SlateStone WEALTH

Rate Cuts, Trade Deals and Strong Earnings Propel Stocks Higher

Third Quarter Review

Major stock indices surged to new all-time highs in the third quarter as economic growth remained stable, tariff increases were no worse than feared and the Federal Reserve cut interest rates.

Markets started the third quarter with a continuation of the year-to-date rally, thanks to the passage of the One Big Beautiful Bill Act ("OBBBA"). This legislation contains several pieces of economic stimulus; making the 2017 tax cuts permanent, reintroducing accelerated depreciation, and committing billions to the development of domestic industries.

Second quarter corporate earnings results were stronger than anticipated and showed no significant signs that tariffs or policy uncertainty were weighing on results. Then, in late July, the Trump administration announced trade agreements with some of the largest U.S. trading partners. These trade deals reduced investor anxiety stemming from the re-imposition of reciprocal tariffs in early August and lowered trade-related concerns among investors. These factors, along with stable economic and inflation readings, helped push the S&P 500 Index steadily higher by 2.24% in July.

The beginning of August ushered in a negative economic surprise that temporarily paused the rally in stocks. The July jobs report, released on August 1st, was much weaker than expected, and there were substantial negative revisions to the May and June jobs reports. The underwhelming employment data introduced the idea that the labor market was not as strong as expected and economic slowdown talk increased. The soft employment data boosted expectations for a Fed rate cut and stocks ultimately continued their advance on that news; the S&P 500 rose 2.03% in August.

The rally accelerated in September despite growing signs that the labor market was indeed seeing some deterioration. The August jobs report was another underwhelming print showing just 22,000 jobs added for the month, well below the consensus estimate. Similar to August, the expectation for Fed rate cuts helped offset that negative employment report and the Fed did cut interest rates at the September 17th meeting. The restart of the rate-cutting cycle and strong artificial intelligence ("AI") related tech stock earnings from Oracle and Broadcom sent stocks even higher. This led to a 3.64% September increase in the S&P 500.

The third quarter was resoundingly positive for the U.S. economy and markets as economic data and corporate earnings showed solid growth. Additionally, inflation readings remained mostly stable, the Fed cut interest rates, and the U.S. reached trade agreements with major trading partners. Given these positives, major stock indices rallied solidly in the third quarter.

US Equity Indexes	Q3 2025	YTD - 9/30/25
S&P 500	8.11%	14.81%
S&P 500 Equal Weighted	4.83%	9.88%
DJ Industrial Average	5.67%	10.47%
NASDAQ Composite	11.43%	17.96%
S&P 500 Dividend Aristocrats	2.97%	5.46%
Russell 2000 (Small Cap)	12.39%	10.38%
MSCI EAFE (International Developed)	4.87%	25.83%
MSCI Emerging Markets	10.92%	28.17%

Source: Bloomberg Professional (9/30/2025)

On a sector level, ten of the eleven S&P 500 sectors finished the third quarter with a positive return. Tech and tech-aligned sectors (consumer discretionary and communications services) comfortably outperformed other market sectors and posted strong returns. Positive earnings results from AI-linked tech stocks such as Microsoft, Alphabet, Amazon, Nvidia, and Broadcom kept investor enthusiasm high. Consumer Staples was the only sector that finished the third quarter with a negative return. Investor preference for more economically sensitive sectors and tariff related concerns pressured the Consumer Staples sector.

Foreign markets saw mixed performance versus the U.S. Emerging markets outpaced U.S. stocks in the third quarter and developed markets posted a positive return but slightly underperformed the S&P 500 Index. Emerging markets benefited from a weaker dollar, falling U.S. interest rates, and a rebound in Chinese economic growth. Foreign developed markets also rallied but lagged due to concerns about fiscal stress and slow growth in the United Kingdom.

Switching to fixed income markets, the leading benchmark for bonds (Bloomberg Barclays US Aggregate Bond Index) saw a strong quarterly return as expectations for rate cuts and labor market deterioration boosted demand for both short and longer-term debt. Longer-duration bonds comfortably outperformed those with shorter duration as investors reached for longer-term yield amidst labor market weakness. Shorter-duration bonds also saw a positive return as investors anticipated the start of a rate-cutting cycle by the Fed.

Turning to the corporate bond market, both investment grade bonds and lower quality high yield bonds posted strong gains in the third quarter. Investment grade bonds slightly outperformed high yield bonds as the weakening labor market and slight uptick in economic concerns boosted the attractiveness of higher credit quality corporate bonds.

The tax-exempt bond market has not fared as well this year versus taxable bonds. Supply of municipal bonds was elevated due to tax exemption rumors within the OBBBA, and capital improvement projects are still 25-30% higher than five years ago. There was also some selling pressure now that corporations were not in need of tax-exempt income due to the new tax exemptions provided by the OBBBA.

US Bond Indexes	Q3 2025	YTD – 9/30/25
Bloomberg US Aggregate Bond	2.03%	6.13%
Bloomberg US T-Bill 1-3 Month	1.10%	3.25%
ICE US T-Bond 10-20 Year	2.54%	6.43%
ICE BofA US High Yield Index	2.40%	7.06%
S&P National AMT-Free Municipal Bond	2.99%	2.19%

Source: Bloomberg Professional (9/30/2025)

Fourth Quarter Market Outlook

Financial markets begin the final quarter of 2025 in a decidedly positive macroeconomic environment. Positive trends include the Fed cutting interest rates, tariffs that have not disrupted the U.S. economy (so far), broader economic growth that remains stable and investment enthusiasm for AI-linked tech stocks remains high. While the current macroeconomic setup is positive, it should not be confused with a riskless environment and continued gains in stocks are not inevitable. As always, there are risks to the markets and economy we must monitor.

First, the labor market is beginning to soften, and that is an economic risk which will be monitored closely. Numerous employment indicators, in addition to the monthly jobs report, are signaling a loss of momentum. For now, these are not at levels that would increase concerns about overall U.S. economic growth, but if we see the unemployment rate continue to rise, investors will become more concerned about the state of the U.S. economy. That would be an unexpected negative influence on financial markets, as investors and analysts do not currently anticipate an economic slowdown.

Second, inflation indicators remain stubbornly high. Headline CPI remains just under 3.0%, solidly above the Fed's 2.0% target. Meanwhile, tariffs are now starting to impact broader parts of the U.S. economy and while analysts generally believe tariffs will produce only a one-time price increase and not create broader inflation, that outcome remains uncertain. There is a chance that tariffs will further boost inflation in the fourth quarter and that could result in the Fed having to reconsider future rate cuts, which would produce a negative surprise.

Continuing on tariffs, there remains substantial uncertainty regarding trade policy. The Supreme Court will hear arguments on most reciprocal tariffs in November and if the Supreme Court upholds the lower court ruling invalidating tariffs, it could cause market volatility. While the removal of tariffs may initially boost stocks, it will also extend broader policy uncertainty, as the administration will likely try to reimpose tariffs using different legislation. Markets embrace clarity, and the longer trade policy uncertainty exists, the greater the chance that it becomes a headwind for growth.

Finally, AI and tech enthusiasm has driven the valuation multiples of the S&P 500 Index to historically elevated levels. While elevated valuation alone is not a negative influence on stocks, high valuation does underscore this reality: A lot of profit growth is currently priced into the largest tech stocks. If AI-related capital expenditures begin to decline or payback periods for AI investments get pushed out even more, it could be a substantial negative surprise for markets.

In summary, the macroeconomic environment is currently positive as the economy and markets are benefiting from rate cuts, fiscal stimulus (via the OBBBA), and continued investor enthusiasm for AI-linked tech stocks. We recognize, however, that risks remain on the periphery of both the markets and the economy.

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Sincerely,

SlateStone Wealth Investment Committee

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