

It Depends on Where you Sit.



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October 2025

Last quarter, we reminded readers that August and September were historically weak months for U.S. stocks, with September being the weakest of the year on average. We also cautioned that seasonality is not a major factor in our investment process. Good thing, because the S&P 500 index of Large Cap U.S. stocks gained 7.8% in the quarter and 3.3% in September, its best return for that month in 15 years. The market's strength was impressive, considering it had to overcome not just seasonal headwinds, but continued uncertainty about tariffs, concerns about profit margins, high valuations, softening labor markets, and questions over the independence of the Federal Reserve.

Whilst they underperformed early this year, the market's most popular "Mag 7" stocks have come storming back. In fact, five of them – Tesla, Alphabet (Google), Apple, Nvidia, and Microsoft – added a staggering \$1.4 Trillion in value in the third quarter, pushing the top 10 stocks of the S&P 500 to a weighting of more than 40% of the index. As mentioned before - The market has not been this top heavy and **concentrated in a handful of stocks** for over 50 years.

Non-U.S. stocks are having somewhat of a renaissance.

Emerging markets led during the third quarter, climbing 10.9%, and are now up 28.2% for the year. China has been the largest driver of Emerging Market stock returns, leaping over 41% year-to-date. Who would have predicted that, with the trade war storm clouds hovering over the Chinese economy? Non-U.S. Developed stock markets (Europe, Japan, etc.) joined the party too, gaining 4.8% in the quarter and are up 25.7% for the year. For the first time in what feels like an eternity, the venerable S&P 500 index, with its meager 14.8% return so far in 2025, is trailing far behind many other stock market categories.



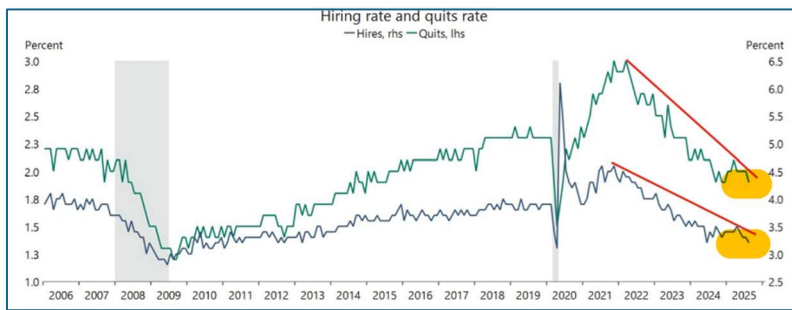
Bonds are having a pretty good year. The interest rate on the 10-year U.S. Treasury has declined from 4.58% to start the year to 4.16% on September 30th. This, along with narrowing credit spreads, contributed to a healthy 2.0% return for Core Bonds in the third quarter and a 6.1% year-to-date total return. As a result, it's not just aggressive stock-heavy investors who are having a nice year - conservative and moderately conservative portfolios are enjoying strong overall total returns as well.

Importantly, returns this year have been **affected a lot by where you sit**. Literally. The U.S. Dollar has dropped against most major currencies this year – over 10% on average. For U.S based investors, this has boosted the non-U.S. investment returns mentioned earlier. On the other hand, foreign investors in U.S. assets, if they were unhedged, saw much lower returns from their holdings.

Within the economy, the big story over the summer was that **the U.S. jobs market is now unquestionably showing signs of softness**. One of the most important economic indicators, a weak job market typically coincides with slower economic growth, weaker demand, and cooling wages. One key feature of a recession, and the large (typically over 30%) stock market decline that comes with it, is a sharp spike in unemployment.

To us, the employment statistics warrant some concern but are **not yet alarming**. For the first time since 2021, the number of unemployed workers surpassed job openings. Officially, unemployment is 4.3% - higher than Washington wants it to be. And KKR estimates that if the labor force participation rate were not so low (mostly due to a wave of earlier retirements the past five years), unemployment would be closer to 5%. This chart shows both sides of the labor equation – the green line

showing the “I quit” rate and the grey line showing “You’re Hired”. The higher these lines, the stronger the jobs market. Upward slopes indicate an improving jobs market. Both have been declining for years and are at levels not seen in a decade or more (outside of Covid) – strong evidence of a weak labor market.



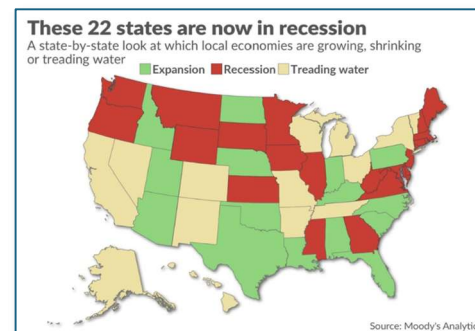
As is often the case nowadays, the jobs market is being buffeted by a number of unusual factors, making headline observations less reliable and calling for a deeper dive. Today, employment is being impacted not just by traditional economic forces, but also by a reduction in the federal workforce, reduced immigration, increased deportations, and the increase in retirements. Here’s another case of how it can depend on where you sit - younger workers are finding it harder to get hired. The **unemployment rate for workers aged 16-24 is 10.5%**, much higher than the pre-Covid rate of 6.6%. This is an alarming trend.

Besides jobs, we all know that one of the other key elements of the conversation this year is tariffs. With tariffs clearly here to stay, the question is “Who will pay the tariffs?” We continue to think the answer is “it’s complicated.” It’s not so simple to think that all tariffs are passed on in an inflationary manner. Some are, for sure. But there are many parties along a supply chain that can absorb some of the cost. According to PIMCO, overall, companies have not passed on the cost of tariffs to the extent predicted by economists, and have reduced costs elsewhere to protect their profits, namely in the form of reduced labor and wage growth.

We think it’s too early to pop the champagne on tariffs being a great thing - they may still put upward pressure on inflation over the next few quarters. But at least for now, it appears that the most dire predictions were off the mark.

With the job market softening, continued uncertainty of tariffs, and consumer and business confidence predictably under pressure, how does the U.S. economy look? Surprising to many – the **headline U.S. economy numbers have continued to look strong**.

While the aggregate headline numbers look good, once again we think it depends on where you sit. Again, literally where you physically sit. You see, we always talk about economics at the national level, but just like Real Estate, your personal economy’s strength can depend a lot on location, location, location. The chief economist of Moody’s, the credit rating agency, recently expressed an out of consensus view that the U.S. economy is much weaker than the headline national numbers suggest. He pointed out that 22 states are likely currently in a recession and another 13 are trading water. This graphic illustrates which states he thinks are in recession (red), trading water (tan), and growing (green).



Now, we’re not very surprised by this analysis. The U.S. is a diverse country, and the map likely looks varied most of the time. But this analysis confirms that the economy is not firing on all cylinders nationwide.

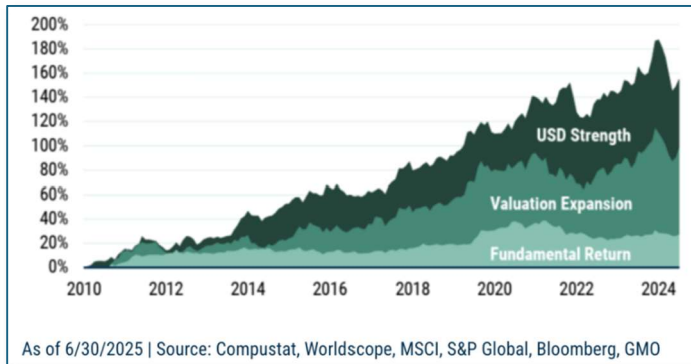
Economic softness and a weakening jobs market **got the Federal Reserve’s attention** this quarter. Investors can be excused for forgetting that the Federal Reserve has what’s called a “Dual Mandate” – they are supposed to maintain two important goals – both strong employment and low inflation, which obviously can conflict with each other. That’s clearly the case today, with inflation still far above their 2.0% target, but with unemployment over 4%.

After nine months of hemming and hawing and waiting for the data to be convincing enough, the Fed decided that the scales have tipped in favor of **protecting employment over reducing inflation** and they lowered their short-term interest rate target by 0.25% in September – the first cut in nine months, bringing the total of their cuts this cycle to 1.25%. While we’re skeptical that slightly lower interest rates will have much effect on the economy, we do think this is the right move. And it’s likely just the beginning of a new period - The Fed, and most market participants, expect short-term rates to keep declining this year and next, falling to around 3.0% by the end of 2026.



Turning back to the markets, the outlook for non-U.S. stocks deserves a deeper dive. Let's look at it in reverse – *how did U.S. stocks outperform non-U.S. by so much over the past 15 years?* Most Americans likely assume that it's simply because U.S. companies posted superior business results like profit and sales growth – “Fundamentals” if you will. Fundamentals certainly played a role, but there were **two other significant factors affecting the relative returns of U.S. and non-U.S. stocks:**

- 1) The impact of relative valuation changes, and
- 2) Currency movements.



The chart above shows the cumulative impact of these three factors separately (and in aggregate) and as you can clearly see – the superior “Fundamental” performance of U.S. stocks underlying businesses was a positive factor, but it was the smallest of the three contributors toward their outperformance. An increase in their popularity/valuation as well as U.S. Dollar strength contributed much more to the significant outperformance of U.S. stocks the last 15 years. This is important as we sit here today - a reversal in these two non-fundamental factors could create a major tailwind for non-U.S. stocks going forward. If foreign investor demand pivots from U.S. stocks back toward those of their home regions, and if the U.S. Dollar continues to weaken, this year's strong non-U.S. stock relative performance could be just the start of a multi-year move.

We can't talk about the third quarter without mentioning another major theme – the one that fueled the Mag 7's resurgence - **Artificial Intelligence (AI)**. Some analysts have argued that without AI, we would likely be in a bear market. They may have a point - **since ChatGPT launched in November 2022, AI related stocks have accounted for 75% of the gains in the S&P 500, 80% of growth in earnings, and 90% of capital spending.**

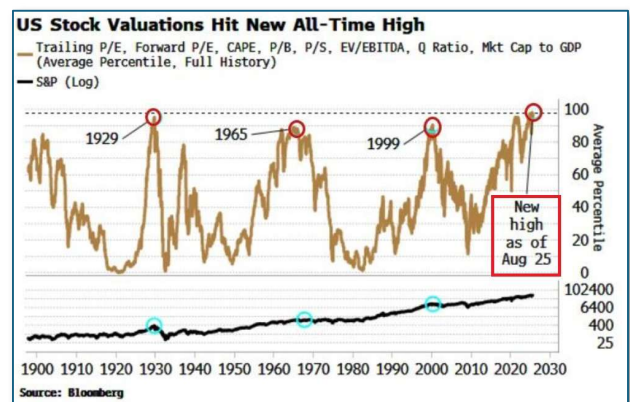
Is the hype over AI justified? In some ways we think it is. We have pivoted to using AI (Grok, ChatGPT, and Google) for some search related activity and if you haven't tried it yet, we can tell you that it is an amazing experience, much

better than traditional internet search. AI is far from limited to internet search though, and it's destined to be used in business processes throughout the economy. The stock market's hope is that this boosts productivity and profitability.

There's no doubt that AI could be a game changer. But there is **doubt about which companies will ultimately benefit the most** in the long run. For now, lots of money is being spent with little revenue to show for it in somewhat of an AI “arms race.” The current AI environment is looking more and more like the internet bubble of the late 90's (remember AOL and Lucent), with investors and companies spending money first and asking questions about profitability later.

So, as we head toward the home stretch of 2025 full of good feelings over portfolio growth this year, it's worth asking that **if things are really so good that many stock markets should be up 15-20% with barely any volatility** over the last five months? The glass half empty crowd would argue “no” and cite stubborn inflation, still unknown effects of tariffs, gold's strength, a weak jobs market, high valuations, dangerous concentration at the top of the market, and more.

We rarely mention valuations for a couple of reasons. For one, they are not a good tactical allocation indicator as stocks can remain cheap or expensive for many years. And secondly, they've been relatively expensive now, compared to history, for a long time. Even so, it may be time to worry again. This chart shows a composite of eight market valuation measures going back to 1900 – and it shows that we are currently at **all-time high valuation levels for U.S. Stocks.**



This is no secret of course. The market has ignored these nosebleed valuations and its strength since April has reminded investors of a few important lessons. First, **“Don't Fight the Fed”**. The level and direction of interest rates is critical to the stock market. With the Fed cutting,

the bar is high to be bearish. Importantly, it's **not just the U.S. Fed lowering rates** – Over the last 12 months, Central Banks around the world have cut rates 168 times, the third most widespread rate cutting in the last 23 years.

Secondly, **“Don't Fight the Market”**. Many investors try too hard to predict the future or to develop a theory about how things will play out and want to be “right” for their ego's benefit. Some investors unwisely let politics into their investment process – a very dangerous game, as this year has proven. In the end, investors are usually well served cutting through the noise, avoiding personal biases, and simply identifying and respecting if we are in a bull or bear market. And we're clearly still in a bull market.

Over the short term, we would be surprised if the markets did not finish the year strong. Historical seasonality, while wrong in September, would argue for continued strength – December has historically been the market's best month. Also, simple **momentum argues for continued strength** as well – this year saw only the 10th time that U.S. stocks corrected more than 10% and recovered enough to finish the 3rd quarter up over 10% year-to-date. The prior nine times, stocks gained in the fourth quarter every time. Usually by more than 7%.

But it **may not be clear sailing**. For one, the President has reminded investors this month that he is still prone to making drastic changes to tariff policies on short notice. And then there is something lurking between here and a year-end rally that could really rock the apple cart – the Supreme Court will rule on the legality of the President's tariff policies in November. We can't handicap the outcome, but a reversal could inject the kind of uncertainty that roils stocks.



Beyond that, like a poker player who has put all her chips into the pot hoping to draw a winning hand, markets remain **vulnerable to disappointment on key themes – Inflation and AI**. If the inflation rate starts to rise again, or

even if inflation merely plateaus and stubbornly refuses to fall any further, then further interest rate cuts would be called into question, and stocks and bonds would likely both suffer, with stocks suffering more. With the AI theme driving so much of the market's momentum, and the space starting to exhibit bubble-like behavior, any disappointment or loss of confidence in that trade could trigger a quick and violent correction as well.

Through all the confusion and uncertainty, it seems to us that there are a few things we can expect with confidence. Short-term interest rates are likely to continue declining. The result is that “Cash” and Bank Deposit yields will go down. If that's the case, and if inflation stays a little stubborn, then Bond yields may not have much further to decline, and going forward, Core Bond returns should be close to current yields – in the 4-5% range. Not bad, but likely lower than most investors need or desire for their total portfolio to meet their financial goals.

While stocks may be vulnerable, absent a recession, and with the Fed poised to continue cutting rates, volatility should be limited to short-term air pockets and typical **corrections of 8-15% that investors should expect to endure nearly every year**. Alternative investments may continue to play an important role, especially if inflation remains a risk, or if recession risks increase. The return of contributions from Bonds and Non-U.S. stocks is welcome, as it's healthy to have returns coming from more than one sector or category. We think there's a good chance this continues. Yet, even if we sail smoothly into year-end, with high uncertainty, a wide range of outcomes possible, and elevated risks in key themes, we expect volatility to pick up again next year. We won't be sitting still - we'll continue to strive to balance both risk management

and return opportunities across the spectrum of stocks, bonds, and alternatives, both foreign and domestic, striving to build the most prudent portfolios for these challenging times.

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