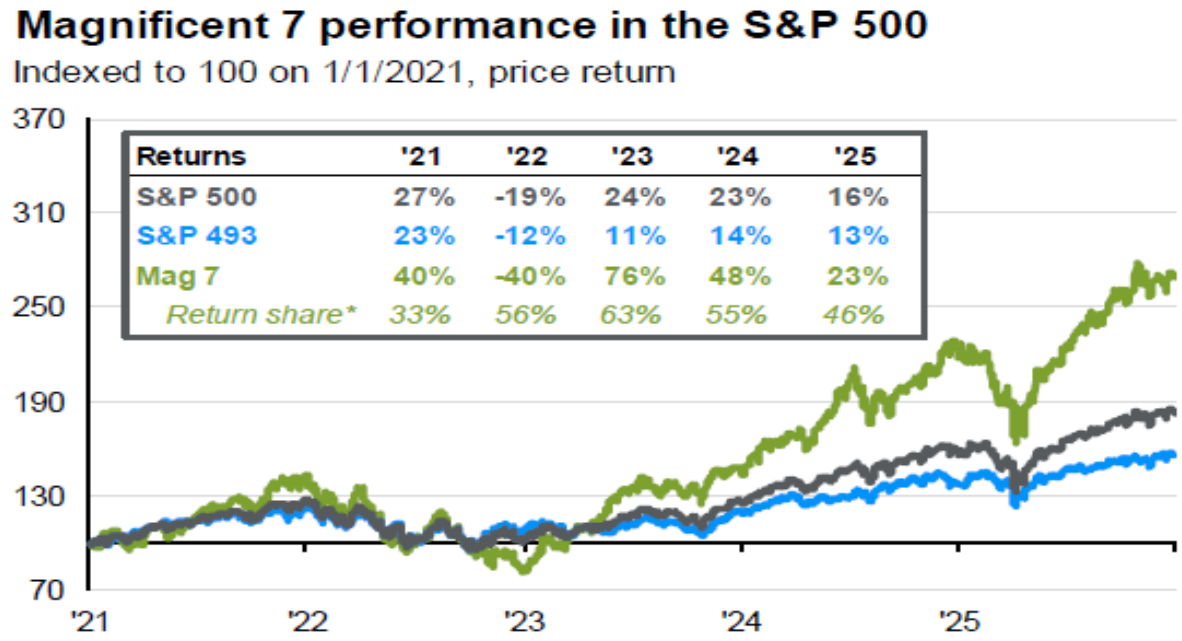


Source: Capital IQ, First Trust Advisors. Annual data from 1995-2025.

The Magnificent 7 Ride On

Technology and AI stocks have powered the U.S. market higher since the last market low in October 2022. The focus on this new technology has disproportionately benefited a small group of companies now known as the Magnificent 7, whose mind-numbing returns have driven them to weightings within the Index that would have formerly been unthinkable. These 7 companies, which comprise just 1.4% of the S&P 500's constituency, account for 37% of the Index's total weight and 46% of the Index's gain in 2025. Their contribution last year to the S&P's gain was actually down from prior years, when they accounted for 63% and 55% of the market's rise in 2023 and 2024, respectively.

In all, 55% of the markets of the market's rise over the last three years has been concentrated in this group of 7 stocks.



The standout among the Mag 7 has clearly been Nvidia, which has risen from $11 at the last market low in October 2022 to its current price $182 – a gain of more than 1,560%! This single stock accounted for almost one-fifth of the market's gain over the last three years, and now represents more than 7% of the S&P 500's total market capitalization. Nvidia's current market capitalization of $4.4-trillion is greater than the gross domestic product of every economy in the world except the U.S., China and Germany – and it is rapidly closing in on Germany.

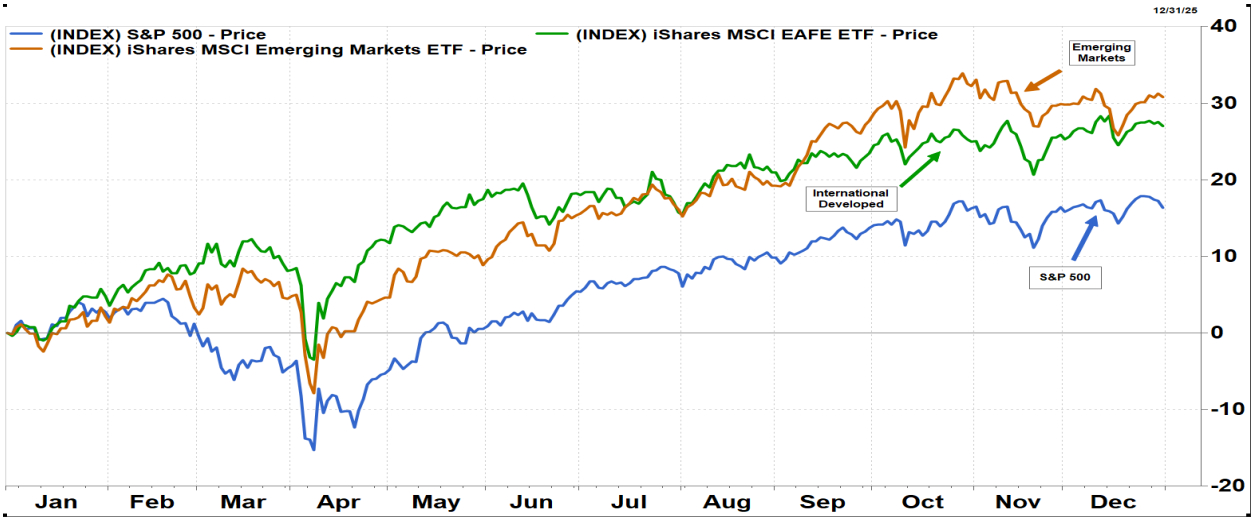
International Stocks – An Even Better Year

As rewarding as 2025 was for the U.S. stock market, international stocks did even better, outperforming U.S. stocks for the first time since 2017. And it wasn't particularly close.

The MSCI EAFE index of the stocks of international developed markets rose approximately 28%, and a similar index of emerging markets stocks rose by more than 30%. When dividends are included, the S&P 500 generated a "total return" of 17.88%, while developed markets returned 31.22% and emerging markets stocks returned 34.36%.

The AI boom has also provided a boost to Asian markets, as tech companies and chipmakers have seen surges in demand. In Europe, monetary stimulus and plans for increasing defense spending have improved economic growth prospects.

Foreign stocks have also benefited greatly from a weaker U.S. dollar. The United States Dollar Index, which measures the dollar against six other major currencies, fell 9.4% last year, its worst year since 2017 – coincidentally the last year when international markets outperformed the U.S. market. When the dollar weakens and other currencies strengthen, assets denominated in those currencies become more valuable when converted back into dollars.



The Bond Market

The bond market, like the stock market, was really a tale of two markets in 2025 – with the line of demarcation being the President's Liberation Day tariff announcement. Overall though, bond yields generally declined in 2025, with the 10-year U.S. Treasury yield beginning the year at 4.57%, and ending the year at 4.16%.

Since bond prices rise when interest rates decline, bonds provided total returns that exceeded their coupons. The Bloomberg Aggregate bond index generated a total return of 7.3% in 2025, its best performance since 2020.

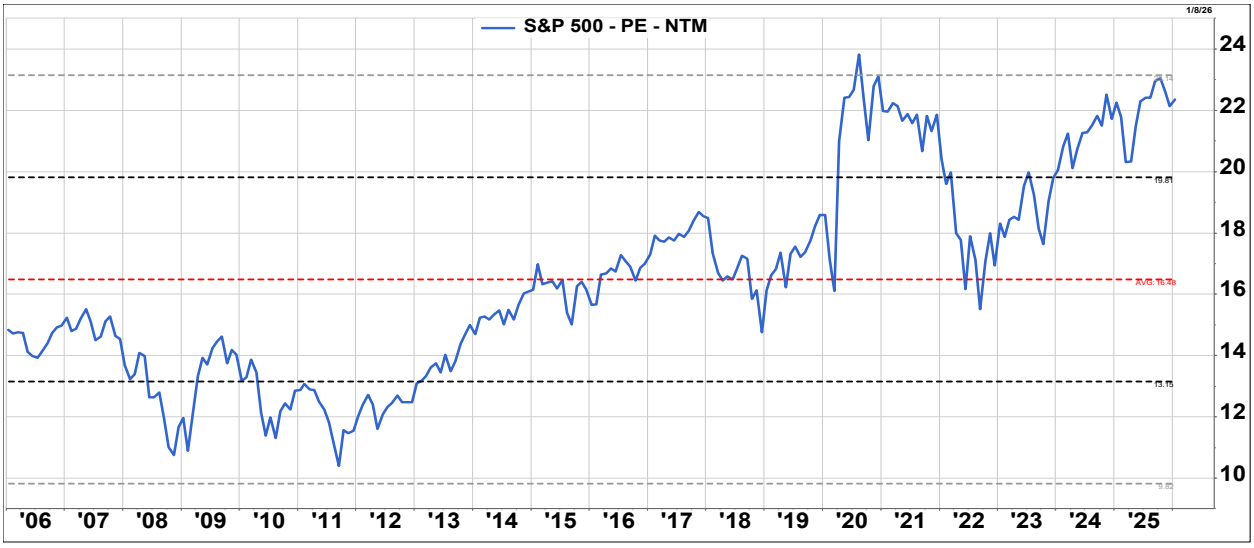
Other Markets

Gold futures rose 64% in 2025, their biggest annual gain since 1979. Other precious metals followed, with silver being the undisputed winner, rising 140%.

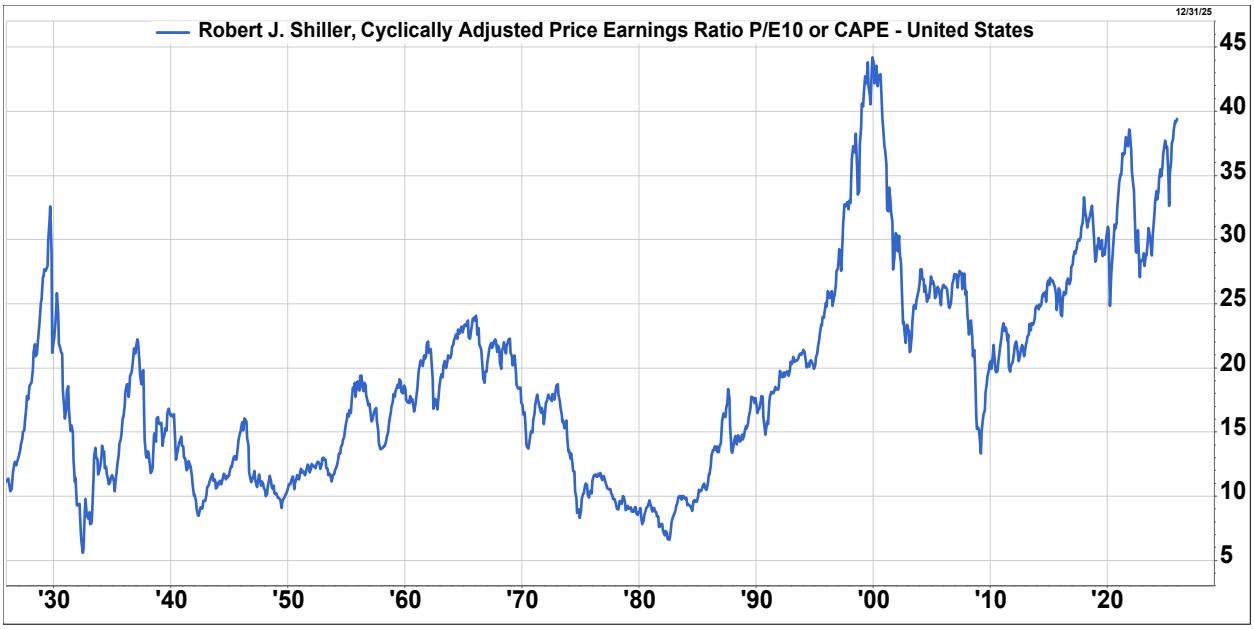
Other tangibles and commodities were mixed last year. Copper prices soared due to increased industrial demand, tariff uncertainty and increasingly fractured trade. Oil prices, though, were whipsawed amid rising geopolitical tensions, but ended the year decisively lower. U.S. crude oil prices fell roughly 19.9% during the year, to their lowest level in almost five years.

Technology Valuations: The AI Bubble?

In what feels like a serious case of Déjà vu, the S&P 500 ended the year trading at 22.5 times its forward earnings estimate, after reaching a peak price-to-earnings (P/E) ratio of 23.3 at the end of October for the year.

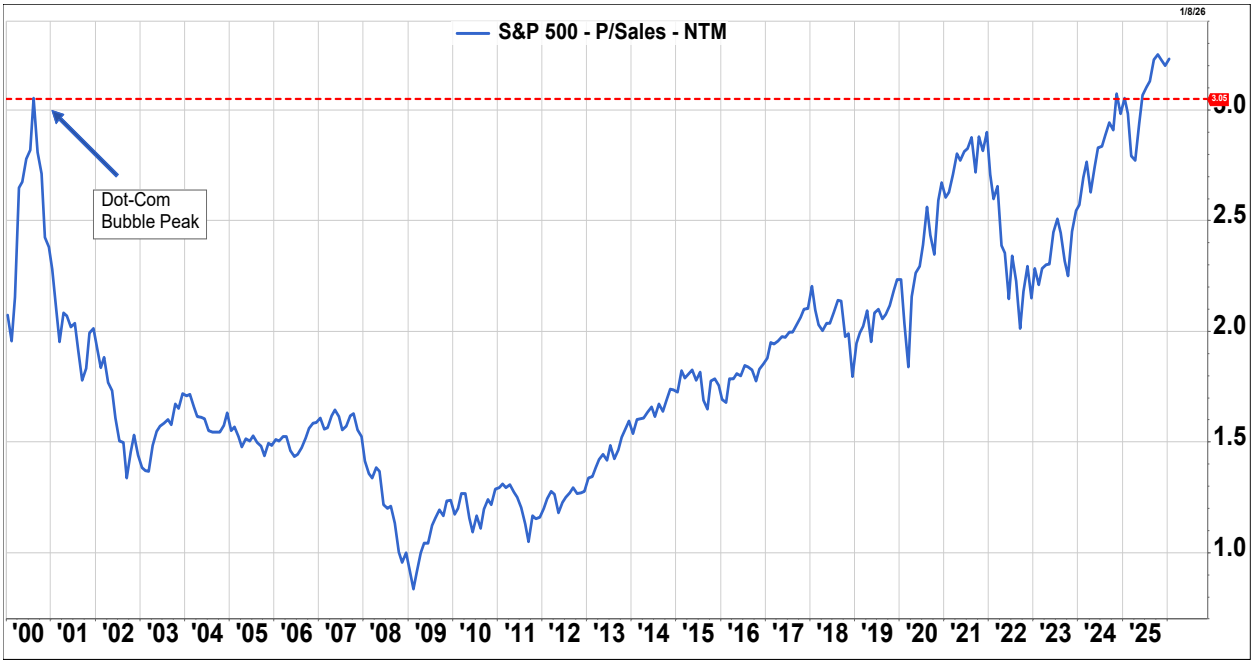


With the conclusion of 2025, this now marks three consecutive years where the S&P 500 traded well above its long-term average valuation level. Robert Shiller, an American economist, developed a modification to the standard P/E measure to address the shortcomings of the volatile ratio. Shiller replaced the single year earnings estimate with a 10-year average level of earnings adjusted for inflation. When this longer-term ratio is used, the S&P 500 Index now trades at the second highest valuation level in the last 100 years!



Only the Dot.Com bubble of the early 2000's produced a higher valuation level than what exists at the index level today based on the Shiller P/E.

The valuation picture is not any rosier when viewed from a sales perspective. Measuring companies on the basis of sales is sometimes preferable to earnings, because sales figures are far more difficult to manipulate. The S&P 500 Index has now surpassed the peak levels of the Dot.Com era. During the 2000 peak, the Index had a forward price-to-sales (P/S) ratio of 3.05.

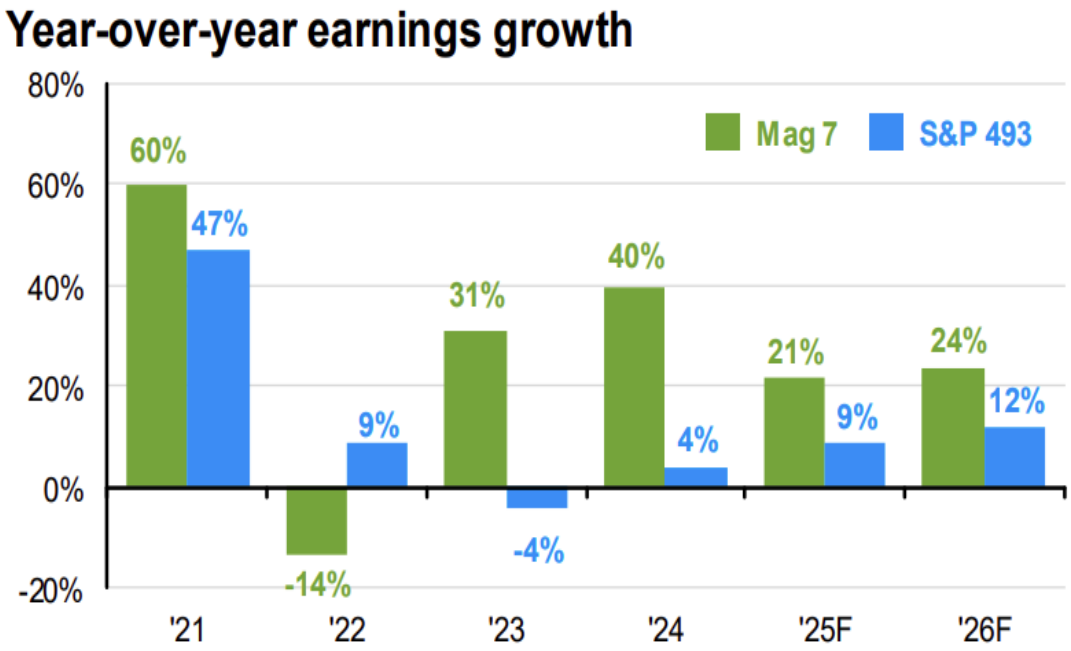


At the end of 2025, the S&P 500's forward P/S ratio had risen to 3.2. For some historical context, the average P/S ratio going back to the start of 2000 through 2025 was 1.86. This means that the Index is now trading at more than a 70% premium to the long-term average sales ratio.

After comparing current valuation ratios to their long-term averages, most investors should be questioning the sustainability of these levels, and rightfully so. We certainly are.

As evidenced time and time again, the most dangerous phrase in the investment management profession is that "this time is different." The phrase is generally used to dismiss concerns in the equity markets in support of a narrative that market strength will continue indefinitely. During the Dot.Com bubble, it was argued that valuations were inconsequential because the internet would be life-changing and these stocks would experience exponential growth. Well, the internet by all accounts has been life changing, but this did not justify the unrealistic multiples that internet stocks traded at in the late 1990's. The value of a technology and the value of a stock are two separate considerations.

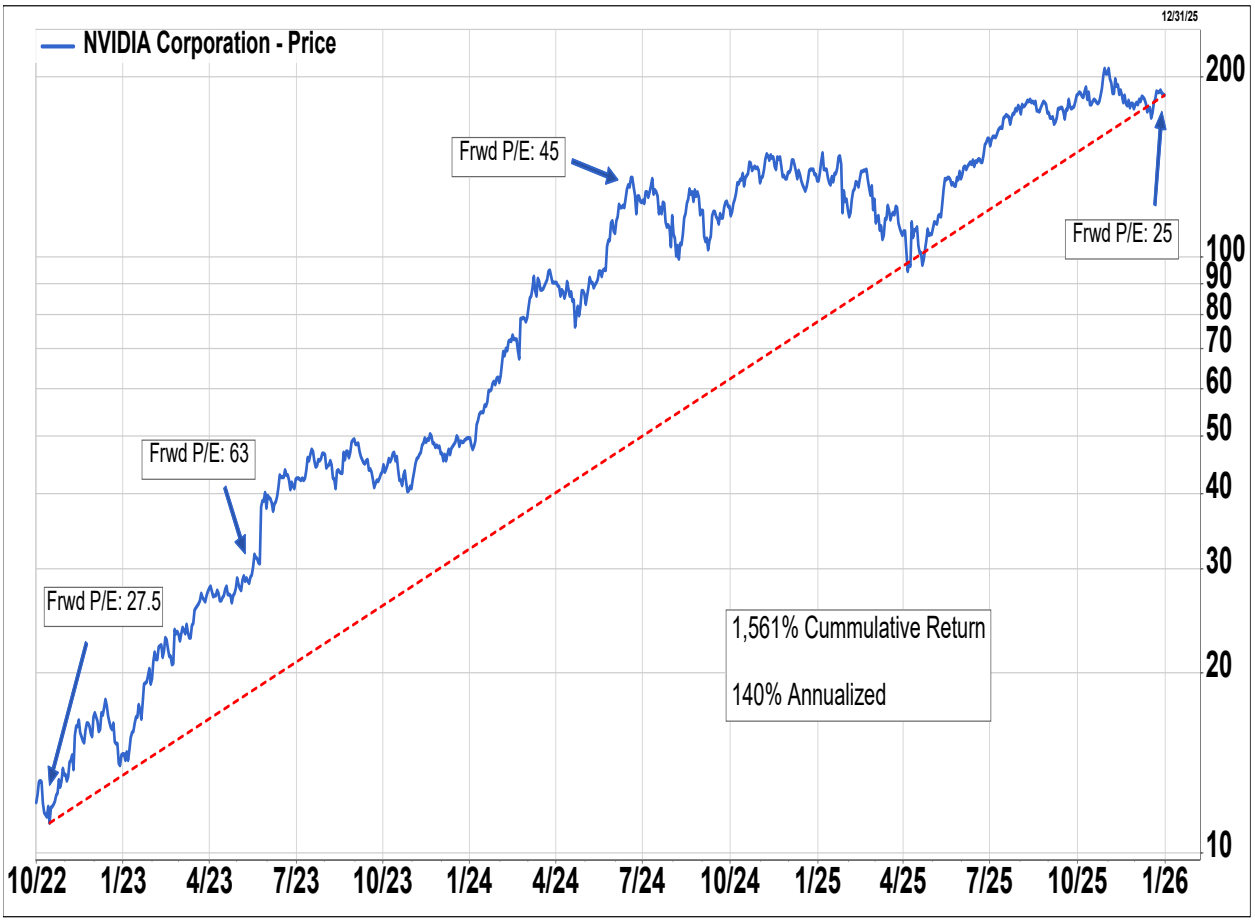
Today, the Magnificent 7 stocks trade at a lofty valuation premium to the already expensive S&P 500 Index. The primary explanation for the historically high Index valuation levels is that the Mag 7 stocks account for almost 40% of the weight in the S&P. What these valuations fail to demonstrate is that these mega-cap technology stocks have accounted for majority of the earnings growth in the S&P 500.



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.

On a compound basis, the Mag 7 have grown their earnings by more than 120% from the start of 2023 through the end of 2025, using estimated fourth quarter results. Over this same period, the other 493 stocks in the S&P 500 have grown their earnings by just under 9%. The growth in earnings by Nvidia, the darling of the AI revolution, illustrates this valuation and growth tradeoff well. In October 2022, Nvidia stock reached a low point at a closing price of $11.23 a share. At that price, the stock traded at a forward P/E ratio of 27.5. Nvidia has appreciated by more than

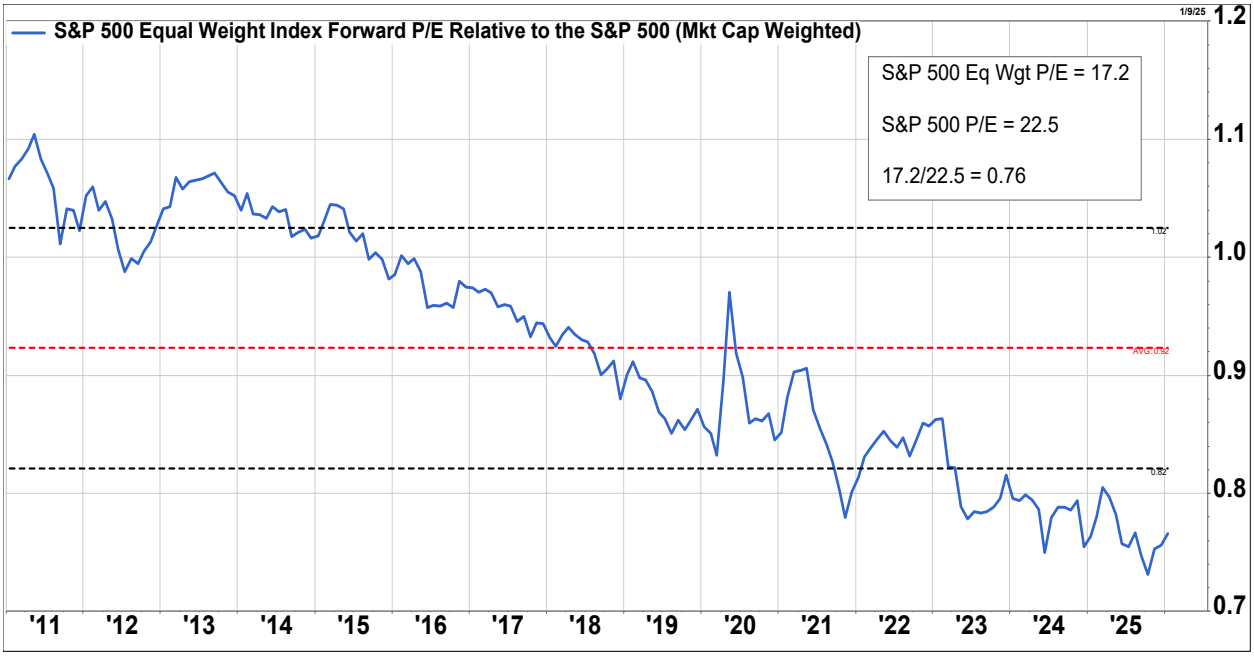
1,560% through the end of 2025 using the October 2022 low as a starting point. What is most remarkable is that Nvidia has a lower valuation today at 25 times earnings!



The rise in the Index over the past three years has led investors to question whether valuations really matter. To their point, since the start of 2023, the S&P 500 has not once traded below its long-term average valuation level despite the nearly 80% price appreciation of the Index. It's true that the stock market can remain richly valued for substantial lengths of time. However, over long periods of time, 5 or 10 years, valuations are much better predictors of future returns. Ignoring valuations can prove to be very costly for investors. Cisco, which was briefly the largest technology company in 2000, is a great example of this. During the Dot.Com bubble, Cisco reached a peak forward P/E of 126 times earnings and a price of $82 a share. Following the burst of the bubble, Cisco fell to just $8. Cisco finally regained its peak bubble price in December of 2025, 25 years later! Cisco could be substituted with any number of Dot.Com darlings, many of which have still not recovered to this day.

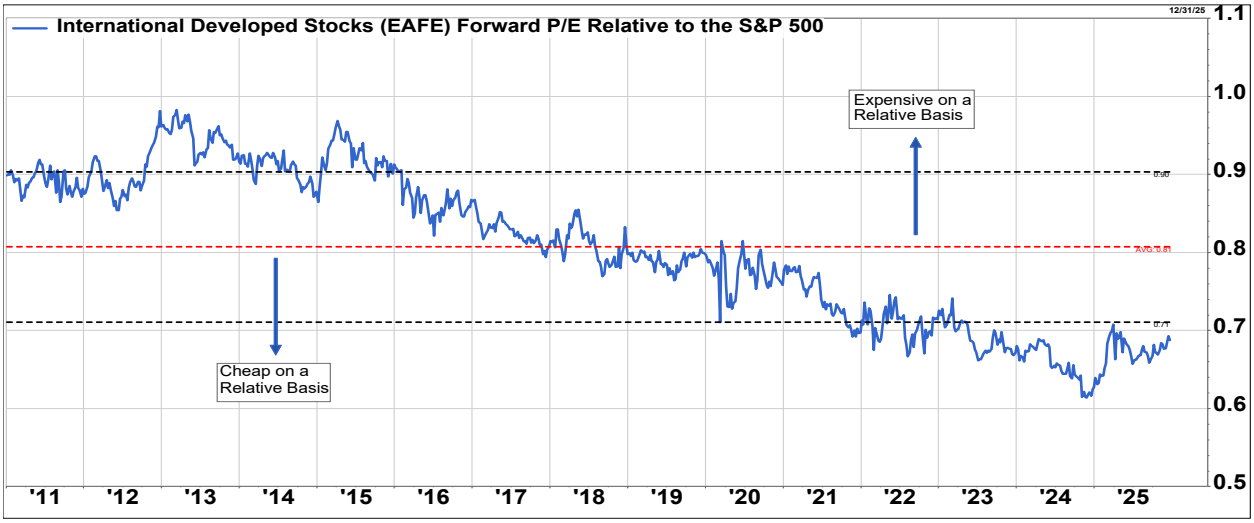
It is impossible to answer the question of whether AI stocks are overvalued given their growth prospects and potential societal impact. There are countless points and counterpoints to support either side of the argument. A better question is whether value still exists within the financial markets, and the answer *so far* is a resounding yes.

Value Still Exists



As a result of the Mag 7 concentration, the S&P 500 Equal-Weight Index, now trades at the deepest discount relative to the market capitalization weighted S&P 500 Index in the last 15 years. This is 1.5 standard deviations below the 15-year average relative valuation of 0.92. This means from a statistical perspective, this is a significant deviation from those historical averages.

Elsewhere value still exists within the equity markets. Even after a 31% rise in 2025, the stocks of the MSCI EAFE Index of international developed economies are still undervalued on a relative basis compared to the S&P 500.



Even more surprising, the same is true of emerging market stocks, which doubled the performance of the S&P 500 Index last year. Emerging markets stocks still trade at a full one standard deviation discount to their long-term relative valuation level.

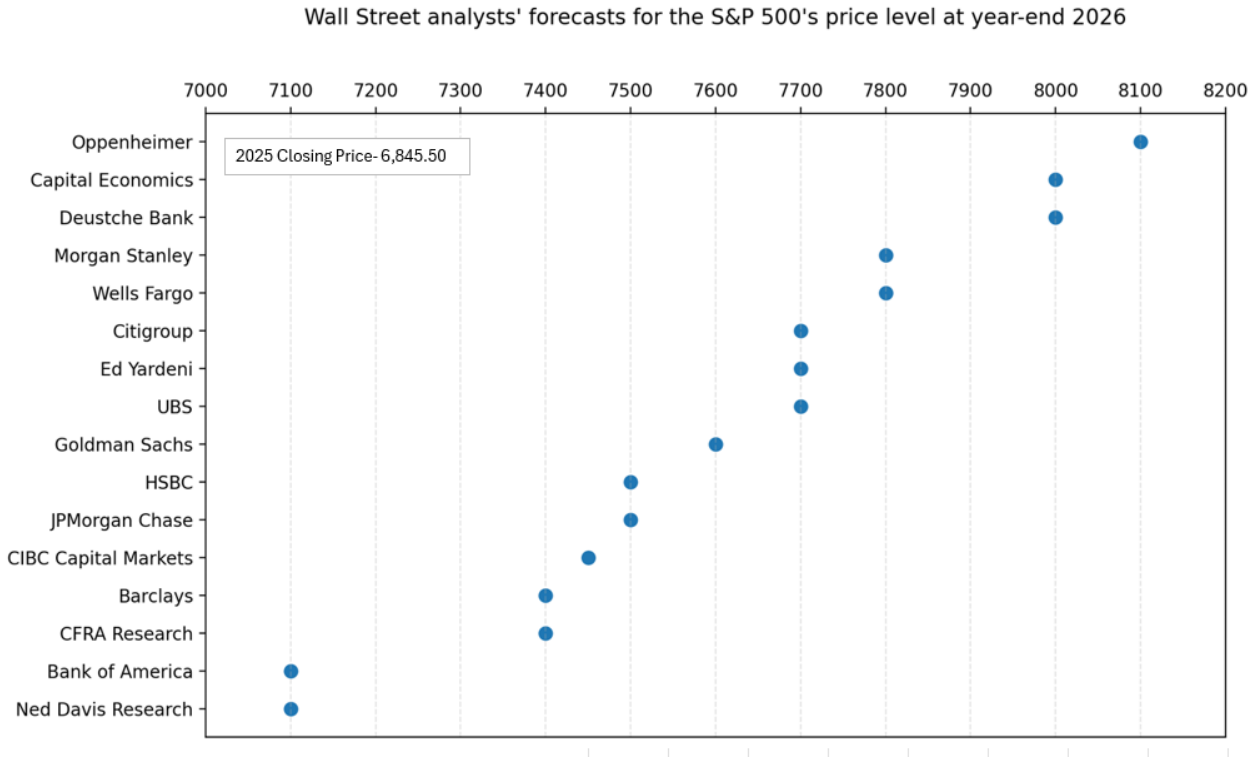
Ultimately, investors need to be aware that if historical relationships hold, future returns will very likely be lower than what has been experienced over the past three years. This is in no means a comment related to the upcoming year, but simply an acknowledgement of the valuation level of the S&P 500 Index.

What Wall Street Is Expecting

We emphasize from time to time that this piece is purposely called an outlook, not a forecast. The latter is a specific prediction of future conditions, while the former is a broader, more general view of likely future conditions.

We have learned that single point predictions to be totally useless in forming an outlook or in managing our clients' portfolios. There are simply too many variables and moving parts in our large and complex economy to lead an analyst to a single view, and the modern, technology-driven economy is evolving too rapidly to make assumptions based on historical norms reliable.

Still, all of the major Wall Street firms publish annual forecasts if for no other reason than that their clients expect them to. And we look to them for what they can tell us about what level of expectations may underlie current market valuations.



Excluding two outliers at either end of the range, forecasts for the S&P 500 at the end of 2026 range from 7400 to 7800. From the 2025 closing price of 6845, the consensus level of 7600 would represent a gain for the year of around 11%, within a range of 8% to 14%.

Analysts unanimously expect record levels of AI spending to continue to fuel profit and price gains. None expressed any concern over possible unintended side effects or potential misuse of this transformational new technology, postponing that discussion for another day. Very few even mention the possibility that future returns on this capital spending binge may prove to be disappointing.

Most analyst note the slowdown in the labor market, but expect that future interest rate cuts by the Federal Reserve will make this a temporary condition. The consensus also expects that the economy will remain resilient and inflation will remain benign, even if the inflation rate remains above the Fed's 2% target.

The major concerns center around valuations, the credit markets, continuing weakness in the dollar, and the worsening geopolitical conditions. Venezuela holds the world's largest proven oil reserves and Iran is the world's 8th largest oil producer, and our actions in both areas are viewed as potentially de-stabilizing. The U.S.-Mexico-Canada trade agreement is set to expire this year, and the unpredictable implementation of our tariff policies remains a concern for businesses forming their future spending and hiring plans.

There are two observations we would make about analysts in general.

The first is that they are generally an optimistic lot, preferring to take the glass-half-full approach to forecasting. History supports this of course, as the economy grows more often than it declines, and markets rise more often than they fall. But there is also a self-serving aspect to this as well, in that they would never want their clients to flee the markets and stuff their money in their mattresses.

The second is that they generally tend to ride their horses in the direction they are going. Forecasts are formed from facts that are already known, while major economic or market inflections are caused by the unknowns. Not a single forecast in 2020 predicted that COVID-19 would lead to a global shutdown that would whipsaw the markets and have long term effects on global trade and inflation. And no one in 2022 foresaw the potential of AI to fuel an historic market advance and potentially transform the economy.

Economic and Market Risks: Fed Independence

The Federal Reserve has been under scrutiny from the Trump Administration for some time, but the pressure has increased exponentially during this second term. It's worth noting that the Federal Reserve is charged with two broad mandates: maintaining price stability and maximizing employment. They have several mechanisms to achieve this dual mandate, but most notably is their ability to set short-term interest rate policy.

Today, we know the Fed as a totally independent organization, but this was not always the case. From the creation of the Federal Reserve in 1913 until the 1951 Treasury-Federal Reserve Accord, the Fed was effectively controlled by the U.S. Treasury Department. Prior to the Accord, the Federal Reserve agreed to keep interest rates artificially low to aid the Treasury in

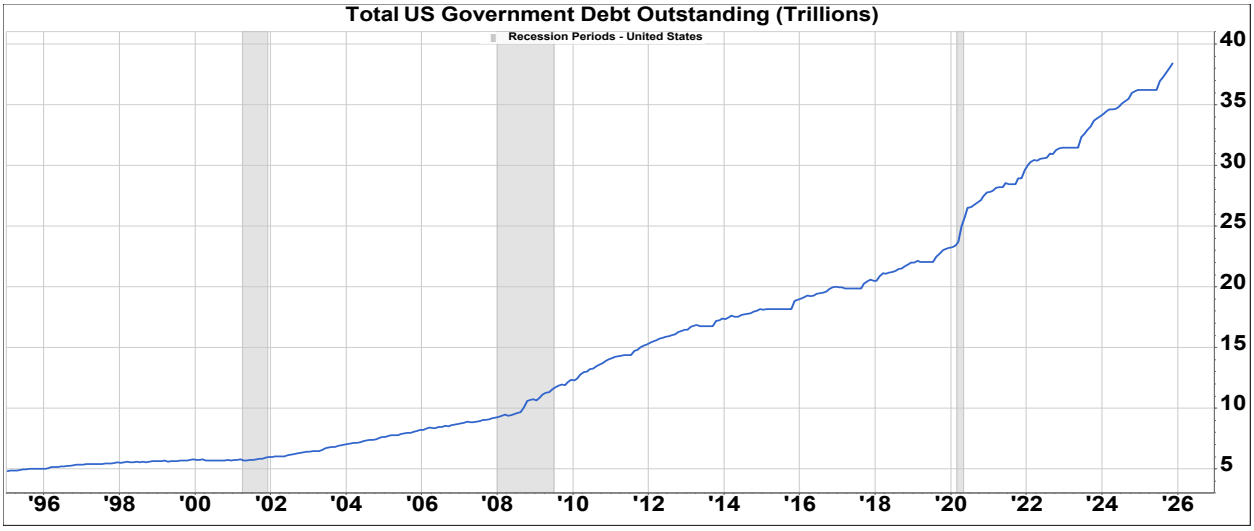
issuing debt cheaply to fund spending during World War II. Short-term interest rates were set at 0.375% and long-term bond yields were capped at 2.5%. It took an inflation spike in the early 1950's for the Fed to finally break ranks with the U.S Treasury.

In achieving its dual mandate, the Federal Reserve encounters the likelihood to set policy in a way that is unpopular from a political perspective. In a scenario where inflation has risen, it's probable that the Fed may slow growth, and in turn, lower the rate of inflation. Politicians are judged, incorrectly in many cases, based on the economic conditions that prevail during their term in office. The reality of the situation is that politicians do not generally have the ability to influence economic growth during their term, at least not to the degree that the public perceives. Most economic booms or busts are independent of who is in the White House, and far more likely the result of the Federal Reserve. To pressure the Fed to modify their monetary policy stance for political gain sets an incredibly dangerous precedent.

If the Federal Reserve succumbs to political pressures, it could undermine its ability to control inflation and promote full employment. Political interference is highly likely to result in decisions aimed at short-term gains, like potentially keeping interest rates artificially low to boost growth before elections, at the expense of long-term stability. Over time, if market participants viewed the Fed as lacking credibility, monetary policy would likely become an ineffective tool.

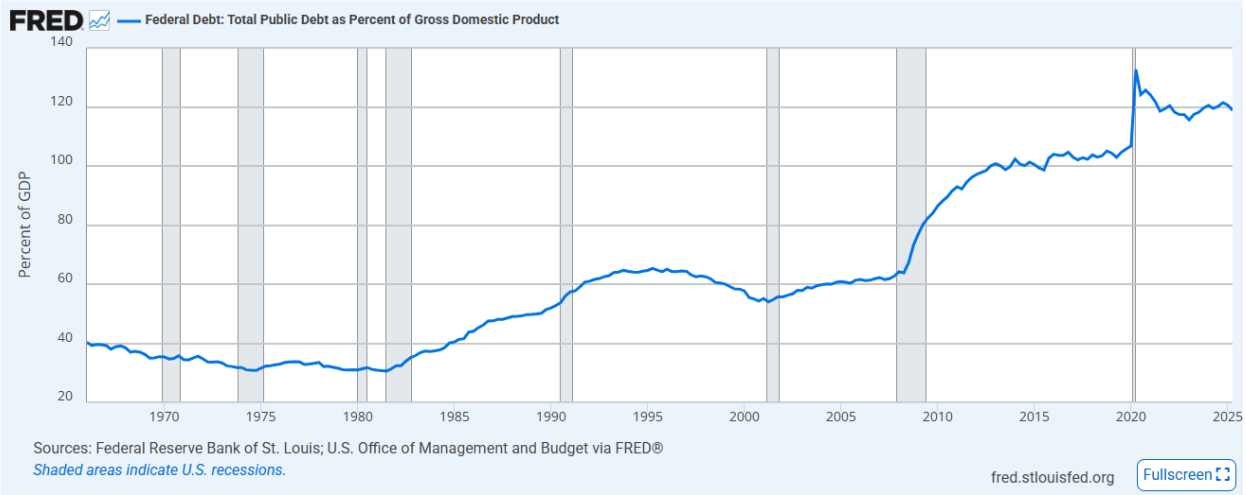
U.S. Government Debt

Analysts and economists are becoming increasingly shrill in their warnings that U.S. fiscal deficits are on an unsustainable path, but these warnings are so far going unheeded by our policymakers.



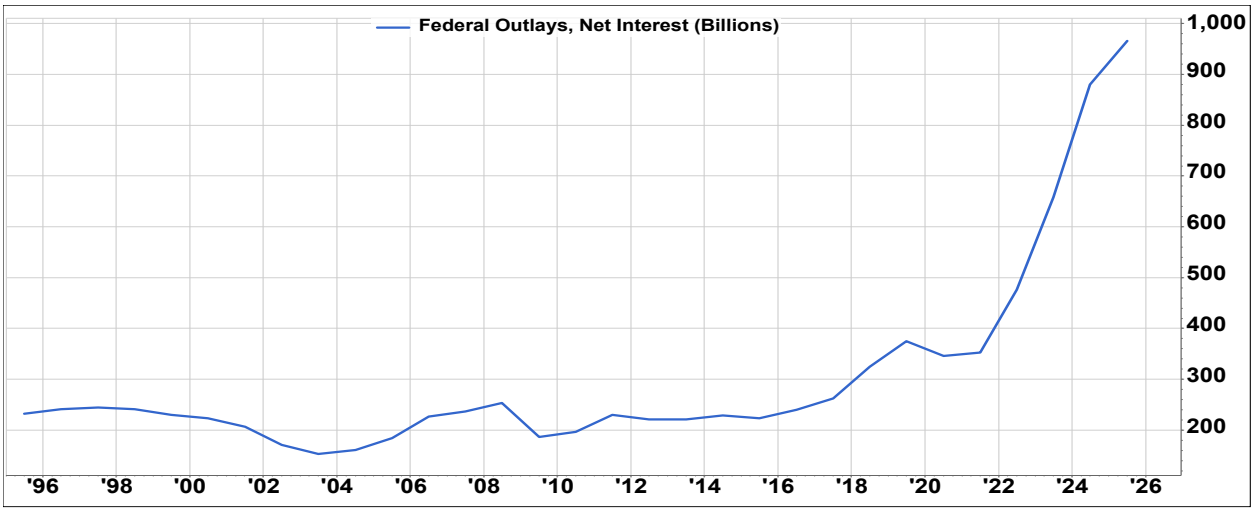
Federal debt outstanding now exceeds $36-trillion – 25% above where it was less than 5 years ago – and it is projected to exceed $38-trillion by the end of the 2026 fiscal year. The number itself is really too large to put into context, until you understand that it amounts to more than $285,000 per U.S. household! It now exceeds 120% of our national GDP. Historically, the debt-

to-GDP ratio had never exceeded even 50% outside of World War II, and had been just 30% as recently as 1980, and was 60% in 2010.



By itself, the actual number doesn't mean much, except for the moral question of passing this burden onto future generations. But the growing expense of servicing the debt must inevitably create downward pressures on other spending needs like national defense, social security and health care. It exerts upward pressure on interest rates, raising the cost of capital for private businesses, thereby affecting investment and hiring. It impacts our national security as 25-30% of the debt is held outside the U.S., including countries who are among our biggest competitors. And as the debt grows, our ability to respond to domestic downturns is lessened. In that regard, it is particularly distressing that we are spending our "rainy day fund" while the economy has been growing and employment levels have been near historical highs.

Interest expense is now the 2nd largest federal expenditure – exceeding spending on national defense and medicare – and it is by far the fastest growing outlay in the federal budget. In fact, interest costs have doubled as a percent of GDP in just the last 4 years.

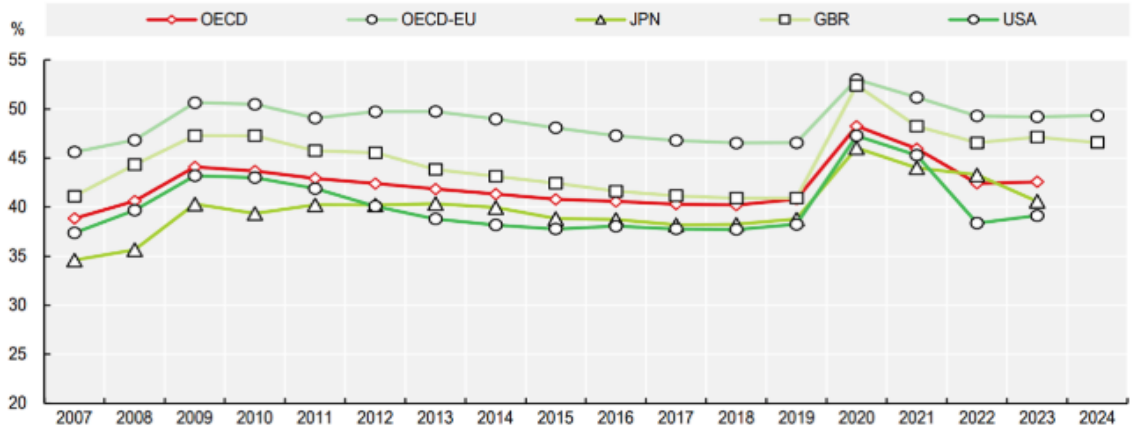


Spending demands on the federal budget appear to be ominous. More "Boomers" are retiring every year, putting more strain on social security and medicare. Health care costs continue to rise as the U.S. continues to spend more than twice as much per person on health care as any other developed country. Growing geopolitical unrest allows little opportunity to reuce defense spending.

Yet, while policymakers continue to roll out poll-tested sound bites about needing to cut spending, the facts tell us that the problem lies elsewhere.

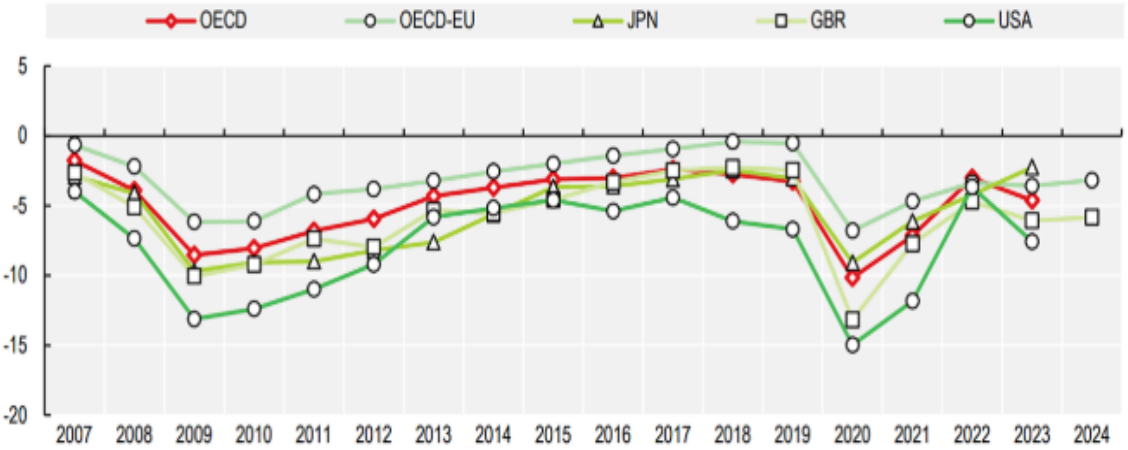
Fact: U.S. government spending as a percent of GDP is **lower** than the average of the 37 countries that comprise the OECD (Organization for Economic Co-operation and Development). Our spending is below the levels of the European Union (EU), Great Britain or Japan – despite the fact that U.S. defense spending is more than three times that of any other nation.

Figure 15.2. General government expenditures as a percentage of GDP, 2007 to 2024



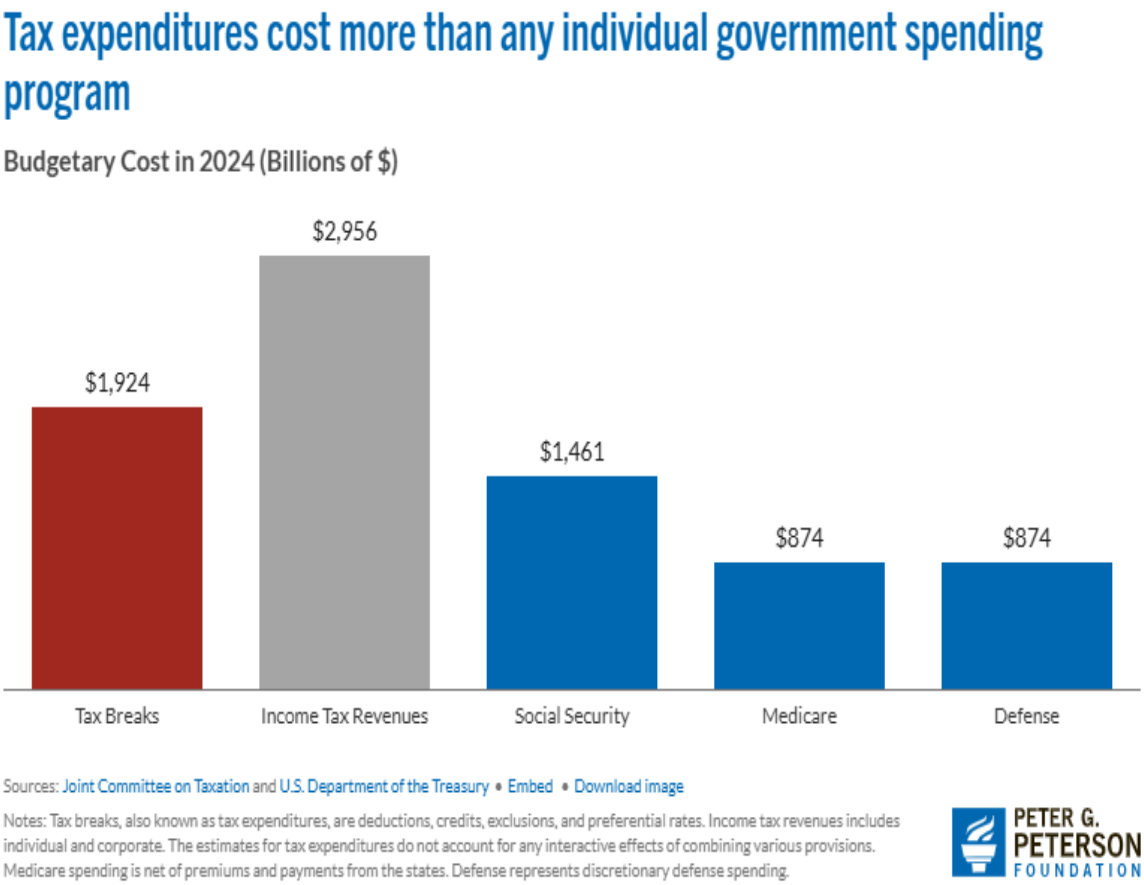
Fact: Despite our low level of spending relative to other developed countries, our annual fiscal deficits are greater than those of the EU, Japan, Great Britain, and the OECD average,

Figure 15.8. General government fiscal balance as a percentage of GDP, 2007 to 2024



Conclusion: The U.S. tax system does not generate nearly enough revenue to pay for our spending needs. U.S. tax revenues as a percent of GDP are the 5th lowest among the OECD countries, exceeding only Turkey, Chile, Ireland, Colombia and Mexico. U.S. corporate tax revenues as a percent of GDP are the lowest of any developed country except Germany.

The Peterson Foundation, a non-partisan foundation founded by Peter Peterson, former Commerce Secretary for President Nixon, has identified more than $1.9-trillion in foregone revenues from these so-called "tax expenditures." This is more than 53% of what the government actually collects in tax revenues, and is more than the government spends on any of its major expense categories. It is also greater than the fiscal deficit of $1.8-trillion in 2024, the year for which these results were reported.



Certainly, there are other contributors to our fiscal deficits, but all of them – including reforming our tax system to its rightful purpose of raising revenue are addressable if our policymakers only had the political will to do so. But so long as 97% of incumbents in Congress are reelected, as was the case in 2024, there is little likelihood of any serious attempts to remedy the situation. So if the electorate is not sending a message that our fiscal irresponsibility must end, it will be up to the markets to do so.

AI Concentration Poses a Risk to Markets and the Economy

The major artificial intelligence hyperscalers (Amazon, Microsoft, Meta, Alphabet, etc.) are projected to spend $400 billion in 2025 alone on their AI infrastructure buildout. This is estimated to account for more than 60% of these companies operating cashflow! Much of this investment is in the Graphics Processing Unit (GPU) chips that power AI applications. The most notable GPU manufacturer, Nvidia, is the obvious beneficiary of this massive spend.

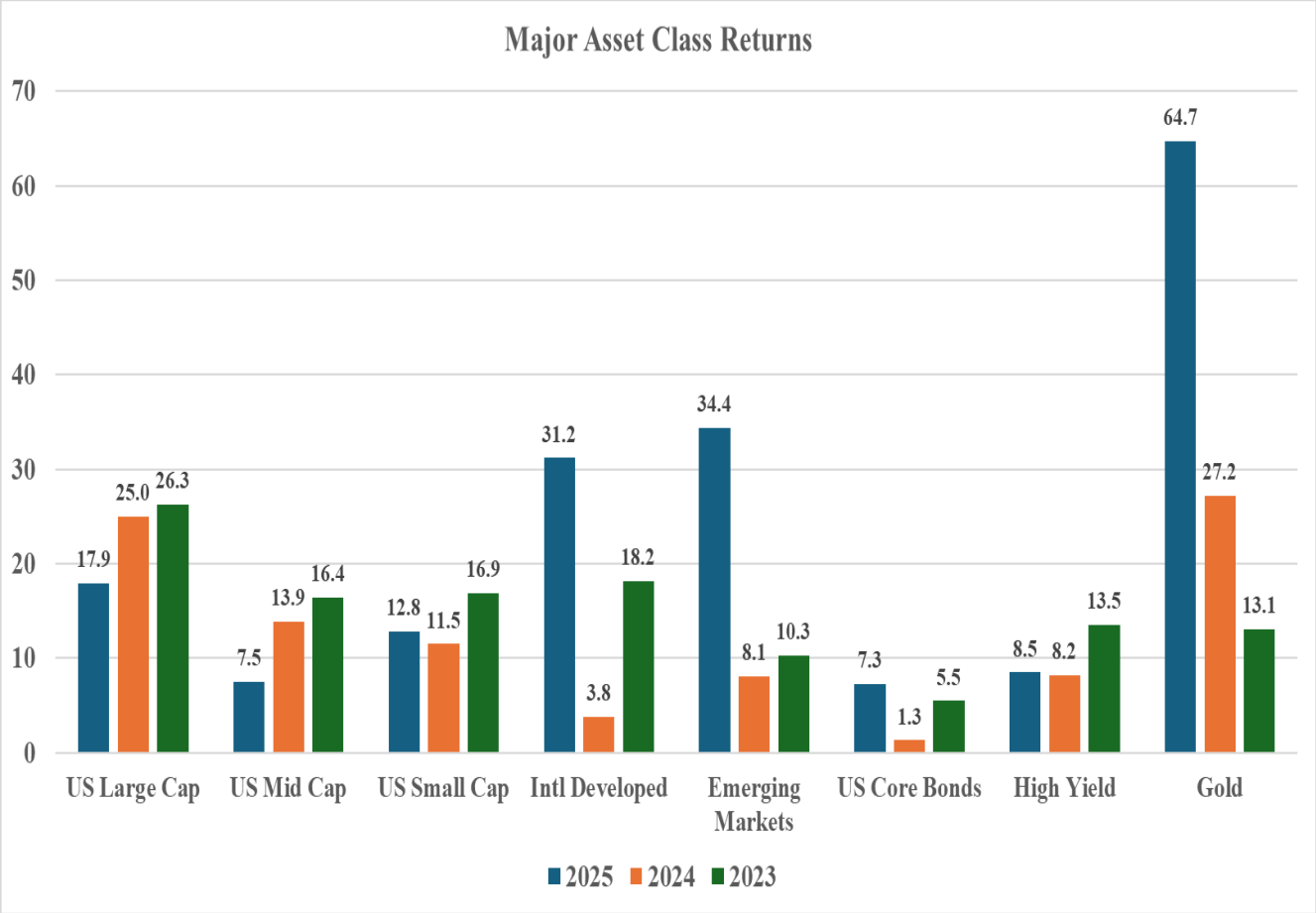
What tends to be overlooked is the degree of concentration in Nvidia's customer base. Just two customers make up 40% of the sales of the largest public company in the world. If this is expanded out to the top four customers, they make up more than 60% of Nvidia's revenues. It is hard to fathom that the largest company in the world is undoubtedly tied to the decisions of just four customers. Regardless of the industry, when a single supplier is so critical to the viability of a market, a systemic risk exists. If even one of these customers scales back their purchases, Nvidia's growth trajectory is likely to be disrupted, which would undoubtably be felt throughout the entire AI ecosystem, financial markets, and even the broader economy.

A separate but related issue is the occurrence of circular financing by a handful of AI companies. As the name suggests, large AI and cloud computing companies are investing in smaller, related companies who in turn use the investment to purchase chips and cloud computing capabilities. This investment loop artificially increases the demand for cloud computing services and GPU chips. If the companies who are making the investment are the direct beneficiaries of that same investment, has any value really been created? The resounding answer to this question is no, or at least no sustainable value has been created through this circular financing loop, despite the appearance of increased demand and earnings.

Final Thoughts

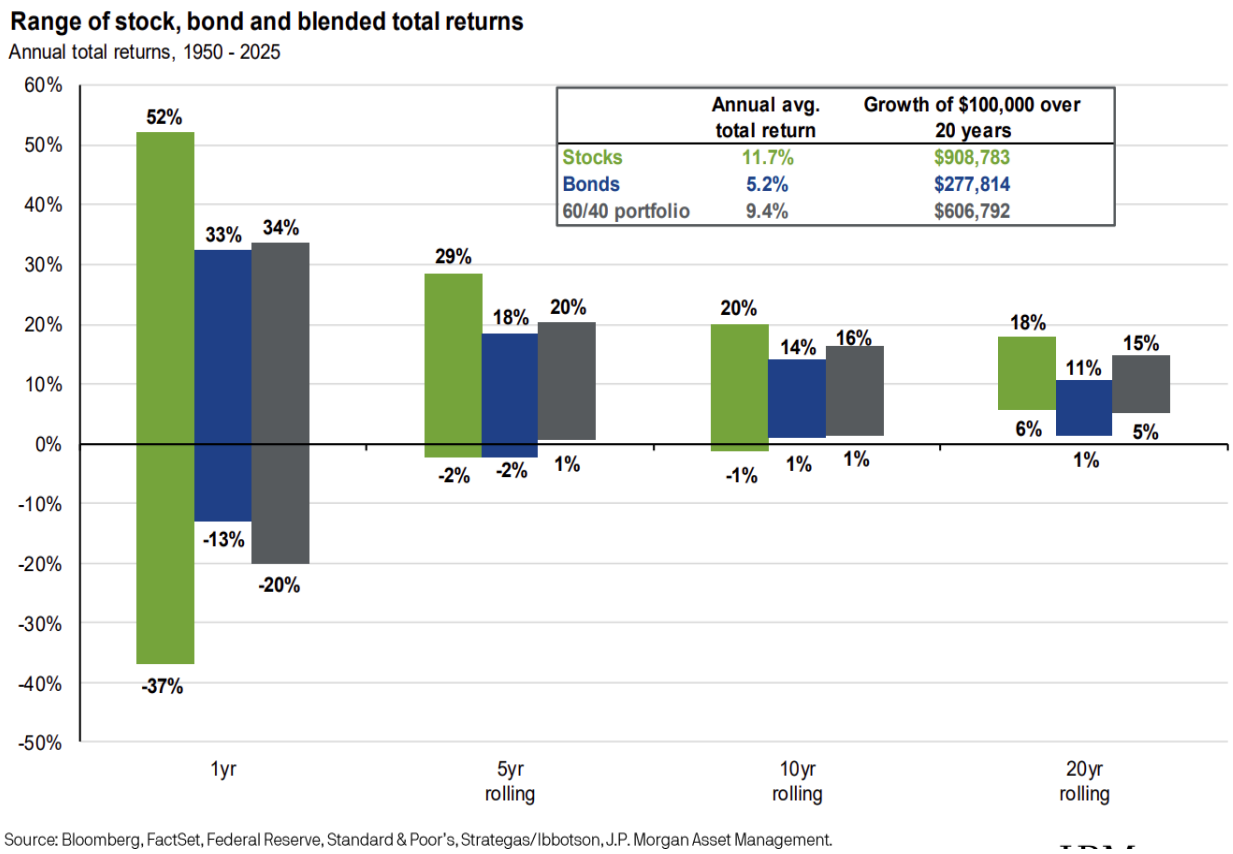
Any market outlook or commentary would not be complete without a reminder of how exceptionally strong financial markets have been these last three years. We have analyzed S&P 500 returns as far back as 1928, during which there have been 96 rolling 3-year periods. The median cumulative gain of these 3-year periods has been 27.4%, which equates to an 8.4% annualized gain. By comparison, the cumulative S&P return over the last 3 years has been 78%, which equates to an annualized gain of 21.3%. This represents the 7th best 3-year market performance of the 96 such periods we have measured. If this same exercise was expanded out to rolling 10-year periods, these last 10 years mark the 9th best on record out of 89 such periods being measured.

If the lens is widened, such strong returns were not limited to just U.S. large-cap equities. Every major asset class that we include in our portfolios has generated a positive return in *each* of the last three years, including mid and small cap stocks, bonds, and international stocks. None of these asset classes has experienced a negative return in any of the last three years. This has not happened in the last 20 years.



It's natural for investors' expectations to be overly governed by their most recent market experiences and it's incredibly easy to forget that these types of returns are the outlier, not the norm. Investors will surely be disappointed if their baseline expectation is for 20% equity returns year after year, especially now when market forecasts are pinned to a single technology whose potential is still largely a matter of conjecture. The same is true of the other asset classes, though to a lesser extent. These comments are in no way an outlook, or an expectation of what might happen in the coming year, just a word of caution to realize that the last three years are more likely an outlier, and not a "new normal."

No matter how much effort, thought, and data go into formulating a market outlook, the reality is that short-term returns are unpredictable. Over the last 75 years, the S&P 500 Index has posted average annual returns of 11.7%, but has posted 1-year gains of as much as 52% and losses as deep as 37%. Bonds, the less volatile asset class, have recorded annual returns as high as 33%, and losses as much as 13%. We have no proof, but we are quite certain that none of the extremes were ever forecast in advance. Markets become predictable as time horizons become longer, as the chart below clearly demonstrates.



Our advice is to have faith in the markets over the long term, and to adjust your risk tolerance accordingly.

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