

Mid-Quarter Update

Six months ago, investors were just beginning to recover from what felt like a long “liberation day” for markets, emerging from a bear market and a barrage of recession fears. At that time, headlines focused on whether a “soft landing” was achievable and whether strong employment could coexist with slowing growth.

Fast-forward, and the tone has shifted. Equity markets not only regained lost ground but continued to climb, supported by higher earnings per share and lower interest rates. The AI spending boom continues with capital spending now near 2% of GDP and investors demonstrating considerable enthusiasm around AI and its potential to enhance productivity. We note that widespread optimism carries risk if expectations outpace near-term results or profitability.

Bond investors are either taking their cue from the Fed’s actions by reducing longer maturity interest rates, or they are detecting signs of a weakening overall economy. They seem content with the benchmark 10-year Treasury note near a 4% yield.

The U.S. economy remains resilient, but momentum may be slowing. The Atlanta Fed’s GDPNow model currently estimates third-quarter real GDP growth at 4.0%, reflecting continued economic resilience. However, consensus expectations call for growth to moderate toward 2.0% in 2025 and 1.8% in 2026, more in line with the economy’s long-term trend.

Job creation has decelerated from last year’s rapid pace and is an area of concern. The unemployment rate has risen modestly to 4.3%, still consistent with a healthy labor market but indicative of gradual cooling. Importantly, wage growth has slowed, which may help contain inflationary pressures and allow the Fed to maintain its current policy stance, prioritizing employment stability over further progress on inflation.

Consistent with jobs, consumer sentiment continues to weaken, reflecting growing caution amid high costs and softening labor market trends. However, consumption is still good. As sentiment deteriorates and excess savings fade, consumer-driven growth is likely to moderate, reducing support for broader GDP expansion.

In our opinion, the biggest economic concern is inflation. It increasingly looks to be locked in around

3%, far above the Fed's target of 2%. Following its recent meeting, the Federal Reserve lowered the target range for the federal funds rate to 3.75%–4.00%, characterizing the move as a “risk management cut” intended to bring policy closer to a neutral stance. Policymakers acknowledged that job gains have slowed and that downside risks to employment have increased, even as inflation “has moved up and remains somewhat elevated.”

Long-term interest rates have declined as markets anticipate additional easing in the months ahead, even though the Fed does not directly control long-term rates. The prospect of a more accommodative policy path has supported markets, as investors continue to price in further cuts and a more stable policy environment. Despite this favorable backdrop, it is important to recognize that markets do not move up indefinitely. Valuations have expanded, and investor sentiment has turned decidedly optimistic. An environment where earnings growth normalizes and valuations face renewed scrutiny could present challenges even amid generally favorable conditions.

Our investment approach remains unchanged. We continue to focus on high-quality companies with durable cash flows, conservative balance sheets, and the ability to compound value over time. We believe these businesses are best equipped to navigate periods of uncertainty and to deliver consistent, long-term results.