



Investment Management Group*

The following contains a brief discussion of the equity markets from Chief Investment Officer and Senior Portfolio Manager, Ryan E. Crane.



FOURTH QUARTER 2025 MARKET OUTLOOK

MARKET OVERVIEW ¹

As expected, the Federal Reserve delivered two more 25 basis point cuts to the Fed Funds rate this quarter, although it was less clear if there are more cuts on the table for early 2026. Longer term interest rates moved lower early in the period but finished the quarter nearly unchanged. GDP figures for Q3 came in surprisingly high, and employment data has been resilient enough not to spook markets.

News out of D.C. remained chaotic. There was continued trade noise with China. The 43-day long government shut-down added some stress to markets and the economy but ultimately resolved without much issue.

While the technology itself seems to continue to scale and improve, the investment narrative around Artificial Intelligence got more complicated this quarter. Some investors have begun to fret about a “bubble.” As the industry races to build capacity, the easy and obvious funding of capex has been used up. There was real volatility under the surface, but equity markets continued their march forward with the S&P 500® Index gaining 2.66%.

OUTLOOK

In 1969, Milton Friedman first wrote about the idea of “helicopter money,” as a thought experiment where the government simply adds money to the economy by dropping it out of a helicopter. It didn’t matter exactly who got the money or whether they deserved it or not, it’s just about injecting money into the system. Ben Bernanke referenced the idea during his term as Fed Chairman as one of the tools to fight deflation. It turns out that stimulus from the government can take many forms.

During the worst of COVID, policy makers were sufficiently terrified of the recession and potential deflation, that if they were to make any policy error, it would be in the direction of inflation. As a result, they went overboard with stimulus. We all know about the stimulus checks that were directly sent to many Americans but less is written about how prolific the PPP loans were (in many cases for businesses that clearly didn’t need the help), and less still about the PPP loan fraud or the unemployment fraud.

Since in-person interactions were discouraged, unemployment offices went fully online in a hurry, and whether because of the time constraints, shoddy programming, or mal-intent, unemployment claims were paid very quickly, without vetting. Fraudsters figured this out very quickly, and it became a lucrative operation – all you needed was a name and a social security number, and you could have money sent to your account.

Estimates of this type of fraud during COVID range from \$100-\$400B. It’s a shocking number. And taxpayers would be justified to be outraged. While the government did look into the issue, and some people were chased down (supposedly less than \$1B has been recovered), the whole scam largely was ignored. Why? Because it was helicopter money. It was less important that “bad” guys got the money via fraud, it was far more important that money was entering the economy.

Yes, I know I’m a cynic.

You may have seen the news lately about the allegations of fraud in Minnesota, with respect to Medicaid, and other state-supported services, like day care and nutrition programs. Estimates are in the billions of dollars. Depending on who you listen to, there are allegations that some state officials were complicit with the fraud, and actively thwarted investigations into it. Again, taxpayers should be outraged, but some policy makers might just see it as helicopter money, or even a just form of wealth redistribution. Afterall, that money makes its way into the economy very quickly. It contributes to GDP, and there’s no doubt it contributes to inflation.

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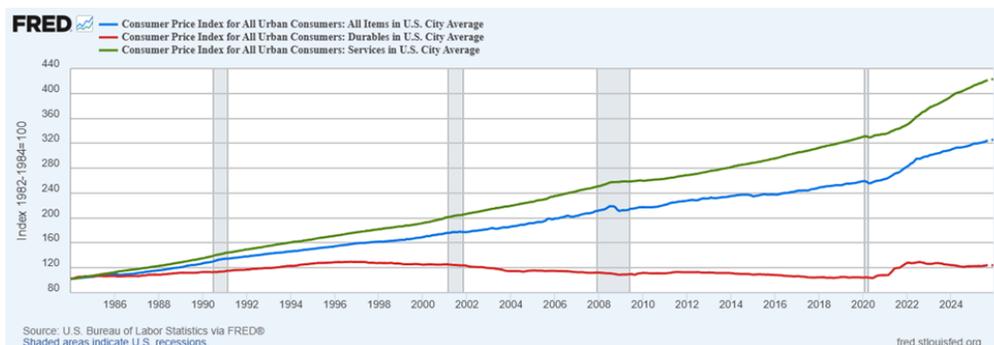
OUTLOOK

What's the point of all this? It's just another piece of my inflation puzzle. I've often wondered if deflation is really the bogeyman that economists make it out to be. I think the answer is that it's not such a terrible problem, **but only in a world without reliance on debt**. In a system built on debt, deflation is downright toxic, and policy makers will do anything and everything to fight it. I'm not going to go so far as to say that the government welcomes fraud as a way to fight inflation, but it's not a stretch to think that some may be ambivalent about it after the fact. Elon Musk (after his time with DOGE) has estimated that such fraud and waste could amount to as much as \$1.5 Trillion dollars. As I write this, Treasury Secretary Scott Bessent was quoted as saying fraud and abuse is "about 10% of the federal budget, 1 to 2% of GDP." ([Article linked here](#)) Incrementally, removing spending on even fraudulent activities or imprudent matters is disinflationary. After eliminating such wasteful spending, policy makers might have to compensate for it elsewhere in order to keep inflationary/deflationary pressure neutral.

For the other puzzle pieces, it's important to remember that technological innovation is a powerful source of deflation, and generative AI might be one of the most powerful we've seen. Nonfarm Productivity just ticked up to 4.9%, contributing to a *reduction* in Unit Labor Costs of 1.9%. We regularly hear from company management teams that AI is leading to material improvements in productivity across a variety of industries and applications, and we are still in the early days of adoption.

As AI succeeds in being a powerful engine of productivity, it will tautologically be a powerful deflationary force. Central bankers know that deflation cannot be allowed, so policy makers will have to ramp up policies which spur inflation to offset it. On top of that, the current administration is effectively pursuing policies that will lead to less spending on immigration and immigration support programs, and that will be an additional incremental source of disinflationary or deflationary pressure. *Perhaps this is the reason the current administration is so hellbent on getting interest rates lower.*

Years ago, I wrote about how inflation had really come from growth in the price of services, not goods – this was a 40 year trend. Here's the updated version of the chart we published in our Q2 2021 commentary.

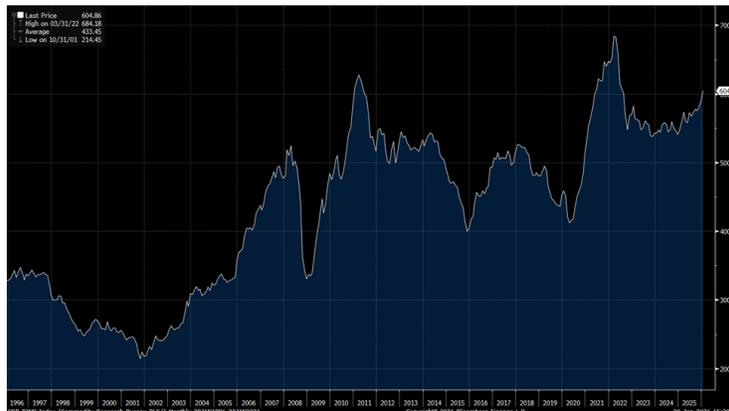


Technology, manufacturing efficiencies, and globalization (wage arbitrage) were some of the powerful forces that drove the price of durable goods lower, while anything services-related (and particularly things subsidized by the government, like education and healthcare) were inflating at an uncomfortable pace. Combined, the CPI picture was relatively tame... until COVID.

During COVID we saw a big uptick in goods inflation. As Roberto Perli said, we responded to a supply shock with a demand shock. Since 2022, the goods inflation has settled back down.

I don't think there's any question that the near-term impact of AI will be deflationary for white collar work first. We are seeing evidence of this in real time. Not all services will be impacted by AI in the near term, but certainly some will. I believe it's very possible that AI will be the catalyst for disinflation or maybe downright deflation in services.

At the same time, it seems like we are at an inflection point for goods as well. Tariff policies, complex trade negotiations, the recognition of strategic resources, and other factors could have the effect of driving goods prices higher. Here's the CRB RIND index, which is made up of raw industrials (that usually aren't affected by trading or speculation in financial markets) like hides, tallow, burlap, cotton, tin, etc. The latest trend is a little troubling.



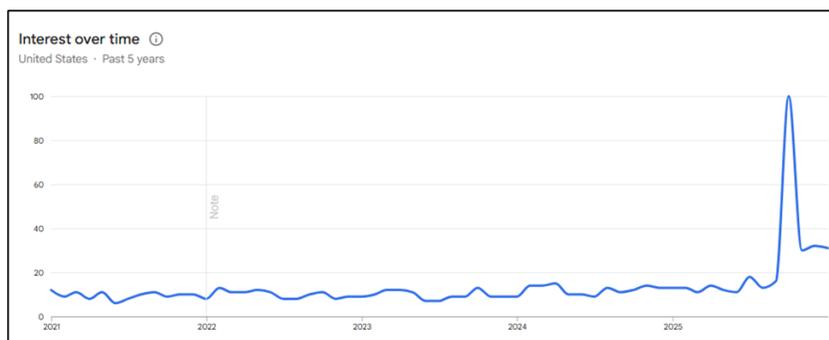
The cynic in me worries a little less today about CPI or headline inflation. I think it’s quite possible that CPI will be managed to look tame (see my prior commentaries on how this happens). What I do worry about is that I don’t think the world is prepared for a reversal in this 40 year trend – that goods inflation could reignite while services deflate. What I’m describing here are changes in inflation dynamics as a result of underlying market forces – not the impending monetary policy or direct fiscal policy, which complicate things further.

In summary, we could have a situation where:

- AI causes deflation in services (and longer-term maybe in goods too, because of robotics).
- Changes in immigration policy are deflationary (in terms of government support).
- Government addressing fraud, waste, and abuse is deflationary.
- Goods or commodity disinflation could be reversing in the short-term.
- In the complexity and gyrations of all this change, policy makers will not risk deflation and will likely err in the direction of adopting very accommodative policies.
- These inflationary policies will have implications elsewhere, namely exacerbating the K-shaped economy and in capital markets and in asset prices.

Now, I don’t mean to totally dismiss the risk of actual measured inflation. What’s going on with raw materials and goods could overwhelm the deflationary aspect of AI in the near term. The changes to immigration policy could drive wages higher for some jobs – a pretty clear path to inflation. On top of that, inflation expectations aren’t as anchored as we might like them to be.

Google Search Trends for the term "Debasement"



Last quarter I mentioned the risk of a fiat-asset spiral (as opposed to a wage-price spiral). If enough people come to the conclusion I’ve outlined above (and in previous commentaries), the logical step is to avoid fiat currency and own assets. Recently silver has gone into meme-stock territory. Other commodities have moved higher as well. I stand by my claim that gold is telling us something - don’t ignore its message.

OUTLOOK

Since AI plays a key role in my argument above, let's check in on developments there.

First off, the investment landscape for AI got a bit more complicated. In the race to build out data centers, the hyperscalers have spent a great deal of cash, and are now having to get more creative in terms of financing further expansions. The best example of the change in reality and the change in sentiment might be Oracle. Investors loved it in Q3 as they were ramping spend in AI and signing contracts with the major providers, but this quarter it appeared to be over-hyped as revenue and earnings missed expectations and investors worried about debt, timing, and profitability.

If AI really is a winner-take-all or winner-take-most market, then some of today's players won't make the cut. When that happens, the data center capex ecosystem will take a hit. I won't begin to venture a guess as to when, but it's something we should all consider, and is probably behind some of the volatility in the stocks.

Secondly, the competitive landscape really seemed to shift. Google's Gemini demonstrated massive performance improvements. Anthropic's Claude showed continued gains in commercial use and adoption from corporate America. Meanwhile, OpenAI's position has weakened a little, in part due to a legal battle with Elon Musk over their shift away from non-profit status.

Most importantly, is that there is no evidence that generative AI systems have hit a wall in terms of scalability. It's quite the contrary – there have been almost weekly developments and improvements in functionality. Just recently, OpenAI's GPT 5.2 Pro generated a novel proof to a previously unsolved decade's old mathematical problem. Naysayers have complained that generative AI simply regurgitates rather than creates or innovates; this could be important evidence that it can be creative and expand human knowledge.

Finally, I think the market is underappreciating the potential inflection point in robotics. AI's ability to create synthetic data is allowing for much faster improvements in robot development. Long-term, there are profound economic and societal implications.

Given these changes, I stand by my claim last quarter that the AI theme has entered the second inning. In this quarter there was a fair amount of chatter of an "AI bubble," and if people are using the term "bubble," then it's clearly not the first inning. But it's not a late inning either. People thought the Internet investment theme was a bubble in 1997, before today's Internet leaders were even in existence. We have a long, long way to go!

I know I sound like a broken record at this point, but I'll keep reiterating this message as long as it is true: the fundamental, secular change that is taking place across the economy and society is unprecedented and change is the fuel for our process. The various factors that impact inflation and the economy at large are changing rapidly and all at the same time. Expect volatility; expect policy errors; expect opportunity. It's an exciting time...just be on the lookout for things falling from helicopters.

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