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Market Review and Outlook 3Q25

Highlights

Equities added to their solid year-to-date gains during the third quarter, with the S&P 500 Index posting a quarterly total return of 8.1% (+14.8% YTD).

Growing clarity across critical policy matters and stronger than expected second-quarter earnings growth aided the market's sustained rally.

With stock prices continuing to move higher, the S&P 500's P/E multiple (23.0x) pushed through already-elevated valuation levels and now sits nearly 40% above the historical average.

The market's P/E multiple expansion over the last few years is attributable to the index's extreme concentration of richly-valued tech companies at the forefront of the artificial intelligence (AI) boom.

Fixed income continued to provide a stable source of gains for investors, with the Bloomberg U.S. Aggregate Bond Index posting a positive third-quarter total return of 2.0% (+6.1% YTD).

With inflation elevated and government deficits rising, we continue to favor short- to medium-duration bonds over more fiscally sensitive long-term bonds.

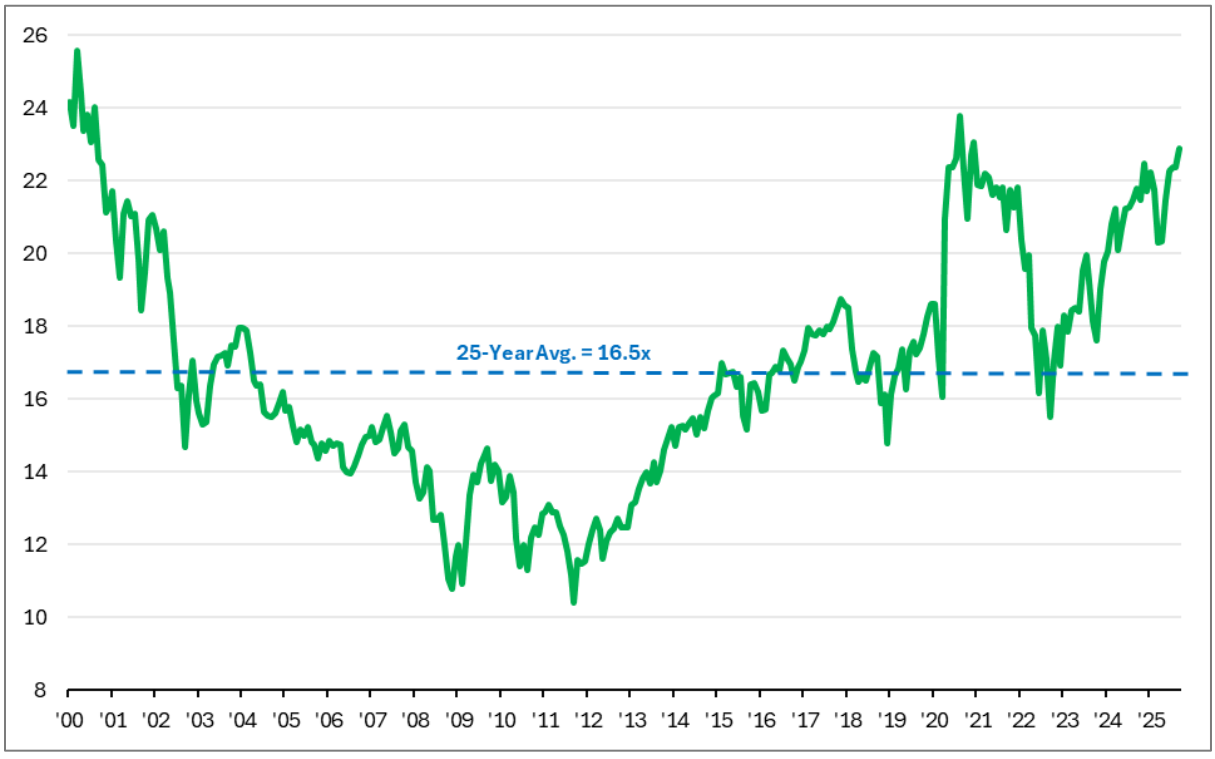
Market Review and Outlook

Global equity markets continued to push higher during the third quarter, adding to their solid year-to-date gains. Domestic stocks have exhibited remarkable resiliency to the effects of higher tariffs (thus far), with the S&P 500 Index posting a third-quarter total return of 8.1% (+14.8% YTD). Meanwhile, international markets sustained their impressive rallies during the quarter, with developed markets (EAFE) increasing another 4.8% (+25.1% YTD) and emerging markets (EM) posting a third-quarter surge of 10.6% (+27.5% YTD).

A supportive backdrop, marked by economic stability and growing clarity across critical policy matters, has aided the market's sustained expansion. Tariffs had been the biggest source of market insecurity earlier this year, prompting a ~20% decline in stocks in April, but this cloud of uncertainty gradually lifted with the announcement of more trade deals. Stronger than expected earnings also boosted investor confidence, with the S&P 500 Index companies posting second-quarter EPS growth of 12%—the third consecutive quarter of double-digit profit growth for the index and more than twice the consensus earnings growth forecast (5%) heading into the reporting period. Finally, the interest rate picture also started to clear, with the Fed delivering on the widely anticipated 0.25% interest rate cut in September (the first since December 2024) and signaling that another 0.50% reduction could come by the end of the year. Given this framework, it's clear why equity prices continued to rush higher during the quarter.

The sustained rally in stock prices has put additional upward pressure on already elevated valuation levels, however, with the S&P 500 Index closing the third quarter at a forward P/E multiple of 23.0x. The forward P/E ratio is now 12% higher than immediately prior to the April 2nd announcement of U.S. tariffs (20.5x), nearly 40% above the market's 25-year average multiple (16.5x), and on the doorstop of record valuation levels.

S&P 500 Index Forward P/E Multiple
(2000-2025)



Source: FactSet

As we've noted in the past, valuation measures are poor timing tools, so a stretched P/E multiple doesn't mean a correction is imminent. Moreover, it could be argued that today's 23x forward earnings multiple is reasonable relative to companies' robust profitability metrics. The S&P 500 Index recorded a net profit margin of 11.6% over the last 12 months, more than 27% above the index's 25-year average net margin of 9.1%. Higher margins mean more money can flow to the bottom line—giving companies flexibility to invest more in their operations to sustain profit growth and/or increase stock buybacks to boosts earnings-per-share growth—potentially justifying richer valuations relative to historical levels.

The S&P 500's margin expansion and P/E multiple uplift over the last few years are both attributed to the growing concentration of the "big eight" stocks (Nvidia, Microsoft, Apple, Alphabet, Amazon, Meta, Broadcom, and Tesla). These companies are at the forefront of the artificial intelligence (AI) revolution, which has catapulted their values to dizzying levels that now comprise 37% of the S&P 500 Index's total value. The degree to which AI stocks can keep pushing equity markets higher is of critical importance to investors, especially with the U.S. economy showing signs of slowing, as the frenzied investor exuberance behind the AI narrative exhibits notable parallels to past speculative manias.

While there is little debate that the big eight AI companies are exceptional cash-producing entities, the combination of very high valuations and extreme concentration in these stocks raises the market's susceptibility to a sudden and significant downturn on any hiccups in the euphoric AI storyline. Similar to the dot-com era, the current AI boom is being fueled by the mentality of "it's better to spend too much than too little". With the mega-cap technology companies becoming increasingly capital intensive, investing heavily into a new business with uncertain revenues and completely unknown profit margins, it seems naive to believe this technological revolution won't experience its own share of fallout from unanticipated setbacks.

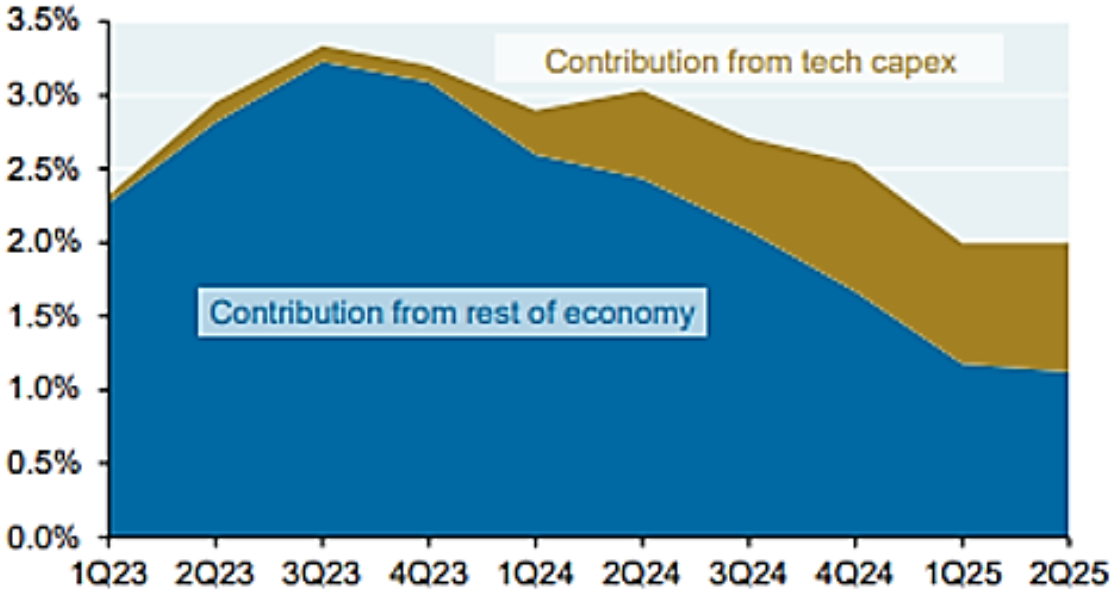
Whether the current elevated expectations and valuations for the AI stocks have outpaced their realistic prospects for growth and profitability is an open question. The average company in the S&P 500, however, is not trading at the nose-bleed valuation multiple of the AI darlings. Thus, selectively picking businesses that could benefit from using artificial intelligence's increased productivity, but don't yet command AI-hyped valuations, may ultimately prove to be a more value-enhancing investment opportunity than the AI producers themselves from a longer-term perspective.

With seemingly little room for P/E multiples to move sustainably higher at the index level, broader market upside over the near term will largely depend on corporate earnings expansion. The S&P 500 is projected to generate double-digit (+11%) profit growth in 2025, which would be encouraging amid a backdrop that had extreme trade uncertainty, soaring tariffs, and below trend (sub-2%) projected annual economic growth during the year. The current consensus view is that earnings growth will further accelerate to a 14% pace during 2026. That confidence is aided by the belief that a combination of lower interest rates from more accommodative monetary policy and tax reductions/incentives in the so-called One Big Beautiful Bill Act will support continued (albeit modest) economic expansion next year.

Profit margins and earnings growth could fall short of analysts' optimistic expectations, however, if the economy slows more than expected—due to continued softening in the labor market, delayed effects of higher tariff costs on consumers/businesses, and/or a pullback in the AI spending race. On the employment front, the change in monthly private nonfarm payrolls has flipped from growth of ~200,000 on average in late 2024, to consecutive monthly declines of -3,000 in August and -32,000 in September—a trend typically only seen around recessions—and the unemployment rate continues to drift higher (from a low of 3.4% in April 2022 to 4.3% currently). Tariffs have had a negligible economic impact to date, as corporations adeptly pulled forward purchases and stockpiled inventory ahead of the levies, but numerous companies

have recently warned that they are now beginning to experience higher tariff costs—which will have to be absorbed in margins and/or passed through to consumers. Regarding the recent AI investment spree, tech sector capital spending has been contributing 35%-45% of overall U.S. GDP growth over the last three quarters, helping to offset the spending pullback from the rest of the economy. Said differently, real U.S. GDP growth would be considerably slower were it not for the spike in AI investment.

U.S. Real GDP Growth Contribution from Tech Capex
(3/31/23 – 6/30/25)

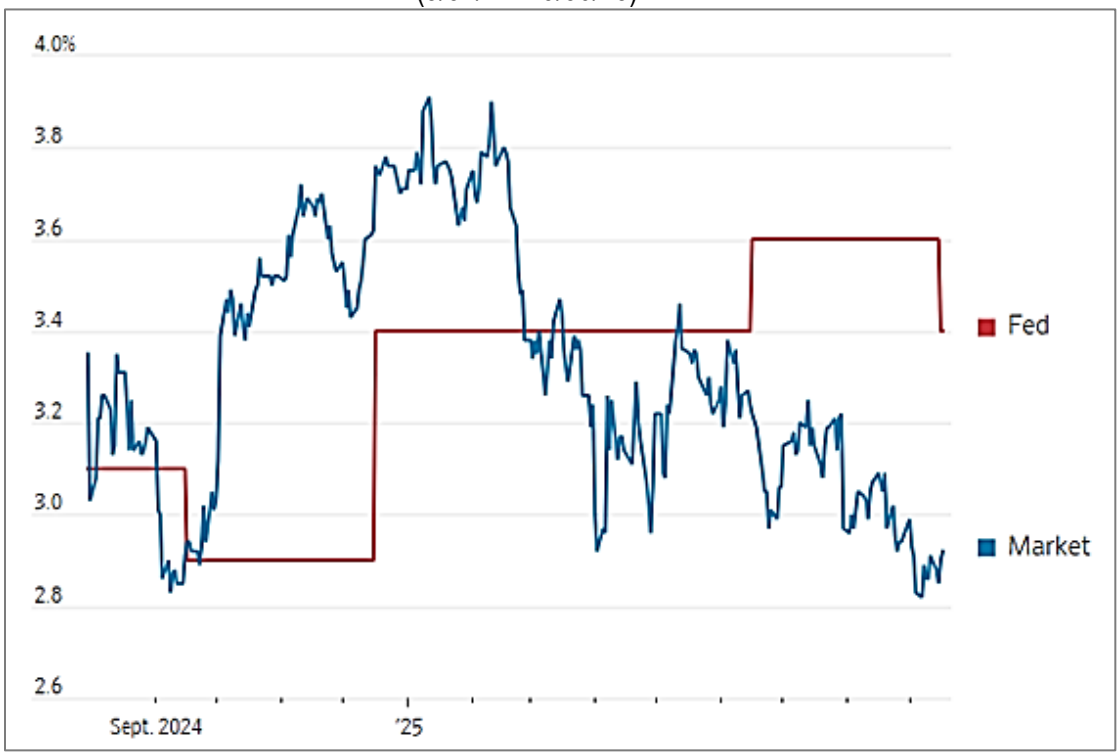


Source: Bridgewater, JP Morgan Asset Management

Realizing the economy may not be robust as it would like, the Federal Reserve shifted to a more accommodative monetary posture at its September meeting, cutting the benchmark federal funds rate by 0.25% to a new target range of 4.0%-4.25%. While inflation remains above the Fed's 2.0% target (with August CPI increasing to 2.9%), the policy shift is seemingly aimed at shoring up the economy now, amid early indications the labor market is softening, rather than waiting to respond to an economic downturn that has already taken root.

The market welcomed the Fed's proactive move to support the economy, despite still-elevated inflation, and traders expect this to re-start a fresh series of rate cuts. As the chart below illustrates, investors now believe that the federal funds rate will fall to 2.9% by the end of next year (vs. slightly above 4.0% currently), which is 0.5% below the 3.4% level most Fed officials are forecasting. In other words, the market is predicting two additional quarter-point rate cuts beyond what the Fed is anticipating by the end of next year. This gap in expectations suggests uncertainty around monetary policy could continue to be a source of volatility over the medium term, with equity valuations likely to be pressured if interest rates remain higher than the optimistic forecasts investors are currently pricing into the market.

Year-End 2026 Federal Funds Rate Forecast
(8/31/24 – 9/30/25)



Source: Wall Street Journal, LSEG, Federal Reserve

Based on present economic and capital market fundamentals, a heightened level of investor caution seems prudent. It's impossible to forecast the longevity of the current market upcycle, or how much further risk assets could climb in the meantime. The secular bull market could continue to push equity prices to new records, especially if economic expansion holds/accelerates and monetary policy becomes increasingly accommodative. That said, given today's extended valuations, this asset-price inflation era feels much closer to the end of the cycle than the beginning. The S&P 500 was highly valued at the close of 2024 and earlier this year just before the tariff announcement, but it's even more richly valued now. While the impact of significantly higher tariff rates has proven relatively benign thus far, the outlook for economic growth and multi-year earning power for companies is certainly less positive on balance than it was before the new tariff policy was announced. This doesn't mean we believe a market downturn is in the offing, but acknowledging the possibility of that scenario keeps us on guard.

Core Portfolio

During the third quarter, we initiated a new position in Mohawk Industries (MHK).

Mohawk Industries is the world's largest manufacturer of flooring products, which includes carpets, rugs, ceramic tile, laminate, wood, luxury-vinyl tile, and vinyl flooring. The company's end-market exposure is predominantly focused on residential markets (75% of revenue), combined with some exposure to commercial end markets (25% of revenue). Mohawk's growth has been stymied over the last three years, due to challenges in the housing market. While the residential flooring market is 80% remodeling activity, most remodeling work occurs when a home is bought or sold. Because high interest rates are suppressing home turnover rates, as existing homeowners are reluctant to trade the low mortgage rate on their current home for a higher interest rate on another house, flooring sales have been constrained. We believe it's only

a matter of time before the flooring suppliers like Mohawk can take full advantage of strong secular housing fundamentals, including an aging housing stock in need of renovation and pent-up demand for new home sales amid a backdrop of under-built supply for the population. While it's hard to pinpoint when macro conditions (i.e., improved housing data metrics) will reignite the housing market, past cycles have shown Mohawk's revenues/earnings increase immediately when the turnover of homes starts to re-accelerate. And while tariff uncertainty continues to cloud the industry's outlook, evolving U.S. trade policy should benefit Mohawk, since ~85% of its U.S. sales are from goods produced in North America.

Tactical Portfolio

In the Tactical Allocation, we initiated a position in The Quadratic Interest Rate Volatility and Inflation Hedge ETF (IVOL) with the proceeds from selling our holding in the Simplify Volatility Premium ETF (SVOL).

IVOL is an actively managed exchange-traded fund designed to protect investors against the erosive effects of inflation by investing the bulk of its assets in U.S. Treasury Inflation-Protected Securities (TIPS). Additionally, the fund uses options to profit from a steepening of the yield curve—which occurs when the gap between long-term and short-term interest rates widens—allowing the fund to potentially profit from increased interest rate volatility and changes in the market's expectations for future interest rates and inflation. We believe this investment could serve as an effective hedge to optimistic assumptions about inflation and interest rates investors are forecasting.

The Simplify Volatility Premium ETF is an investment vehicle structured to generate income by capitalizing on inefficiencies in the volatility market by selling premium-priced VIX futures contracts. We viewed this investment as a compelling complementary source of income for the portfolio. However, style drift in the underlying investments of the fund over recent months caused the investment to be less attractive to our investment objectives, so we decided to exit our position.

In addition to positioning for a steepening yield curve with IVOL (as well as our investment in a regional bank's ETF), the Tactical Allocation continues to feature exposure to investments in gold and uranium/nuclear.

Fixed Income

Bonds continue to deliver steady capital appreciation and accretive coupon income for investors, with the benchmark U.S. Aggregate Index producing another 2.0% of total return during the third quarter (+6.1% YTD). The positive third-quarter performance was largely driven by the decline in yields along the front end of the U.S. Treasury curve. The 3-month Treasury yield fell 0.39% during the quarter, in sympathy with the anticipated 0.25% September federal funds rate cut. Meanwhile, the 10- and 30-year U.S. Treasury yields remained relatively stable in the quarter, as investors balanced the risks between downside risk from labor market vulnerability and upside risk should the growth outlook brighten. At the long end of the rate curve, interest rate dynamics are shaped by the fiscal outlook (inflation and government balance sheet health) rather than the Fed's short-term policy moves. With inflation elevated and fiscal deficits rising, long-dated Treasury yields may be more likely to increase than decrease over the intermediate term, which would put downward pressure on bond prices. As a result, we continue to favor short- to medium-duration bonds, as they continue to offer attractive yields and are less sensitive to the current fiscal/macro risks than long-term bonds.

Final Thoughts

Every year has its own unique twists and turns, but this one has proven to be particularly eventful and unpredictable. While the market is sure to deliver additional periods of reassuring rallies and disheartening downturns ahead, our objective will always remain the same: to create long-term value for our clients. We believe the best way of achieving that is to look beyond the prevailing market narratives, focusing instead on owning quality investments for long periods of time.

Thank you for the continued confidence you place in us to manage your assets. As always, please reach out to us at any time.

Enjoy the closing months of the year!

Parkside Investments, LLC

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