

Third Quarter 2025

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Highlights:

- Strong GDP Growth
- Unemployment and inflation concerns
- SCOTUS reinforces Fed independence
- AI still surprising to the upside
- Credit spreads tighten

Introduction

Next year, we are celebrating America's semiquincentennial (250th) birthday, a milestone in the life of our country. *This* quarter, however, on December 16th, will be the semiquincentennial of Jane Austen's birth.

Firmly embedded in the front ranks of English-language writers, alongside the likes of Shakespeare and Dickens, Twain and Faulkner, Austen might be seen as an "honorary American." While the class distinctions of Georgian England were a far cry from the swashbuckling democracy of the young United States, her focus on personal growth, the everyday realities of life, and making ourselves fit to truly enjoy whatever happiness as may exist in this hard world, was fully attuned to the values of our fledgling Republic.

Four of Austen's six novels were published in quick succession from 1811 to 1815, with two published posthumously (shortly after her death in 1817). Her heroines were decent and sincere, learning important life lessons as the story progressed. Between managing her own integrity and ascertaining the integrity in others—all the while navigating life's practical challenges—an Austenian heroine is the very picture of our humanity.

Perhaps the most instructive aspect of Ms. Austen's writing (Jane, if we may) was her ability to balance irony with duty. On the one hand, she had tremendous insights into the self-serving byways of the human psyche, good-naturedly noting the occasional hollowness of our pieties; on the other, she earnestly subscribed to those pieties herself.

As investors, Jane inspires us to find that balance. We invest because we are committed to our friends and family, to

strong ideals and meaningful causes, and, relatedly, to the pursuit of our own happiness; towards those ends, there is no substitute for being wise to the ways of the world. Earnestness without insight is naïve, and that will not do, but insight without earnestness is jaded, and that is also no good. It is our great privilege to be entrusted with the management of your capital, and we hope that we are providing *you* with the right combination of insight and earnestness.

The thumbnail version of the third quarter of 2025 is that stocks are up *and* bonds are up. GDP growth is impressive, but there are yellow flags for both unemployment and inflation. At the time this newsletter goes to print, the federal government is in shutdown mode again. In other words, life rolls on. But it is interesting, and maybe a bit serendipitous, that both Jane Austen and our country will soon be turning 250 years young!

Quarter in Review

The growth slowdown has been less pronounced than originally feared; quite the opposite, it has been more growth *expansion*. While there are good reasons to be cautious, which we outline more closely in the "Equity Report," fixed business investment, mainly in artificial intelligence, continues to provide surprises to the upside. Despite ongoing policy uncertainties, actual measures of uncertainty like the MOVE and VIX indexes are below their five-year averages.

After posting negative growth in Q1, GDP strongly rebounded in Q2. Indeed, second-quarter growth was recently revised upward to 3.8%. If GDP Now, the Atlanta Fed's real-time macroeconomic measure, is any indication, strong growth continues in the third quarter. Factors such as unleashed "animal spirits," with less regulation and lower taxes, seem to be playing a role.

GDP growth is one thing; inflation and unemployment is another. When it comes to those two key metrics, things look more dicey.

Inflation remains elevated. Important indicators like core PCE (2.9%), headline CPI (also 2.9%), and CPI Supercore Services (3.2%), have all moved higher from their April 2025 lows. Even Truflation, a "big data" index tracking millions of prices in real time, is higher than 2% after bottoming in April at 1.2%.

We think higher prices are the result of tariffs and immigration policies. These policy impacts are offset, or hidden, by a continuing disinflationary trend in shelter

pricing. Our baseline view is that inflationary pressures from tariffs should subside as those one-time hits ripple through the economy, but that shelter disinflation will continue to exert downward pressure on the inflation baskets. We expect inflation to eventually settle closer to the Fed's 2% target than it is now.

Inflation has been above the Federal Reserve's target level for four and a half years, and it is fair to wonder about their commitment to the 2% target. To be sure, 2% leaves little room for error, where it becomes impossible to pull out of a disinflationary spiral, but officials have forcefully reaffirmed the 2% target on multiple occasions. For central bankers, talk is cheap *and* useful: "cheap" because it does not impart immediate economic costs, and "useful" because it can shape market behavior. Notwithstanding their assertions to the contrary, if the Fed's "unofficial inflation target" is higher than the stated 2.0%, then at some point they will have to come clean.

Tariff policy is an administratively challenging piece of business, involving thousands of different products spread across a hundred countries. Moreover, after several decades of global free trade dominance, there are no empirical repositories of knowledge about the monetary and economic impact of tariffs. Is there more tariff inflation in the pipeline? Corporations have been able to use their beefy margins to largely eat the cost of tariffs, but we expect *that* to change as their inventories, which were greatly expanded prior to tariffs being enacted, are fully unwound.

The persistently high inflation must be balanced against emerging weakness on the employment side, the classic "rock and hard place" scenario. Employment has not deteriorated as much as some anticipated, but it *is* deteriorating. The unemployment rate is 4.3%, up from 4.0%, and underemployment is 8.1%, up from 7.5%. At the time of this writing, the government shutdown prevented the release of the September unemployment report—and in fact has created a data vacuum at a delicate moment in economic time.

While the top quartile of American households benefits from high real estate and financial asset valuations, the bottom three quartiles have little capacity to increase spending. Subprime auto delinquencies are now worse than the trough after the global financial crisis. Recent prints show credit card delinquencies breaking their negative trend, perhaps a signal that consumers are pulling back in the face of more worrisome employment situations. Employers seem unwilling to hire but are also reluctant to let workers go; existing workers know the culture and

operational language of their companies, and that is expensive to replace.

Armed with the convictions that tariff inflation is transitory, shelter disinflation is real, and unemployment trends are disconcerting, there has been an expectation of (and clamoring for) lower rates. President Trump, whose professional background as a commercial real estate developer makes him sensitive to the role interest rates play in economic outcomes, regards lower rates as a top domestic priority. Despite his best efforts, though, the Federal Reserve remains outside his direct span of control.

President Trump has long jawboned about the Fed, but in August he attempted to fire Governor Lisa Cook "for cause," that is, for doing something illegal or unethical. Cook claims the allegations are "unsubstantiated and vague," filing a suit to appeal her dismissal. The lower courts reinstated her with a preliminary injunction on grounds that "for cause" is limited to behavior *while in office*. Cook's alleged mortgage fraud occurred *prior* to becoming a Fed governor.

The Supreme Court agreed to hear the case and *Cook v. Trump* will be argued in early January of next year. It will probably be decided in June or early July, after Chairman Jerome Powell's successor is installed. The Trump administration appealed to the Supreme Court to put Cook into the penalty box until the case is decided. On October 1st, the Court said that Cook shall continue to serve as a Federal Reserve governor in the interim.

Combined with the *Wilcox* decision earlier this year, which carved out a "Federal Reserve exception" to its expansion of presidential power over the executive branch, the Supreme Court has so far reinforced the central bank's independence. This makes the substantially lower rates sought by Trump (and his newly minted governor Stephen Miran) less likely, at least in the months ahead. Right now, the Fed's rate policy is, by their own definition, "slightly restrictive," and we expect them to nudge rates fully into "neutral" territory, where policy is neither restrictive nor accommodative. We do *not* expect the Fed to aggressively cut rates unless the evolving data reveals new tranches of downside risk.

Washington is at the epicenter of so much these days, including the financial markets, but with reference to the uncertainties surrounding government policies, the market seems to be more confident in its ability to separate the wheat from the chaff.

We shall see whether this self-confidence is warranted. The Trump administration is promising that the national economy will roar in 2026. We can say this: there are marked differences between how the market stood at the end of the first quarter, versus how it stood at the end of the second quarter, versus how it stands now. It is a limited set of data points, to be sure, but the trajectory, at least where the market is concerned, is in the right direction.

Equity Report

The third quarter of 2025 was defined by a remarkable paradox: a surging stock market against the backdrop of rising stress and economic slowdown. Major U.S. indices reached all-time highs, propelled by a renewed cycle of Fed rate cuts, a slight market broadening, and all-things AI. The S&P 500 continued its impressive run, building on its Q2 gains to deliver strong 8% performance for the quarter.

While the headline indices achieve new peaks, we see a chasm forming beneath the surface, pitting highly valued growth stocks against the discounted value segments. Our core view moving into Q4 and 2026 is defined by this divergence. We maintain a cautious stance on the broad, large-cap index, given elevated valuations and concentration risk, but adopt a distinctly optimistic outlook for value-oriented names, which we believe are poised for significant catch-up even if the economic cycle grinds to a slower pace.

Although Q2 GDP growth was revised upwards, suggesting surprising consumer resilience in the first half of the year, the recent economic data points to mounting strain. Perhaps the most significant development was the moderation of the labor market, showing a clear deceleration in job creation.

While the unemployment rate ticked up slightly, it remains at historically low levels, indicating a shift from an overheated market to a more balanced one. This trend was seen by many as a positive sign that the Fed's monetary policy was effectively reining in inflationary pressures without causing a deep recession. The most recent employment data, though, raises fresh concerns that employment is stalling out.

The Conference Board Consumer Confidence Index fell sharply in September, reaching its lowest level since the initial tariff implementations in April. Consumers cited inflation and a weakening job outlook as their primary concerns. As noted earlier, signs of financial distress are emerging, particularly among lower-income households. Credit delinquencies are not abating, indicating that the cumulative effect of elevated living costs and high rates is starting to bite the average American consumer.

Inflation proved sticky again, particularly in the core components, which saw an upward trend in the latter half of the quarter. Despite this, the Fed delivered a widely anticipated rate cut in September, reflecting a shift in focus from upside inflation risks to downside employment risks.

The second quarter saw the de-escalation of some trade tensions, notably an extension of the US-China trade truce. This substantially boosted market sentiment, especially for Chinese and emerging market equities. Still, the long shadow of higher tariffs in key sectors remains a material risk, with expectations that the pass-through of these costs to consumers will become more evident soon.

The difficult reality of the economy today is persistent price pressures combined with a slowdown in momentum. Since the broad stock market is currently priced as if everything is perfect, we would caution that unexpected bad news could lead to a sharp and disappointing pullback.

For the third quarter, the Russell 1000 Growth increased 10.4%, significantly outpacing the Russell 1000 Value, which increased 4.8%. Year-to-date, Growth and Value have both delivered solid returns by any measure, up 16.7% and 10.0% respectively. We continue to point out that valuation for the Large-Cap Growth side of the market remains meaningfully more elevated than Large-Cap Value. At the end of the quarter, Growth was trading at 31.1x forward estimates (61% above the 20-yr average of 19.3x), while the Value side of the market was trading at 17.3x forward estimates (25% above the 20-yr average of 13.8x).

Mega-cap tech led the charge again with positive earnings results and strong outlooks confirming that AI spending trends remained solidly in place over the near term. We note that S&P 500 earnings estimates for the full year firmed slightly in the quarter, from \$262 in late June to \$266 at the end of September. This still represents a slight markdown from \$272 at the beginning of the year. The S&P 500 PE multiple continues to expand, ending the quarter at 23.0x forward consensus earnings estimates, well above the 10-year median of 18.1x and the 20-year median of 16.1x. As we look out into 2026, the consensus estimates of \$302 (+13.5% y/y) seem quite optimistic against a slowing economic backdrop. We expect those estimates will have to be reset lower as we move into the new year.

At a sector level, investors continued to press their optimistic economic and AI outlook, with Technology leading the market, up 11.3% q/q. Consumer Discretionary, Telecommunications and Utilities also led performance, up 10.3%, 8.3% and 6.8%, respectively. But most notably, it was the Tech and AI-related names *within* those sectors that

drove the lion's share of the performance, such as Tesla +40% (Discretionary sector) and Google +37% (Telecommunications sector). Given the continuation of the "risk-on" rally through the third quarter, defensive sectors such as Consumer Staples (down 3.2% q/q) and Healthcare (+3.3% q/q) have taken a backseat.

While our equity portfolios contain a good balance of growth and value issues, we have been taking the opportunity to lock in some profits on some of our best-performing names, recycling those proceeds into some of the laggards which we still think have significant longer-term upside. For our dividend-oriented accounts, trimming our strongest performers and reinvesting the proceeds into our laggards provides the added benefit of increasing portfolio yield.

Now more than ever, given the rapid recovery from the April correction and the new highs reached in the quarter, investors need to pay close attention to valuations. The excess returns that growth stocks delivered over the past few years have eclipsed the relative performance of the 2000 tech rally. The "this time is different" rationalizations with artificial intelligence have led many investors to become complacent or numb regarding valuations. Markets can stay irrational for long periods, but we think it's prudent to remain well-grounded in the notion that, despite its strong secular growth profile, technology remains one of the most cyclical segments of the market. What we are seeing today is a market applying expanding multiples to revenue and earnings that are more likely closer to peak than trough levels.

We continue to favor businesses and sectors like Healthcare with above-average cash generation that are selling below their long-term averages. We continue to think that Energy offers good opportunities, with well-above-average free cash flow yields and a much more disciplined industry from a supply/demand perspective. We continue to be constructive on Financials, which represent good value as long as the economic cycle grinds along.

Our outlook for Q4 is one of measured return expectations, prioritizing selectivity and value-oriented exposure over passive broad-index holdings. The Q3 market surge was impressive, but we urge investors not to be lulled into complacency by headline indices. We think the path forward for the S&P 500 will be choppy, potentially involving a period of consolidation.

The high valuations and underlying economic friction suggest that the broad market faces a more challenging climb into the new year. In our view, the long-term

opportunity lies in the ignored corners of the market. The combination of deep discounts, resilient earnings, and potentially more favorable monetary policy makes value stocks quite attractive from here.

The current backdrop makes our investment strategy more relevant than ever. In a market where premiums are placed on growth, our focus on value, income, and business quality can provide a crucial element of stability. We will continue to monitor our portfolio companies closely, ensuring they maintain the strong balance sheets and sustainable dividends that form the foundation of our investment philosophy.

Fixed Income Report

The tale of fixed income this year has been a story of "steepening" yield curves. From July 2022 to August 2024, the 2-Year and 10-Year Treasuries were "inverted," meaning the short end of the curve provided more yield than the longer end. This year, curve steepening helped "normalize" the yield curve, where bankers and other financial intermediaries could go back to the basic "borrow short and lend long" model.

But the steeper yield curve also points to a problem with the idea that Federal Reserve rate cuts mean "lower rates." While the Fed controls the short end of the curve, the longer end is driven by market expectations regarding growth and inflation. As a rule, when the Federal Reserve cuts its target Fed Funds rate, or even just provides dovish guidance, the market expects *more* growth and *more* inflation, and discounts longer-term rates accordingly. In other words, the significant rate cuts sought by the Trump administration could have the unintended consequence of sending, say, household mortgage rates higher.

There has been a tremendous amount of policy uncertainty this year, which tends to put a ceiling on Treasury rates. As you can see from the table below, Treasuries have seen a *bull* steepener, where the curve has rallied on expectations of a renewed cutting cycle, with the long bond holding steady.

Change in U.S. Treasury Yields

Rate	Yield				Change BP
	<u>12/'24</u>	<u>3/'25</u>	<u>6/'25</u>	<u>9/'25</u>	<u>YTD</u>
2yr	4.24%	3.88%	3.72%	3.61%	-63
5yr	4.38%	3.95%	3.80%	3.74%	-64
10yr	4.57%	4.21%	4.23%	4.15%	-42
15yr	4.75%	4.46%	4.64%	4.54%	-21
30yr	4.78%	4.57%	4.77%	4.73%	-5

The story is a bit different on the *tax-exempt* side; municipal bonds have rallied on the shorter end but sagged further out. In other words, the curve showed a steepener, but it was a “bull steepener” in one segment and a “bear steepener” in the other. This difference to the Treasury curve was especially pronounced until the second half of September, when investor demand for the mid-to-longer end of the muni market became more elevated.

Municipal AAA Curve

Rate	Yield				Change BP
	12/'24	3/'25	6/'25	9/'25	YTD
2yr	2.82%	2.56%	2.61%	2.27%	-55
5yr	2.90%	2.80%	2.72%	2.31%	-59
10yr	3.13%	3.20%	3.21%	2.92%	-21
15yr	3.38%	3.62%	3.78%	3.59%	+21
30yr	3.87%	4.27%	4.52%	4.30%	+43

A big reason for the “bear steepener” further out was the wave of new (mostly long-term) issuance in the primary market. According to the *Bond Buyer*, primary market issuance is up 9% year-over-year, and that is on the heels of record new supply in 2024. July marked the strongest month of the year, with \$59 billion in tax-exempt new issuance, compared to \$43 billion in July 2024.

That momentum stalled in August, however, with the first monthly year-over-year decline, followed by another decline in September. Since visible (new issue) supply remains an important technical driver of relative performance, even this slight pullback had an immediate impact. The long end in particular rallied as supply downshifted, boosting performance across the term structure. Thanks to that rally, each maturity tenor has now posted positive YTD returns.

Bloomberg Municipal Bond Index

	Q1	Q2	Q3	YTD
Index	-0.22%	-0.13%	3.00%	2.64%
1-yr	1.05%	0.83%	0.99%	2.89%
3-yr	1.01%	1.07%	1.52%	3.63%
5-yr	0.91%	1.36%	2.19%	4.51%
7-yr	0.75%	1.29%	2.74%	4.84%
10-yr	0.26%	0.78%	3.03%	4.10%
15-yr	-0.60%	-0.39%	3.43%	2.40%
20-YR	-1.29%	-1.44%	3.73%	0.90%
30-YR	-1.46%	-1.92%	3.82%	0.31%

Source: Bloomberg

Between ready cash (from coupons, calls, and maturities), reduced supply, and a desire to “lock in” yield in advance of an easing cycle, we think the rally in the 7–15-year segment of the curve is sustainable for the balance of the year. The primary market remains our chief focus. We will continue to enhance our yield advantage by investing in attractive sectors like puttable prepaid gas deals and housing bonds. We will also garner extra performance through yield pickups on the longer end and through curve rolldown opportunities (which were not available in the inverted rate environment). In terms of duration positioning, we are staying close to neutral.

On the *taxable* side, September brought the tightest credit spreads of the 21st century. Despite the atmospheric, this has been a very low volatility quarter. Bond market participants continue to purchase bonds at these tight spread levels, but like our colleagues on the Equity Team, we have misgivings that current spreads do not leave any room for negative surprises.

Credit Index

Option Adjusted Spread

	Q3	YTD
High	77	110
Low	68	68
Start	77	76
End	69	69

When President Trump paused tariffs on April 9th, the market took it as a signal that the Trump administration was willing to work with business on this key part of its agenda. Since that time, credit spreads have moved tighter, ending the third quarter at +69bp. That is lower than where we started the year. The major driver of the demand for investment-grade credit has been high “all-in” yields. This continued during the third quarter, even with extreme spread compression and the largest September ever for new corporate bond issuance (in contrast to the issuance pullback we saw on the muni side).

Credit spreads have not been this tight since 1998. In those days, bonds fetched much higher yields than today, typically carried less duration, and the percentage of lower-rated securities in the credit universe was smaller.

We expect to keep our strategies in a neutral duration orientation relative to their benchmarks. This positioning is a function of continuing uncertainties, but also of the shape of the yield curve, which already reflects current consensus expectations.

Conclusion

Given our outlook for slow (but positive) growth, high (but not out of control) inflation, and worsening (but not to recessionary levels) employment, we are comfortable maintaining our overweight allocation to corporate bonds. While we still see good relative value in individual credits and sectors, we recognize that the corporate bond market is not “cheap.” We continue to position our portfolios to be overweight credit at the short end of the curve, enabling us to add yield (or, another word for the same thing, income).

We maintain an overweight to Energy and Financials. From a debt perspective, we prefer companies with high recurring revenue and less exposure to commodity price movements. Our Energy overweight has a midstream focus, while our Financial overweight is primarily in global systemically important banks (GSIB), where bondholder interests are shielded by large balance sheets and regulated capital levels. We are buying longer-dated Treasury securities, but currently avoid TIPS, seeing them as expensive relative to our inflation outlook.

Finally, we are pleased to report that all seven of our taxable strategies are outperforming their respective indices year-to-date. This is in continuity with our strong history of outperformance, in times both fat and lean.

In her novels, Jane Austen makes subtle moral distinctions which only become obvious at the end. The market does not work that way. Subtle distinctions are less exigent when the opportunities are messy and the risks are open-ended: when investing, one is either right for the right reasons, right for the *wrong* reasons (“lucky,” in other words), or just plain wrong.

In *Mansfield Park*, as Jane summarizes the outcome, her heroine, Fanny Price, despite the long odds, has landed on her feet for no other reason, really, than she was an honorable person. While the pressures of circumstances led others to exhibit bad behavior, some redeemable and some not, Fanny’s integrity had shone through.

Fanny’s cousin Maria left her marriage to run off with Henry Crawford, a feckless Austenian anti-hero. That situation collapses and the heedless Maria is disgraced. Fanny’s tormenter, the busybody Mrs. Norris, leaves Mansfield to “devote herself to her unfortunate Maria.” Lest anyone think that Maria and Mrs. Norris faced no consequence for the damage they inflicted on others, Jane archly adds, “and in an establishment being formed for them in another country, remote and private, shut up together with little society, on one side no affection, on the other no judgment, it may be reasonably supposed that their tempers became their mutual punishment.”

As delightful as Jane’s outcomes are, we know that the real world does not tie up into neat little packages. Indeed, Jane knew as much. As we manage the opportunities and risks ahead, though, it *is* useful to remember the Austenian ideal, where ironic detachment, and its insights, are combined with genuine commitment, and its clarities.

It is gratifying to know that Jane Austen’s life dovetails with the founding of our Republic. While we prepare to celebrate America’s 250th birthday—to acknowledge our depth of gratitude for our country—it does not hurt to remember Ms. Austen’s 250th birthday as well. Her blend of practicality and principle, passion and perspective, was an all-American cup of awesome.

Disclosure: For informational purposes only. Not a recommendation to buy or sell any security or class of security. Investing entails risk, including loss of principal. Past performance is no guarantee of future performance.