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The Good, the Bad, and the Overheated Q3 2025

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2025 Third Quarter Stock Market Update

The Good, the Bad, and the Overheated

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Market indices continued to charge higher in the third quarter. After astunning recoveryfrom tariff-induced hysteria in Q2, stocks added totheir gains in impressive fashion. TheS&P 500 ® Index and Russell2000® Index advanced 8.1% and 12.4%. Year-to-date, theindices finished the quarter up 14.8% and 10.4%, respectively. Recall, theS&P and Russellwere down roughly 15% and 21% year-to-dateearlier this year (4/8/25) when economicfears peaked. Since then,the S&P has risen for five straight months.

First, the good news. Corporate earnings and the economy haveremained resilient even in the face of tariffs. For the second quarter,over 80% of S&P 500 constituents beat earnings expectationscompared to a longer-term average closer to 60%. Gross DomesticProduct (GDP) growth remained strong at 3.8% and estimates for thethird quarter have recentlybeen revised upward. In the background,we have the powerful theme of artificialintelligence (AI), which isprompting enormous spending from tech titans. It's also worthnotingthat the environment for dealmaking has markedly improved.Goldman Sachs pointsout the numberof Initial Public Offerings(IPOs) are up 18% year-over-year and the value ofannouncedmergers & acquisitions is up 29% this year.

The policy backdrop brings more good news. President Trump's "Big Beautiful Bill" promises fiscal stimulus that will goose the economy moving into next year. This piece of legislation brings tax cuts and incentives for capital investments and domestic manufacturing. What's more, monetary stimulus is back in play as the Federal Reserve recently started lowering interest rates again. With relatively tame inflation (the most recent CPI reading was 2.9%), policymakers expressed a desire to get ahead of any potential weakening in the labor market. As for what they will do next, two more rate cuts are expected by the end of the year, provided inflation remains subdued. Typically, lowering rates in the teeth of an already decent economy is a good thing for stocks. Indeed, lower rates could fuel investors to begin moving money from money market funds, where balances recently stood at a record $7.6 trillion according to CNBC.

And now for the not so good news. The most obvious consideration is that valuations appear rich. The S&P 500 currently trades for approximately 23x earnings estimates for the next12 months. This is high by historical standards and tells us risk tolerance is up. The 10-year average is 19.0x and 20-year average is 16.4x. The equal-weighted S&P, whichadjusts for