

Economic Commentary

Investors entered Q3 2025 with cautious optimism, supported by resilient corporate earnings, and widespread anticipation that the Federal Reserve would ease monetary policy through additional rate cuts. Treasury rates fell modestly, and credit spreads continued to compress amid steady demand for corporate bonds. Equities marched to all-time highs, extending the second-quarter momentum that occurred after the spring tariff volatility. Signs of softening in the labor market have emerged after data revisions showed less job growth than previously had been reported. As such the Federal Reserve delivered a much anticipated 25-basis point rate cut amidst a challenging backdrop of weakening labor amid sticky and potentially increasing inflation.

Domestic Fixed Income Markets

During Q3, the yield curve continued to move to a more normal shape as short-term yields fell, reflecting the rate cut and expectations of additional easing. Despite a spike in yields early in the quarter, Treasury rates on maturities from 3 to 30-years finished the quarter between 5 and 8 basis points lower than their starting point. Spreads on corporate bonds continue to compress, with average spreads on 10-year A rated corporates falling 9 bps throughout the quarter, to finish at an average yield of only 0.71% higher than treasuries. Spreads on high-yield bonds continued to narrow, supported by strong corporate earnings and a rallying equity market mitigating credit concerns. An index average spread of high yield bonds fell from this year's high of 4.53%, to finish the quarter at 2.69%, which is near the historical lows. While yields and spreads continue to moderate, fixed income continues providing a compelling alternative to equities for income.

Domestic Equity Market

Equity markets extended their rally in Q3, marching forward to all-time highs. The S&P 500 returned 7.79% for the quarter, with the Nasdaq rising 11.24% off the seemingly never ending rally of AI-focused mega-caps and capital investments by technology companies. Concerns over mega-cap concentration have resurfaced, as the Magnificent 7 now make up roughly 35% of the S&P 500, raising questions about market breadth and sustainability. Small-caps advanced 12.02%, driven by rate-cut anticipation, lower borrowing costs, and growth prospects. Corporate earnings remain resilient, with S&P 500 earning-per-share growth for the quarter estimated at 7.9% year-over-year. Despite robust fundamentals, stretched valuations could warrant caution, as the S&P 500 is trading nearly 23x forward earnings after a 34% rally since April lows. Any disruptions to rate-cut expectations, tariff policy, or labor markets threaten the momentum that have been propelling equity markets.

Federal Reserve

The Federal Reserve delivered its first rate cut of 2025 in September, trimming the federal funds target range by 25 bps to 4.00–4.25%. This rate cut comes amid a challenging backdrop. Labor market data has been sharply revised downward, with revisions showing 911,000 less jobs having been added in the twelve months ending March 2025 than had previously been reported. At the same time, inflation risks are tilted to the upside, with first-round effects of tariffs hitting the market and CPI remaining persistently above the long-term target. August CPI came in at a 2.9% year-over-year price increase, well above the 2.3%

year-over-year reading from May. The combining threats of tariffs reigniting cost pressures just as labor markets moderate—presents a dynamic that could trap the Fed between higher inflation and slowing employment, raising the threat of stagflation and complicating the path to policy easing.

Summary

Despite upside risks to inflation and downside risks to labor markets, Q3 rewarded both bond and equity investors with solid performance. The Federal Reserve will have to continue their balancing act moving forward; cut too aggressively and risk reigniting inflation or don't cut fast enough and labor markets could deteriorate. Upside catalysts such as trade-policy relief or strong consumer spending could extend the rally, while sticky inflation and softening labor markets pose downside risks. Going forward, it will be important to monitor changes in both labor markets and inflation, as markets adjust to the Fed's tightrope act between supporting jobs and reining in prices. Focus should be given to quality assets, given any disruptions could drive an equity market pullback that could see a flight to quality and push Treasury yields lower and widening corporate spreads as investors seek additional compensation for taking on risk.