

All I want for Christmas... Are blue skies of policy clarity



‘Tis the season for our annual holiday tradition! We’ve been making a list and checking it twice — trying to figure out which catalyst could make markets nice. Again, we challenged ourselves to determine the single-most important catalyst to drive markets higher in the new year and put it atop our wish list for Santa Claus.

You may recall that last year, we wished for a mid-cycle acceleration. We must have been on Santa’s nice list this year for a change, because we did start to get an acceleration in economic growth as measured by real GDP growth. From the -0.6% print in first quarter, we rebounded to 3.8% in second quarter and the third quarter estimate is presently 3.6%. It remains to be seen whether this trend will ultimately continue in 2026 given the fever pitch of purple haze policy uncertainty from the tariffs and government shutdown that hit in fall 2025 and may still be influencing fourth quarter GDP forecasts.

Additionally, earnings growth over the course of 2025 has been a consistent upside surprise for investors. Recall, we finished 2024 at 10.4% year-over-year growth. For 2025, we expect S&P 500® earnings growth to finish

at approximately 11.4%, and current forecasts for 2026 are 14.2%. We had expected valuations in 2025 would be highly dependent on the path of earnings growth and interestingly, growth surprised to the upside all year, which helped drive strong positive equity market returns.

Further, the path for valuations has been interesting to monitor this year. The S&P 500 is sitting near an all-time high (\$6,887), with next-twelve-months earnings per share for the index also at an all-time high (\$307 per share) and the next-twelve-months price-to-earnings ratio for the index is essentially at the same level where we started the year (22.4x). Economic growth is accelerating, earnings growth is upside surprise-ing, and valuation multiples are cooperating. Getting back on Santa’s nice list? Priceless.

This year, our ask of Santa is for... blue skies as the purple haze of policy uncertainty dissipates! If Santa can clear the haze, investors might finally get a smooth-flying sleigh ride. Our song of the year, “Purple Haze” by the Jimi Hendrix Experience, served us well in 2025 given the hazy macroeconomic outlook on several issues.

So, why does policy clarity top our wish list for next year? Based on the volume and magnitude of potential policy shifts...you could say we are in unprecedented times. However, if we get our wish, monetary and fiscal policies could play less significant roles for markets by the end of 2026 and allow fundamentals, such as earnings and valuations, to come back into focus, which would be a welcome change for many investors.

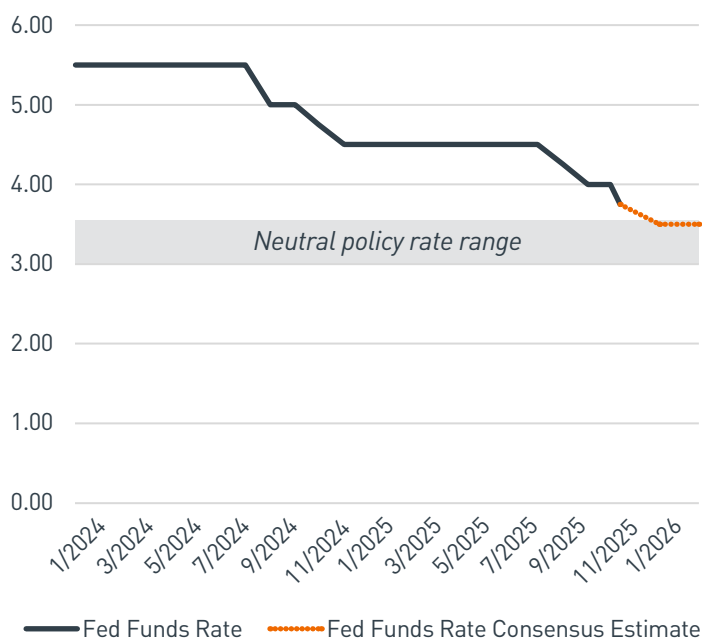
A monetary policy present under the tree?

With 175 basis points of cumulative fed funds rate cuts in place since a peak rate of 5.50% in September 2024, our expectation is that the Federal Reserve (Fed) will likely only deliver one or two additional rate cuts in 2026 (**Figure 1**).

The good news is that by the time we get another rate cut in early 2026, we will have achieved what economists refer to as the neutral policy rate. Think of it like Goldilocks' porridge finally cooling to the perfect temperature — the neutral policy rate implies a dynamic in which monetary policy is neither too tight nor too loose. With a few quarters of lagged effects, the policy stance should be supportive of an acceleration in economic growth over the course of 2026.

Figure 1. Fed Funds Rate (%)

Sleigh ride to neutral?



As of 12/10/2025. Source: Bloomberg L.P.

The bad news is that the S&P 500 has historically viewed rate cuts as tailwinds for a market rally, and in 2026, we do not expect the Fed to deliver many additional rate cuts to sustain a rally. However, we believe the liquidity impact to financial markets from the Fed's \$6.5 trillion balance sheet and various financing programs should help to offset fewer rate cuts. While the Fed stopped its quantitative tightening (QT) program in early December, the balance sheet is still a meaningful 20% of U.S. GDP.

Going forward, the Fed plans to reduce its mortgage-backed securities holdings and reinvest into U.S. Treasuries. While the potential impact of this plan on mortgage rates remains to be seen, the bankrate.com 30-year mortgage rate currently sits at 6.3% as of this writing; it has not been below 6% in three years. Housing affordability for first-time homebuyers has been hovering around the worst level on record as home prices continue to climb despite relatively high borrowing costs.

For months, there has been discussion about “the Kevins” (referring to Kevin Warsh and Kevin Hassett) as potential candidates to succeed Fed Chair Jerome Powell when his term as chair expires in early 2026. Currently, betting markets have the probability of Kevin Hassett becoming Fed chair at a significant level, 74%, according to Polymarket.

Investors are hoping Hassett brings more than just holiday cheer — perhaps a two-turtle-dovish surprise under the tree in the new year. The market views Hassett as the most dovish or market-friendly of the candidates, but the majority of regional Fed presidents tend to lean hawkish.

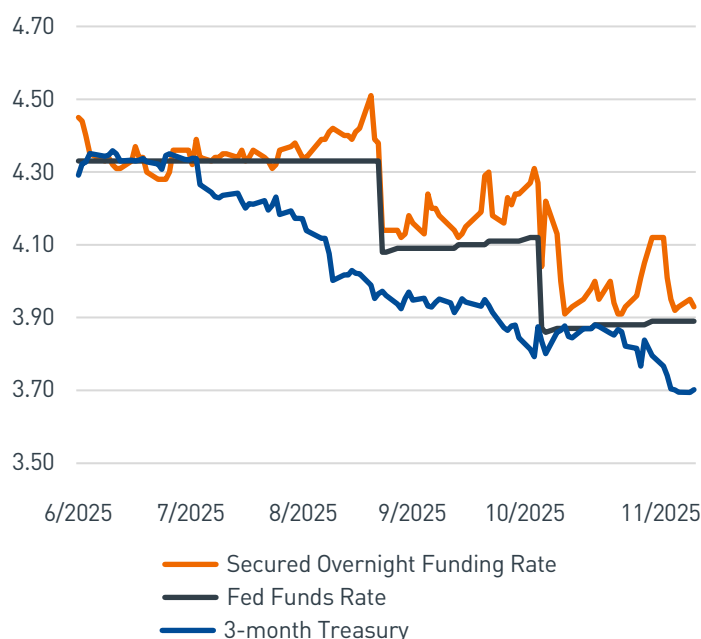
That said, the consensus belief is not that Hassett would be able to unilaterally bring interest rates down significantly from present levels, and the U.S. economy looks to be set on a trajectory that does not warrant it. While most investors are focused on the Fed chair appointment, we believe the overall composition of the Fed is more important; i.e., which governors get reappointed, etc.

Fa la la la financial market liquidity

Despite the Fed's \$6.5 trillion balance sheet, there is some concern that its QT program removed too much liquidity from financial markets. Most notably, in our view, the secured overnight financing rate (SOFR) has been trading above the fed funds rate since August (**Figure 2, page 3**). The U.S. government shutdown amplified the stress in borrowing costs as liquidity was drained from the financial system into the U.S. Treasury's balance sheet.

Figure 2. Short-term Interest Rates (%)

Jingle (repo) bells



As of 12/10/2025. Source: Bloomberg L.P.

Even with the end of the shutdown, the Treasury's balance sheet remains nearly double its three-year average, which means bank reserves have declined to \$2.9 trillion, the lowest level since 2019. Around the beginning of December, the Fed injected \$13.5 billion via overnight repurchase agreements (repos) to help stabilize short-term funding markets — a pre-Christmas liquidity stocking stuffer to keep markets jingling all the way.

We believe it is important to recalibrate this program relative to the policy rate to avoid overcorrecting monetary policy in either direction. If Fed rate cuts are the equivalent of a barrage of multi-colored Christmas light displays, balance sheet management is more like placing just the right ornament on just the right branch of the tree.

While the Fed is like Rudolph's red nose leading the way from a policy easing standpoint, it is important to note that going into 2026, global monetary bank policy is desynchronized, meaning that certain parts of the globe are in easing mode (the United States, United Kingdom and China), while others are in tightening mode (Japan) and the European Union is on pause. It's like a holiday party where everyone's dancing to a different tune — some are tightening, some are on pause and some are spiking the eggnog with policy easing.

The interest rate differentials (and subsequent currency differentials) between the United States (U.S.) and Japan have historically created challenges for equity markets. The last time we had a rapid swoon was in August 2024. At that time, investors who were borrowing yen to purchase securities listed on the Nasdaq Index were also seeing the yen appreciate as the Bank of Japan surprised investors with several policy rate hikes, forcing investors to cover their shorts. This led to a rapid, though short-lived, equity market rotation, with the equal-weighted S&P 500 outperforming its traditional market cap-weighted counterpart. We believe that Japan and the U.S. are back to this dynamic and that investors should take note.

A new source of market liquidity has come from an unexpected place: cryptocurrencies. No, not Bitcoin, but rather, rapidly growing stablecoins, most of which are pegged to the U.S. dollar. Combined, these digital assets total more than \$200 billion, making stablecoins a meaningful player in the U.S. Treasury market and in driving demand for the U.S. dollar. Thus, even as traditional U.S. dollar indices continue to weaken, the combination of the Fed looking to improve market liquidity and the rising demand for stablecoins should be important sources of support for the U.S. Treasury market in a time of elevated macroeconomic uncertainty.

Fiscal policy — festive or frosty?

We expect the U.S. economy to accelerate in 2026. Consumer aid will increase by \$150 billion in 2026 (representing 0.5% of GDP) with most of this coming in the February–April period due to new tax cuts from the One Big Beautiful Bill.

More than \$230 billion in business tax cuts are also in the pipeline for investing in capital expenditures (capex), property and research & development. One of the most underappreciated aspects of the tax bill, in our view, is 100% bonus depreciation on new and used tangible assets. We expect this to lead to renewed capex announcements in 2026 as business investment provisions take hold and tariff uncertainty wears off. In turn, we expect this to feed directly into non-residential fixed investment, helping to further boost GDP. Sounds like Santa's sack is full of tax goodies — bonus depreciation might be the gift that keeps on giving.

We may have reached peak tariff uncertainty and expect this headwind to begin to fade by the time we get to midyear 2026. However, that is also largely dependent on

multiple court rulings. As of this writing, the tariff case is with the Supreme Court, and a decision could be made at any time. Regardless of the outcome of the case, the White House has indicated that they have other measures with which to ensure tariffs remain in place. Therefore, we expect investors to focus more on how tariffs will be enacted, not if. The fiscal policy wildcard also leaves us closely monitoring the trajectory of the U.S. federal debt.

Geopolitical glad tidings

Amid the myriad of geopolitical conflicts currently taking place across the globe, in areas including Ukraine, Venezuela and various parts of the Middle East — will 2026 bring about geopolitical glad tidings and an easing of tensions?

From an investor perspective, markets have historically only focused on geopolitical events for more than a few days if they disrupt oil production, so while we are certainly not betting on specific outcomes, at large, these events remain a wildcard for 2026.

For perspective, despite the number of geopolitical events that have occurred thus far in 2025, U.S. oil production is near an all-time high of 13.9 million barrels per day, and the price of West Texas Intermediate crude oil is down approximately 15% from early December 2024. Even U.S. gasoline prices are down 2% which has helped to offset other sources of consumer inflation during holiday shopping season.

Merry midterms eve

Midterm elections always feel like a challenge of the status quo - change is the only constant, it would seem. The party controlling the White House has historically almost always lost seats in the House of Representatives during the midterms — it turned over in 20 out of the last 22 midterm elections.

The average number of lost House seats in the midterms for a president's party is far more than three French hens — in fact, 29.6 seats! House Republicans currently hold the smallest majority on record, which dates to the Civil War. Based on current approval ratings, this suggests that the Republican Party could lose approximately 10-15 seats in the House in next year's midterms. What's more, U.S. voters have removed the party in power in eight of the past nine elections... we talk about markets being in a high volatility regime, but Washington has also been its own volatility regime of sorts.

There are a few pointed economic and market-based gauges we will monitor throughout the midterm election season.

- Betting odds, according to Polymarket, currently point to a 75% probability that Democrats will take control of the House, and a 34% probability of controlling the Senate.
- Economic data, specifically second quarter GDP, real disposable income per capita and monthly payrolls, can help offer signals that may indicate if the party in power is likely to retain their majority.
- Market performance in the months leading up to a presidential election has historically served as a good gauge, but this holds less accuracy for midterm elections. If the S&P 500 is up in the three months leading up to the presidential election, the party in power tends to stay in power.

A divided government (in which the political party in the White House does not retain majority control over Congress) tends to be the most favorable outcome for the market. Markets prefer gridlock as it limits the potential for significant negative political surprises. A divided government has also historically generated the highest market returns, averaging in the 13%+ range. Markets have historically viewed a Democratic sweep scenario less favorably, but the worst performing outcome from an average market return perspective (just shy of 5%), has historically occurred when a Republican is in the White House and Congress is controlled by the Democratic Party.



Markets typically only react to geopolitical events beyond a few days if oil production is disrupted. While we're not betting on specific outcomes, these events remain a wildcard for 2026.

Gridlock might not sound very festive, but for markets, it is like a silent night, calm and bright. While midterm election years have historically been challenging from a return perspective, they tend to be a “tale of two markets” with volatility and larger pullbacks before the election and then rallies once the dust settles at year end. In addition, the S&P 500 has not declined in the twelve months following a midterm election since 1938 (Figure 3).

Yuletide wrap

Like the Grinch eyeing Whoville’s holiday cheer, policy uncertainty over the course of 2026 might try to “steal” investor optimism—but underneath the noise, fundamentals will sing. We expect joy to expand with economic and earnings growth surprises... but watch out for sneaky valuation headwinds and policy twists that could shrink hearts three sizes.

Improving fundamentals, and a little policy certainty, would be the Christmas gifts that last all year—easing the tension that might come from midterm-election-induced market volatility.

We hope we are not asking Santa for too much and don’t end up with a lump of coal in our stocking.

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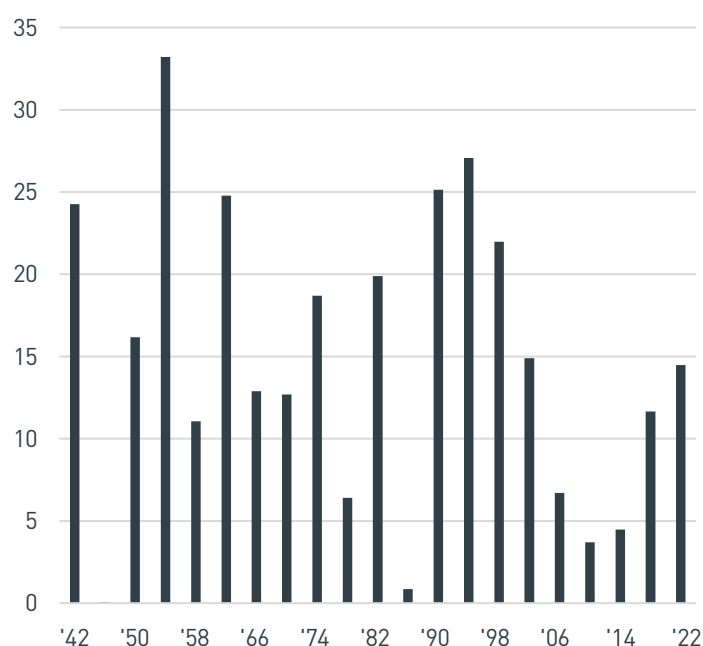
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Figure 3. S&P 500 Price Return 12-month Period Following Midterm Election (%)

Santa rally after the midterms?



As of 12/10/2025. Source: Strategas Research Partners, Inc.