

### Might Makes Right

“Right, as the world goes, is only in question between equals in power, while the strong do what they can and the weak suffer what they must”

*Thucydides, History of the Peloponnesian War, The Melian Dialogue, circa 400 BC*

As is customary at this time of the year, happy New Year to all my readers...but please stay on your toes. 2026 already promised to be eventful given the expected political drama surrounding the midterms, but the year has started with a geopolitical bang, namely the capture of the president of Venezuela by the US and Trump’s announcement that “we would run the country” for a potentially extended period. In the past year, Trump has shown no qualms about departing significantly from the post-World War II “rules based international order”, as his unilateral tariff decisions – which sidelined the WTO - can attest. Over the past few months, narratives on Venezuela have focused on the drug trafficking issue and the non-democratic nature of the regime, and the US military has positioned many assets in the Caribbean, suggesting that some intervention might be in the works. However, the unprecedented nature of this operation, done while the entire world was still recovering from the New Year celebrations and with only a handful of members of the Trump administration being in the loop, does suggest that time was of the essence, begging the question: why the rush? The most obvious reason may be to eliminate an acute and immediate threat to national security. In recent months, Russia has been providing Venezuela with various weapons and statements made by senior Russian officials did not explicitly rule out the supply of hypersonic missiles. Thus, the US may have acted preemptively to avoid a potential repeat of the Cuba missile crisis.

**However, an equally existential, but longer-term issue that could have motivated the intervention is related to the erosion of the petrodollar system.** Since the fall of the Bretton Woods monetary system in the 1970s, agreements between the US and Saudi Arabia have established that oil would be traded exclusively in US dollars, thereby providing natural demand for the US currency and enabling the US to finance its increasingly large budget deficits at relatively low rates. However, the weaponization of the US dollar to impose sanctions on other countries and to make extraterritorial enforcement of our laws have led the BRICS countries to start building an alternative monetary system – likely using Gold as collateral – for cross border trade and financing transactions with one another. **Eventually, the risk for the US is that oil producing countries may be reluctant to accept dollars as payment, especially if the dollar weakens significantly relative to other major currencies.** While technical analysis is not a silver bullet, the long-term monthly chart of the dollar index doesn’t look too good. After a sharp decline following the initial tariff announcements last year, the DXY has failed to reclaim decisively the important psychological level of 100. In addition, the support line that has been in place since 2009 seems to be on the verge of being broken to the downside.

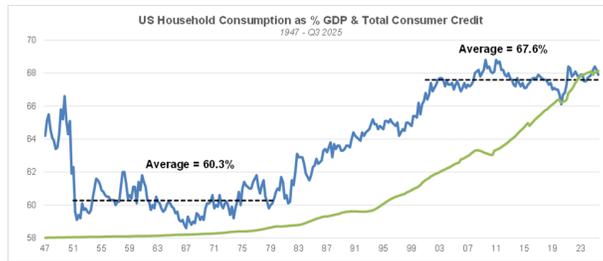


Source: Bloomberg, SIMG Analysis

While the US produces a lot of oil, it is primarily light sweet crude whereas many refineries were designed to process the heavy sour variety. As a result of this mismatch, the US still needs to import ~ 7 million bpd of crude and related products. As has been widely publicized in recent days, the largest holders of oil reserves are...Venezuela, followed by the Gulf countries and some that are not among our friends: Iran, Iraq, Russia, Libya. Given the size of its reserves and its location in America’s backyard, Venezuela will likely be steered to trade its oil exclusively with the US. Over the years, Maduro has arranged loan agreements with China where the repayment is to be made with oil deliveries – a Chinese delegation was even visiting the presidential palace the day before the intervention – so the regime change’s intended goal was likely to enforce exclusivity.

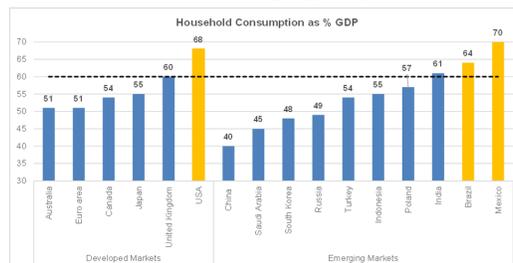
Countries the world over have protested this intervention, but as the Ancient Greek historian Thucydides reminded us, when it comes to international relations, might makes right. As has become increasingly clear since the war in Ukraine started, **the globalized world order that prevailed after the fall of the Soviet Union has now given way to a fracture between two blocs: the Western bloc led by the US, and the Global South, led by the BRICS countries but primarily China.** In the coming decades, the two blocs will likely build separate trade networks, financial systems, supply chains for goods and commodities etc... Trump's tariff and reshoring policies make sense when viewed in that light, along with this latest military intervention. Inspired by Thucydides' account of the Peloponnesian war, Harvard professor Graham Allison warned about the Thucydides trap, i.e. the high probability of a war when an established power gets challenged by an emerging one. **The Thucydides trap may be best avoided via a negotiated divorce between the two major world powers, and that's what the trade deals between the US and China are truly aiming to achieve.**

**As both blocs hopefully go on their merry ways, the US economy will have to rebalance away from consumption and towards more production and investment,** since the supply of cheap foreign made goods may become less abundant than during the glory days of globalization. As shown below, consumer expenditures' average share of GDP during the period from 1951 to 1979, when the US was a manufacturing powerhouse, was around 60% versus 68% today. The rise in consumer expenditures' share of the economy from 1980 to the early 2000s was accompanied by a momentous surge in consumer credit, as financial products like credit cards made it easy for US consumers to spend more than what they earned. As a result, the saving rate has dropped from 10% on average in the period 1951-1979 to only 4% now.



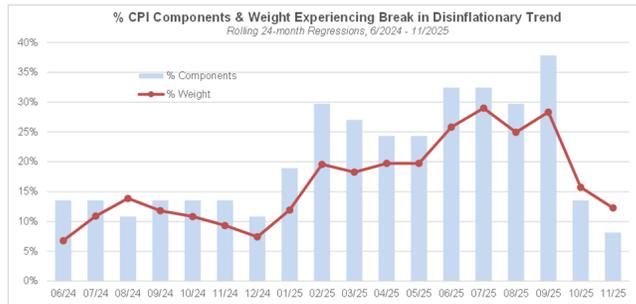
Source: St. Louis Fed's FRED Database, SIMG Analysis

**If the share of consumer expenditures does return to about 60%, this would only bring it in alignment with that in other developed economies.** In Europe, Japan, Canada, and Australia, consumer spending only represents 50-60% of GDP. In several emerging markets, the share of household consumption is even lower, in the 40%-50% range. In other words, such a reduction in the share of domestic consumption should not be seen as some sort of purgatory, but rather as a return to a healthier, more sustainable economic model.



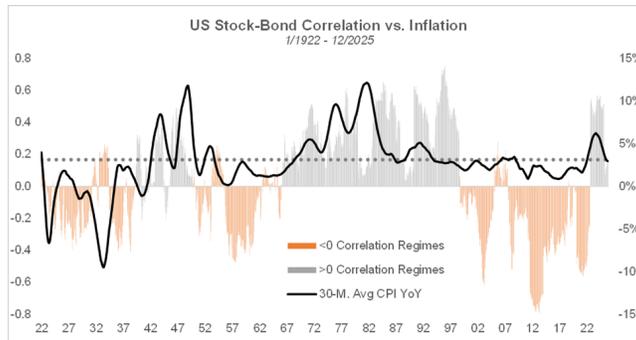
Source: World Bank Open Data (<https://data.worldbank.org/>), SIMG Analysis

**The rebalancing of the US economy away from consumption and towards more production may be what truly solves the current, persistent inflation problem and its close relative which is the affordability issue.** My conviction is that inflation can be better fought using supply side solutions rather than monetary policy. While Paul Volcker gets credit for having tamed inflation in the early 1980s, inflation declined only gradually throughout the 1980s and 1990s, coincident with an increasingly abundant supply of cheap foreign made goods brought about by globalization. Fast forward to today, it is unclear whether Jay Powell's sharp hiking cycle has played a decisive role in bringing down inflation. First, it started a few months before inflation peaked in the summer of 2022 and inflation was bound to come down naturally, as COVID related supply chain issues were being resolved, and fiscal stimulus was wearing off. In addition, inflation has declined very gradually and remains well above target 3.5 years after the start of monetary policy tightening, an observation which has led some economists to conclude that we have entered a regime of fiscal dominance, where monetary policy has a limited influence on macro variables. A potential supply side solution to the current inflation issue would come from the reshoring of manufacturing, as automated (with the help of AI) US based factories could generate an abundant and cheap domestic supply of goods. We can only hope that the Trump administration's policies will be successful in bringing that outcome, but it will likely take years to materialize. In the meantime, the president will be on the receiving end of the public's complaints about the cost of living being too high. As the affordability issue is gaining prominence – and will likely take center stage in the months leading up to the midterms – Trump has made a flurry of announcements aiming to bring down the cost of shelter and certain food items. Whether or not such measures prove to be effective, monitoring potential inflection points in the trajectory of inflation is going to be key in understanding (and may be predicting) the state of the economy and of equity markets in 2026. A few months ago, I introduced a piece of analysis that aims to quantify the breadth of CPI components that are experiencing a statistically significant upward inflection in their price trajectory since overall inflation started decelerating in the summer of 2022. A closer look at the breadth of components may be able to reveal some manifestations of inflation acceleration that may not be visible in the headline number. As shown below, **while the breadth of components experiencing an upward inflection has been on a rising trend from 6/2024 to 9/2025, the latest (November) data suggest the trend has been broken, providing some confirmation that inflation is not on the cusp of accelerating for now.** Note that the October data point has been created by interpolating the data, since October inflation numbers are missing because of the government shutdown.



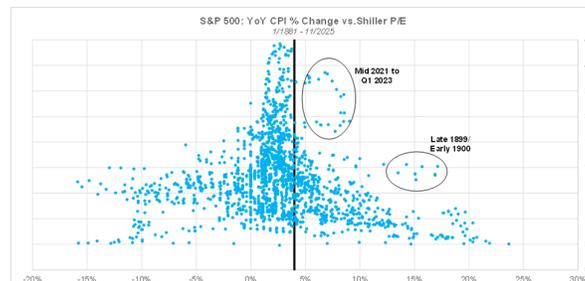
Source: Bureau of Labor Statistics, SIMG Analysis

While CPI data suggest that inflation continues to move towards the Fed's target for now, thus providing cover for additional rate cuts, **the stock-bond return correlation remains solidly in positive territory, an observation that has historically been consistent with the economy remaining in an inflationary regime.** It would certainly be premature for the Fed or the administration to declare victory.



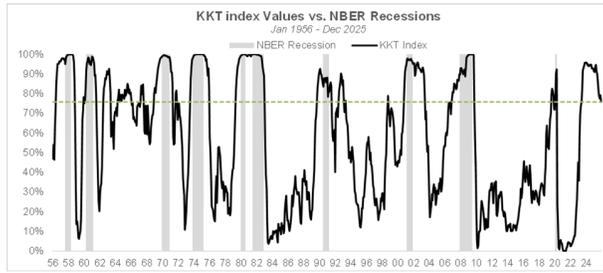
Source: Bureau of Labor Statistics, Robert Shiller's data (<http://www.econ.yale.edu/~shiller/data.htm>), FactSet, SIMG Analysis

As mentioned in prior notes, **the inflation rate also has an impact on equity valuations, with long term historical data revealing the presence of an inverted U-shaped relationship.** The chart below shows that the S&P 500's Shiller P/E ratio tends to cliff dive when inflation rises past 4%. The current extreme market valuations remain consistent with the inflation rate near 3%, but **any meaningful acceleration towards 4% or more would, if the historical experience holds, be accompanied by a compression in the market's valuation multiple** that would more likely result from a bear market rather than from a strong surge in earnings.



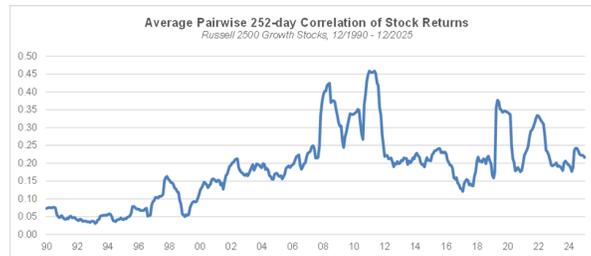
Source: Prof. Robert Shiller's website (<http://www.econ.yale.edu/~shiller/data.htm>), SIMG Analysis

With the impact of the government shutdown on economic data collection now fading, we can run clean updates of the KKT index (which we use to assess the current position of the economy in the business cycle) that don't rely on estimating some of the underlying variables. **As of the end of December, the KKT index sits at 75.8%, a reading that is consistent with the US economy being out of recession.** The recent, strong GDP growth prints (+3.8% in Q2, +4.3% in Q3 according to the first preliminary estimate, and +5.1% in Q4 as estimated by GDP Now) do seem to confirm that the US economy is indeed in an early cycle phase. However, this economic upswing is uneven, with top income earners and asset owners capturing the lion's share of the fruits of economic growth, so it's not surprising that overall consumer sentiment remains depressed (even though the latest data suggest it may have bottomed out). In addition, payroll creation remains weak, as is typical in the early cycle phase given that employment tends to be lagging the economic cycle. In the aftermath of the GFC, the recession ended in June 2009 but the rebound in payrolls only materialized in earnest in late 2010, so **the positive impact of the current economic upswing on the employment situation may not become evident in time for the midterms.**



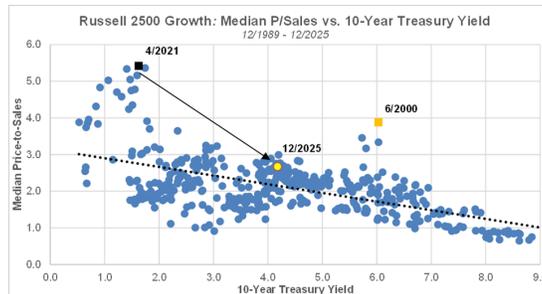
Source: St Louis Fed's ALFRED database, Robert Shiller's data (<http://www.econ.yale.edu/~shiller/data.htm>), Bloomberg, SIMG Analysis. The methodology behind the KKT model is explained in the research paper below: A NEW INDEX OF THE BUSINESS CYCLE by William Kinlaw, Mark Kritzman, and David Turkington

Given that the US equity market has experienced strong returns over the past 3 years, it would be reasonable to expect that some regression to the mean would occur this year. Since, as Yogi Berra famously said, "it's tough to make predictions, especially about the future", I won't join the chorus of market strategists' forecasts - which for the most part consist of taking the 12/31 close and adding 10 or 15 percent - but so far, various indicators of sentiment seem to be consistent with their bullish views. The long-term measure of sentiment we follow, **the average pairwise correlation of stock returns, at 0.216 remains near the median of historical values since the GFC** and nowhere close to the 0.158 level reached in 1/2020, much less the 0.05 low from 12/1999, **suggesting that investors' risk seeking sentiment is not that extreme.**



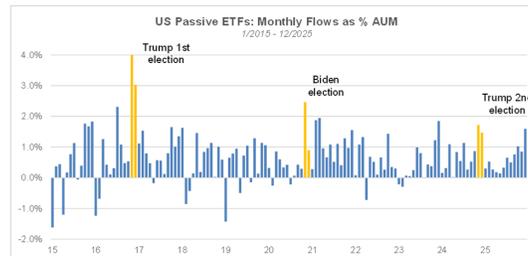
Source: FactSet, SIMG Analysis

Besides, in the small and mid-cap growth universe, valuations – which, at the aggregate level are also a measure of sentiment - are far from the extremes reached by a handful of mega caps: as shown below, **the median price-to-sales in that space is broadly consistent with the level of the 10-year Treasury yield**, and is nowhere near the extremes reached in 6/2000 and 4/2021.



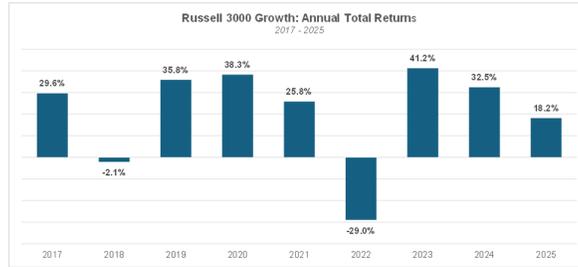
Source: FactSet, SIMG Analysis

**In addition, the liquidity factors that have helped fuel the bull market since late 2022 remain in place.** Besides continued Fed policy accommodation and tight credit spreads - which make it easier for investors to borrow money that can be deployed in financial markets - **passive ETFs, which provide price insensitive demand for equities, continue to see strong inflows.**



Source: FactSet, SIMG Analysis

However, the data points that could temper investors' enthusiasm are the outcomes of the past two presidential cycles. Since the GFC, the increased influence of the government on the economy and the divided political landscape - which makes it difficult for Congress to get anything done - have increased the relative power of the president who, via his executive orders, can make consequential decisions (even though they could be reversed later) that move markets. As a result, the presidential cycle has been receiving renewed attention in recent years. **In the past 2 cycles, the market has performed poorly in the second year (i.e. in 2018 and 2022), so one may wonder if a similar outcome is in store for 2026.** Of course, it would be silly to draw any meaningful conclusions based on a sample size of 2, but the history of financial markets is filled with heuristics based on thin historical data that end up working one more time.



Source: FactSet, SIMG Analysis

**Within the factor space, stocks with strong earnings revisions and high trailing revenue growth rates have been the best performing cohorts.** High price momentum stocks have also performed well through October, primarily because of the continued strength of the AI theme, but have given back most of their gains in the last two months. The performance of attractively valued stocks has been mediocre on average and volatile last year.

Alpha Factor Performance, Top Quintile vs Market  
Russell 3000 Growth Universe, Through 12/31/2025

|          | Fwd P/E | Price/Sales | FCF Yield | ROE    | Gross Profit | Total Yield | Sales Growth (12M) | Sales Growth (FY) | 12-M Price Mom. | 1-M. Mom. Reversal | Earnings Revisions |
|----------|---------|-------------|-----------|--------|--------------|-------------|--------------------|-------------------|-----------------|--------------------|--------------------|
| Jan 2025 | 0.7%    | 1.4%        | 0.7%      | 0.1%   | 1.8%         | (0.6%)      | (1.3%)             | 1.0%              | 0.1%            | (0.3%)             | (0.3%)             |
| Feb 2025 | 0.7%    | 2.0%        | 2.0%      | 2.7%   | 1.6%         | 1.2%        | (1.1%)             | (4.0%)            | (1.5%)          | 0.4%               | 0.9%               |
| Mar 2025 | 2.3%    | (0.3%)      | 1.6%      | 2.0%   | 0.6%         | 2.4%        | (0.1%)             | (2.7%)            | (0.5%)          | (4.2%)             | (0.4%)             |
| Apr 2025 | (2.7%)  | (3.7%)      | (2.9%)    | (0.4%) | 0.4%         | (2.8%)      | 1.6%               | 0.8%              | 2.4%            | 2.6%               | 3.8%               |
| May 2025 | (2.1%)  | 1.7%        | (0.6%)    | 1.2%   | 0.5%         | (2.3%)      | 2.3%               | 4.6%              | 2.7%            | (0.1%)             | (0.3%)             |
| Jun 2025 | (0.7%)  | 1.6%        | (1.1%)    | 0.4%   | (1.7%)       | (1.1%)      | 1.9%               | 1.8%              | 0.4%            | (0.6%)             | 1.3%               |
| Jul 2025 | (2.0%)  | (1.6%)      | (2.5%)    | (0.3%) | (0.6%)       | (1.0%)      | 2.5%               | 3.3%              | (0.0%)          | (0.7%)             | 0.9%               |
| Aug 2025 | 3.1%    | 2.7%        | 3.9%      | 0.3%   | 0.6%         | 0.5%        | (0.7%)             | (2.3%)            | (3.6%)          | 0.9%               | 1.5%               |
| Sep 2025 | (3.1%)  | (0.8%)      | (2.9%)    | (2.0%) | (1.7%)       | (3.5%)      | 1.8%               | 3.6%              | 5.0%            | 1.3%               | 4.1%               |
| Oct 2025 | (3.2%)  | (2.1%)      | (1.9%)    | (0.8%) | (1.5%)       | (1.0%)      | 3.1%               | 3.4%              | 2.4%            | (3.9%)             | 1.5%               |
| Nov 2025 | 3.2%    | 0.7%        | 3.4%      | 0.4%   | 1.5%         | 3.0%        | (1.4%)             | (4.4%)            | (3.8%)          | 0.8%               | 2.9%               |
| Dec 2025 | 2.0%    | 0.2%        | 1.7%      | (0.2%) | (0.2%)       | 0.4%        | 0.2%               | 1.8%              | (2.8%)          | (0.4%)             | 1.1%               |
| 2025     | (1.8%)  | 1.7%        | 1.5%      | 3.5%   | 1.5%         | (4.6%)      | 12.4%              | 4.5%              | 1.7%            | (3.8%)             | 16.6%              |

Source: FactSet, SIMG Analysis

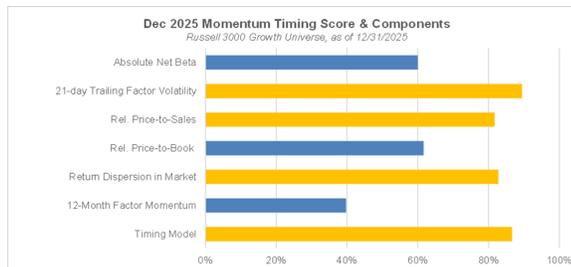
A key benefit from looking at the performance of quant factors is that they reveal insights into investors' preferences. In particular, the performance of factors – like high vs. low volatility stocks – that are sensitive to macro regimes provides indications on investors' sentiment and potentially their views on the state of the economy. Regarding styles, **high volatility, junk and most shorted stocks outperformed materially on average over the course of 2025, and especially in the period from April to October**, while their low volatility, high quality, least shorted counterparts underperformed. High rate sensitivity stocks (that benefit when rates rise) also did well in 2025.

Style Performance, Top or Bottom Quintile vs Market  
Russell 3000 Growth Universe, Through 12/31/2025

|          | High Volatility | Low Volatility | Most Shorted | Least Shorted | Large Caps | Small Caps | Quality | Junk   | High Rate Sensitivity | Low Rate Sensitivity | High Passive Ownership | Low Passive Ownership |
|----------|-----------------|----------------|--------------|---------------|------------|------------|---------|--------|-----------------------|----------------------|------------------------|-----------------------|
| Jan 2025 | (2.6%)          | (0.2%)         | 0.1%         | (0.6%)        | 3.1%       | (3.0%)     | 0.3%    | (2.4%) | 0.3%                  | 0.6%                 | (0.1%)                 | (1.7%)                |
| Feb 2025 | (3.5%)          | 5.0%           | (3.8%)       | 4.7%          | 2.6%       | 0.8%       | 4.3%    | (2.6%) | 0.3%                  | 1.2%                 | (0.8%)                 | (1.8%)                |
| Mar 2025 | (5.8%)          | 4.7%           | (1.9%)       | 2.1%          | 1.9%       | (4.4%)     | 4.3%    | (5.0%) | (1.5%)                | 2.8%                 | 2.4%                   | (2.3%)                |
| Apr 2025 | 5.7%            | (1.9%)         | 2.0%         | (1.2%)        | 1.2%       | 2.1%       | (1.6%)  | 3.7%   | (1.8%)                | 0.9%                 | (3.1%)                 | 1.9%                  |
| May 2025 | 2.8%            | (3.2%)         | 0.5%         | (0.5%)        | (0.1%)     | 1.1%       | (1.4%)  | (1.6%) | 0.9%                  | (3.1%)               | (0.1%)                 | (0.6%)                |
| Jun 2025 | 7.1%            | (4.0%)         | 3.0%         | (0.6%)        | (0.2%)     | 2.9%       | (3.5%)  | 3.1%   | 2.9%                  | (0.5%)               | (0.9%)                 | 0.7%                  |
| Jul 2025 | 3.9%            | (2.4%)         | 3.7%         | (2.6%)        | (0.1%)     | (1.0%)     | (2.2%)  | 4.7%   | 2.0%                  | (1.0%)               | (1.1%)                 | (0.7%)                |
| Aug 2025 | 1.1%            | (2.4%)         | 0.1%         | 0.3%          | (5.3%)     | 2.7%       | (3.0%)  | 0.9%   | (1.2%)                | 1.1%                 | 0.5%                   | 0.6%                  |
| Sep 2025 | 7.0%            | (3.9%)         | 5.5%         | (2.4%)        | (1.2%)     | 3.2%       | (3.8%)  | 8.3%   | 6.1%                  | (2.8%)               | (1.7%)                 | 2.1%                  |
| Oct 2025 | 7.1%            | (3.8%)         | 5.9%         | (2.7%)        | (0.1%)     | (2.6%)     | (3.6%)  | 7.1%   | 2.6%                  | (2.1%)               | (1.4%)                 | (1.8%)                |
| Nov 2025 | (7.9%)          | 2.4%           | (3.0%)       | 1.7%          | (1.5%)     | (1.4%)     | 1.9%    | (4.8%) | (3.9%)                | 4.4%                 | 0.2%                   | (1.4%)                |
| Dec 2025 | (0.4%)          | (0.4%)         | 0.4%         | (0.0%)        | (0.9%)     | 1.7%       | (0.5%)  | 0.1%   | (0.4%)                | 0.0%                 | (0.1%)                 | 0.6%                  |
| 2025     | 14.6%           | (10.1%)        | 12.5%        | (1.9%)        | (0.7%)     | 2.1%       | (8.6%)  | 11.3%  | 6.3%                  | 1.4%                 | (6.2%)                 | (4.6%)                |

Source: FactSet, SIMG Analysis

**Our momentum timing model continues to indicate that high momentum stocks have a high probability of under-performing in January.** The model's indication is supported by 3 of the 6 underlying variables: the return dispersion within the market observed last month, the trailing 21-day momentum volatility, and the relative price-to-sales multiple of high momentum stocks. After a strong run in September and October, high momentum stocks have underperformed materially in the past two months, and the timing model predicts that more downside is to come.



Source: FactSet, SIMG Analysis

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