Market Review
Third Quarter 2025

In the third quarter of 2025, stocks continued their strong advance as the improbable post-Liberation Day rebound matured into a full-grown rally.

During the period, the S&P 500 Index returned 8.12% while the Russell 2000 Index increased 12.39%. The Large Cap progression was steady month-to-month. The Small Cap gains were more pronounced in August and September, coinciding with improved prospects for lower interest rates. The same indices are now up 14.83% and 10.39%, respectively, in the first nine months and have risen for five consecutive months. There were three primary drivers behind the expansion.

The initial spark for the solid gains was stronger-than-expected earnings growth. In the second quarter, S&P 500 earnings increased 12.0%, which compared with analysts' original projections for 4.9% growth. Although the "bar" was low, and the aggregate skewed by small pockets of extreme growth, the resilient results helped appease concerns about the potential for recession. It also provided an important fundamental basis to justify a significant, but unconvincing stock market rebound to that point.

The prospects for stocks improved further as the potential for an interest rate cut increased. It also broadened the rally. In addition to increasing signs of strain in the labor market, there was a growing contingent in the Fed that viewed the implementation of tariffs as more of a one-time reset for pricing than a precursor to runaway inflation. The combination led to a more balanced assessment of policy (and risk) at the Jackson Hole Economic Policy Symposium in August. In September, the Federal Open Market Committee lowered interest rates by 25 basis points for the first time since December.

The real foundation of the rally, however, continues to be the incredible investment in and fervor around the proliferation of Artificial Intelligence (AI). While not a new theme, the strength was reinforced by the exceptional growth and enormous investment announcements from the leading hyperscale data center operators. What is new is that AI project funding has expanded to include well-capitalized start-ups, large foreign enterprise, and sovereigns. In addition, the benefits of the massive investment have begun to extend to much broader swaths of the economy, including construction and power generation, as well as supporting equipment, inputs, and services.

As a result of the combination of corporate resilience coupled with cyclical and secular drivers, stocks soared, and the conventional wisdom has tipped that we are on the front-end of another bull market. The recent experience has been that anemic economic reports are deemed "goldilocks", there is little concern that the Federal Reserve is moving away from its 2% inflation target, and valuation is not even a consideration in the hottest parts of the market.

While we agree that stocks have a better fundamental grounding now than three months ago, the team is wary about the complacency and speculation that have become common place. We continue to believe that there are small pockets of extreme strength in the economy rather than a strong economy. We also see cause for increasing volatility in the bond market and view rising yields as an obvious trigger for a massive reassessment of risk. The elephant in the room, however, is the sustainability of the AI investment.

On one hand, the team is a firm believer in the promise and progress of AI, which is evident in the portfolios. But we are also very familiar with these cycles and recognize that (i) the enormity of the undertaking will inevitably create bottlenecks and competition that complicate the earnings growth picture, and (ii) the majority of the current Small Cap stock market sensations will not be the long-term winners in industry.

In this environment, we continue to take a thoughtful and balanced approach to our portfolios that is consistent with our conservative growth process. Although we have fitting exposure to the most important secular growth themes in the market – including AI and Defense – we only seek to invest in profitable companies and avoid "story stocks". The benefit of the bifurcated economy is that we are finding a lot of opportunity to invest in high-quality growth businesses in less trafficked parts of the market. The team is also very hopeful that lower interest rates and less policy disruption can drive a much broader and more sustainable bull market over time.

Sources: *FactSet, GICS Sector Classification, CNBC*

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Index Definition Sources: *Standard & Poor's, FTSE Russell*

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