Quarterly Market Outlook

October 2025

Economic Growth Remains Strong

Despite looming tariff uncertainty and concerns about higher interest rates, deficit spending, geopolitical turmoil and a potential shift away from U.S. assets, the economy has been robust. U.S. GDP growth was revised up to 3.8% for Q2 and is tracking a similar level for Q3 – well above recent averages. Tariffs have had a surprisingly muted impact thus far, in part because of their delayed implementation, legal challenges, limited retaliation, and the Administration's willingness to negotiate and reach agreements. Consumer spending remains strong, and earnings have been robust, buoyed by demand for technology/AI and the infrastructure needed to support it.[1]

Markets Rally in Q3

All risk assets made gains in Q3 as policy uncertainty faded, growth increased, and inflation stayed range-bound. Global equities were up 7.3% (now 18.3% year-to-date), the U.S. bond aggregate returned 2.1% (6.2% YTD), commodities gained 3.6% (9.4% YTD), and gold surged 16.8% and is now up 47.0% this year on the back of ongoing central bank demand, dollar weakness, heightened geopolitical risk, and longer-term concerns about the integrity of fiat currencies – particularly given unsustainable deficit spending and the inflation that may ultimately be needed to pay off that debt. Nonetheless, 10-year Treasury yields continued to drift down from their cyclical highs post-election, ending the quarter at 4.15% (8 bps below where they started the quarter), and credit spreads tightened.[2]

A Constructive Outlook

Conditions look increasingly favorable for the economy. The Fed cut interest rates 25 bps in September and is expected to ease further, the availability and cost of financing have improved, and the broad asset rally continues to support wealth and spending. Meanwhile, reduced uncertainty amid strong demand should enable businesses to plan again, including for hiring and capital expenditures. M&A activity may also improve given a clearer and more benign regulatory and financing backdrop and a growing need for liquidity.[3]

To be sure, tariffs have yet to fully flow through, but their projected impact is only a ~2% onetime increase in costs (pre-substitution), some of which may be absorbed by businesses or passed on gradually. This headwind will likely be more than offset by the One Big Beautiful Bill Act ("OBBB"), which, in addition to extending lower tax rates for individuals and corporations, reduces taxes on tips and overtime (increasing disposable income), lifts the cap on deductions for state and local taxes (SALT), introduces new deductions (e.g., $6,000 for seniors), and offers more favorable tax treatment for businesses (including 100% bonus depreciation, an immediate deduction for R&D, and more generous interest-expense deductions (based on EBITDA rather than EBIT)). [4]

Lower interest rates and the modest boost to incomes and incentives should provide a tailwind to growth in the coming year.

A Slowing Labor Market Poses Risks

While easing fiscal and monetary conditions should be supportive, a slowing labor market poses a key risk to the current income-driven expansion. The unemployment rate has ticked up to 4.3% even as demographic shifts (e.g., baby boomer retirements) and tighter immigration enforcement are shrinking the labor force and labor-force participation continues to decline. Indeed, there are now more unemployed workers than job openings for the first time since before Covid. Slowing employment and immigration reduce the income base that fuels spending, while at the same time a constrained labor supply may keep wages elevated. That said, a clearer policy backdrop could lead to a pickup in hiring, and with balance sheets healthy, increased borrowing and spending can potentially fuel growth going forward.[5]

Caution Is Warranted

Risky assets look expensive, and expectations are high. With a forward P/E ratio of 22.5, S&P 500 valuations have returned to their 2021 peaks (levels previously seen in the dot-com bust), despite significant uncertainty around the timing and magnitude of AI's promised productivity impact. At the same time, earnings expectations have risen – with analyst consensus now projecting 14% growth for 2026. While international developed and emerging markets have also rallied, at forward P/Es of 15 and 14, respectively, they still look cheaper on a relative basis and offer an important source of diversification – particularly if the dollar continues to decline. Fixed-income also looks rich, with credit spreads tight and Treasuries pricing a benign average 10-year inflation rate of 2.35% (inflation remains at 2.9%). Market pricing leaves little room for the risk that inflation stays elevated, growth weakens, or policy volatility upends the status quo. Real assets may offer some protection against ongoing fiscal challenges and currency risks, but with gold surging to new highs, the risk of a reversal may be heightened.[6]

Leaning into Diversification, Alpha and Alternatives

Valuations and the expectations they reflect have been the best predictor of long-term returns, and with valuations elevated, we see heightened risk that future returns will disappoint. With investors highly concentrated in U.S. equities, we continue to emphasize the importance of diversification, both to international and emerging equities and other assets that can potentially outperform if economic outcomes are negative. We also believe the case for lowly correlated active management is particularly compelling in this environment, as policy volatility and dislocations can create opportunities for skilled investors irrespective of how markets perform. Finally, we see value in private-market alternatives, as top managers can potentially take advantage of their positioning in less efficient markets to add value through differentiated sourcing, underwriting, and operational capabilities.

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Notes

All data as of 9/30/2025.

[1] Gross Domestic Product | U.S. Bureau of Economic Analysis (BEA); GDPNow - Federal Reserve Bank of Atlanta; Tariff Impacts: Delayed or Avoided? | Federal Reserve Bank of Minneapolis; Short-Run Effects of 2025 Tariffs So Far | The Budget Lab at Yale; US economic growth revised up on strong consumer spending; Strong Crop of Earnings Eases Investors' Economic Concerns – WSJ; Citigroup forecasts Big Tech's AI spending to cross $2.8 trillion by 2029 | Reuters.

[2] Source: Bloomberg (MXWD Index, LBUSTRUU Index, BCOMTR Index, XAU Curncy, UGG10YR Index, LF98TRUU Index).

[3] Source: Bloomberg (DOTS); Credit Conditions - Q3 2025 | McDermott Will & Schulte – JDSupra; M&A deals top $1tn in third quarter; The latest M&A deal trends in 2025 | McKinsey; Where Is US Growth Headed from Here? | observatory.bwater.com.

[4] State of U.S. Tariffs: September 26, 2025 | The Budget Lab at Yale; The Implications of the "One, Big, Beautiful Bill" | observatory.bwater.com; One Big Beautiful Bill Act Tax Policies: Details and Analysis; The One Big Beautiful Bill Passed: Learn What's Changing | TaxAct; The OBBBA and Its Impact on M&A Transactions.

[5] Employment Situation Summary - 2025 M08 Results; US added just 22,000 jobs in August, continuing slowdown amid Trump tariffs | US unemployment and employment data | The Guardian; Labor force and macroeconomic projections overview and highlights, 2023–33 : Monthly Labor Review : U.S. Bureau of Labor Statistics; US labor force participation drops to lowest level since 2022 | S&P Global; 1.2 million immigrants are gone from the U.S. workforce under Trump, preliminary data shows | PBS News; Number of unemployed persons per job opening, seasonally adjusted.

[6] Stock Market P/E Ratios - Yardeni Research; Forward P/Es - Yardeni Research; YRI Earnings Outlook - Yardeni Research; 10-Year Breakeven Inflation Rate (T10YIE) | FRED | St. Louis Fed.

Important Information

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