

THIRD QUARTER FINANCIAL MARKET COMMENTARY
“NINETY DAYS IN NINETY SECONDS”
SEPTEMBER 30, 2025

A COMPLICATED ECONOMIC PICTURE FOR THE FED

- ♦ The US economy remains remarkably resilient, even in the face of tariffs and uncertainty around government policy. Employment gains have slowed, and the unemployment rate has risen, but these trends can largely be attributed to the slowdown in immigration that has reduced the supply of labor.
- ♦ These divergent economic data points are sparking debate within the Fed regarding how to balance its dual mandate of maximum employment and stable prices. The key takeaway from the September FOMC meeting was that the Fed is now highlighting employment risks more than inflation risks. Chair Powell referred to the “tension” between these two goals and cited the “curious balance” in the labor market.
- ♦ The big question is whether the emphasis on employment and rate cutting is sustainable. Rate cuts typically are in response to the Fed viewing monetary policy as too tight. That view is not consistent with stocks, AI beneficiaries, and crypto hitting new highs. Likewise, the Atlanta Fed’s GDP model is forecasting robust 3.8% growth. Aggressive rate cuts might provide a near-term boost to the job market, but it would likely come at the expense of upside risks to inflation.
- ♦ The housing market has been among the most visible of the areas that have been negatively impacted by the current level of interest rates. However, a bigger culprit has been the lack of growth in new home construction that has left most housing markets chronically undersupplied, and therefore highly valued.
- ♦ Inflation remains stubbornly high with the primary price indexes hovering around an annual rate of 3.0%. Digging deeper reveals that about 60% of the items in the CPI basket reflect 3% annualized price hikes, which is almost twice as many items as a year ago.

THE CIRCULARITY OF THE AI BOOM

- ♦ Mega-cap technology companies have historically operated on a capital light and free cash flow heavy financial model. That is how they built fortress-like balance sheets, but capital spending is now dwarfing free cash flow. The providers of AI chips and infrastructure, led by NVIDIA, have experienced phenomenal revenue and profit growth thereby propelling their stocks to record highs. The buyers of those chips and the builders of those data centers have also seen their stocks rally sharply in expectation of future growth. A cautionary observation is that there are very few games in which everybody wins.

THE CIRCULARITY OF THE AI BOOM (CONTINUED)

- ♦ Cumulative capital spending on AI is expected to reach \$3 to \$5 trillion over the next five years. Huge revenues from AI will be necessary to earn a satisfactory return on that investment. Of course, such revenues are imaginable, which is why the money is being spent, but human enthusiasm is such that capital spending will very likely overshoot. All capital spending cycles go through a euphoria phase of spending for growth and market share followed by a return-focused phase that prioritizes near-term cash flows. The next AI wave in the stock market is likely to involve sorting out the long-term importance of AI versus the near-term funding economics.
- ♦ NVIDIA recently announced a \$100 billion investment in OpenAI. The cash will fund the purchase of NVIDIA chips for next generation AI models. In another example of circular spending, Oracle is leveraging its balance sheet to build cloud computing facilities for OpenAI. Beginning in 2027, the annual cost to OpenAI of \$60 billion is more than five times its current revenue. In other words, the best performing part of the stock market has been self-fulfilling.

COMPANIES ARE FLUSH WITH CASH

- ♦ Improving CEO confidence and a rising equity market have led to a 29% year-to-date increase in announced merger and acquisition transactions. The initial public offering market is also active with 18% more IPOs compared to the first three quarters of last year. This rebound comes after a multi-year drought in capital markets activity.
- ♦ Companies are also repurchasing their own shares at the fastest pace on record. These capital market transactions should be supportive of stock prices, bullish for the banking system, and positive for the legions of private company owners who are looking for an exit opportunity.

POLITICS VERSUS COMPANY FUNDAMENTALS

- ♦ Almost irrespective of where one resides on the political spectrum, the current environment of heightened rhetoric, power grabs, and tariff uncertainty can be disconcerting. However, I would highlight a phrase that I began using about a dozen years ago that “companies are much better managed than countries.” In the most recent quarter, corporate revenues, margins, and earnings were much better than analysts’ expectations. That trend is expected to continue for the balance of the year and into 2026.

THE CONSUMER SPENDING CONUNDRUM

- ♦ The downtrend in consumer sentiment data reflects rising concerns around a substantial decline in hiring and stubborn inflation. Those survey results are in contrast with back-to-school demand, which was robust, and the views of most major retailers that the consumer remains resilient.

THE CONSUMER SPENDING CONUNDRUM (CONTINUED)

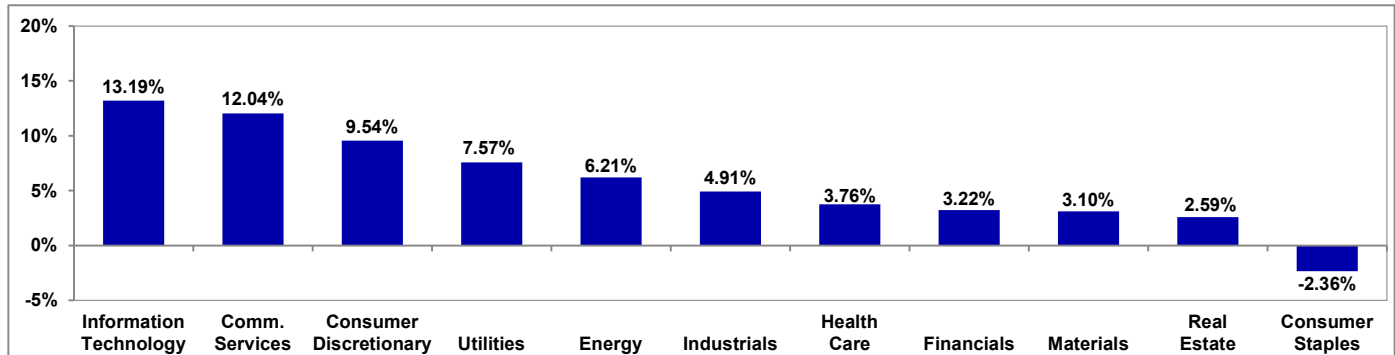
- ♦ Analyzing consumer spending data by income group helps to explain this strength. Over the past three decades the share of spending by consumers in the top 10% of income groups has grown from 35% to almost 50%. These consumers are less sensitive to labor market conditions, and their spending has been supported by rising equity markets and elevated home values.

CONCLUSION

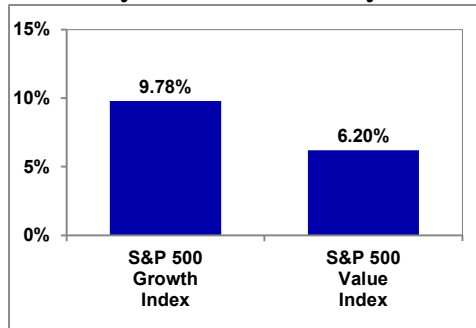
- ♦ It is “old news” that valuations are high, retail speculation is rampant, Washington is dysfunctional, and that the Fed is at a crossroads in terms of interest rate policy. The biggest offsets to these negatives are that old news is rarely a driver of future market swings and earnings growth is forecasted to remain strong.
- ♦ The two most important questions for the equity market are: Is the staggering level of AI capital spending durable and will the Fed continue to cut rates if the economy is not experiencing a growth slowdown.
- ♦ Market rallies typically benefit from periodic corrections that curb some of the more rampant areas of speculation. It would not be surprising to see either a price pullback or a major rotation in the fourth quarter. In fact, the beleaguered health care sector has recently been the beneficiary of a huge rally as traders rotated into the group during early October.

Third Quarter Investment Performance (including income)

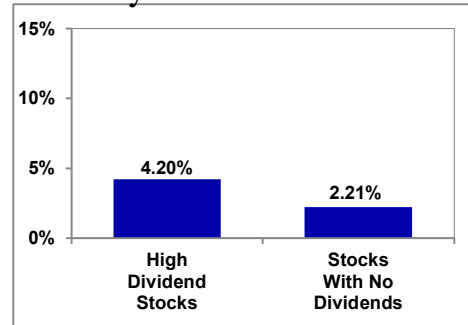
By Economic Sector



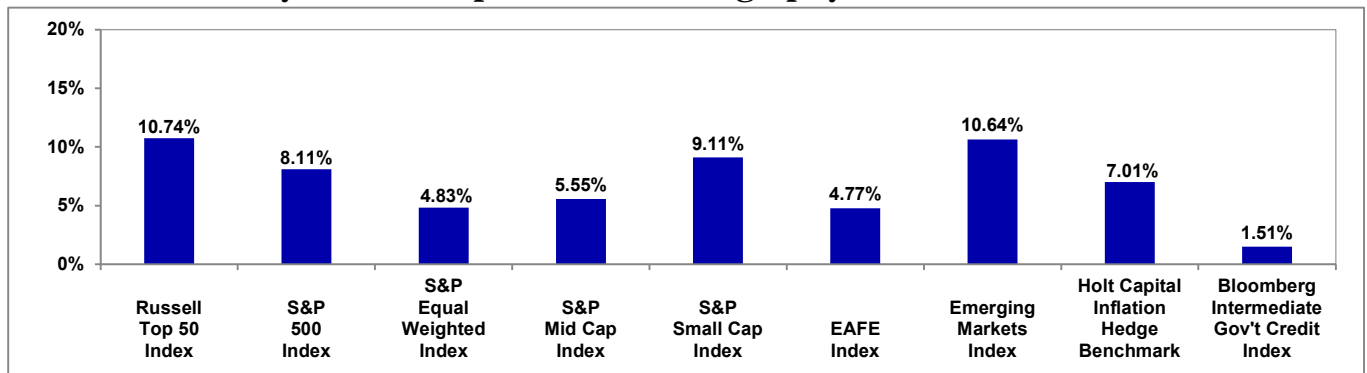
By Investment Style



By Dividend Yield



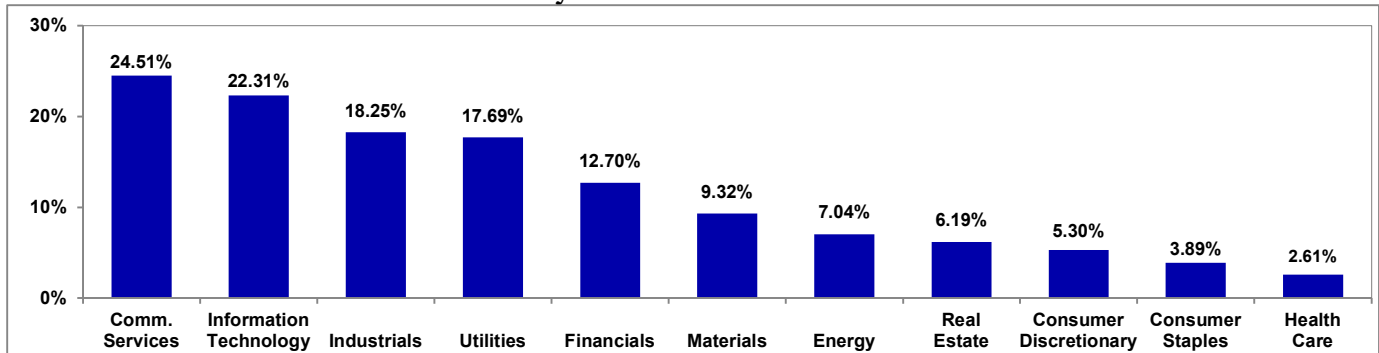
By Market Capitalization, Geography and Asset Class



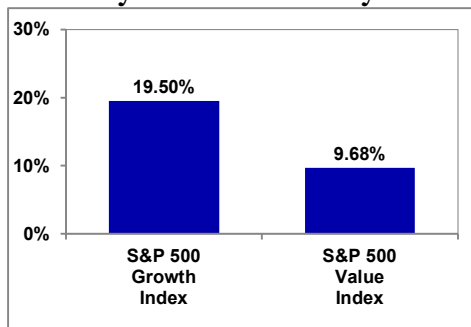
- ♦ The third quarter was another period characterized by narrow leadership from mega-cap growth stocks. As a point of reference, NVIDIA, Microsoft, and Apple collectively represent over 60% of the technology sector. Alphabet (formerly Google) and Meta (formerly Facebook) are almost 40% of the communications sector. Lastly, Amazon and Tesla comprise over 50% of the consumer discretionary sector.
- ♦ In contrast to the strong index level return of the S&P 500, over 37% of the index's constituents declined during the quarter. The consumer staples sector posted negative returns, which reflects the impact of price inflation on input costs, as well as consumer demand.
- ♦ The S&P small cap index was a bright spot in this environment with the technology sector generating the best results and staples the worst. These sector trends tracked large cap peers.

Year-to-Date Investment Performance (including income)

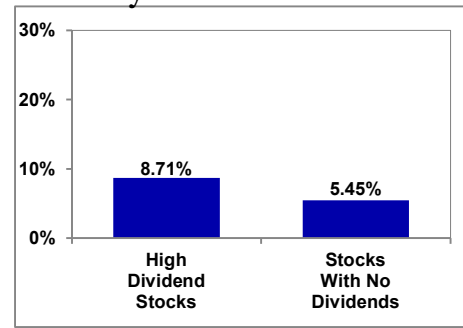
By Economic Sector



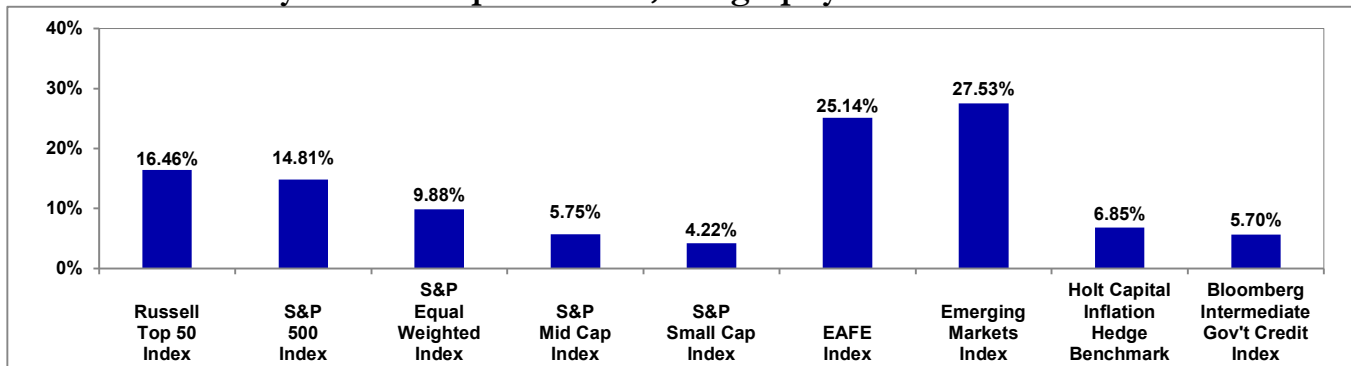
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- ♦ Company size was the dominant driver of returns for the year-to-date period. Diversification across market capitalizations reduced volatility, but did not enhance returns.
- ♦ Lower valuations, more accommodative monetary policies, and a weaker dollar have all contributed to strong year-to-date returns for international stocks. Since the Great Financial Crisis in 2008 and 2009, domestic stocks have only lagged their international counterparts by a material amount in one calendar year.
- ♦ Fixed income returns benefited from a steady decline in yield levels, especially in bond maturities of ten years and shorter.