

## Quarterly Market Update

Third Quarter, 2025

### BEGINNING TO BUILD A BULLISH CASE FOR 2026

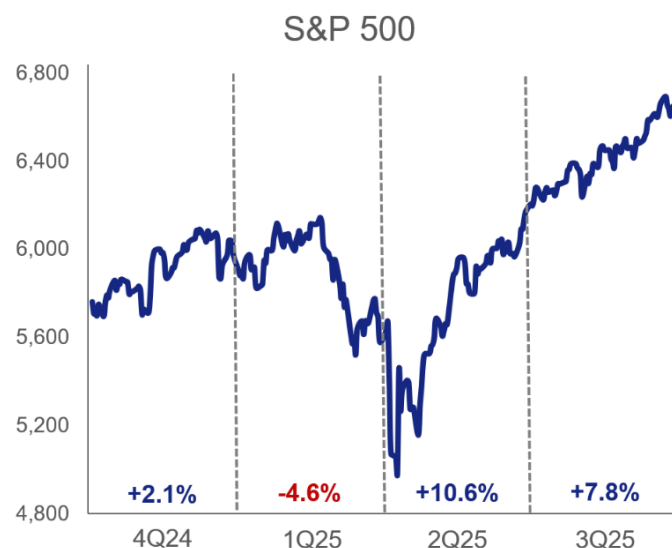
**Fiscal boost.** Until the the OBBB tax cuts started to come into shape, we had taken to treating the second quarter of 2025 like the famous Vegas tagline: “What happens in Q2 stays in Q2.” Mercifully, while it may not ultimately speak well of America’s fiscal situation or that of its citizen spenders, the legislation suggests corporate and consumer tax cuts and spending credits will supplement more than \$515 billion of consumer tax refunds next spring (~\$150 billion above levels seen the last several years).

**Bullish signposts.** In Q3, profit guidance rebounded from the downward revisions that followed the major tariff announcements of early April. Perhaps even more impressively, corporate operators managed to deliver results above the earlier forecasts and have continued to grow revenue and earnings. Profit margins remain strong, and the underpinnings of economic health have started to broaden. As a general rule, when profits remain positive and are growing closer to double-digit rates as opposed to low single-digit rates, the economy can usually stay out of trouble and avoid the pre-recession progression. By our lights, it’s tough not to get bullish on capital spending and consumption next year.

**Spenders.** To be fair, concerns are mounting about the state of the labor market and what it portends for the U.S. consumer. While some slowdown in the labor force may be related to immigration policy, many sectors have continued to absorb workers at premium wages through the summer. Moreover, weakness in consumer spending has thus far been confined to the lowest-earning spenders. Not an overwhelming social commentary, but not a signpost of an imminent decline in the broader economy, either.

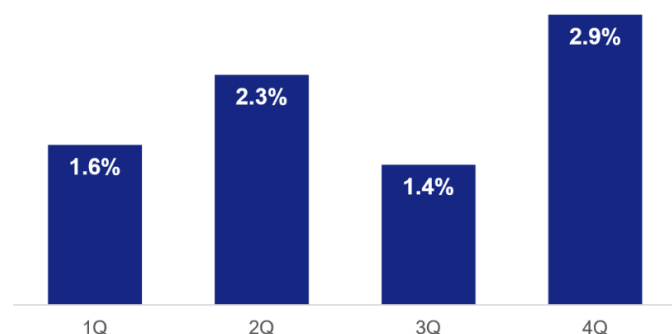
**Fade stagflation.** Inflation and inflation expectations have remained generally anchored but continue to run above the Fed’s long-run target of 2%. Choppiness related to the haphazard rollout of tariff policy has also given rise to concern that “stagflation” is poised to take hold. For now, we don’t see it. While the building blocks for a second wave of inflation may be stacking on the back of fiscal spending and easier monetary conditions, worrisome levels do not appear imminent (i.e., in 2026).

**Themes to watch.** We see market leadership continuing to evolve against a shifting thematic landscape. Deglobalization remains an important theme, but the converging catalysts of the forthcoming “consumption wave” suggests a strong outlook for 2026 once a period of uncertainty has been traversed.



Asset Class	Representative Benchmark	Q3 2025 Total Return	YTD 2025 Total Return
US Large Cap	Russell 1000	8.0%	14.6%
US Small Cap	Russell 2000	12.4%	10.4%
International	MSCI AC World ex-USA (USD)	7.0%	26.6%
Commodities	Bloomberg Commodity	3.7%	9.4%
Gold	LBMA Gold PM (\$/ozt)	16.4%	46.6%
Municipal Bonds	Bloomberg Municipal Bond	3.0%	2.6%
Taxable Bonds	Bloomberg US Aggregate	2.0%	6.1%
Cash	Bloomberg 3-Month T-Bill	1.1%	3.2%

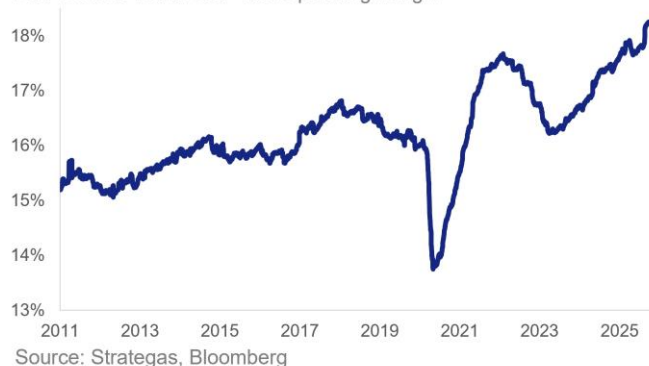
### S&P 500 Average Quarterly Return (since 1928)



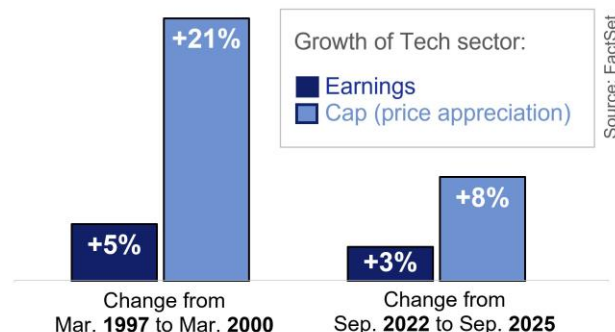
Source: Data for the charts and table on this page come from data-provider Factset.

**Profit margin estimates are hitting new highs**

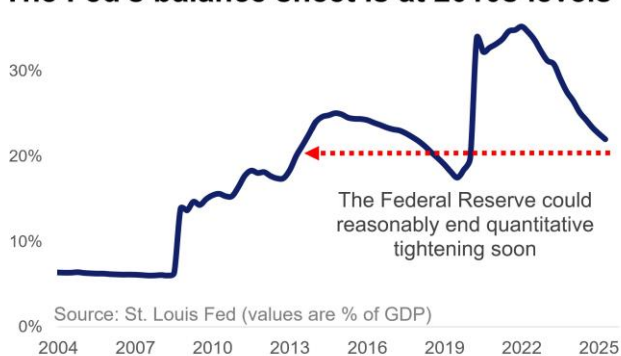
Est. Next 12-month S&amp;P 500 Operating Margin



After a string of soft job reports and the large downward revision to early estimates, the gains in S&P earnings and corporate profits of recent years occurred with fewer workers than initially thought. That would be consistent with productivity starting to improve, and is perhaps reflected by the record next-12-months profit margin estimates. Optimism for Q3 earnings growth also remains strong. Estimates have been revised higher throughout the quarter, defying the historical trend of downward revisions. Seven of the eleven sectors are expected to report positive Q3 earnings growth, with four of those projected to see growth in the mid-to-high teens.

**Smaller gap between stock price and earnings now than in the dot-com bubble**

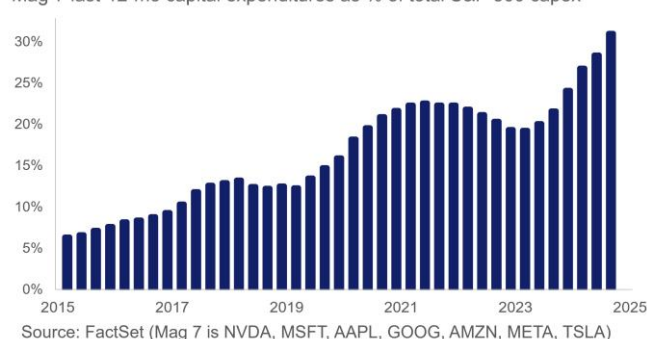
The run-up in the stock market since 2022 has led to comparisons to the late 1990s. There are many similarities, including a transformative technology central to both market and economic growth (then the internet, today artificial intelligence). Like the late 1990s, today's market is historically concentrated in the country's biggest tech companies. However, before the "Dot Com" bubble burst, Tech's earnings weight rose only 5% versus a 21% increase in market cap weight. Today, that gap is far less extreme, as the rise in price has been more closely tracked by growth in earnings. This will bear watching closely in coming years.

**The Fed's balance sheet is at 2010s levels**

The Federal Reserve seems to be positioning itself to end its policy of quantitative tightening (i.e., letting the bonds on its balance sheet mature without reinvesting proceeds). This would be a material update to the country's monetary policy, and would allow the Fed the ability to reinvest the proceeds of maturing bonds into mortgage-backed securities, Treasury bills, and other assets. This potentially adds another buyer to the Treasury market (putting downward pressure on short-term yields) and could be particularly helpful in reducing mortgage spreads at a time when housing activity looks ready to re-accelerate.

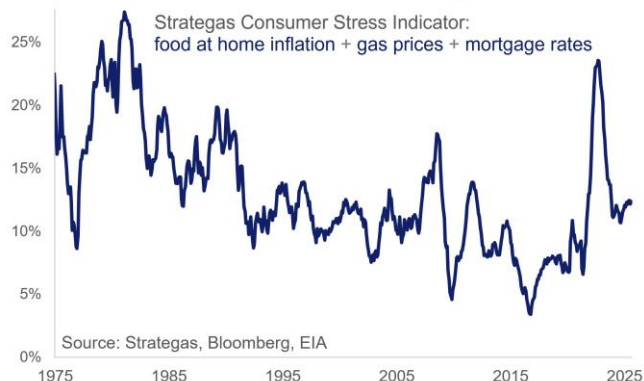
**Big Tech spending is ramping up quickly**

Mag-7 last-12-mo capital expenditures as % of total S&amp;P 500 capex



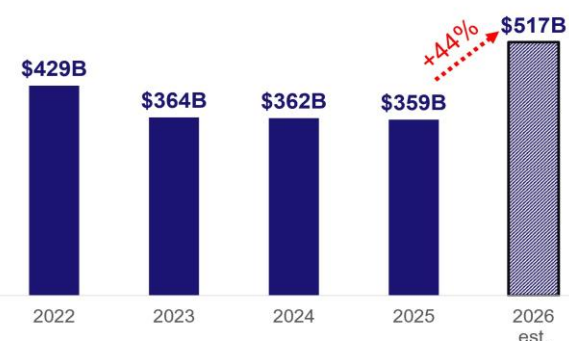
There are many reasons to own the Mag. 7 even at today's relatively lofty valuations. The companies generate a ton of cash, AI is likely to be a transformative technology with first-mover advantages, earnings are growing rapidly, and generally speaking, they have little debt. One reason sometimes cited to own some of these companies has been that they are "capital light." However, AI appears to have changed that. Investments in artificial intelligence are costly, and Mag. 7 cash flow growth is negative for the first time in two years. This could pay off, but that is far from guaranteed.

### Consumer strain is moderating



Despite concerns over a softening labor market, recent consumer spending data based on credit card transactions indicates that spending remained strong through the end of summer. With measures of consumer stress back to relatively normal levels, we upgraded the Consumer Discretionary sector to overweight, on the potential for a consumer spending surge in 2026, based this on the potential for lower interest rates, tax relief, and tailwinds from U.S. 250<sup>th</sup> and World Cup.

### Federal tax refunds are set to spike



Source: Strategas estimates based on OBBBA provisions

A major catalyst for consumers set to take effect in 1Q26 is the stimulus from OBBB. Our policy team estimates that the total value could reach \$150 billion, driven by an increase in the SALT limitation, an expanded child tax credit, a higher standard deduction, and several other measures. This would be an influx of cash into the economy, as studies suggest most of these refunds are likely to be spent. Moreover, a strong back-to-school season (like the one we just saw) typically signals robust holiday spending. Some CEOs with visibility into the winter timeframe are already predicting a pickup in activity.

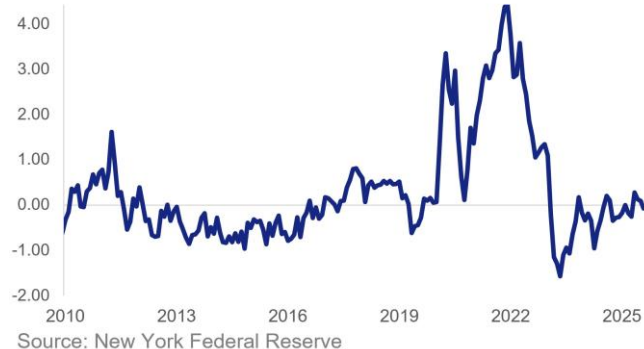
### As mortgage rates spiked, home sales plummeted



The U.S. housing market attempted a thaw last year as the Fed began rate cuts. But mortgage rates have proven sticky this year, keeping most measures of housing market activity fairly depressed. Residential investment has been unable to grow with this backdrop. With the Fed re-engaging its rate cut cycle in September (with more cuts expected), there's renewed hope, and timely measures of U.S. mortgage applications (to purchase *and* refinance) reflect this situation. Bottom line: the FOMC put monetary policy on an extended hold in 2025, but this is starting to change as U.S. monetary policy moves toward a more neutral setting. More may be needed, but it's a nice start.

### Supply chains aren't under strain yet

NY Fed Global Supply Chain Pressure Index



While tariff volatility has roiled U.S. trade data and corporate planning, no signs of supply chain pressure or major bottlenecks have yet emerged (the NY Fed's measure of global supply chain pressure tracks global trade using cost and survey data from the transportation and manufacturing sectors). This is likely in part due to the administration setting tariff rates according to a nation's proximity to the U.S. supply chain and to the U.S. geopolitically. Countries closer to China with large trade surpluses are facing tariff rates in the range of 16-20%. Countries challenging the U.S. dollar are facing even higher tariff rates.

**S&P 500 Index (Large Cap / U.S. Stocks):** A representative sample of 500 leading companies in leading industries of the U.S. economy. These are equity securities of large capitalization (generally \$7 billion plus market cap) companies having growth and value characteristics. • **Russell 2000® Index (Small Cap / Small Core):** Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. These are equities of small capitalization. • **MSCI EAFE Index Net (International / Developed Markets):** A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US and Canada. As of December 2024, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. • **BBGBarc Aggregate Bond Index (Taxable Bonds / Bonds):** Composed of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years. • **BBGBarc Muni Bond Index (Municipal Bonds):** Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least \$3 million, part of a transaction of at least \$50 million, issued after December 31, 1990, and have a year or longer remaining maturity • **FTSE 3-month T-bill Index (Cash):** This index measures monthly return equivalents of yield averages that are not marked to market. It consists of the last one-month and three-month Treasury bill issues, respectively. • **Bloomberg Commodity Index (Commodities):** Composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Subindices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs.

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