Review & Outlook

Third Quarter 2025

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Review and Outlook

The stock market powered forward in the third quarter of 2025, with the S&P 500 Index up almost 8%. This performance is remarkable, especially in the face of downward revisions to employment data, declining consumer sentiment, a possible government shutdown (that is currently ongoing), and continued worries about inflation related to both tariffs and deportations.

While the market as a whole is up, its growth has been dominated by a small number of mega-cap stocks, largely tied to the real and projected buildout costs of the Artificial Intelligence world, which reach into the hundreds of billions of dollars, or more. Many of these AI companies also dominate the S&P 500 Index. Currently, only about ten companies account for 40% of the S&P 500's total market capitalization, or approximately $23 trillion of its $56 trillion. And seven of those ten companies have some kind of AI growth story. One way to measure the divergence of AI stocks from the rest of the market is to compare the S&P 500 Index's market-weighted returns with the S&P 500 Equal Weight Index, which considers the growth of each company equally across the entire index, regardless of each company's specific market capitalization. For the third quarter of 2025, the market-weighted S&P 500 Index was up 7.9%, while the Equal-Weight S&P 500 was up only 3.2%.

Index Performance Data
Total Return as of 9/30/2025

Indices[1]	Q3 2025	Trailing 12 Months
CRSP U.S. Total Market Index Total Return	8.24%	17.37%
iShares MSCI ACWI EX-US Total Return	6.68%	13.61%
Bloomberg U.S. Aggregate Bond Index	2.03%	2.88%

Companies making multibillion-dollar investments have put their confidence in future AI wealth creation. However; many analysts are not convinced. They point to similarities in other eras of bubble-like investment, such as railroads, radio technology in the 1920s, and optical fiber during the dot-com era. With AI investment, they see red flags ahead. For example, the amount of electricity required to run all of the planned data centers is equivalent to what is used by many countries, and, by all reasonable calculations, it will be challenging to achieve that level of power generation within the required timeline.[2] But for now, the optimistic view of AI is dominating the flow of capital into AI-related investment and associated stocks.

In addition to the AI tailwind, investors are also anticipating that the Federal Reserve will lower interest rates, with the lower rates supporting higher stock prices. And we think it does seem likely that the Fed will cut the Federal Funds rate at least once more this year. However, there is some concern that lowering short-term rates may not lead to lowered long-term rates, as has been the historic norm, because of worries about inflation and the risk of weaker demand for U.S. Treasuries. Longer dated bonds are crucial to setting mortgage and commercial loan rates, so continued economic growth depends as much on what happens to longer term rates, not just what the Federal Reserve does in the short term.

An important headwind to both short and long-term interest rates is persistent inflation. Setting aside future tariff or immigration related inflation, there appears to be persistent inflation close to 3%, much of this in the service sector, including property and health care insurance. Further, the U.S. dollar has weakened in recent months, which could increase the cost of imports. In addition, borrowing will likely increase with the buildout of server farms and other AI infrastructure, putting upward pressure on interest rates.

With all the caveats, S&P Global predicts U.S. growth of 1.8%-1.9% this year and next. This outlook reflects recent upward GDP revisions for the second quarter of 2025, and better-than-expected activity so far in the third. They cite high-tech investment as a key tailwind, and immigration policy and a weak labor market as headwinds. In short, the outlook is for continued growth, but at a slower pace.

In the end, there is likely to be a continued tension between a slowing labor market and higher inflation. If the Fed can lower interest rates without driving up inflation, this should be good for the stock market. However, if lower interest rates are driven by a significantly slowing economy, or if persistently high inflation curtails the Feds' ability to lower interest rates, the market may encounter challenges.

In Focus

While economic data such as the unemployment rate or inflation is usually reported in a simplistic fashion, often as a single number, its production is incredibly complex. Data is usually collected from multiple sources over time, and the time between collection and reporting creates a lag, so that recently reported data is somewhat out of date, and may not be a very accurate representation of what is happening at present. For example, we learned in March about the number of people who were working in January.

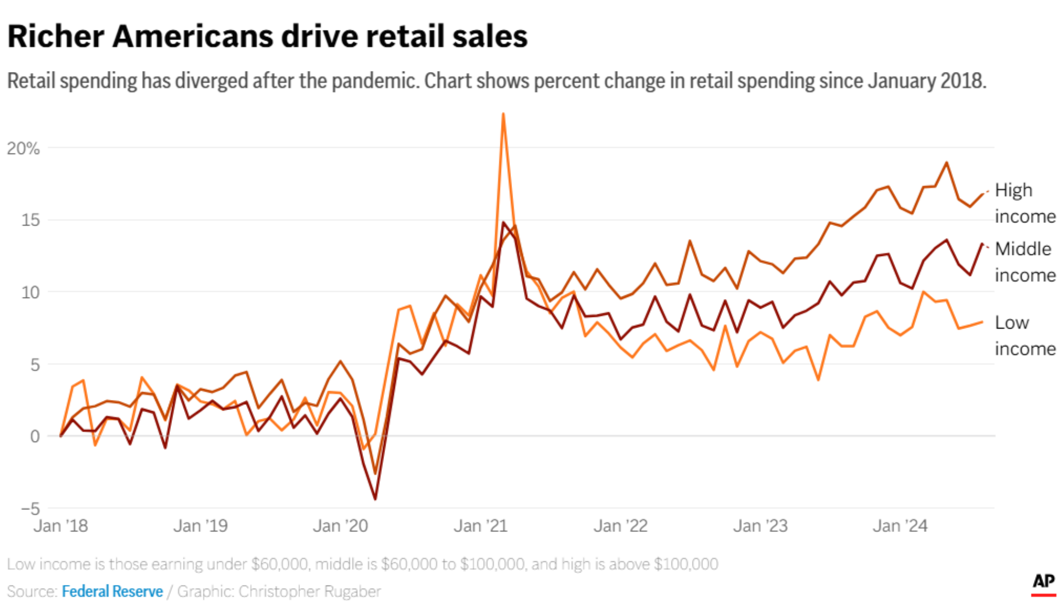
To add to the confusion, data centers like the Bureau of Labor Statistics often have to further adjust previously reported numbers, as particular statistic may rely on multiple data sets, some of which can take months, if not more, to collect, clean, and analyze. This can be particularly relevant to data collected by survey.

And last but not least, many statistics are reported as a single number, but rely on a process that in actuality creates a range of possible outcomes. For example, last week, the Census Bureau reported that retail sales from July to August 2025 were up 0.6%, meaning that sales increased in that period. But this number is a mid-point. The fine print reveals that while this estimate is a precise number, the true estimate is really a range: retail sales between July and August 2025 were up between 0.4% and 0.8%, with a point estimate of 0.6%. In recent years, this range of uncertainty around the point estimate has been increasing, as fewer businesses complete surveys in a timely manner, and more missing data needs to be imputed or estimated.

We also need to be careful how we interpret the reported statistics. For example, a low unemployment rate could mean that the labor market is healthy, and that most of the people looking for work are able to find jobs. But it could also mean that many people are discouraged, and are simply not looking for work, so they are not counted in unemployment calculations.

Another example is retail sales. Does a strong retail sale figure mean that everything is okay? There are many threads to tease out with this particular statistic. Reported as a single number, things can look great. Strong consumer spending has continued to help drive economic growth, and has helped support the stock market. But if you dig a little deeper, and break out the data by income group, a different story emerges.

For the past year, high-income households have been driving the growth in retail spending. In fact, high-income households have become steadily more responsible for retail spending since the pandemic.[3] When you break out spending by income group, it is clear that high-income earners are spending



actively, while lower income groups are showing signs of distress. It appears that something happened during the COVID years where stimulus money collected within certain pockets of the economy. And the staggering amount of money pushed into the economy in 2020 and 2021 appears to have played a role in the ongoing run-up in stock valuations, and other asset classes, like real estate. The distribution of the resulting wealth effects matter. Wealthy people have seen significant increases in the value of their homes and retirement accounts, letting them spend quite freely (hence the uptick in retail sales).

AI adjacent companies in the technology and communication sectors, mostly based in the U.S., have been a particular focus of investment. Stocks are now quite expensive relative to underlying earnings, reaching levels not seen since the dot.com era. And the bond market is also behaving oddly, where some companies can borrow at a cheaper rate than the U.S. government, meaning the spread between corporate and government bonds is historically low. In short, the stock market is expensive, very concentrated (a small number of companies make up an unusually large share of the S&P 500), and bond spreads are historically low. Those facts make us worry about the resilience of the market going forward.

While the amount of money circulating in the economy is sufficient to keep the party going in the near term, there are reasons to be at least a little worried. A recent article in CNN noted that Americans have more money in stocks than ever before (based on the percent of household financial assets, not just total dollars).[4] The article also notes that such concentration could be problematic if and when there is a slump in the market. The wealth effect that comes with increasing home values and increasing stock prices can also work in reverse, where people spend less and invest less if the market reverses and they see their retirement accounts declining in value. It's the red flag highlighted by CNN.

For Waycross clients, we've tried to balance staying invested to ride the move up in markets, while maintaining some conservative positions given many of the uncertainties discussed here, including the potential bust that could be on the other side of the AI boom.

1. Index performance data provided by ICE Data Services, and calculated by Black Diamond, an SS&C Advent company.
2. Bogmans, Christian, Patricia Gomez-Gonzalez, Giovanni Melina, and Sneha Thube. "AI Needs More Abundant Power Supplies to Keep Driving Economic Growth." *IMF Blog*, 13 May 2025, International Monetary Fund, https://www.imf.org/en/Blogs/Articles/2025/05/13/ai-needs-more-abundant-power-supplies-to-keep-driving-economic-growth.
3. Rugaber, Christopher. "Wealthier Americans Are Driving Retail Spending and Powering US Economy." *AP News*, 18 Oct. 2024, https://www.apnews.com/article/economy-consumers-inflation-retail-spending-growth-wealth-be68f97bba5970ed4ce4fc8b8c7333af.
4. Towfighi, John. "Americans Have More Money in Stocks Than Ever Before. Economists Say That's a Bright Red Flag." *CNN*, 28 Sept. 2025, www.cnn.com/2025/09/28/business/us-stocks-record-highs-american-households.