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Bubble Bath
2026 Annual Letter

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For a year that began with low expectations, 2025 delivered a pleasant surprise. The year was volatile, politically charged, and occasionally absurd, yet somehow highly profitable. Then 2026 opened with a bang, literally and figuratively, in a few corners of the globe.

Amid the tariff chaos of 2025, staying invested paid off. Our Global Equity Strategy finished ahead of the S&P 500, a welcome result given the backdrop.

U.S. equities delivered positive returns but trailed foreign markets. Growth beat value, and large caps beat small caps again. International equities surged 30%, with emerging markets edging out developed markets. And while stocks broadly did well, gold quietly beat just about all asset and sub-asset classes, rising 64%.

2026: May it be a year of fewer wars and tariffs, and more hugs, puppies, and chocolate.

2025: Chaos, Instability, and Resilience

Markets fell sharply after the U.S. announced tariffs in April as investors scrambled to understand the scope and timing of the new levies. Negotiations eventually produced some clarity and partial deals, which helped sentiment recover. But the tariffs also triggered a backlash from abroad, prompting a “Sell America” rotation into cheaper international equities, aided by a weaker dollar.

Tariff uncertainty hasn’t disappeared. The Supreme Court has signaled that tariffs function as a tax requiring congressional approval and could soon rule on whether they can remain in place. If SCOTUS overturns them, it would be a major setback for the Trump administration and a messy unwind.

Still, 2025 was a reminder of how resilient markets can be. High S&P 500 valuations matter little in the short run as long as the music keeps playing. Tariffs, geopolitics, artificial intelligence (AI) arms races, and political theater made for constant noise. Yet markets pushed through it all.

Asset Class	Index	2025 Return
S&P 500	S&P 500	17.88%
Dow Jones Industrials	Dow Jones Industrial Average	14.92%
US Small Cap	Russell 2000	12.81%
US Large Cap Value	Russell 1000 Value	15.91%
Foreign Stocks	MSCI World Ex USA	32.55%
Treasury Bills	Bloomberg US Short Treasury (1-3 Month)	4.35%
Municipal Bonds	Bloomberg Municipal Bond 3 Year (2-4)	4.11%
Gold	Gold United States Dollar Spot	64.58%
REITs	MSCI US REIT	2.95%

Data from Bloomberg

Beyond Uncertainty

2025 delivered more than uncertainty—it delivered instability. In a normal year, economic forces are uncertain, but they tend to move slowly. Consumer confidence, labor markets, inflation, earnings, and interest rate policy unfold over time, not overnight. Instability occurs suddenly with little warning and becomes an immediate problem for companies. It causes sudden supply chain disruptions and price swings, making planning impossible. In 2025 and early 2026, attacks on foreign nations, tariffs, and counter-tariffs announced overnight via Twitter/X drown out normal economic forces, turning business planning and forecasting into pure guesswork.

Despite the instability, we enter 2026 with growth intact, inflation cooling, and employment in semi-decent shape. "Semi-decent" because the labor data is deteriorating. Shutdown-related data gaps and downward revisions have muddied the jobs picture, but **the trend is slowing**—584,000 jobs added in 2025 versus two million in 2024. If that weakness persists, recession risk rises. Taken together, we judge the U.S. economy to be a notch above mediocre, with instability still a threat.

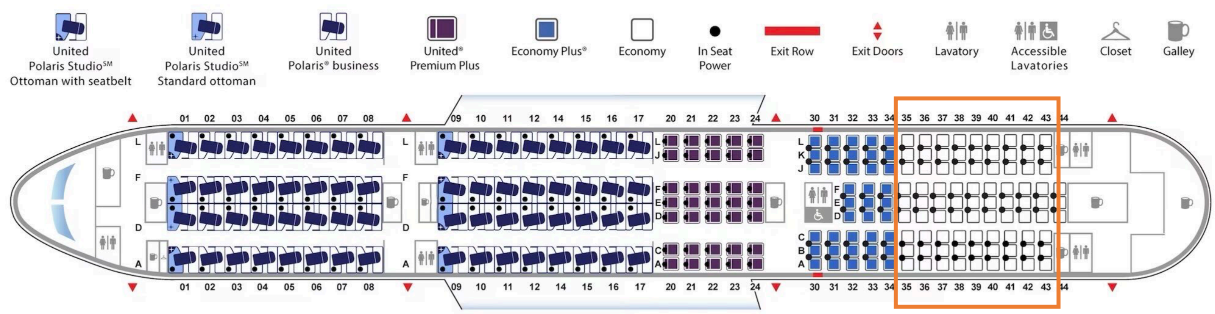
The K-Shaped Economy

At the household level, a more durable structural trend continued to assert itself. This view of household spending predates the current administration and will outlast it: the K-shaped U.S. economy, a framing popularized by Peter Atwater of William & Mary.

Top 20% Income Group = Making over $175,000 per year

Sources: Federal Reserve, Moody's Analytics, @Markzandi on X

The “K-shaped” economy describes a split in which wealthier households (the top 20%) continue to spend freely while many others (the bottom 80%) struggle to make ends meet. Luxury travel, premium goods, and high-end services are booming, even as Walmart shopping and credit card use surge elsewhere. Inflation has widened this divide, creating an economy that feels strong for some and fragile for many. The contrast between financial strain and premium consumption is striking. Auto loan delinquencies are now hitting a 15-year high, even as United Airlines’ new 787 Dreamliners roll out with an economy seating section that feels like an afterthought.



We believe this K-shaped dynamic contributed to the odd combination of strong asset returns and deteriorating consumer sentiment in 2025. This trend might explain how the U.S. avoided a recession during the 2022 to 2024 period of high inflation.

The AI Bubble Bath

Another contributor to U.S. economic resilience is capital spending on AI. The capital investment in hardware and data centers is jaw-dropping. In the first half of 2025, AI-related spending contributed more to GDP growth than U.S. consumer spending. It is not just software and hardware — it is energy, water, and infrastructure. AI computing demands enormous amounts of electricity, thereby making the electric grid itself part of the AI supply chain.

We have written extensively about how the Federal Reserve’s easy-money era (2012–2022) inflated U.S. equity valuations. AI has taken valuations higher still. The large platforms have committed hundreds of billions of dollars to data centers and energy infrastructure—much of it financed through U.S. debt markets. Capital expenditures at Microsoft, Google, Amazon, OpenAI, and Meta are set to ~~surge~~ explode in the coming years. Credit investors are understandably uneasy: asking lenders to buy 30-year debt tied to technology that may be obsolete in five years generates a foul smell.

The equity side appears even more bubbly, with AI-linked companies trading at valuations that imply flawless execution, unlimited demand for AI services, and no constraints on energy or financing. AI is likely to prove transformational, but the finance behind it increasingly resembles a bubble bath—warm, inviting, and full of froth.

One standout example of AI froth came when Mark Zuckerberg pledged "at least $600 billion U.S. [$] through 2028" to support AI infrastructure and workforce expansion. Moments later, on a hot mic next to President Trump, he casually apologizes, "Sorry, I wasn't sure what number you wanted to go with." [Mark Zuckerberg Hot-Mic with Trump].

For context, Microsoft's Office 365—software on every business computer in the world—generated about $120 billion in revenue in FY 2025. Against that backdrop, the $1 trillion+ in expected AI CapEx looks wildly disproportionate to what the most successful software product in the world can monetize.

> *"It's one thing to be bullish, it's another to believe in the tooth fairy."*
> *Investment Strategist, Peter Bernstein*

Here is the paradox: everyone keeps calling AI a bubble. Magazine covers, strategy notes, and CIO letters are full of warnings about AI exuberance. Bubbles are rarely called by so many investors before they pop, which argues for humility on timing and discipline on AI investment participation.

Sell America – Buy Everything Else

If AI bubble stocks grabbed the headlines in 2025, the "anti-bubble" did much of the heavy lifting. Foreign value and high-dividend stocks had a big year. Tariff announcements triggered a "Sell America" sentiment overseas, a soft dollar, and international valuations too attractive to ignore. Foreign equities outperformed the U.S. by the widest margin since the early 1990s, delivering a standout year for diversification.

Europe still faces slow growth, shaky earnings, and a hot war in Ukraine—introducing geopolitical risk that must co-exist with the opportunity. Imagine war raging in New York while Florida thrives. That is roughly the same distance from Italy to Ukraine.

Gold Reinvents Itself (Again)

As money rotated abroad in 2025, gold staged another powerful leg higher. Spot gold finished the year up roughly 64%. Falling interest rates, a weaker dollar, and rising geopolitical stress helped drive the move.

Gold is, as Aussie investment strategist Gerard Minack puts it, the ultimate "chameleon asset." Sometimes gold behaves like a currency, sometimes like a commodity, and sometimes like a safe haven. Falling yields helped the currency phase. The seizure of Russian foreign asset reserves triggered the safe-haven phase. In that state, valuation models do not apply—**gold's appeal is what it is not**: a dollar claim, a bond, or an asset seized at the New York Federal Reserve Bank. When retail investors and banks joined the rally this summer, it became a capital flow story.

We added a gold exchange-traded fund in 2021 and have debated trimming the position more than once, but the case for holding it has only grown stronger. Trump poked a big bear when the DOJ opened a criminal investigation into Chair Jerome Powell's extravagant spending on the Federal Reserve's headquarters. When the man who runs the $ printing press needs a defense attorney, investors start asking different questions. Even JPMorgan's Jamie Dimon recently suggested that "in this environment, gold could go to $10,000." We do not invest based on quotes, but we do pay attention when the most establishment-friendly banker on Wall Street sounds like a gold bug. For now, we expect to keep the gold position through 2026.

Beyond Mega-Cap Tech

Lastly, the "anti-bubble" in U.S. value and dividend-growth stocks posted a quiet but meaningful win in 2025. These stocks still trailed the S&P 500, but as the mega-cap AI trade became crowded and super expensive, leadership finally began to broaden. At the same time, U.S. market concentration hit levels not seen in decades, making the risk more threatening. We are optimistic this broadening trend can carry into 2026, but we are not ready to declare a multi-year value cycle in the U.S. just yet.

Key Takeaways

1. Markets proved far more resilient than the headlines. Tariffs, shutdowns, geopolitical conflict, and political theatrics made for a chaotic year, yet staying invested paid off.

2. The U.S. economy avoided recession for unconventional reasons. Instability was the dominant macro theme, but growth held up thanks to the K-shaped consumer, AI-related capital spending, and cooling inflation.

3. AI is both transformational and bubbly at the same time. Massive CapEx, leverage, and valuation excesses are building even as AI adds genuine economic resilience. We respect the long-term potential but remain disciplined about future free cash flow potential and bubble bath risk.

4. Diversification finally worked again. Foreign stocks, value, and dividend payers improved compared to U.S. mega-caps for the first time in years. A weaker dollar, better valuations, and tariffs powered a global rotation that could persist in 2026.

5. Real assets made a big comeback. Gold surged on falling rates, geopolitical stress, and central bank buying. We continue to hold our position into 2026 as risks shift from being "over there" to increasingly domestic.

This letter has been heavy on macro drama, but something interesting is happening: a genuine rotation. Stock leadership is broadening, foreign markets are waking up, free cash-flow discipline is back in fashion, and real assets are relevant again. It is a reminder that diversification is important — it's how you deal with instability and participate in new leaders as they emerge. Thank you for your trust and partnership. Let's connect soon.

Very truly yours,

Scott A. Roads
Founding Principal

Julia E. Zaino
Principal

PS – You may have noticed the new Spectra logo. After eight years of trying to explain our mean-reversion logo, we decided it was time for a change. Branding advice confirmed our suspicion: our old logo missed the mark – by a lot. Nothing else has changed—we simply chose something more "up and to the right," which is what we aim to do in investing your portfolio. We hope you like it.

Spectra

Important Disclosures:

PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. THE POTENTIAL FOR PROFIT IS ACCOMPANIED BY THE RISK OF LOSS.

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