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3Q 2025 Commentary

October 9, 2025

THIRD QUARTER REVIEW

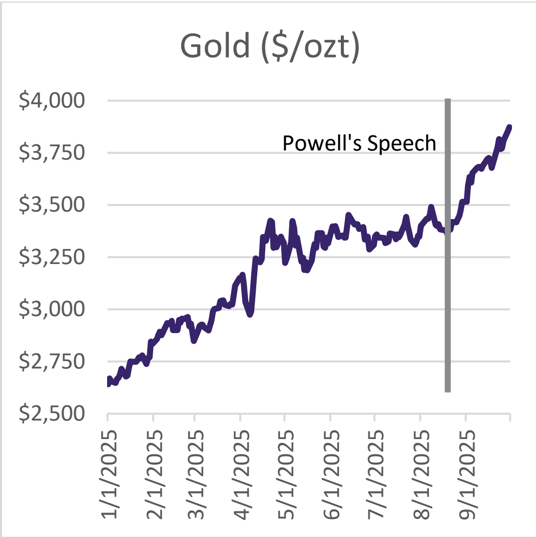
Changes in Fed policies fueled higher gold and stock prices in the quarter.

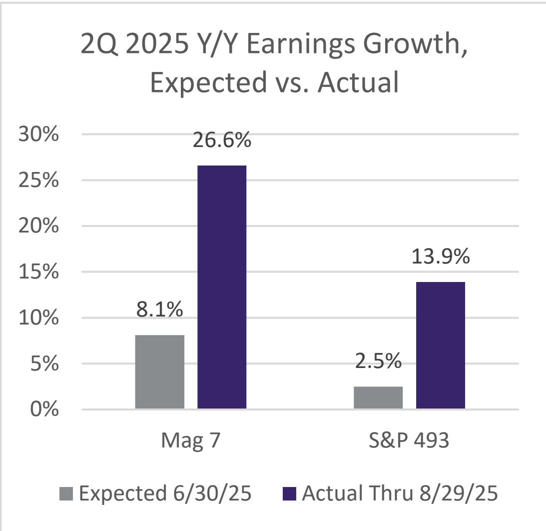
Stock markets hit all-time highs in the quarter as earnings continued to surprise to the upside, the Artificial Intelligence (AI) buildout accelerated, and reciprocal tariffs continued to be delayed or diluted. The One Big Beautiful Bill Act (OBBB) passage confirmed there is little fiscal restraint in the midst of an expanding economy and 6%+ budget deficits.

Adding monetary fuel to the already hot fiscal fire, on August 22, Federal Reserve Chairman Jerome Powell announced in his annual Jackson Hole speech that strong employment did not necessarily mean high inflation, current policy was restrictive, and though higher prices were likely because of tariffs, they may cut rates.[1] Soon after, employment was revised significantly lower for the prior year. The Fed proceeded to cut interest rates by 0.25% in September despite inflation moving back up to almost 3%, well above their 2% target. Gold was up over 14% from the time of that speech through quarter end, up 17% for the entire quarter, and up 47% for the first three quarters of 2025.

Earnings came in much better than expected.

Second quarter earnings (reported in the third quarter) broadly came in much better than expected, and future earnings expectations did not come down as they typically do. The "Magnificent 7" (Mag 7)[2] earnings continued to crush expectations, validating their own use of Artificial Intelligence and the acceleration of spending in the technology.





Tariffs have not had a large impact on reported earnings thus far.

Tariffs have not had a significant impact on earnings or inflation through the third quarter. The administration has not pursued reciprocal tariffs with China with the vigor originally

[1] https://www.federalreserve.gov/newsevents/speech/powell20250822a.htm
[2] Magnificent 7 stocks are (name, ticker, % of S&P 500 as of 7/3/25): Alphabet Class A, GOOGL 2.0% & Alphabet Class C, GOOG, 1.6% (3.6% combined); Amazon, AMZN, 3.9%; Apple AAPL, 6.0%; Meta, META, 2.8%; Microsoft, MSFT, 6.8%; NVIDIA, NVDA, 6.6%, Tesla, TSLA, 1.9%; Source – FactSet & State Street.
* S&P 493 are the 493 companies in the S&P 500 excluding the Mag 7.

intimated in April. Markets have been on a tear since the 90 day tariff truce with China was announced over the weekend of May 10-11, with the S&P 500 and NASDAQ returning +18% and +26% since then.

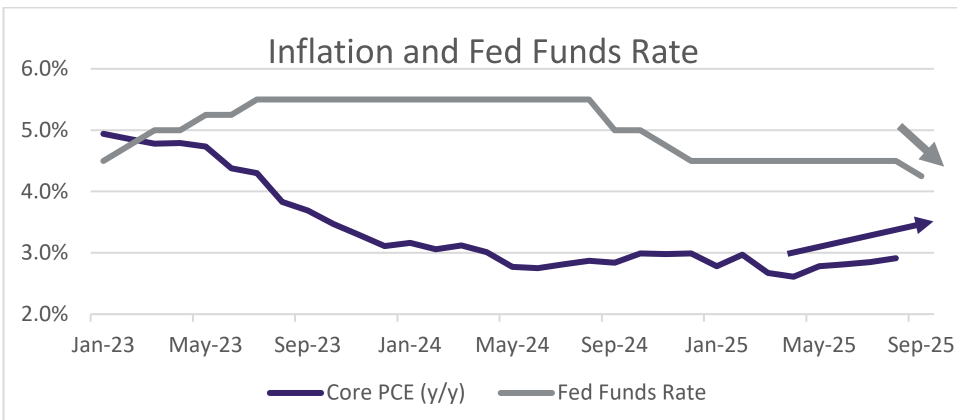
Like last quarter, all styles (large, small, growth, value) had positive returns. In a sign of the "risk on" nature of the quarter, all Small Cap index styles outperformed their Mid and Large Cap counterparts, and Microcap Growth was up 20%.

PSG'S PERSPECTIVES

Federal Reserve Policy Change

The Federal Reserve's new framework justifies lower interest rates despite higher inflation.

Passage of the OBBB and the current government shutdown (over spending, however justified) are clear signals there will be no reduction in fiscal spending growth in the near future. The apparent capitulation by Chairman Powell of the Federal Reserve to cut interest rates in the face of higher inflation has been interpreted to mean that the Fed's dual mandate is now focused on employment. This new framework allows interest rates to be kept low or cut simply because unemployment may be higher in the future even if short-term inflation fears remain elevated. This makes the Fed more susceptible to political pressure to keep interest rates lower than they might have been otherwise. It also opens the door for multiple interest rate cuts in the near term despite higher price expectations. We believe this was a catalyst that pushed gold higher in the quarter.



New Policy Implies Higher Gold, Equities, Even Bonds

Gold could pull back but still belongs in diversified portfolios.

Gold's performance is always hard to predict in the short term, but its continued ascent seems likely in the medium to long term unless new forces emerge to reign in fiscal or monetary stimulus. Equities should continue to benefit from growing budget deficits, as nominal growth (real growth plus inflation) should continue to fuel higher earnings for better managed or structurally more efficient companies. Even bonds could do well in this new monetary environment if the Federal Reserve keeps cutting interest rates and is persuaded to buy longer term Treasuries to drive long term rates down. Lower rates should help the struggling housing and auto sectors and achieve "maximum employment."

Artificial Intelligence

AI spending continues to astound.

Spending on Artificial Intelligence (AI) has continued to accelerate at a staggering rate. One growth manager we spoke with recently noted that in October 2024, expected spending on AI was $50 billion. It is now $600 billion and growing. In the third quarter alone, the following announcements were made:

- OpenAI, Oracle, and Softbank announced five new data center sites, which brings their planned investment to over $400 billion over the next three years.
- Oracle is spending about $40 billion on NVIDIA chips to power one of the large new data centers.
- NVIDIA announced it plans to invest up to $100 billion in OpenAI to help fund the new data centers (NVIDIA supplies the key chips to those data centers).
- According to the CFO of OpenAI, the company is expected to generate $13 billion of revenue this year.[3]

Market participants tend to extrapolate recent trends as continuing. For example, Morgan Stanley Head of US Credit Strategy Vishwas Patkar estimated the total required spend for AI over the next four years to be **$2.9 *trillion***.[4] Framing the size of this investment: in 2024, investment in all non-residential structures in the United States totaled $4 trillion. Spending will need to continue to accelerate to meet that expectation. To date, most AI funding has come from private equity or Mag 7 cash flows. There are no signs of it stopping, but we are seeing signs that we have entered a different phase of the cycle where alternative sources of financing will be required.

Artificial Intelligence spending has required more creative financing.

- Oracle may have to borrow up to $100 billion to fulfill their obligations to OpenAI.
- PIMCO will supply $26 billion in debt to Meta to help pay for Meta's AI expansion. [5]
- Morgan Stanley estimates $1.5 trillion in debt financing will be needed over the next four years.
- NVIDIA's investment in OpenAI has shades of the dot.com bubble where the vendors would finance the customers (which did not end well).
- OpenAI employees sold $5.6 billion of stock at company valuation of $500 billion.[6] (This is not a bullish signal.)

Debt financing is now being pursued because there is enough confidence the investments will be successful and the financing cost is reasonable. ($2.9 trillion is also more than equity investors are willing to bear.) If AI continues to improve with each new iteration, we would expect more and more capital to be pulled into the investment cycle and the boom will continue. If AI progress stalls out, or the rapid deployment of AI does not appear to deliver anticipated returns for companies deploying it, we would expect substantial pullbacks in the highest flyers.

Mag 7 companies are spending more on AI but still have room to borrow and spend more before it becomes worrisome.

We have entered a higher risk investment period for AI though returns could remain robust. We are not calling for a market crash even if AI does not meet the optimists' expectations… at least not yet. While Mag 7 valuations are high, much of it is justifiable. The top technology companies (including those like Alphabet and Meta) generate 3x more excess

[3] A Look at OpenAIs Tangled Web of Dealmaking - CNBC
[4] https://www.morganstanley.com/insights/podcasts/thoughts-on-the-market/credit-markets-ai-financing-gap-vishy-tirupattur-vishwas-patkar?utm_source=chatgpt.com
[5] https://www.bloomberg.com/news/articles/2025-08-08/meta-picks-pimco-blue-owl-for-29-billion-data-center-financing?embedded-checkout=true
[6] OpenAI Valuation Hits $500 billion After Sale To Softbank, Others; this was announced after Sept 30.

cash than other public companies.[7] This exceptional cash flow means they have not yet needed to borrow significant sums of money to spend on AI and other research and development. While Meta announced it is borrowing $26 billion in the third quarter, as of the end of the second quarter Meta had no net debt. Looking back, Meta changed its name from Facebook to Meta on October 28, 2021, spent somewhere between $40-60 billion building out its "Metaverse" which was a total bust, and yet the stock is up over 100% since the name change and spending binge. If debt is kept low, Meta could do it again. There are very few companies in the world that can burn $40-60 billion and keep marching higher. The Mag 7 comprises many of them.

Excluding Tesla, the average price to earnings multiple (PE) for the Mag 7 is 29x, a 26% premium over the S&P 500.[8] Given the impressive earnings growth noted above, higher valuations can be justified. However, Mag 7 companies are also spending more on AI, and while there is some room to borrow to keep up with OpenAI and Oracle, they will use up all their free cash and start to rely on debt to fund future growth, dividends, and buybacks. That would increase the stakes for them and the markets generally. While not an issue at this point, such an outcome looks more and more likely, increasing both the risks and rewards.

Strong equity markets offer opportunities to rebalance, particularly for investors pulling money from their accounts, to maintain desired asset allocations. As we have said repeatedly, diversification, both in and outside of the Mag 7, seems to be the prudent option.

DEEPER DIVE

Quarterly and Year to Date Review

EQUITIES

Small cap stocks led in 3Q; the least profitable did the best.

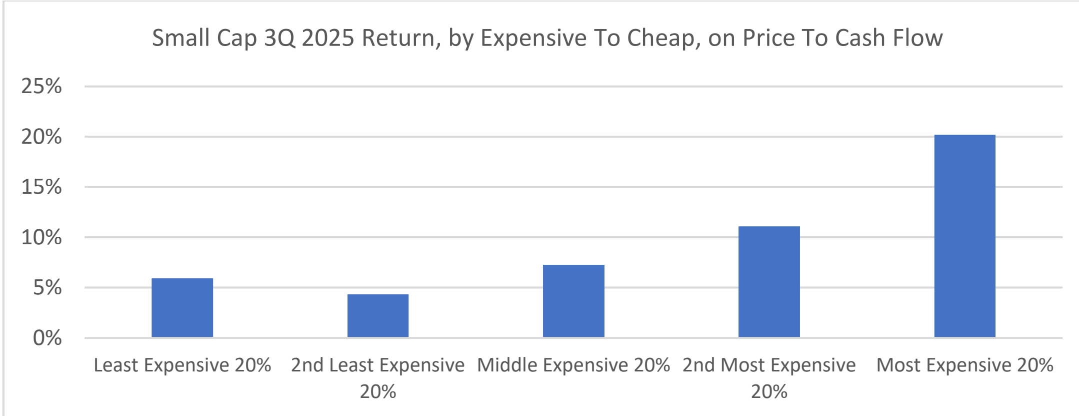
3rd Quarter – Small Cap Generated Largest Returns

- Small cap core, value and growth were all up between 12-13%.
- The S&P 500 was up 8.1%.
- The "Magnificent 7" (Mag 7), which make up 34% of the S&P 500, generated over five percentage points of the 8.1% return (or 63%).
- International developed market indices were up 5%.
- Gold continued to rally 17%, while Bitcoin rose 6%.
- Within small cap, the "safest" companies with most cash flow per share did worst, while the companies with the least cash flows performed best.[9]

[7] Empirical Research, Portfolio Strategy and Stock Selection, 9/16/2025.

[8] Based on the next four quarters projected earnings. Source: FactSet and PSG.

[9] Small Cap referred to the Russell 2000 Index. Data in table from FactSet. Companies which do not have cash flow captured by FactSet, either because the data is not captured properly or because the cash flow is negative, were up 28% in the quarter. Least expensive companies had Price to Cash Flow (P/CF) of 0.0-7.3x; 2nd least expensive 7.3-10.6x; middle 10.6-14,7x; 2nd most expensive 14.8-23.5x; most expensive 23.5-1,736x.



Year To Date – All Indices Now Positive

- Large Cap best performing among US indices- Value +12%, S&P 500 +14.8%, and Large Growth +17%.
- Almost all indices up 10%+ except Small Cap Value +9.0% and Mid Cap Value +9.5%.
- International stocks still lead US indices; Developed Int'l +26%, Emerging Markets +25%.
- Gold leads all asset groups +47%, and Bitcoin outperformed US stocks +22%.

BONDS

Bonds generated positive returns in the quarter as interest rates fell slightly.

3RD Quarter & Year to Date

- Interest rates trended lower throughout the quarter. (***See Table 1)***
- The Federal Reserve seemed to signal a new approach to setting interest rate policy- they will now put more weight on projected weakness in the labor market despite inflation running above their stated 2% target rate.
- The Federal Reserve lowered interest rates by 0.25% in September, a shift from their previous wait and see approach.
- Interest rates on high quality investment grade bonds fell more than Treasury rates in the quarter, and now provide the lowest incremental yield spread over Treasuries in at least 25 years.
- President Trump attempted to fire Federal Reserve Governor Lisa Cook, the first time a president has tried to remove a Fed official, bringing into question the Fed's independence from executive power. This may prove meaningful when Federal Open Market Committee voting members are determined in February 2026.
- Bonds offered steady returns and a source of income in the quarter, which seems less interesting when other assets are doing well but still serve a purpose in a diversified portfolio.

Table 1

US Treasury Yields *(source- FactSet; numbers may not sum due to rounding)*

Maturity	12/31/24	6/30/25	9/30/25	3Q25 Yield Change	YTD thru 9/30 Change
3 Month	4.3%	4.3%	3.9%	**(0.4%)**	**(0.4%)**
2 Year	4.2%	3.7%	3.6%	**(0.1%)**	**(0.6%)**
5 Year	4.4%	3.8%	3.7%	**(0.1%)**	**(0.7%)**
10 Year	4.6%	4.2%	4.2%	**(0.1%)**	**(0.4%)**
30 Year	4.8%	4.8%	4.7%	**(0.1%)**	**(0.1%)**

TARIFFS, LEGISLATION, & ECONOMICS

Tariffs continue to be announced, negotiated, and increasingly reflected in prices.

Tariffs

- Tariffs continue to be negotiated with many countries, most notably China.
- Tariffs on most goods from the European Union and Japan are capped at 15%.
- New tariffs continue to be announced.
- Thus far, the tariffs seem to be manageable for most exporters, importers and middlemen as there has been limited pass through to consumers.
- We have not seen large price increases flow through to inflation or earnings data, but we continue to expect evidence of price increases in the coming quarters.
- The Supreme Court will rule on the legality of some of the tariffs in the coming months.

Government Shutdown Could Last Longer Than 2018/2019

There was a significant downward revision employment; timeliness of future reports will be impacted by the government shutdown.

- The US government shutdown began at midnight, October 1st, as negotiations over various aspects of the US budget are debated between Republicans and Democrats.
- The longest previous shutdown spanned 35 days from December 22, 2018 through January 25, 2019.
- According to the Congressional Budget Office, that shutdown furloughed 800,000 federal employees and reduced GDP by $11 billion.
- At this point we do not see this shutdown as an imminent threat to the US economy or markets.

Job Picture Weakening, But Not Worrisome

- Federal Reserve Chairman Powell called the current labor market a "low-hiring, low-firing environment."[10]
  - This may be, in part, because of AI adoption.
- Job growth was revised lower by 911,000[11] and the unemployment rate drifted higher to 4.3% from 4.1%.
- Initial weekly unemployment claims have begun to trend higher but are still quite low.
- Continuing unemployment claims reached 3+ year highs in August before easing lower in September.
- The government shutdown will delay numerous data employment releases, limiting visibility to the health of the job market.

Economic Growth Continues, But Tariff Impacts Continue to Impact Data

- The zaniness of economic growth reporting continued in the second quarter.
- 2Q 2025 GDP growth was 3.8%, after a revised (0.6%) decline in the first quarter.
  - Normalizing imports and inventory levels in 2Q (from the spikes in 1Q to get ahead of tariffs) added over 1.5% to GDP in the quarter.
- Consumption growth was strong in the second quarter, evidence that the US consumer continues to spend and support economic growth; credit card debt grew 5.9% in the latest reading.[12]

[10] https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20250917.pdf
[11] March 2024 – April 2025 employment revision https://www.bls.gov/news.release/prebmk.nr0.htm
[12] https://www.newyorkfed.org/microeconomics/hhdc.html

Diversified portfolios have fared well in 2025.

SUMMARY

Markets have generated strong returns two quarters in a row. Lower than expected tariffs, strong earnings growth, incredibly strong earnings results, spending expectations around Artificial Intelligence, and lower interest rates have been good for markets. It was good to see market performance broaden from the last few years as diversification paid off. While gold has been the biggest winner this year, a pullback would not surprise us, though it still makes sense to own it for the longer term. AI will continue to be a key catalyst for equity markets going forward, and perceived success of new AI models may well move the day-to-day equity prices the next few quarters. Bonds continue to be a source of stability and income, though yields are now lower.

FUN FACTS

- Communications Services sector (dominated by Alphabet and Meta) revenue growth in the second quarter was 9.7%, but earnings growth was 45.6%.
- The Federal Reserve removed the “makeup” strategy from their framework, removing the COVID era’s low inflation as a reason to allow inflation to run above 2%.
- KMPG AI Survey revealed 42% of organizations have deployed some AI agents, up from just 11% in the 1Q 2025 survey. https://kpmg.com/us/en/media/news/q3-ai-pulse.html?utm_source=chatgpt.com

DISCLOSURE