

Market Matters: 3rd Quarter 2025

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“Life is like riding a bicycle. To keep your balance, you must keep moving.” – Albert Einstein

Markets continue to operate in a “Goldilocks Zone” - some growth, contained inflation, and the promise of support from stimulus.¹

Equity valuations are elevated, leaving little margin for error if earnings or policy outcomes disappoint. Tech/AI companies continue to lead, though their high multiples amplify volatility risk. The prospect of a lengthy government shutdown is a wildcard, but a shorter one would likely blow over.

While we do not view recession as the base case, vulnerabilities in labor markets, trade, and valuations highlight the need for caution. We believe investors should remain positioned to benefit from ongoing momentum - with discipline, diversification, and ample downside protection.

2025: The Goldilocks Zone

The Goldilocks Zone is a habitable zone that’s just close enough to the sun for liquid water and other life sustaining conditions, yet also just far enough away for us to not overheat. In this habitable zone we have the necessary conditions for life to exist.

In today’s markets, we find ourselves in a similar position. Inflation is not accelerating out of control, but growth is not slowing into a recession. Instead, the environment is relatively balanced—offering reasons for cautious optimism, yet still warranting vigilance, while a government shutdown is adding to reasons for caution.

Equity markets continue to push all-time highs, buoyed in part by the extraordinary valuations of AI and technology leaders, along with the promise of rate cuts and monetary accommodation. **This reflects pricing of a near-perfect balance between economic tailwinds and headwinds.**

Short-lived government shutdowns tend to blow over, but a prolonged shutdown, especially one involving mass layoffs that have been threatened by the administration, could have a greater effect. In past shutdowns, the equivalent of ~0.2% has been shaved off of GDP growth per each 1 month of closure, the majority of which was reversed when workers received back pay and delayed government spending caught up. If mass firings take place, more GDP loss would potentially go unrecovered. Specific localities and sectors that rely on federal activity are particularly adversely affected, including defense, aerospace, research institutions, agriculture, national parks, healthcare services, etc.

Start of Shutdown	Reopen Date	Length (Days)	S&P 500 Return	S&P 500 12 Months After End
9/30/1976	10/11/1976	11	-3.5%	-6.6%
9/30/1977	10/13/1977	13	-2.5%	12.0%
10/31/1977	11/9/1977	9	0.4%	1.5%
11/30/1977	12/9/1977	9	-1.0%	3.2%
9/30/1978	10/18/1978	18	-2.0%	3.1%
9/30/1979	10/12/1979	12	-4.4%	24.7%
5/1/1980	5/1/1980	1	-0.8%	25.8%
11/20/1981	11/23/1981	3	0.7%	9.3%
9/30/1982	10/2/1982	2	0.3%	36.2%
12/17/1982	12/21/1982	4	2.4%	18.0%
11/10/1983	11/14/1983	4	1.6%	-0.4%
9/30/1984	10/3/1984	3	-2.2%	13.5%
10/3/1984	10/5/1984	2	-0.6%	12.6%
10/16/1986	10/18/1986	2	0.0%	18.4%
12/18/1987	12/20/1987	2	2.5%	11.9%
10/5/1990	10/9/1990	4	-2.1%	23.2%
11/13/1995	11/19/1995	6	1.2%	22.8%
12/15/1995	1/6/1996	22	0.0%	21.3%
10/1/2013	10/17/2013	16	3.1%	8.9%
1/19/2018	1/22/2018	2	0.8%	-7.1%
2/9/2018	2/9/2018	1	1.5%	3.4%
12/21/2018	1/25/2019	34	10.3%	23.7%
Average		8.2	0.3%	12.7%
Median		4.0	0.1%	12.3%
% Higher			54.5%	86.4%

Source: Carson Investment Research, FactSet 03/07/2025

Overall Market Tailwinds:

- AI resource investment and professionalization
- Government stimulus from the One Big Beautiful Bill
- Falling interest rates
- Energy transition, renewable power
- Digital infrastructure
- Stable unemployment and consumerism

Overall Market Headwinds:

- Deglobalization
- Threats to Fed independence
- Unemployment, low immigration, and labor force participation (lower employment)
- Unpredictable inflationary trends, with bias to upside
- Higher long-end interest rates
- Potential prolonged government shutdown

The lists on both sides could go on, but the balance is on the side of US companies to win over a short-to-mid-term horizon. It is a delicate balance, nonetheless.

Most government shutdowns are short-lived, and stocks typically overlook them, though they have the potential to markedly increase volatility due to headline risk. Historically, the S&P 500 has risen

55% of the time during a shutdown, and ended higher 86% of times 12 months after a shutdown.²

Total returns ended up par for the course. Present conditions are never the same as historical conditions, but these trends underscore that profits matter more than politics.

Current economic dynamics are interacting in subtle ways. Consumer spending is decelerating (flattening in the chart to the right), so companies are absorbing a little more of tariff costs rather than fully passing them on.³ Firms are managing margins through labor reductions or attrition, often supplemented by efficiency gains. At the same time, labor supply constraints may be limiting layoffs, creating a fragile balance.

Inflation pressures remain modest, though certain consumer categories (furniture, toys, apparel) are showing early signs of upward repricing. Corporate cost structures are adjusting in parallel, leaving the economy in a low-growth but stable position.

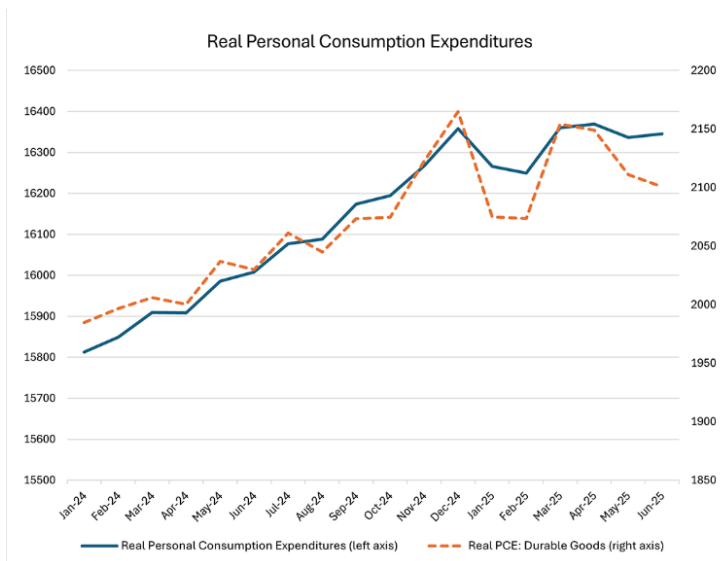
The Goldilocks Zone is narrow. When the balance is delicate and risk isn't priced in, it may not take much to tip the scales of the economy, and even less to disrupt the bull market. This may be one reason for the state of anxious enjoyment among investors.

Buy the Rumor, Sell the News

Markets are forward-looking, and current valuations leave little margin for error with regard to forward earnings. With big companies trading at sky high multiples, small shortfalls could translate into significant valuation correction. **Higher multiples indicate higher risk.**

Consider Microsoft (MSFT). Consensus forecasts anticipate forward EPS growth of roughly 14%, with a forward P/E ratio of ~33. If growth instead materializes closer to 10%, the implied valuation could fall from ~\$510 to ~\$495 per share—a meaningful decline despite strong absolute earnings. The challenge is even greater for companies like NVIDIA, priced at ~40x forward earnings with expectations for 20%+ growth.

Optimism about the future has been endemic in the markets, but upwardly biased errors in earnings forecasts tend to be especially high in just these cases – in times of uncertainty, in bull markets, and for companies that are hard to value. There tends to be target price over-



² Kiplinger, chart by Carson Investment Research/Factset

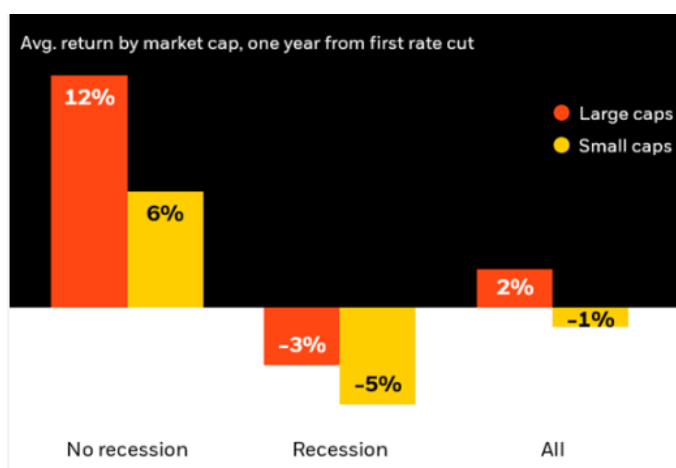
³ Bureau of Economic Analysis, sourced from Haver Analytics

optimism for high-beta firms like tech and AI whose trajectory is difficult to predict and which are difficult to value. The noisier/riskier the firm, the more optimistic analysts tend to be.^{4 5}

Elevated multiples amplify the consequences of forecasting errors and bias. The AI boom has strong tailwinds, but any softening could cause sharp reversals. Building AI infrastructure is costly, and there is a long lag for some companies between investment and profitability. Many highly valued companies won't generate profits from their AI operations for years. As hype surges, overinvestment will cause winners and losers even among the frontrunners. Some well-known players may leave the game one way or another.

The Economic Balancing Act

Markets are pricing in two 25 bps (0.25%) rate cuts in 2025 and another 75 bps (0.75%) next year, which would bring rates to ~3%. **Stocks, even when priced to perfection, tend to return positively when rate cuts are implemented – as long as conditions aren't recessionary** (Right). Note that the "All" category has very low returns, even though the "No recession" category has extremely high returns and the "recession" category is modestly negative. Rate cuts without recessionary conditions are rare, and the overall average is muted.⁶



The good news is that conditions currently don't look to be recessionary. The economy sustained strong 3% growth through the first half, although the data is noisy, but appears to be growing at a slow but real pace going forward. With the stimulus from the OBBB (tax refunds, tax cuts, etc.) and more accommodative monetary policy, a recession isn't the likely base case. The labor market is signaling more signs of weakness, with certain categories of workers disproportionately affected. It was estimated the economy *lost* 32,000 jobs in September, a significant change in momentum. These positions were mainly in hospitality/leisure and small business, which have also been more heavily affected by government policy.

The longer a shutdown continues, the more uncertain economic and political variables will become, and the more markets may be liable to react. The potential sentiment effects on valuations could be worse than underlying economic effects. Investors often assume shutdowns are short-lived. If

⁴Bordalo, P., Gennaioli, N., La Porta, R., O'Brien, M., & Shleifer, A. (2023). *Long Term Expectations and Aggregate Fluctuations*, National Bureau of Economic Research.

⁵Grinblatt, M., Jostova, G., & Philipov, A. (2023). *Analyst Bias and Mispricing*, National Bureau of Economic Research.

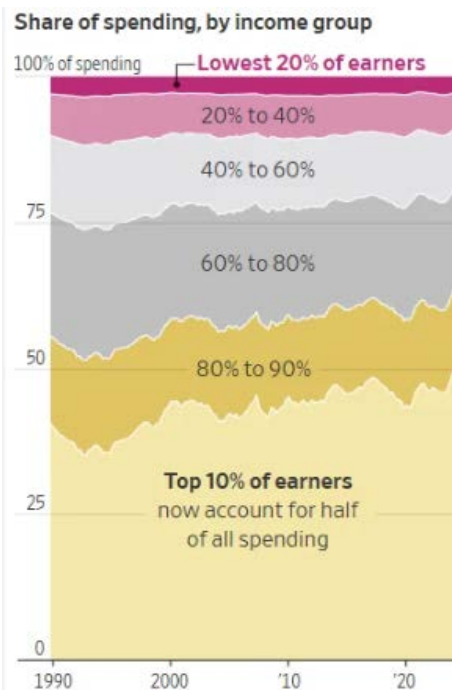
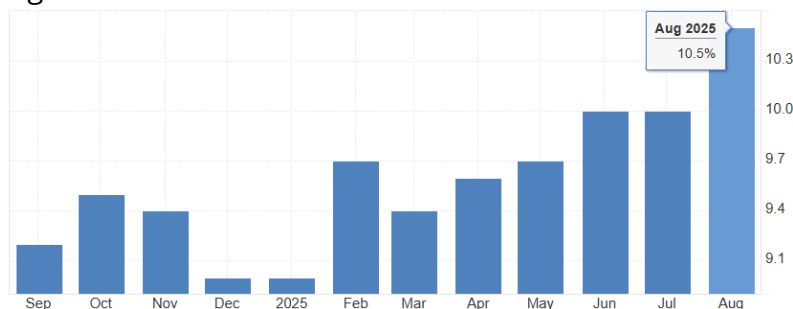
⁶ Chart from BlackRock

this shutdown turns out to be a long event, it could be a blow to confidence, triggering pockets of selloffs and even slowing business investment and consumer spending.

Like riding a bicycle, we need to keep moving to stay balanced. Looking past the immediate headlines, there are plenty of other variables that may not work out as planned, and markets may have something to say about it to the downside. **Stimulus is not a perpetuity, and slower growth means a more difficult balancing act.**

A few economic vulnerabilities deserve attention:

- A market correction could trigger a negative wealth effect, dampening both confidence and consumer spending. The top 10% of households now account for 50% of consumer spending (vs. 40% in 2005). These same households hold most investments, meaning a correction—not unemployment—could reduce spending power.
- Rising youth (see bar chart below)⁷ and minority unemployment, with Black unemployment at 7.5%, may signal broader labor market weakness.



- Manufacturing and small businesses remain exposed to tariffs.
- Government debt, as well as policy inconsistency, weigh on long-term outlooks.
- A prolonged shutdown could permanently erase jobs, hindering the historical 73% GDP recovery seen after the 2018–2019 shutdown.

Any of the above could tip the markets out of favor, increasing recession signals and correcting valuations.

Everything from price shocks and monetary policy (1981/1991), asset bubbles bursting (2001) to financial crises (2007-2009) to global pandemics (2020) have caused recessions, and these causes were identified only in hindsight. Above a certain scale of economic consequence, anything and everything is a part of the economic puzzle and the market system, and can have an impact in the right conditions.

⁷ U.S. Bureau of Labor Statistics, sourced from TradingEconomics

Investors should be optimistic and enjoy a healthy market landscape; with a little healthy anxiety and the knowledge that downside protection still matters because risks are not priced in with rewards. We believe the current market environment represents a narrow Goldilocks Zone: still supportive enough to sustain growth, but fragile enough to warrant caution. Investors should remain positioned to benefit from ongoing economic momentum while acknowledging that high valuations leave a lot of room for disappointment. As always, downside protection and discipline remain integral to long-term success.

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