

Q4 2025 Edition
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The Aurora Project

Market Research

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Market Outlook – Q4 2025

From The Aurora Project

Overview and Performance: Q4 2025 capped a resilient year for equities, with the S&P 500 returning 2.3% for the quarter to close the year up 16.4%. Despite a marginal 0.1% slip in December, the broader narrative remained one of persistent optimism. Markets consistently found reasons to climb, supported by relatively tame volatility and tight credit spreads; signals that investors remain anchored by earnings durability. With 15% earnings growth projected for 2026, the fundamental backdrop continues to justify current valuations. This strength was mirrored globally; the Nasdaq finished the year up 20.4%, while Global Equities (ex-U.S.) outperformed with a 28.7% gain. Notably, U.S. Small Caps secured their third consecutive year of positive returns, rising 11.3%.¹

Sector Dynamics and "The Magnificent Seven": While Technology and Communication Services remained the primary engines of performance (returning 23.8% and 21.6% respectively), the internal dynamics of the market shifted. We are seeing healthy dispersion within the "Mag7" complex with only two of these seven names outperforming the S&P 500 in 2025. Alphabet and Nvidia accounted for 70% of the group's total contribution to the index, yet roughly half of the S&P's total gains came from outside this group. This suggests a maturing bull market supported by H2 rotation away from megacap hallmark names. Outside of the laggards in Real Estate and Consumer Staples, participation was broad, with Industrials joining Tech and Communications as a top-performing sector for the year.

Volatility and the "AI Scare": Q4 was not without its stress tests. Sentiment was briefly rattled by the leak of Sam Altman's internal OpenAI "Code Red" memo and defensive remarks regarding the firm's ability to deliver on datacenter CAPEX. This "scare" unleashed a fresh wave of rotation away from the hyperscaler and supplier ecosystem, notably triggering inverse performance in Alphabet and OpenAI's partner networks. However, the market's "buy the dip" mentality remained unphased. The S&P 500's pullback in the quarter was contained to 5%, and the VIX retreated from an October open of 17 to finish the year below 15.

Productivity and AI efficiency: Beyond market sentiment, the fundamental case for equities received a significant boost from recent productivity data. In our Q2 letter, we noted a puzzling 1.8% annualized decline in Q1 2025 nonfarm productivity, suggesting at the time that the "AI revolution" was either lagging in its implementation or being obscured by outdated measurement methodologies. Based on data from H2, it does appear to have been a problem with lagging data in efficiency gains now booming in the latest numbers.

Following an upwardly revised 4.1% gain in Q2, Q3 productivity surged by 4.9%, its strongest advance in over two years. This efficiency gain is particularly visible in the contraction of unit labor costs, which fell by 2.9% and 1.9% in the last two quarters, respectively.² If these trends persist, we anticipate continued upward drift in corporate margins as output outpaces labor expenses. However, this surge in efficiency does reinforce the "K-shaped" narrative of the post-pandemic era where high-adoption industries and capital owners capture massive efficiency gains while the benefits remain unevenly distributed across the broader labor market.

Outlook: 2025 headlines spanned the full spectrum; from secular "doomerism" to unbridled AI optimism. By absorbing the mid-quarter volatility and maintaining its upward trajectory, the market has demonstrated a robust bullish foundation. We enter 2026 with high investor confidence, backed by a stable economic outlook and a market that has proven it can digest individual shocks without substantially breaking the broader trend.

Quantitative

Systemic Positioning and Tactical Adjustments: Throughout Q4, our funds maintained a disciplined long-bias while strategically increasing short exposure to navigate late-quarter volatility. This posturing reflects our approaches core strength: the ability to dynamically moderate exposure in response to shifting internals without prematurely exiting a structural bull market. The efficacy of this approach was pressure-tested during the S&P 500's -5% correction in November. While the broader market wavered, our models reacted with precision. Our largest peak-to-trough during the quarter was contained to -2.45% representing less than half the magnitude of the market's drawdown.

The quantitative profile of our funds confirms that we are producing "true alpha": returns driven by disciplined risk controls and selective positioning rather than simple market tailwinds. By pairing a long-biased core with tactical shorting and precision sector rotation, our funds have demonstrated an institutional-grade ability to compound capital while aggressively mitigating downside risk. We believe this profile makes the fund not only a primary performance vehicle but a critical diversifier for the modern portfolio.

Fundamental

The Macroeconomic Foundation: Fundamentals remain robust in Q4; characterized by operating margins holding near record levels of 13.9% and full-year earnings growth of 11%. Third-quarter GDP surprised to the upside at 4.3%, bolstered by a 1.6% contribution from net exports and 2.4% from private consumption. GDP Now is even flashing 5.1% for Q4, with consumption still representing 68% of the economy. These figures provide a sturdy floor for 2026 growth expectations which are currently pegged at a consensus 2.5%. With debt service ratios at 11.6% (well within historical norms³), household balance sheets show limited signs of systemic fragility.

Inflation and the Sovereign Backdrop: The inflation trend continues to improve. Official CPI and Core CPI cooled to 2.7% and 2.6% respectively and real-time data from Truflation shows CPI hovering at 1.95% suggesting that official prints will likely converge toward the Fed's 2% target this quarter.⁴ Despite a 9.4% decline in the DXY index over the year, the U.S. Dollar's status as the global reserve anchor remains unchallenged, supported by superior liquidity and the relative strength of U.S. growth. Bond markets further reflected this stability. Despite the 10-year yield finishing the quarter flat, it ended the year down 40bps, signaling a calm transition in the rate environment.

The CAPEX Evolution: The magnitude of AI-related capital expenditure remains the most significant fundamental force in the corporate landscape. Hyperscaler spend for 2025 is estimated at \$400 billion, with 2026 projections climbing to \$539 billion (if Hyperscaler CFO targets are actually hit, capex spend would be \$711B).⁵ This relentless investment is fundamentally altering the profile of these entities. Once prized as asset-light, high-margin platforms, these firms are transitioning into infrastructure-heavy giants. Free Cash Flow (FCF) margins have shifted from the mid-20% range a decade ago to the low teens today. While the "return on invested capital" (ROIC) for this spend remains a point of intense scrutiny, the scale of deployment appears decoupled from short-term margin compression.

*Consumer Tailwinds and Policy Risks:*³ Looking ahead to Q1 2026, the consumer is set to receive a significant liquidity pulse. Due to the passage of the OBBBA, the average tax refund is expected to jump nearly 25% to \$4,000. This \$100 billion aggregate boost represents roughly 40bps of additional annual disposable income. When combined with the federal government's reopening following its record-long shutdown, we anticipate a meaningful tailwind for discretionary spending. While student loan delinquencies have ticked up to 14%, we view this as a function of new enforcement mechanisms rather than a collapse in debt-servicing capacity.

Transitions and Geopolitics 2026 Outlook: While we expect inflation to surprise to the downside (potentially prompting more than the two Fed cuts currently priced in), the year is not without risk. The transition to a new Federal Reserve Chair is our primary concern. Markets could require

several meetings to calibrate to a new Chair's communication style, so we anticipate elevated potential for short-term volatility. Furthermore, the geopolitical landscape has grown increasingly complex following the unilateral military action in Venezuela. This sets a high-stakes precedent for ongoing tensions in Taiwan, Ukraine, Mexico and the Middle East. Ongoing global saber-rattling rhetoric towards sovereign nations in the Caribbean, Central American and the Arctic bear close attention. Against a backdrop of U.S. midterm elections, we expect fundamental resilience to be tested by heightened headline volatility.

Technical

Breadth and Market Participation: The final quarter of 2025 was defined by a notable expansion in market breadth. The Russell 2000 successfully breached the 2,458 resistance level established in October, closing the year at 2,481 and signaling a decisive push into new all-time highs. This internal strength was further validated by the S&P 500 Equal Weight Index (RSP), which notched its own record highs near the 200 level. For much of the year, the "concentration risk" of Mega-cap Tech was a primary concern. However, late-year rotation suggests a healthy diversification of leadership that provides the broader bull market with a more stable foundation heading into 2026.

Momentum and Trend Analysis: While the S&P 500 successfully navigated a late-November correction, limiting its drawdown to a standard 5% pullback before recovering to new highs, the Nasdaq 100 has exhibited more precarious technical behavior. After testing its August high of 24,000 during the November dip, the NDQ has struggled to reclaim its prior trajectory. It is currently locked in a battle with its 50-day SMA (25,336), a moving average that is widely considered as a barometer of the strength of the recent trend.

On weekly timeframes, a "bearish tilt" is emerging. The MACD for NDQ triggered a sell signal in early November as the index became stretched against its upper band. Unlike the overbought extremes seen in Q3, RSI levels have now settled into a "neutral" middle range. This lack of momentum, coupled with the failure of the Nasdaq to keep pace with the S&P 500's new highs, suggests that momentum in the growth complex may have peaked for this cycle, leaving the tech sector more susceptible to price consolidation or a corrective event.

Relative Strength and Regime Change: Perhaps the most significant technical development of the quarter was the reversal in the QQQ/SPY ratio. After peaking on November 3rd, the ratio has trended lower, marking a clear shift in relative performance and reverting towards the broader S&P 500. This break in the long-standing leadership of Technology vs. the broad market could indicate a regime change is afoot. Our systems are designed to model these shifts in real-time,

and as the technical profile of "Growth" deteriorates relative to "Value" and "Cyclicals", our deployment continues to adjust to capture the emerging dispersions while maintaining agnostic factor/sector allocations.

[1] DataTrek Research, Morning Briefing: January 4, 2026 (Colas & Rabe, 2026).

[2] U.S. Bureau of Labor Statistics, "Productivity and Costs, Third Quarter 2025 (Preliminary)," News Release, January 8, 2026.

[3] J.P. Morgan Asset Management, Guide to the Markets — U.S., 1Q 2026, as of December 31, 2025.

[4] Truflation, "U.S. Inflation Real-Time Marketplace Data," accessed January 9, 2026.

[5] J.P. Morgan Global Research, "2026 US Equity Outlook: Great Potential," (Snider, January 6, 2026).



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