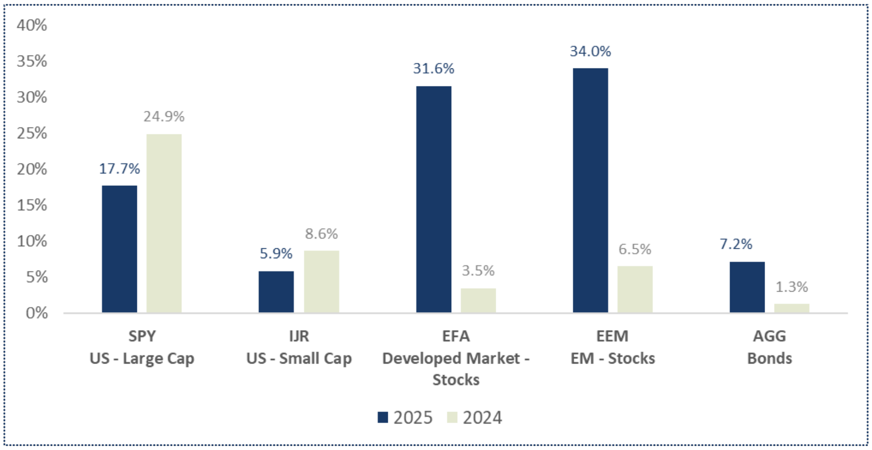
2026 Outlook

"A Public Opinion Poll is No Substitute for Thought" – **Warren Buffet**

Markets finished the 4th quarter up another 2.5% and the S&P 500 finished the year with a gain of nearly 18%. Although we faced a historic decline following the introduction of tariffs, markets quickly rebounded in April and never looked back. The technology trade and AI buildout continued to dominate returns and stocks feel like they are on stable ground with overall earnings increasing by around 10%.



The Nasdaq increased by 21%, but smaller company stocks underperformed as they did not get the relief in interest rates that had been expected. The biggest surprise of the year was international stock performance, with Developed Countries up 32% and Emerging Markets up 34%. These returns were aided by the US Dollar, which declined by 10% over the course of the year, and was the largest decline since 2017. The dollar decline was fueled by the Federal Reserve easing and ever-increasing fiscal deficits.

Bonds, as measured by the Bloomberg Aggregate Bond Index were up over 7% and this was the best performance since 2020. Returns were driven by stronger overall yields and slight appreciation as the 10-year Treasury rate declined from 4.58% to 4.14% during 2025.

Diversifying Strategies had another strong year led by Private Credit, which averaged returns in the 9-11% range. Real Estate transactions continued to increase and the recovery from the prior few years appears to be underway. Below we provide a brief recap of 2025 and our views as we move into 2026 and beyond.

2025 Recap

In our Outlook last year, we alluded to another good year for equities but believed there would be volatility in the first half as is typical in the first year of a new presidency. Historically, markets get frothy following elections and then there is a letdown as the proposed agenda takes time to implement. This time we were introduced to a whole new tariff agenda and markets were caught off guard. From the end of February through April 7th, the S&P 500 dropped by over 20%, as massive global tariffs were proposed. Eventually, the tariff rates were substantially reduced, and they ultimately proved to be a negotiation tactic. Markets bounced in mid-April and gained over 40% into year end. Fears of a tariff induced inflation calmed and the AI technology build gained momentum. The top 5 AI datacenter builders spent over $400 billion last year,

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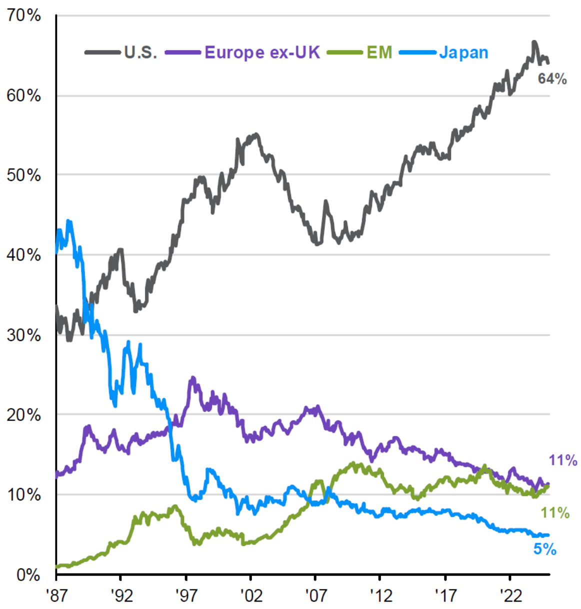
and those dollars filtered through to the rest of the economy and acted as a stimulus for overall economic growth. 2025 showed strong earnings growth, which should end the year up 9-11% once we get the 4th quarter earnings. Margins also continued to expand as companies continued to show increased efficiency. Once again, these numbers were exacerbated by the top 10 companies in size, which now make up 41% of the S&P 500. This is the highest level of concentration in history and is concerning to many professionals should the AI hype slow down. These ten stocks were responsible for 75% of the market's return for the year.

Perhaps the biggest surprise of 2025 was the performance of international stocks, which significantly outperformed the US. This was first time that international stocks have outperformed US stocks since 2017, which happened to be first year of Trump's first term and was also a year with a depreciating Dollar. Over the past 15 years, US stocks have gained 14% per year, while International Stocks have gained 7% per year. As can be seen on this chart, the US share of global stocks has grown dramatically since the financial crisis and is now 64% of the world market capitalization. Is American exceptionalism over? Probably not, 2025 was driven by the Dollar, European defense stimulus and hope of a Ukraine/Russia ceasefire. Most of the Dollar's decline took place in the first half of the year and was relatively flat the 2nd half. Although European Defense spending will go on for 10 years, the initial appreciation we have seen in the industrial names could be front loaded. It's anyone's guess on the Ukraine/Russia outcome, but it does seem like the market is anticipating an end in sight. Europan stocks are still extremely undervalued versus their US counterparts, but they have been that way for 15 years.

Share of global market capitalization

% weight in MSCI All Country World, USD, monthly



Bond performance was quite good in 2025, but it was more a result of the initial setup than anything else. At the end of 2024, the 10-year Treasury yield rose by 1% as the Fed was cutting its rates by 1%. The Treasury Market was seeing certainty of a Trump presidency, which would mean Tariffs (Inflation), tax cuts and deregulation which could boost animal spirits and overheat the economy. As a result, the 10-year ended 2024 near its peak and then normalized to its typical range of the last three years by the end of 2025. The normalization is really what allowed such a great year for bonds and was mostly a recouping of the price losses from the end of 2024. So where do we go from here? Below we discuss our outlook for Stocks, Bonds & Alternatives.

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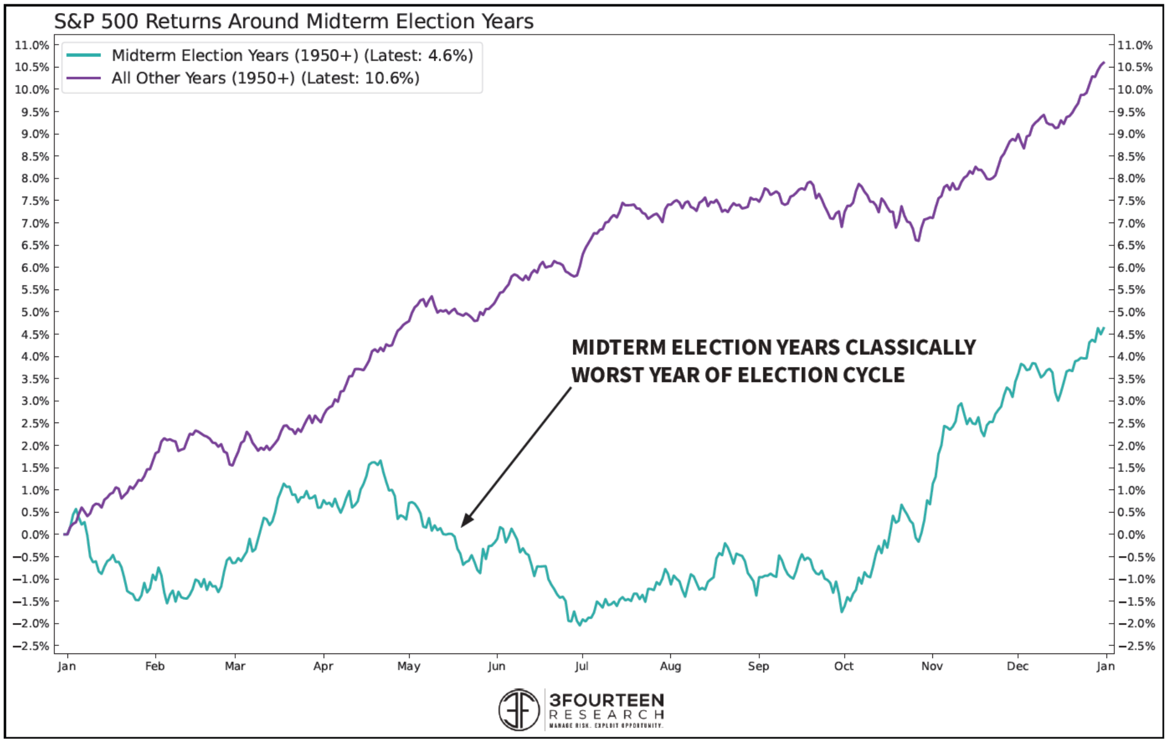
2026 Outlook

"Volatility is the Price of Admission. The Prize Inside are Superior Long-Term Returns
– Morgan Housel

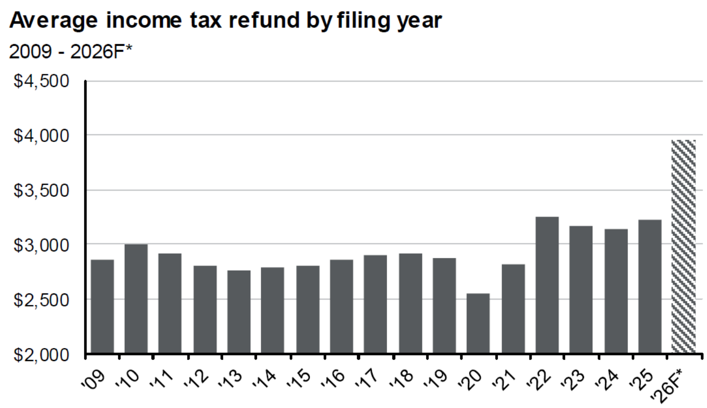
Stock Outlook

During the first half of 2025, the Presidential cycle worked quite well. The chart below shows the returns of all midterm election years going back to 1950. Historically, midterm years have exhibited more downside (17.5% declines) and lower average returns (+4.6%) than any other year in the cycle. Intuitively, this makes sense as markets hate uncertainty and once we get through the elections, there is more clarity. However, after studying the numbers, it's not quite that simple. If we remove the midterm years in which the Fed was raising rates or years in which we were in a recession, the numbers change dramatically and returns increase to 10.6%. Thus, maybe it is a coincidence that market challenges occur in midterm years. Currently, we don't believe the Fed is going to raise rates as they are now easing and we don't see a recession on the horizon.

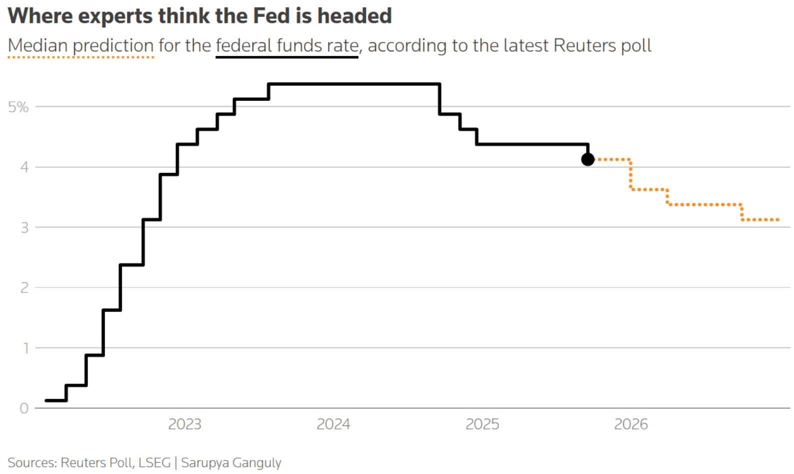


As with every new year, there is a wall of worry as we head into 2026. However, we believe the current setup paints a pretty good picture, at least for the first half of the year. We have three main catalysts that should keep stocks moving higher; the new tax bill, projected lower rates and very good earnings expectations.

OB3 (One Big Beautiful Bill) passed over the summer, and it made permanent the current tax rates and tax brackets that were set to expire at the end of 2025. It also added some inflation adjustments for the 10% and 12% brackets, which will help all taxpayers. For businesses, section 199A (Qualified Business Income) was extended and allows a 20% deduction on business income for many business owners. OB3 restores and makes permanent the ability for businesses to immediately deduct 100% of the cost of qualified equipment and property. This was previously scheduled to drop to 20% in 2026 and should fuel investment by large public companies. There are also new tax benefits for tips and new deductions for Seniors designed to offset Social Security taxes. IRS data in this chart shows that tax refunds are expected to be the largest in many years. With this level of stimulus, we believe the current stock and economic momentum should carry on through the first part of the year. After the 2017 tax cut, GDP was lifted for a few quarters and then reverted to the mean, so this is probably more like a shot in the arm than permanent growth.



Based on the Fed's meeting in December, rates should continue declining in 2026, it is just a question of timing. Although inflation spiked a little this summer, it continues to decline. Shelter, oil and labor all remain mostly dormant at present. Housing is the largest component of inflation, and many geographies are seeing disinflation in rents for both single family homes and apartments. Just to be clear, we are not saying that prices are affordable, we are saying that the rate of increase has greatly moderated and that is what the Fed is measuring. Unemployment rates have crept higher but are still in pretty good shape. Although there has been some noise in the true numbers because of the government shutdown, DOGE job losses and immigration changes. Nevertheless, unemployment rates are very low compared to history. Thus, moderating inflation and stable employment should lead to lower rates.



Analysts expect **Earnings** to grow by 15% in 2026 and then by another 15% in 2027. Although this may seem lofty, analysts actually raised their earnings projections throughout the 4th quarter, which is a very positive sign. Typically, earnings estimates decline into the end of the year. Going back to 2011, only the

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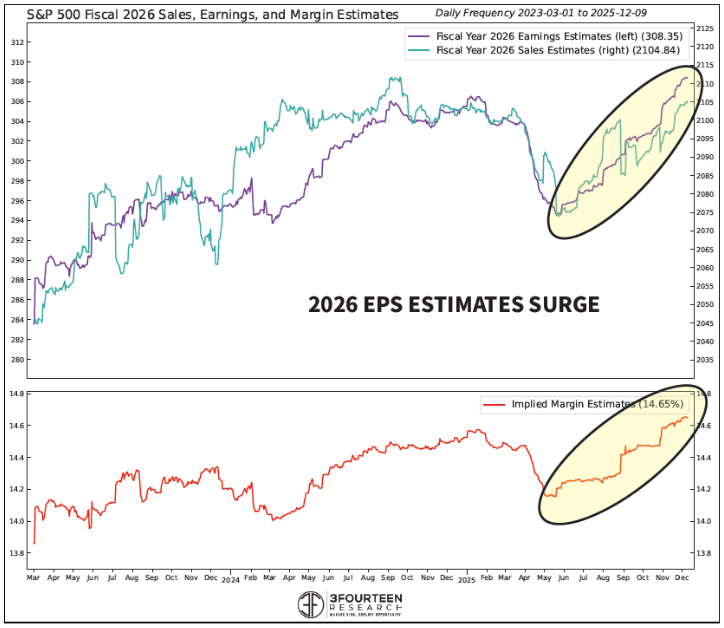
Covid recovery year (2020), saw higher revisions. Sales and profit margins are also pointing higher as indicated in this chart. Most encouraging, all of this growth is <u>not</u> concentrated in the AI boom as 59 out of 62 sub sectors of the economy are projecting positive earnings this year. Although we have historically beaten up analyst expectations for year-end market price targets, we acknowledge this is an impossible prediction. However, based on our research analysts have proven over time to be fairly accurate with earnings estimates. The one caveat



is that in recessions, these estimates become worthless. Nevertheless, in an environment like this, where recession risk appears low, we should be able to expect increasing earnings and margin expansion in the coming quarters.

Stock Outlook (Longer Term)

Although we believe the tail winds are at our back to start the year, we realize that there are always risks lingering. Last quarter we discussed the possibility that we could be in an AI bubble and most of the major AI hyperscaler CEOs have publicly admitted that we are in a bubble, but they must continue to invest or risk being left behind. This is the not the first technological bubble, there have been many in history and this quote from Derek Thompson sums it up, *"The railroads were a bubble and they transformed America. Electricity was a bubble, and it transformed America. The broadband build-out of the late-1990s was a bubble that transformed America. I am not rooting for a bubble, and quite the contrary, I hope that the US economy doesn't experience another recession for many years. But given the amount of debt now flowing into AI data center construction, I think it's unlikely that AI will be the first transformative technology that isn't overbuilt and doesn't incur a brief painful correction."* ("AI Could Be the Railroad of the 21st Century. Brace Yourself." November 4)

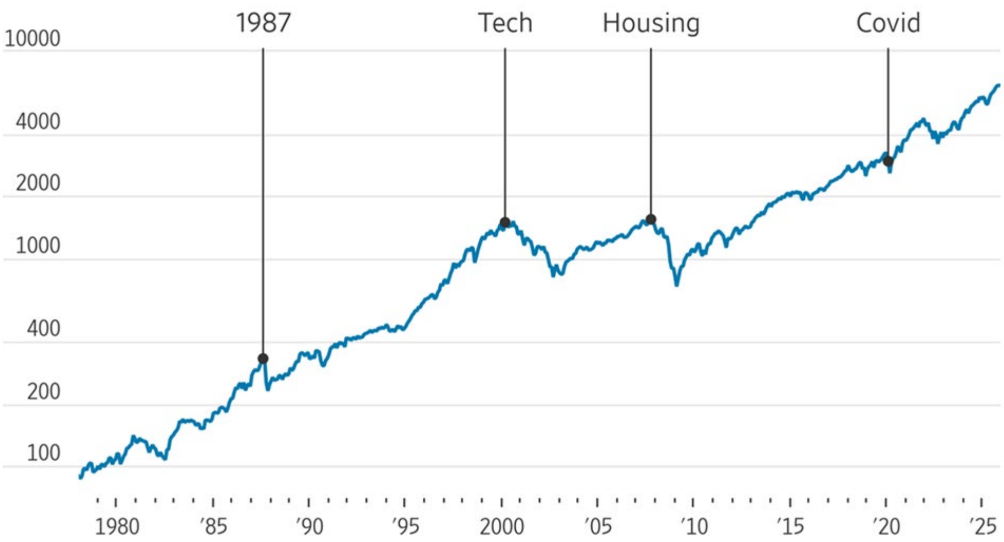
So how do we know when the bubble is going to burst? No one truly knows! The late stages of past bubbles have demonstrated extraordinary returns and can go on for much longer than expected. Below are some of the warning signs we are monitoring:

- There is still no proven return on investment (ROI) for AI and the more models that we have the more they become a commodity. This is the year we need to prove these capital investments are profitable.

- We are in a massive AI race with the Chinese. China has spent 1/20th of the dollars as US companies have spent and their models are nearly as good. This needs to change.
- Data Center roadblocks include the scarcity of electricity, water and local communities saying, *"We don't want these in our back yard."* This is slowly becoming an issue.
- Regulation has been nonexistent and this powerful technology will most certainly fuel bad actors and will force regulators to act.

We believe a well-designed investment portfolio is the best defense against this potential bubble. The old adage of not putting all your eggs in one basket certainly applies here. Usually, what goes up the fastest is also what drops the hardest. There are many great stocks that have been left behind by the AI names and although the market itself is now very concentrated in technology, investors have many great investment choices. We all worry about the big drop, but most drops are concentrated in sectors or industries. As can be shown the in the chart below, the "big drop" of greater than 30% is actually quite rare and has only happened 4 times in the last 45 years.

S&P 500 Index with declines of at least 30%



Note: Data are shown on a logarithmic scale.
Source: FactSet

Fixed Income Outlook

The fixed income markets remain in good shape. Corporate and High Yield spreads remain historically low. These spreads are a measure of the anticipated risk in the bond markets. Corporate bonds look solid, and investors should expect yields in the range of 4-5%. Of course, the direction of overall rates will have a positive or negative effect on total return on bonds and although impossible to predict, if the Fed moves rates lower, it may have a positive impact on bonds.

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Floating rate bonds have been very good performers over the past several years and should continue to provide diversification and a high level of income. The overall movement of rates will have little impact on floating rate returns, so this continues to be one of our favorite areas in the fixed income markets.

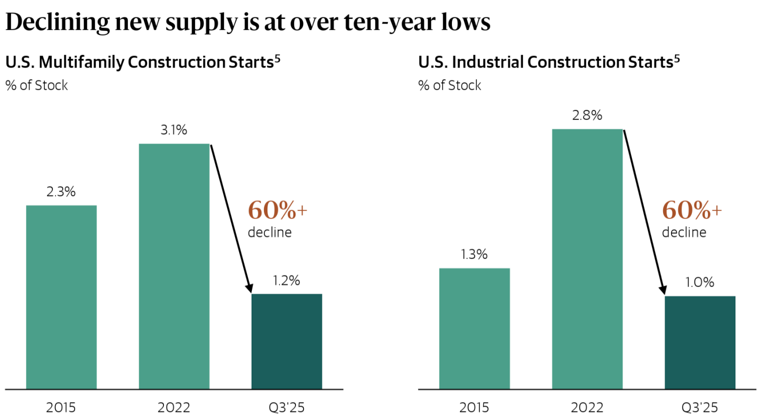
The fed funds rate should decline again this year with The Fed indicating 3 potential rate cuts. With rates declining, this will continue to push rates on savings, money markets and CDs lower. Therefore, we see this as a pretty good time to allocate back to traditional fixed income versus the short-term instruments.

Private Markets Outlook

As a reminder, we use private markets as a diversifier to both stocks and bonds as well as a source of returns. The two main ways that we invest in private markets are through real estate and private credit.

The previous three years of the commercial real estate cycle have been defined by higher rates, with the 10-year Treasury holding above 4.00% for most of that time after more than 15 years below 3.00%. This higher-rate environment led to a bid-ask spread between buyers and sellers that measurably slowed transaction volume. In parallel, debt markets tightened, and assets purchased before the 2022 rate hikes faced challenges because many loans were variable-rate, creating cash flow pressure. In 2025, debt costs and the availability of financing improved compared to the tightest conditions of 2024. The lending landscape has grown more diverse as the private credit sector has been flooded with new participants. With strong competition among lenders to deploy capital, financing terms have generally improved. We expect 2026 to continue the trend of 2025. Banks and balance-sheet lenders may also re-enter to the market, which would support an incremental increase in transaction volume. In 2025, buyers and sellers also capitulated and finally met on pricing. Sellers are increasingly coming to terms with “higher for longer” rates. Sales volumes were up 17% year-to-date (through October 2025). Private fund managers increasingly report being under-allocated to real estate in 2025, a positive sign for 2026 deployments. Some investors may view the stability and income-producing nature of real estate as attractive and reliable in today’s environment compared to the volatility of equities.

Industrial vacancy rates have steadily increased since 2022 as the development pipeline and new supply accelerated. The development pipeline peaked in 2025. From 2026 to 2028, Cushman & Wakefield forecasts that 230 million square feet of industrial space will be delivered per year, roughly half the average annual pace from 2022 to 2025. As supply moderates, we expect vacancy rates to decrease or remain flat, with rent growth varying by market. Industrial assets continue to look attractive as new supply



declines. In particular, small-to-mid size bay industrial appears to be outperforming larger-scale industrial in occupancy and rent growth, as most of the supply boom from 2022 to 2025 was concentrated in larger-format product. E-commerce continues to be a demand driver for industrial leasing for the foreseeable future, with e-commerce representing roughly 30% of retail sales and continuing to rise.

Multifamily continues to be an attractive asset class for several reasons, starting with a shrinking supply pipeline. Record construction activity between 2022 and 2025 led to higher vacancies and pressure on rents. However, construction starts are down roughly two-thirds from the peak and are at the lowest level since 2012. We expect this to support occupancy and drive rent growth. Housing affordability remains depressed due to the stickiness of long-term rates and the significant appreciation in single-family home prices over the past five years. Many renters are not renters by choice, and economic incentives currently favor renting over homeownership. Given expectations for higher rates for longer and the ongoing undersupply of single-family homes, we do not expect homeownership to become relatively affordable in the foreseeable future.

Private Credit had another solid year of performance, but there was certainly some noise as there were two high profile bankruptcies, Tricolor Holdings and First Brands Group. In the case of First Brands there appears to be considerable fraud through the double pledging of collateral. Although these were high profile defaults, they were a very small part of the $1.5 trillion private credit market. Out of 166 private credit lenders, only 15 had exposures to the default, and it represented just .05% of the total market. Annual defaults in private credit typically average 1.5-2% and 2025 looks to be in that range.

The outlook for private credit in 2026 is solid as traditional bank financing continues to be tight. We are anticipating a major refinancing wave this year, and this new supply of loans should allow lenders to strengthen terms and capture healthy returns. Over the last few years there has been more money to borrow than loans available. We believe top tier managers who are focused on principal protection first and yield second will continue to be the key to success in private credit.

Resources

What We Are Reading:

Is It a Bubble? Howard Marks' most recent memo discusses the AI Bubble.

Smothering Heights? Michael Cembalest 2026 Outlook

Canal Update & Conclusion

Please welcome two new employees to the Canal Capital Team!

Emily Gilchrist joined us in October and will serve as a Family Office & Accounting Associate. Prior to joining Canal, Emily worked at Tuckahoe Holdings for 9 years doing accounting and special projects. Prior to that, she worked in public accounting performing audits. As Family Office & Accounting Associate, Emily focuses on family office client deliverables as well as portfolio accounting. She will also assists with tax support and compliance filings. Emily received her undergraduate degree in Business Administration with concentrations in Accounting and Finance from Roanoke College. She is a Certified Public Accountant (CPA).

Cooper Casillas joined us in December and will serve as an Associate. Prior to Canal, Cooper was with another financial planning firm in Richmond for 6 years and will work with Canal's existing clients coordinating financial planning, tax and investment decisions. Cooper received his Bachelor of Science Economics with a concentration in Financial Economics from James Madison University. He is a Certified Financial Planner (CFP®).

Thank you for taking the time to read this letter. As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall plan or risk tolerance. The New Year is a great time of year to set up a review meeting.

Sincerely,

Canal Capital Management

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