

2025 Third Quarter Review of the Markets

Market Commentary

The third quarter of 2025 was positive for both U.S. and international stocks. The S&P 500 increased 8.1%, bringing the year-to-date return to 14.8%. International stocks increased 6.9% during the quarter and are up 26% year-to-date. Small cap stocks performed the best after a negative return through the first half of 2025, increasing 12.4%, and are now up 10.4% year-to-date.

Bonds continued to perform well, returning 2% for the quarter and they are up 6.1% for the year.

Economic Outlook

As of this writing, the U.S. government shutdown continues. At least 750,000 government employees have missed a paycheck, and that number will grow if the shutdown lasts much longer.

During the most recent government shutdown of 35 days from December 2018 to January 2019, we did not see a meaningful impact on consumer economic data. That said, the percentage of outstanding consumer debt balances greater than 90 days past due is higher now than at the beginning of last shutdown, suggesting that a higher percentage of workers may be under greater financial strain now than at the end of 2018. From a market perspective, there are countervailing forces compared to the end of 2018. During the last shutdown, the Fed was at the end of a tightening cycle, and the Fed Funds target rate was not lowered until six months after the shutdown ended. Currently, there are broad expectations for the Fed to continue its rate cuts this year. The prospect of more accommodative monetary policy is good for markets, albeit a benefit that is baked into current valuations. On the earnings front, the end of 2018 saw a higher-than-average number of companies in the S&P 500 issuing negative earnings guidance, which contributed

to a 13% decline in the index during the fourth quarter of 2018. This provided a bit of a coiled spring for a stock market rebound during the first quarter of 2019. Today, a slightly below average percentage of companies in the S&P 500 have issued negative earnings guidance, and earnings growth estimates are a little more than 2% above their 20-year median. These more favorable expectations of the future are currently supporting stock prices but leave less room for error in the event that there are earnings surprises going forward. On balance, it seems less likely that the economy and markets would fare as well as they did after the 2018 shutdown if this shutdown lasts 30+ days.

Government shutdown aside, valuations on U.S. stocks remain high, suggesting lower future returns from stocks. While lofty valuations in the 10 largest names in the index certainly skew these valuations higher, the remaining 490 stocks are also trading on average at a significant premium to their long-term averages.

Much of the fixed income universe seems to be participating in the above-average valuations brought on by high expectations in the equity market. While total yields on investment grade bonds are certainly high relative to the past 15 years, corporate bonds are near their most expensive levels in history relative to treasury bonds. We remain constructive on bonds over the intermediate term, but we believe reaching for yield in lower quality credits given current high valuations will dampen the potential defensive benefits of fixed income should the markets stumble.