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# Goldilocks Strengthens

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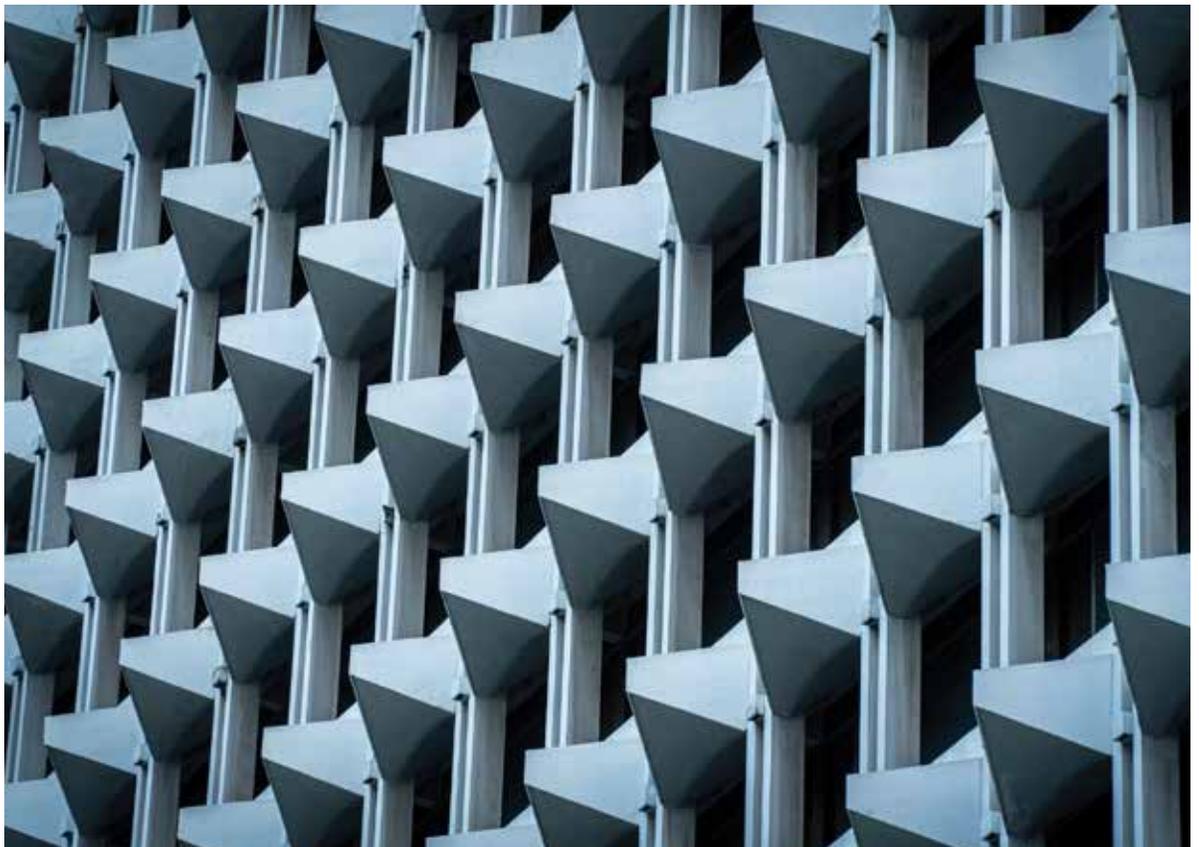
# Goldilocks Strengthens

## From Narrow Strength to Broadening Expansion



By Mike Harris, Chief Investment Officer

The “Goldilocks with fragility” backdrop we outlined last Summer shifted to a rare “broadening” phase as we entered the fourth quarter of 2025. Early signs of improving breadth did exactly what they tend to do, they eased much of the fragility created by the prior narrow leadership. That transition didn’t merely hold; it evolved and strengthened as we closed out the year.





We are now in the full-blown broadening and strengthening part of the cycle. Parts of the Market that haven't meaningfully participated for some time – years – are beginning to re-emerge as sources of leadership. Importantly, returns are no longer being driven exclusively by the Magnificent 7. That shift from concentration toward participation is both healthy and constructive.

Domestic and global growth is set to firmly accelerate in the first quarter with earnings continuing to follow suit. Cooling inflation is supporting real purchasing power, helping sustain consumption even as the consumer remains fragmented. Wage growth is moderating, but still positive, reinforcing consumer resilience.

The Fed is effectively in an easing-and-pausing mode, providing a meaningful tailwind. The primary risks today are less about an imminent recession and more about the duration potential of the broadening phase itself. Valuations remain elevated and are another risk, but for now they are being supported by growth, liquidity, and improving participation beneath the surface.

This is not a late-cycle collapse setup at the moment. Rather, a Goldilocks Balance between growth acceleration and inflation coming down. We also see sprinkling in a soft employment backdrop, helping keep a lid on interest rates and inflation.

It's a maturing expansion with improving breadth, historically a very favorable regime for equities, especially when the risk is actively managed. We plan to take advantage.

### Earnings: Still the Anchor

Earnings continue to do the heavy lifting.

Earnings growth rate for the S&P 500 last quarter was 13%. Quietly, it will mark the 10th consecutive quarter of earnings growth.

Analysts now expect the S&P 500 to report double-digit earnings growth for the 3rd straight year in 2026.

Margins remain a standout. Fortune 500 margins pushed to 13+% (record highs), from ~10% a decade ago and ~8% two decades ago.

This isn't just cost-cutting—it reflects pricing power, operating leverage,

and scale. Is AI helping? Certainly. It's helping big companies maintain and expand margins, driving earnings ever higher. From JPMorgan to Eli Lilly to Walmart, they've all made big operational gains investing in AI and their products, process, efficiencies and margins have benefited.

Elevated valuations are far easier to sustain when profits are compounding, which they are currently. We need to worry when the earning growth stalls.

### The Consumer: Bifurcated, But Functional

The consumer remains resilient—but unevenly so.

- Retail Sales: averaged an impressive nearly +5% year-over-year.
- Wage growth continues, especially for mid- to upper-income cohorts. Slowing from the peak growth acceleration out of Covid, but still growing nicely.
- Credit availability is expanding – this is a big driver.
- Asset prices remain elevated.

As a reminder:

**Consumption = Income + Savings + Credit**

All three consumption inputs remain supportive for the top half of the income distribution, which matters because the top 10% of households account for roughly 50% of total consumption.

The top 20% of incomes drive 67% of total consumption. Staggering.

Stress exists at the lower end. It's not all good:

- Student loan delinquencies continue to rise.
- Subprime auto loan delinquencies continue to rise, and revolving credit deterioration is underway, albeit at a much slower rate.

- Higher borrowing costs disproportionately affect lower-income households.

Importantly, these pockets remain contained and have not spread systemically.

Meanwhile:

- Mortgage rates have eased.
- Home equity is at record levels.
- HELOC and cash-out refi activity is ticking up.

This supports spending. Combine that with aggregate wage growth of 4.1% and inflation slowing from 3% to 2.7%, to likely the mid and low 2% region in 2026 and the spread between income and costs is real buying/spending power.

Cost at the pump is alleviating some pressure for consumers as well.

We see consumer cyclicals leading in 2026 and are positioned for it.

## Valuations: Full, But Context Matters

Yes - valuations are elevated:

- 95th+ percentile historically
- The forward 12-month P/E ratio for the S&P 500 is 21.8. This P/E ratio is above the 5-year average (20.0) and above the 10-year average (18.7).

Long-term future returns at current valuations are well below average.

However, there is far less correlation to current high valuations and more immediate returns, such as 1 year out. We are positioned for the nearer-term and aware of the longer-term implications of higher valuations and lower future long-term returns.



Context helps here:

- Earnings are accelerating, not decelerating.
- Margins are at record highs, and expanding.
- Liquidity remains ample.
- Market leadership is beginning to broaden.

Historically, valuation compression tends to matter when growth slows. We are not seeing that. Quite the opposite.

Concentration risk remains real but not irrational, given the earnings power of the largest companies. Our expectation is that breadth continues to improve, easing this concentration risk as we enter 2026.

## Volatility, Sentiment & Flows

Volatility remains subdued:

- VIX – Volatility Index is back in the low to mid-teens, well off of last year’s high in the 30s.
- Realized daily moves are quite muted compared to history at < 0.5%.
- Historically, this is a Bullish backdrop.

This has been validating and is a set up for buyers.

Volatility-targeting strategies have added long exposure and continue to do so in this backdrop. As volatility declines, volatility control funds have to buy more. They are agnostic to fundamentals. These flows are becoming larger every year, so we must pay attention and understand them.

Interestingly, sentiment is **not euphoric**:

- Investor sentiment surveys remain well below historical peak optimism, but has risen over the past half year.
- Commercial hedgers remain net short.

These are the “mystic” parts of the Market we pay attention to and often show us the first signs of risk forming. We think, as the broadening and strength continues, higher sentiment readings may occur. This Bullish setup can strongly surprise participants next year and likely ultimately leads to some even stronger exuberance readings down the road.

We will be paying close attention.



## Global Growth: Continues Broadening as Well

Outside the US, the story is similar—steady, not spectacular, but broadening.

- Europe: slow but positive growth.
- Emerging Markets: stabilization and improvement.
- Dollar weakness continues to ease global financial conditions.

AI-driven capital expenditure, infrastructure growth is spilling beyond the US into Global Industrials, Global Energy, Global Materials and Emerging Market supply chains. These are all important to sustain the global trend of growth heading higher. This global diffusion matters for durability and breadth. It's underway.

## Labor Market: Softening

The Labor Market continues to soften, make no mistake about it. The quits rate has been steadily falling, signaling that workers recognize it's become harder to find a better opportunity. Wage growth is also slowing. Pay is still rising, but no longer at the accelerated pace of the past few years.

Employers are increasingly aware that a loosening Labor Market has shifted some leverage back in their favor, a sharp contrast to the post-Covid period, when firms were aggressively hiring and hoarding labor at nearly any cost.

At a current 4.6% unemployment rate, joblessness has been slowly rising from a cycle low of 3.4% in 2023 and 3.8% just one year ago. The strain is most evident in the 16–24-year-old cohort, where unemployment is now north of 10%.

Here's a data point that may surprise some: California's unemployment rate sits more than a full percentage point above the national average, at roughly 5.5%. While parts of the Bay Area don't visibly reflect this yet, pockets of Labor Market weakening are clearly emerging across the state.

Job postings have continued to roll over, hiring rates are falling, and the average monthly gain in non-farm payrolls has slowed sharply: down to roughly 22k per month from well over 150k in late 2024 and closer to 200k in 2023.

The direction and trajectory of the Labor Market have the Fed's full attention. This was a primary driver behind last year's rate cuts, which

lowered policy rates from roughly 4.5% to 3.75%, and remains a key reason policymakers are likely to continue easing into 2026.

The Labor Market represents one of the largest macro risks in 2026. It is the linchpin of consumption, which accounts for roughly 68% of US GDP and ultimately drives overall economic growth. Last year, real GDP growth came in at 2.3%. Remember, real growth strips out inflation, while nominal GDP growth exceeded 5%.

Of the roughly 2.1% real GDP growth in 2025, consumption contributed about 1.7%. The remainder came primarily from business investment (+0.4%) and government spending (+0.3%), with other components flat or negative.

We will be watching the Labor Market closely as we move into the year.

## Inflation: Continuing to Cool

As we outlined in our Fall presentations, our expectation has been for the Consumer Price Index (CPI) to continue cooling. From the high-water mark of roughly 3% in September 2025, inflation has already begun moving in the right direction, with November's reading coming in at 2.7%.

With rents easing and food and energy prices cooling, CPI is likely to remain on a downward trajectory into 2026. This disinflationary trend gives the Fed additional cover to continue its easing campaign, while simultaneously providing support to consumption.

When growth is still progressing and prices are rising more slowly, households are left with incremental Dollars to spend. In a nutshell, this dynamic captures the broader, more favorable macro backdrop we believe is now firmly in place.

## Policy & the Fed: On Pause But...

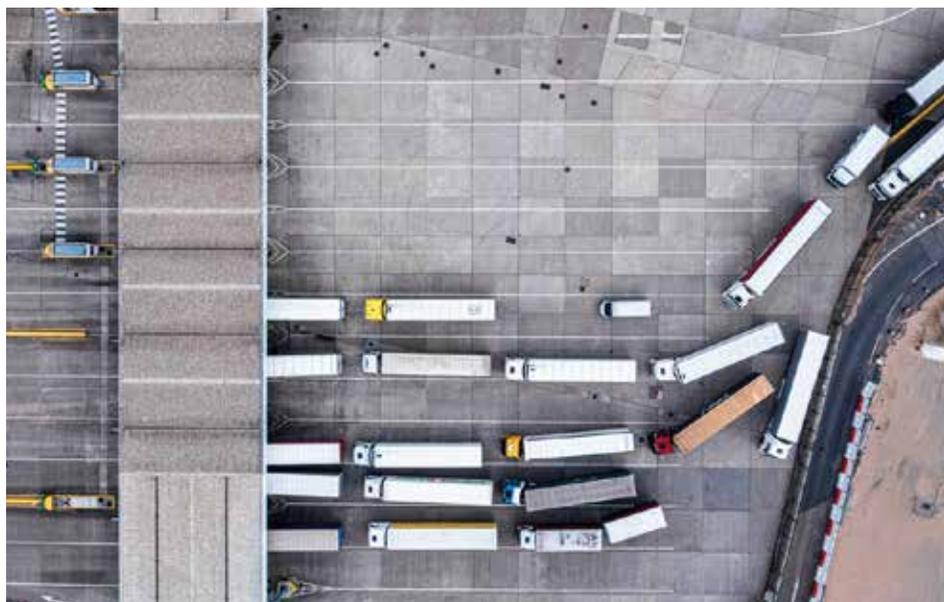
Following the November rate cut, the Fed now finds itself in a pause. The next cut is currently expected early Summer, though a faster-than-anticipated decline in inflation could pull that timeline forward. Inflation remains the key pillar, as continued disinflation would give the Fed greater flexibility to ease policy.

While the Labor Market is clearly softening, it has not yet broken. That balance creates room for the Fed to cut a bit earlier, or slightly more than currently expected. Potentially providing additional support to the Economy and helping to cushion or extend the Labor Market slowdown rather than allowing it to accelerate.

Markets are currently pricing in:

- Two additional rate cuts through 2026.
- A Fed Funds Rate potentially reaching ~3.0–3.25%, down from the current 3.75%.

Historically, rate cuts that occur during economic expansions have been supportive for risk assets. With fiscal policy remaining stimulative as we head into 2026, this adds another meaningful tailwind to the broader “broadening” thesis.



## Leadership Is Evolving—from Narrow to Broad.

Markets are no longer being driven by mega-caps alone. Leadership is rotating toward cyclicals and real-economy exposures: Industrials, Materials, Financials, Consumer Discretionary, and Energy. Think transportation and logistics. Think retailers. Think chemicals, natural gas, and energy-transition beneficiaries. Think global miners and infrastructure.

I enjoy writing this because it’s no longer all about the Mag 7. The broadening is real, and importantly, it’s investable.

At the same time, secular technology and AI investment remain firmly intact. The CapEx cycle still appears to be in the middle innings. That was the leadership. Valuations across much of the complex are now elevated, with a significant amount of good news already priced in. There are still compelling long-term opportunities here, but the probability of repeating the outsized returns of the recent past, at the same pace has diminished.

Commodities and real assets continue to benefit from a powerful alignment of forces: a weaker Dollar,

accelerating growth, and persistent global fiscal deficits. Years, if not decades, of underinvestment are now colliding with rising demand. Yes, Gold had a remarkable 2025, up more than 60%, and it still deserves a role in portfolios.

That said, 2026 may increasingly be about copper, lithium, nickel, iron ore, cobalt—and the essential materials we quietly depend on every day. The AI buildout, global growth, and structural underinvestment are creating durable tailwinds across these markets, reinforcing the broader leadership shift now underway.

## Portfolio Implications: Translating Macro Into Positioning

In practice, this backdrop argues for a shift away from concentration risk and toward broader participation. As leadership expands, portfolios benefit from diversified exposure across cyclical value, real assets, and selective secular growth, rather than reliance on any single theme or factor. The objective is not to abandon long-term winners, but to rebalance toward areas where earnings momentum, valuation support, and improving macro conditions are increasingly aligned.

What makes this cycle different from prior false starts is the foundation beneath the broadening. Unlike earlier attempts driven largely by multiple expansion, today's participation is supported by accelerating earnings growth, durable margins, and improving policy alignment. At this stage of the cycle, return potential is less about chasing higher valuations and more about capturing earnings breadth—favoring capital spending, infrastructure, energy, and global industrial activity alongside disciplined exposure to secular growth where cash flows and balance sheets remain strong.

Risk management remains central, but in a true broadening environment, risk becomes more evenly distributed. That shift tends to create a more balanced, resilient, and durable portfolio opportunity set.

## Risks to the Broadening: Key Investor Concerns for 2026

### Unemployment Spikes

Historically, major market corrections have been driven by higher rates (51%), exogenous shocks (26%), or job losses (23%). This data is thanks to one of our researchers, Piper Sandler. Today's unemployment rate is rising slowly—not accelerating. Without Fed tightening or an Oil shock, a sharp spike in unemployment remains unlikely.

### Interest Rates Rise as Data Improves + Inflation

Stronger data could put upward pressure on rates. However, without inflation reaccelerating, rate volatility should remain contained. Inflation reaccelerating is a risk in itself, but plays off interest rates well. A resurgence in inflation would challenge the outlook. Our base case is down to sideways or slow-moving inflation—helped by subdued energy prices. It's difficult to sustain an inflation problem when Oil remains low. A geopolitical event

causing Oil to spike would have a huge impact on the trajectory of inflation and increase risk.

### Valuations Are Too High

Valuations are elevated, particularly in former leadership areas. Broadening reduces concentration risk, but upside may be more incremental than explosive. Valuations compress when growth stalls and slows. In our estimation, global and domestic growth holds the cards here. As long as growth continues, valuations can sustain.

### Mag 7 Drawdown and AI Bubble Concerns

A pullback in mega-cap tech is possible. The good news: today's tech leadership bears little resemblance to past bubbles. Balance sheets are strong, cash flows are real, and speculation remains contained relative to prior cycles. Our broadening thesis will go a long way to alleviate the concentration risks that are warranted.

## Putting It All Together

The “Goldilocks with fragility” backdrop we outlined last Summer has evolved into a far more durable setup. As we entered Q4 '25, improving breadth began to ease the risks created by narrow leadership—and that shift strengthened as the year closed. Entering 2026, leadership is expanding beyond the Magnificent 7, with previously dormant areas of the Market re-emerging and participation improving beneath the surface.

Growth is accelerating, earnings continue to follow, and inflation is cooling—supporting real purchasing power even as the consumer remains uneven. Wage growth is moderating but still positive, reinforcing resilience rather than signaling stress. At the same time, the Fed's easing-and-pausing stance helps anchor rates and liquidity.

This is not a late-cycle collapse environment. It is a Goldilocks balance—growth strengthening as inflation cools, with a softening Labor Market helping keep rates contained. For the first time this cycle, monetary policy, fiscal support, credit conditions, and AI-driven investment are aligned rather than offsetting one another.

In this environment, returns increasingly shift from concentration and multiple expansion toward earnings breadth and participation. Secular AI leadership can persist, but cyclical value, global industrials, and real-economy assets are increasingly sharing the load. This is a maturing expansion with improving breadth—historically a favorable regime for stocks when risk is actively managed. We will be active here.

A sustained reacceleration in inflation, a sharp Labor Market break, or a material slowdown in AI-driven capital spending would warrant reassessing this framework. As we like to say, if the facts change, so will we.



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