

Q3 2025 Stock Market Update

The Good, the Bad, and the Overheated

Market indices continued to charge higher in the third quarter. After a stunning recovery from tariff-induced hysteria in Q2, stocks added to their gains in impressive fashion. The S&P 500® Index and Russell 2000® Index advanced 8.1% and 12.4%. Year-to-date, the indices finished the quarter up 14.8% and 10.4%, respectively. Recall, the S&P and Russell were down roughly 15% and 21% year-to-date earlier this year (4/8/25) when economic fears peaked. Since then, the S&P has risen for five straight months.

First, the good news. Corporate earnings and the economy have remained resilient even in the face of tariffs. For the second quarter, over 80% of S&P 500 constituents beat earnings expectations compared to a longer-term average closer to 60%. Gross Domestic Product (GDP) growth remained strong at 3.8% and estimates for the third quarter have recently been revised upward. In the background, we have the powerful theme of artificial intelligence (AI), which is prompting enormous spending from tech titans. It's also worth noting that the environment for dealmaking has markedly improved. Goldman Sachs points out the number of Initial Public Offerings (IPOs) are up 18% year-over-year and the value of announced mergers & 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 next 12 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, which adjusts for the size of the large tech leaders, is more reasonable at 17x earnings estimates although still a little above recent norms. Similarly suggesting investors are accepting little compensation for taking on additional risk, high-yield spreads (the spread between investment grade bonds and junk bonds) stand at record lows. There are also economic risks. Apart from the obvious risk of economic weakness, there's the counterintuitive and perhaps more relevant risk of things being "too good". Right now, moderate inflation and decent economic growth have investors pinning their hopes on the Fed lowering short-term interest rates. Accelerating growth and inflation could squash this agenda and/or lead to upward pressure on longer-term interest rates, which could impair equity valuations and the economy. Put simply, we need to keep threading the needle between "good" and "too good".

We've also noticed a worrisome uptick in speculative behavior. A powerful technology theme in the form of AI has joined forces with monetary stimulus to embolden risk taking that has shades of early 2021 and the late 90's tech bubble. Since the "Liberation Day" low in April, unprofitable tech stocks, AI-linked stocks and so-called meme stocks, which gain popularity through social media, have posted explosive moves higher. AI is incredibly promising, and we expect to participate via ownership of select technology leaders. To be clear, we don't question the utility or "coolness" of the technology; however, it feels like a gold rush mindset has commenced in certain corners of the market (especially more speculative stocks tied to the theme). We are clearly in the phase when investors are focused more on "stories" than actual intrinsic value, and they have flocked towards richly valued momentum stocks. Recent deals tallying hundreds



George L. Smith III, CFA®

Managing Director
Chairman, Investment Policy Committee
804-780-2155
gsmith@investdavenport.com

of billions for additional compute power have added fuel to the fire. Again, we don't doubt the promise of AI or other emerging technologies, but many perceived beneficiaries are prioritizing growth over profit and investors may begin to question the ultimate returns on this AI spending.

Meanwhile, many other stocks have been left in the dust as investors have given chase to stocks hitting new 52-week highs. There's been little reward for having differentiated perspectives as winners keep on winning while losers keep on losing. This has presented a challenging dynamic for us. We generally shun momentum and pride ourselves on exercising valuation discipline. Many of the investment opportunities we've recently uncovered fall well outside the bounds of tech/AI and are out of favor for some reason or another. Such opportunities seem to be attracting little interest from others for now, but this could change if market dynamics shift. In the meantime, we are standing firm with our process and redoubling efforts to find stocks that offer asymmetric risk/reward profiles.

All told, the confluence of a solid economy, fiscal stimulus, monetary stimulus and a generational technology theme provides a powerful backdrop for markets. However, it's important to recognize that we've rallied sharply (the S&P is up 16% since Memorial Day) and many stocks already discount this backdrop. Further, there are pockets of excess emerging in certain corners of the market. It's important to pay attention to any caution flags and adjust our investing approach accordingly. We understand this may entail some frustration during periods where investing starts morphing into speculation, but we expect our clients to ultimately be rewarded while taking less risk.

Sincerely,



George L. Smith III, CFA®
Chairman, Investment Policy Committee

Important Disclosures:

Any opinions expressed here are statements of judgment on this date and are subject to future change without notice. This information may contain forward looking predictions that are subject to certain risks and uncertainties which could cause actual results to differ materially from those currently anticipated or projected. The information contained herein has been compiled from sources believed to be reliable; however, there is no guarantee of its accuracy or completeness. There is no guarantee that a company will continue to pay a dividend. The investment return and principal value of an investment will fluctuate. Small and mid cap company stocks may be more volatile than stocks of larger, more established companies. The portfolios may invest in foreign securities which are subject to additional risks such as currency fluctuations, political instability, differing financial standards and the potential for illiquid markets. The information provided in this letter should not be considered a recommendation to purchase or sell any particular security. Diversification and Asset Allocation does not ensure a profit or guarantee protection against a loss. **Performance shown is historical and is no guarantee of future results.** *Investing in securities carries risk including the possible loss of principal.*

Data as of 9/30/2025. Sourced from Morningstar and FactSet financial data and analytics. ©2025 Morningstar, Inc. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information.

Index Definitions:

The **S&P 500 Index** is comprised of 500 U.S. stocks and is an indicator of the performance of the overall U.S. stock market. The **S&P 500® Equal Weight Index (EWI)** is the equal-weight version of the widely-used S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight - or 0.2% of the index total at each quarterly rebalance. The index is a product of S&P Dow Jones Indices LLC, a division of S&P Global, or its affiliates ("SPDJ"). Standard & Poor's® and S&P® are registered trademarks of Standard & Poor's Financial Services LLC, a division of S&P Global ("S&P"); Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones"). The **Russell 2000 Index** measures the performance of the 2000 smallest companies in the Russell 3000® Index. London Stock Exchange Group PLC and its group undertakings (collectively, the "LSE Group"). © LSE Group 2025. FTSE Russell is a trading name of certain LSE Group companies. "Russell®" is a trade mark of the relevant LSE Group companies and is used by any other LSE Group company under license. All rights in the FTSE Russell indexes or data vest in relevant LSE Group company which owns the index or the data. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. No further distribution of data from LSE Group is permitted without the relevant LSE Group company's express written consent. The LSE Group does not promote/sponsor/endorse the content of this communication. **An investor cannot invest in these indices and their returns are not indicative of the performance of any specific investment.**