RICE HALL JAMES
& ASSOCIATES, LLC

***Market Review***
***Fourth Quarter 2025***

In the fourth quarter of 2025, stocks continued their advance, capping another excellent year for equities. It was, however, a bumpier path.

During the quarter, the S&P 500 Index and the Russell 2000 Index gained 2.66% and 2.19%, respectively. For the full year, the Large Cap benchmark increased 17.88%, while the Small Cap index climbed 12.81%. The discrepancy in annual performance was exacerbated by exceptional gains in a broadening ensemble of "AI stocks" (artificial intelligence). The Nasdaq Composite led the major indices higher (20.36%) for the same reason. This marked the third straight year of double-digit gains for stocks, which is all the more remarkable considering the depths of the initial tariff policy shock.

The primary drivers of the gains were very consistent with recent periods. According to FactSet Earnings Insights, in the third quarter, S&P 500 earnings increased 13.6%, providing a fundamental grounding for the rally. The investment in, and fervor around, AI continued. The spend is also benefiting much broader swaths of the economy, including construction and power generation as well as supporting equipment, inputs, and services. Lastly, the Federal Reserve continued its easing campaign, lending support when conditions turned less sanguine. This, however, was not the full story for the quarter as new nuances emerged that challenged the bullish sentiment.

First, while the Federal Reserve lowered interest rates in November and December, it remains an unusually divided committee, reflecting the challenge to balance stubborn inflationary pressures, rising affordability challenges, and sobering employment data. The tension was also aggravated by persistent rumblings from a blunt executive branch. The result was a series of "hawkish cuts" that (i) confused the outlook for the future path of policy, and (ii) increased market volatility between meetings. The policy statements also read like a begrudging acknowledgment of an increasingly dire employment picture as evidenced by the highest level of layoffs since 2008.

The bigger deviation to the script, however, was that investors turned much more skeptical about the sustainability of AI investment. The most recent projections are that the four largest datacenter operators are on track to spend $383 billion in 2025, up from $217 billion in 2024. That said, the "arms race" has reinvigorated scrutiny around monetization, returns, and funding, including the ability of OpenAI to finance over $1 trillion in deal-related spending commitments. The resulting change in sentiment was evident in muted reactions to strong earnings reports, Nasdaq losses in November and December, and a sharp sell-off in **Oracle Corp.'s (ORCL)** stock and bonds.

As we look ahead, the team's bias is that there are small pockets of extreme strength in the economy rather than a strong economy. As a result, we believe lower interest rates are appropriate and likely - assisted by future Trump Administration appointments. As such, the (financial) hope for the new year is a broadening economic recovery and market abetted by less trade uncertainty, the fiscal impacts of the One Big Beautiful Bill Act, and continued domestic reshoring and production.

The challenge, of course, is continuing to navigate a narrow, AI-driven stock market while waiting for a broader, more sustainable bull. Although we are firm believers in the disruptive promise and progress of AI, the team is familiar with these cycles and recognizes that (i) the enormity of the undertaking will inevitably cause pauses, constraints, and competition that complicate the earnings growth picture, and (ii) the majority of the recent Small- and Micro-Cap sensations will not be the long-term winners in industry.

As a result, we continue to take a thoughtful and balanced approach to our products consistent with our conservative growth process. Although we have fitting exposure to the most important growth themes in the market – including AI and Defense – we only invest in profitable companies and avoid "story stocks". Because of the bifurcated economy and market, we are also continuing to find significant opportunity to invest in high-quality growth businesses, at reasonable valuations, in less well-trafficked parts of the market.

Sources: *FactSet, GICS Sector Classification, Challenger Jobs Report (December 2025), Needham & Company (October 2025)*

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*The Nasdaq Composite Index is the market capitalization-weighted index of over 2,500 common equities listed on the Nasdaq stock exchange. The types of securities in the index include American depositary receipts, common stocks, real estate investment trusts (REITs) and tracking stocks, as well as limited partnership interests. The index includes all Nasdaq-listed stocks that are not derivatives, preferred shares, funds, exchange-traded funds (ETFs) or debenture securities.*

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Index Definition Sources: *Standard & Poor's, FTSE Russell, Nasdaq*

*Investment Statistic Definition Source: Federal Reserve*