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US equity markets continued to move higher during the third quarter of 2025, concurrent with elevated levels of market volatility. The 8.1% rise in the benchmark S&P 500 index during the third quarter brought the YTD increase to 14.3%.

Factors driving financial markets during the summer months included tariffs, inflationary pressures, and a significantly slowing jobs market. Payroll growth has ground to a near halt, averaging just over 20,000 new jobs per month since April 2025. Changes in net immigration are helping to keep the unemployment rate from rising as fast as it would historically with job growth this mundane.

The Federal Reserve cut the Fed Funds rate by 25 basis points at their mid-September meeting, resuming the easing cycle that began a year ago. The Fed projected another 50 basis points of rate cuts by year-end 2025 which could bring the Fed Funds rate to 3 5/8%. Somewhat surprisingly, they projected only a single cut in each of 2026 and 2027 which means the Fed currently expects the rate to remain above 3% over the long-term. Futures markets are pricing in a Fed Funds rate below 3% in 2027. We note that with a new Fed chair likely next May and other potential changes to the Federal Open Market Committee, the rate path could change significantly. Chair Powell described the labor market as being in a “curious kind of balance.” Both the supply of workers and demand for workers have fallen significantly over the past six months. We believe the rate cut was more of an insurance policy against rising unemployment, considering the stubborn inflationary pressures in the economy. The implications of a quiet or explicit abandonment of the Fed’s 2% target are a topic worthy of debate that is likely to evolve as the Fed continues to cut rates with inflation closer to 3% than 2%. We note that intermediate and long-term Treasuries saw rates rise following the Fed Funds cut.

Economic and Market Outlook

Interest rates across most of the maturity spectrum declined modestly during the quarter as softening economic data and a benign inflation outlook combined to move rates lower. The 1-year Treasury bill yield declined to 3.63% from 3.98% on June 30. The 2-year Treasury note began the quarter yielding 3.72% and declined to 3.60% at the end of September. The benchmark 10-year US Treasury note ended the quarter with a yield of 4.15%, slightly lower than the 4.23% yield on June 30. Projections for S&P 500 earnings in 2025 are \$265-270, down from a range of \$275-280 at the start of the year. However, with stocks rising meaningfully YTD, the forward P/E multiple approximates 22x 2026 earnings estimates. With stocks priced at elevated levels, the concerns from geopolitical conflicts, stubborn inflationary pressures, and a slowing jobs market give us concern of a potential disappointment causing a pullback in equities.



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Portfolio Positioning

Our overriding concern regarding US equities is their current high valuation. Under nearly any metric, stocks are near their highest valuations based on earnings in modern history. While market bulls point out Artificial Intelligence, Earnings growth expectations, American supremacy, or other justifications; we remind you that the most dangerous words for investors are, “It’s different this time.” Vanguard recently released guidance for investors to use portfolios of 30% stocks and 70% bonds for the next decade based on their predictions of asset class returns. This is significantly different from the standard 60/40 portfolio breakdown. Extensive studies have shown that starting valuations explained more than 75% of subsequent ten-year returns. While earnings growth could help support current valuations, we continue to remind investors that the tariff situation remains quite fluid. Although exporters may be eating a percentage of the tariffs, the bulk is passed to US companies and US consumers. The combination of higher input costs due to tariffs and limited pricing power with a stretched consumer could limit any further margin expansion and thus cap earnings growth potential.

Based on higher valuations in the US versus most international markets, we have seen a definitive shift towards non-US equities outperforming US equities during 2025. Higher US budget deficits, slower economic growth, and policy uncertainty have combined to weaken the US dollar versus many other currencies. As short-term rates decline, it makes the cash versus fixed income asset allocation more challenging. Longer-term fixed income is still unappealing with yields of 4% for a 10-year Treasury with inflation running close to 3%.

As always, periods of elevated valuations test investor discipline. A conservative allocation may feel overly cautious if markets continue higher in the short term. Conversely, sticking with a growth-heavy allocation could be costly if returns stagnate or decline.

Conclusion

As we write this Commentary in the first week of October, we must note the government shutdown due to a budget impasse. This shutdown feels different, and we believe it will be measured in weeks rather than days, with neither side seeming to be willing to cede any ground. We find government shutdowns due to funding limitations or budget negotiations to be farcical. The monies always get paid, nobody misses their transfer payments, etc. It reminds us of the term, “When all is said and done, a lot more is said than done.” While we do not know what will end this shutdown, we do know it will end.

We believe the next several months could set the tone for the remainder of the decade. There will be significant changes at the Federal Reserve, budget battles are well underway, and the midterm elections will begin dominating the news in early 2026.



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Third Quarter 2025

As we head into the final months of 2025, we suggest you review your portfolio asset allocation and contact us if there are any significant changes in your financial situation, risk tolerance or if you have any specific questions or concerns about your investments.

September 30, 2025

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