



## “Minimize Type 2 Error” Market Commentary – January 2026

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**The initial estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 4.3% in the third quarter of 2025.** This is higher than +3.8% in 2025 Q2 and -0.6% in 2025 Q1. The components of the 2025 Q3 GDP number are: consumer spending +2.39 percentage points, investment -0.02 percentage point, net exports +1.59 percentage points, and government spending +0.39 percentage point. The sum of these numbers equals +4.35%. On December 10, the Federal Reserve updated its economic projections that were last released in September. It now sees GDP growth of 1.7% in 2025, 2.3% in 2026, 2.0% in 2027, 1.9% in 2028, and 1.8% in the “longer run” (beyond 2028). It projects inflation to be 2.4% in 2026, 2.1% in 2027, 2.0% in 2028, and 2.0% in the longer run. As for unemployment, the Fed expects 4.4% in 2026, 4.2% in 2027, 4.2% in 2028, and 4.2% in the longer run. The Fed was probably surprised by the strong GDP growth in Q3. It will be curious to see whether this causes them to delay future rate cuts.

**The Federal Open Market Committee (FOMC) cut its benchmark federal funds rate by 0.25% to a range of 3.5% to 3.75% on December 10.** Fed funds futures predict another 0.50% in rate cuts by October 2026, which would put the fed funds rate at a range of 3.0% to 3.25%. Meanwhile, the Fed’s balance sheet had \$6.581 trillion in assets on December 24, up from \$6.552 trillion on November 26. The Fed promised that as of December 1, 2025, they would end their 3.5-year quantitative tightening campaign. The next FOMC announcement on monetary policy is scheduled for January 28.

**Technical factors of the market are bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market.** The Standard & Poor’s forecast for S&P 500 operating earnings per share (EPS) through December 31, 2026 is \$308.97, which implies a price-to-earnings (P/E) ratio of 22.2 with the S&P 500 at 6,846. The earnings yield (E/P) of 4.51% represents fair value relative to the 10-year U.S. Treasury note yield of 4.18% (a yield spread of 0.33%). The eight largest companies in the S&P 500 make up \$23.2 trillion of the \$61.1 trillion index market capitalization with a weighted P/E of 40.2. If 38.0% of the index has a P/E of 40.2, then 62.0% of the index has a P/E of 11.1 for the overall P/E to be 22.2. A P/E of 11.1 is an E/P of 9.01%, which is attractively priced compared to the 10-year Treasury note yield of 4.18% (a yield spread of 4.83%).

**The S&P 500 is struggling to get meaningfully above 6,900, a level which has proven to be resistance since late October.** Technically, the index continues to trend higher, pinching into the resistance area. A breakout above resistance should result in an explosive rally significantly above 7,000. Should stocks pull back, support levels should be around 6,800 (50-day moving average), 6,540 (November 2025 low), 6,290 (200-day moving average), and 6,100 (February 2025 high).

**Another helpful model to consider while making decisions under uncertainty comes from statistics: Type 1 and Type 2 error.** Imagine a grid with four quadrants, with the x-axis labeled as “expectation” and the y-axis labeled as “reality”. If you expect a given stock to perform well, you buy it, and over time the stock performs well, then buying the stock would be a correct decision. Similarly, if you expect a stock to perform poorly, you do *not* buy it, and over time the stock performs poorly, then *not* buying the stock would be a correct decision. However, there are two errors you can make. “Type 1 error” is not buying a stock that over time performs well (with the benefit of hindsight, you “rejected the good stock”). The financial downside of Type 1 error is opportunity cost. The portfolio does not take a direct hit, but it could have benefitted from potential upside. “Type 2 error” is buying a stock that over time performs poorly (you “failed to reject the bad stock”). The financial downside for Type 2 error is real money lost as the portfolio declines in value. Avoiding the mega-cap technology bubble while it is inflating could be considered Type 1 error in the short run (spanning years). However, in the long run, those who participate in the bubble may ultimately be committing Type 2 error. Absent a crystal ball, it is better to minimize Type 2 error.