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Quarterly Review and Outlook

The stock market advanced to new highs in the third quarter despite headwinds from President Trump's tariff policies announced in the spring. The S&P 500 index has risen ~32% off the April 9th low and gained 8% for the quarter. Market breadth broadened beyond the "Mag 7" stocks (Amazon, Apple, Google, Meta, Microsoft, Nvidia and Tesla) to include a larger share of overall gainers. Key factors supporting the rally included lower interest rates, contained inflation and strong corporate earnings.

In response to a weakening job market, the Federal Reserve lowered the federal funds rate in mid-September, bolstering investor sentiment. Chairman Powell signaled that further rate cuts could be considered if economic data—particularly employment—show additional weakness. While the softening labor market has raised concerns, job growth and overall economic growth remain positive. On September 17, the Fed reduced the federal funds rate by 0.25% to a range of 4.00–4.25%. Powell warned that "downside risks to employment are rising and if those risks materialize, they can do so quickly in the form of sharply higher layoffs and rising unemployment." The Fed's rate cut was aimed at mitigating such risks. Markets are currently pricing in two additional rate cuts of 0.25% each by year-end. Long-term yields have also declined, with the 10-year U.S. Treasury yield falling to ~4.15% from ~4.75% earlier this year.

Inflation remaining at a "manageable" level has been a welcomed surprise for investors, despite tariff-related concerns and their impact on consumer prices and business costs. A Goldman Sachs study estimated that ~65% of tariff costs were absorbed by businesses, with consumers and exporters sharing the remainder. Inflation, whether measured by the Consumer Price Index (CPI) or the Fed's preferred Personal Consumption Expenditures Index (PCE), is currently in the mid-to-high 2% range. While this remains above the Fed's 2% target, it is far below the ~9% peak reached in June 2022, reinforcing investor confidence in the longer-term downward trend.

Strong corporate profit growth has also fueled the market's rise. S&P 500 profits rose 12% in the first half of the year, outpacing expectations for a 7% increase. A healthy economy growing at ~3% and gains in worker productivity (~2.6% in Q2) contributed to earnings growth outpacing sales. Looking ahead, corporate profits are expected to grow at a low double-digit % pace for the remainder of 2025 and into 2026.

While workers have become more productive, employment gains have slowed in recent months. Non-farm payroll growth has averaged 29,000 per month over the past three months, down sharply from 144,000 in the previous five months of the year. Employers appear reluctant to expand headcount, likely due to tariff-related uncertainty around input costs and supply chains. However, employers have not been laying off workers either. Economists have characterized this as a “low hiring, low firing” environment.

The combination of lower interest rates, contained inflation and strong corporate earnings has created a favorable backdrop for equities. However, valuations have become elevated. The market’s forward price to earnings or P/E ratio, now above 22x projected earnings, is at its highest level in many years. While double-digit earnings growth remains healthy, time may be needed for the “E” (earnings) to catch up with the “P” (stock prices) in terms of the market’s valuation.

The inability of Congress and President Trump to come to terms on a government spending bill has caused some investor concern. Republican lawmakers have been advocating a stopgap bill to temporarily fund the government until a longer-term agreement can be reached. Democrats want the funding bill to include provisions that extend expiring Obamacare subsidies and reverse Medicaid cuts. As a result of the impasse, the Federal government shut down effective Oct. 1st with all but essential services ceasing operations. Past government shutdowns have historically been resolved in a matter of weeks. The last one occurred during President Trump’s first administration for a period of 35 days ending January 25, 2019. No one knows how long this one will last, but historically government shutdowns have had limited economic and financial market impact.

International developments have caused some investor concern as well. In France, the prime minister resigned after losing a no-confidence vote tied to failed spending reforms, sparking nationwide protests. Germany’s economy is growing only marginally above zero percent. In the U.K., debt-to-GDP has surpassed 100%, pressuring interest rates and stoking fears of a fiscal crisis. In Japan, the prime minister announced his resignation after local election losses, while Japan’s debt-to-GDP ratio remains the highest among developed nations at ~260%. Even so, international equity markets have generally held up well, as investors anticipate continued economic growth and earnings gains despite trade tensions.

Back in the U.S., technology, industrial and financial stocks led the third-quarter rally. In an environment of monetary easing, contained inflation and solid earnings growth, we remain focused on high-quality growth companies with strong balance sheets and sustainable earnings power. Our investment philosophy is grounded in the belief that long-term stock appreciation is driven by earnings growth over time. Our current equity focus includes technology, industrial, healthcare, specialty finance, and select consumer stocks.

On the fixed income side, our portfolios have benefited from declining interest rates which lift bond prices as yields fall. Bonds play an important role in providing income and dampening portfolio volatility. Depending on client needs, this income may be taxable or tax-exempt. We typically structure bond portfolios with laddered maturities, giving us flexibility to reinvest proceeds as bonds come due. Corporate balance sheets in general are strong and credit spreads (a measure of risk) remain low, indicating healthy demand for corporate issues. With the Fed expected to further cut rates this year and into next year, we are starting to see mortgage rates move lower which could give a boost to housing and an added tailwind to the economy if this trend persists.

As always, we are grateful for your continued trust and encourage you to reach out with any questions you may have about your investments or portfolio strategy.