

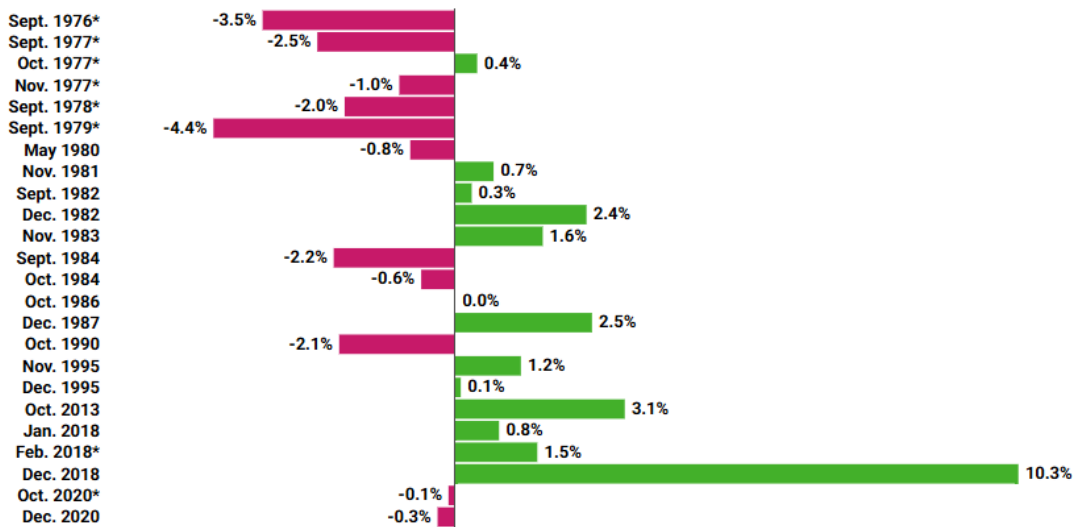
2025 Fourth Quarter Investment Outlook

The Federal Government Is Shut Down – Should the Markets Care?

The Federal Government has been shut down since October 1st, and all non-essential functions have been halted. A shutdown can be worrying for investors, but it doesn't necessarily mean there's trouble ahead for the stock market.

There's no clear correlation between government shutdowns and market performance, and the odds of a market decline during a shutdown are little worse than a coin flip (46%). And with every shutdown since 1980, the S&P 500 has ended up higher one month after the start of the event.

Stock market performance during every government shutdown



It might seem that lengthy shutdowns would be more likely to have a negative impact on stock prices, but that hasn't been the case. In fact, the market had its best performance during the longest shutdown, rising 10.3% during the shutdown that lasted 35 days from December 22nd, 2018 to January 25th, 2019. And whether the market rises or falls during a shutdown, the cause is almost always the broader economic climate, and not the shutdown itself. For example, the market's 10.3% rise during the 35-day shutdown in 2018-19 was largely due to the Federal Reserve signaling a more relaxed stance on interest rates.

From an economic perspective, government shutdowns have tended to be minor events. Analysts estimate that these funding gaps can reduce GDP by 0.1% to 0.2% for every week the government is closed. And there is usually no long-term economic impact from a shutdown, as

the economy recovers immediately when the government re-opens. Knowing that, investors have held to the expectation that things will soon return to normal.

This is not to say that the current shutdown doesn't matter, or that it's a non-event. For one thing, the average shutdown has lasted just 8 days, and half of them lasted 4 days or less. But the current shutdown is in its 23rd day as this is being written, and neither side seems interested in talking to the other.

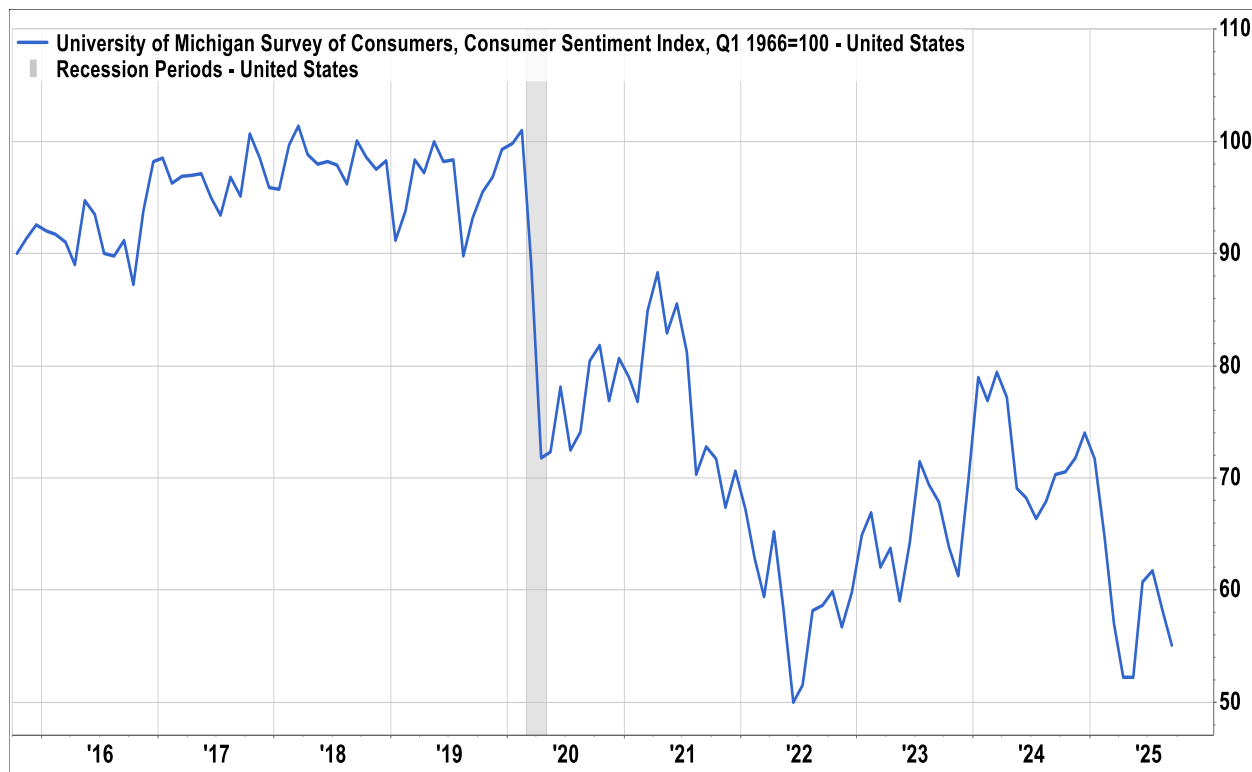
Shutdowns Add Drama, But Historically Stocks Don't Really Care

S&P 500 Performance During And After Government Shutdowns

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

The House Speaker has said that this could become the longest federal government shutdown in history, while the Treasury Secretary in an interview acknowledged that, "This is getting serious. It's starting to affect the economy, and it's starting to effect peoples' lives." As many as 750,000 federal workers could be furloughed, costing them \$400-million in wages every day. Moody's Analytics estimates that GDP will be reduced by 0.1% for every week the shutdown continues, and The White House forecasts that a month-long shutdown would result in the loss of 43,000 private sector jobs.

Some analysts are suggesting that this could be enough to tip the economy into recession. They argue that businesses have been on a months-long hiring freeze, and unemployment has already begun to trend higher. Consumer sentiment has been falling throughout the year, and is lower than it was during the COVID-induced economic shutdown of 2020.



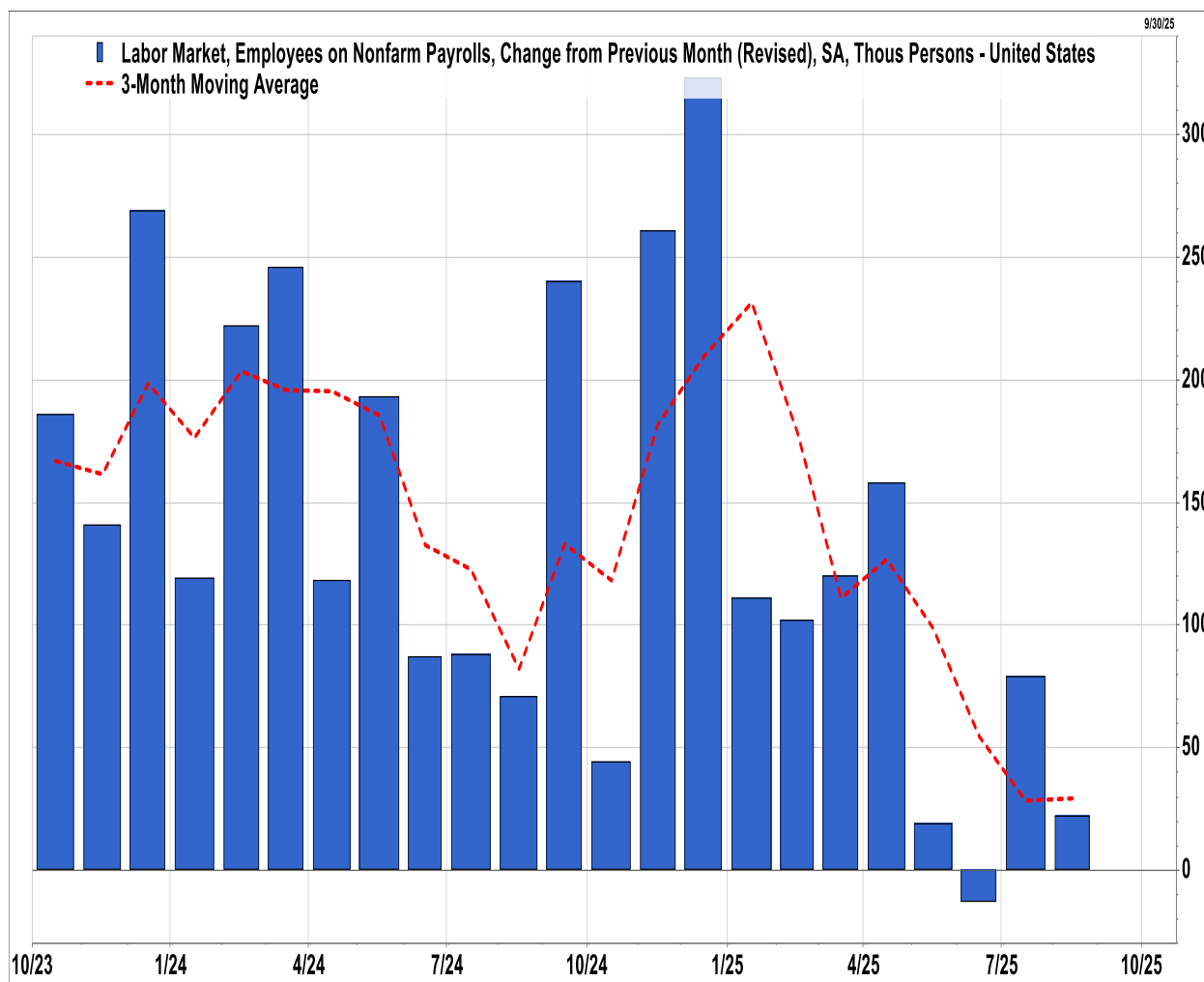
Wage growth is slowing and loan defaults are rising. The trade war and restrictive immigration policies are causing slowdowns in many vital industries.

The counter-arguments to such pessimism are that the economy is starting from a strong base, with GDP rising at a strong 3.8% rate for the most recent quarter. We are in the midst of a massive technology and infrastructure boom. The Federal Reserve is cutting interest rates, reducing borrowing costs to credit-starved businesses and home buyers. And consumer spending has remained resilient despite prices that continue to rise.

Rather than belaboring these points, it's enough at this point to proceed on the basis that the government shutdown will likely impact the broader economy only at the margins. Investing is a long-term endeavor, while shutdowns are much shorter events. While the political climate is worth monitoring, it shouldn't affect the outlook for the markets – at least not yet.

The Labor Market: Cold, or Just Cooling?

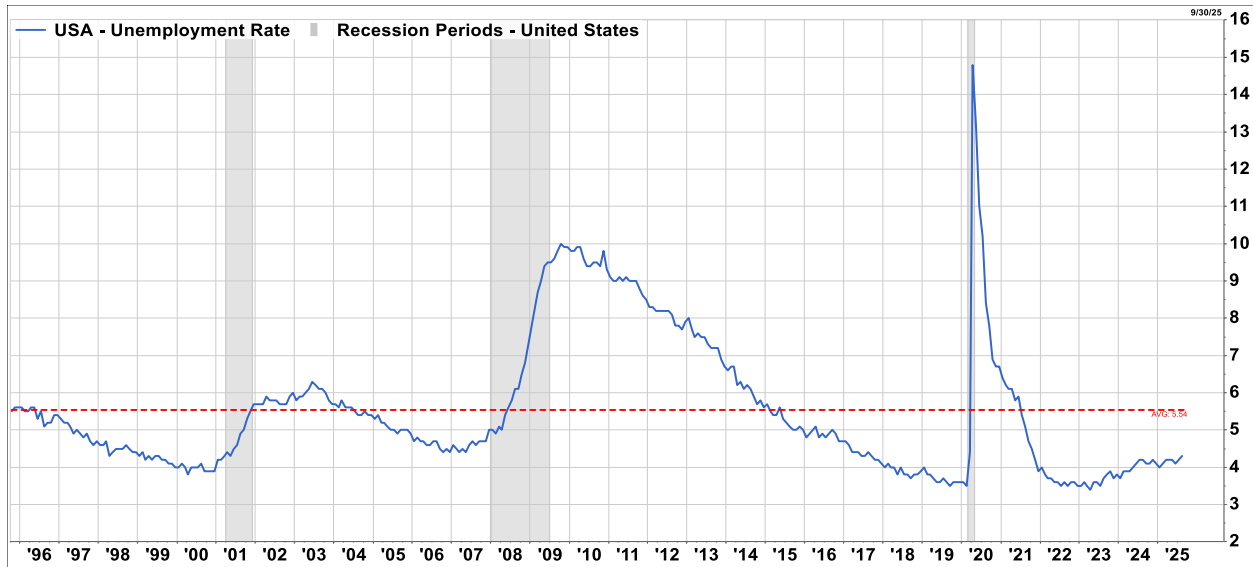
Markets were caught off-guard when the September jobs report indicated that after revisions, payrolls actually declined during the month of June. This marked the first negative non-farm payroll print in more than four years, and was a far cry from the *gain* of 147,000 jobs that was reported in the initial release. The angst was compounded by the fact that the May payrolls data also experienced a heavy downward revision. Altogether, the May and June payrolls figures were lowered by almost 300,000 jobs on a combined basis.



The three-month moving average for payrolls gains has declined to just 29,000 jobs. A moving average is commonly used because the monthly payroll numbers tend to be “noisy,” with large swings in the monthly reported job additions (or losses). The moving average smooths out this data so a trend is more apparent. From the start of the year, it’s quite clear to see that there has been a downward trajectory in the number of new jobs added each month. As is the case with most economic data, the trend is generally far more important than any individual data point.

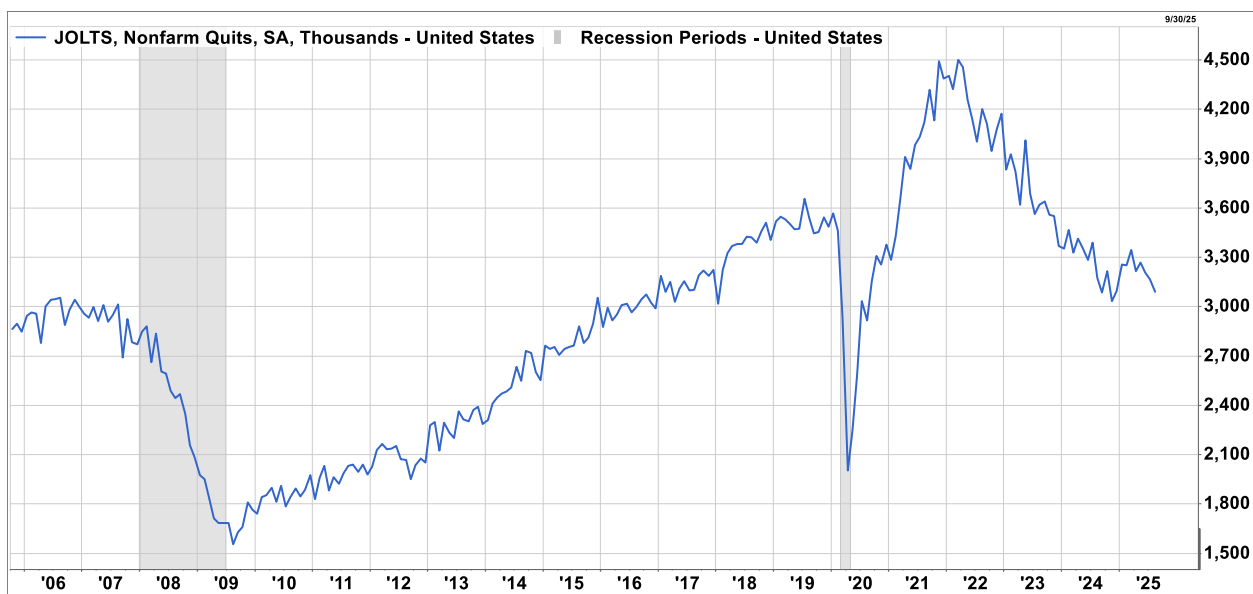
The government shutdown has delayed the release of the highly anticipated September payrolls report. Only “essential” government functions are continuing during the shutdown, and economic data releases fail to rise to the essential level. However, the September ADP payrolls report showed a 32,000 *decrease* in private payrolls compared to the expectation for a 52,000 increase. Generally, the market pays little attention to the ADP numbers, but even this report caused some concern. The 2-year U.S. Treasury yield dropped by 7 basis points on the day, with investors betting on more easing by the Federal Reserve.

Despite the payrolls slowdown, the unemployment rate has still remained quite low on a historical basis. At 4.3%, the unemployment rate remains more than 1% below the 30-year average, after rising 0.9% from the post-COVID cycle low of 3.4%.

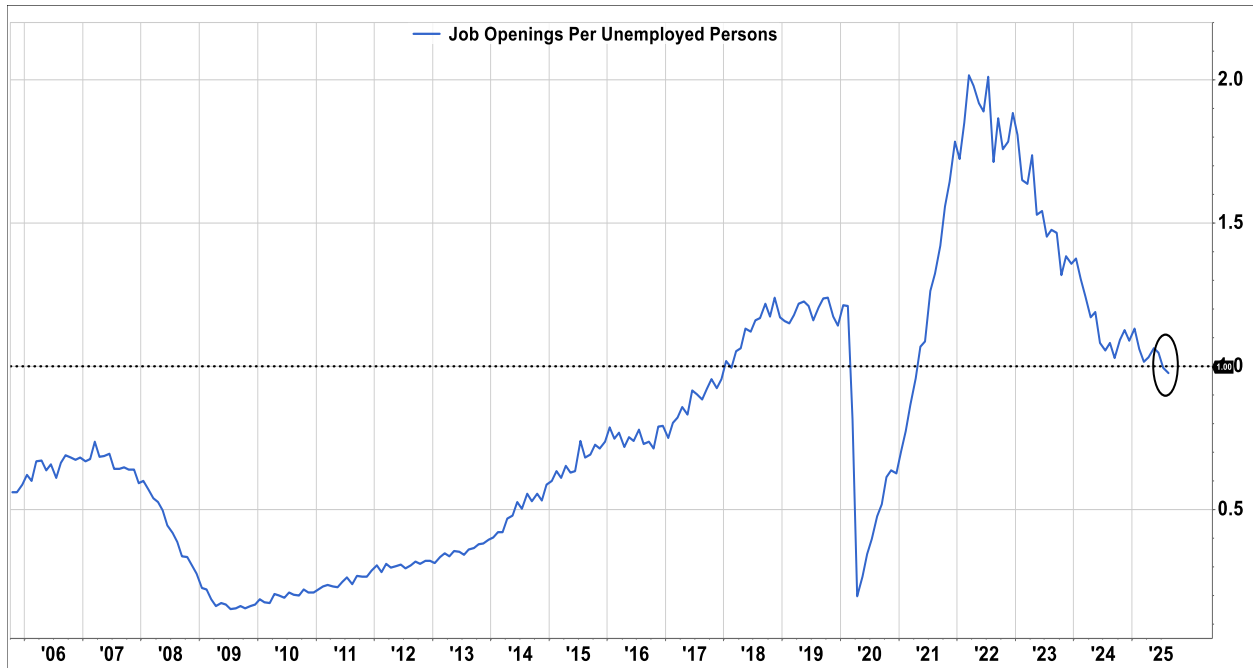


While the market tends to focus on the payrolls data and unemployment rate, several less common indicators are showing signs of a softening labor market as well.

The Quits Rate, published by the Job Openings and Labor Turnover Survey (JOLTS) program at the Bureau of Labor Statistics (BLS), has shown a steady decline in the number of workers who are reported as quitting their jobs. The relationship between the health of the labor market and workers quitting their jobs may not be as direct as some of the other data points, but the explanation is still relatively straight forward. When the labor market is strong, workers are confident that they will quickly find another job. They are more likely to quit their current job, since they will find new employment without much trouble. When the labor market deteriorates, the Quits Rate tends to fall since workers believe it will be difficult to find a replacement job. There has been a steady decline in the Quits Rate since the start of 2022. Even though the absolute level isn't particularly concerning, as previously mentioned, the trend is important.



For the first time in more than four years, there are now more job-seekers than there are available jobs. Even though this is the historical norm, it represents a significant departure from the slack in the labor market that has been present since the COVID-19 pandemic. At the peak in 2022, there were two jobs available for every unemployed person!



It's difficult to push back against the notion that the health of the labor market has declined. Most indicators would support that the labor market has weakened to some extent. The key word, however, is "weakened." It's easy to forget that following the COVID pandemic, the labor market was historically strong. It has been more than 50 years since the unemployment rate reached a low of 3.4%. The last time the unemployment rate was lower than 3.4% was in the early 1950's.

Payroll Revisions

Dr. Erika McEntarfer, the Commissioner of the Bureau of Labor Statistics (BLS), was dismissed from her post on August 1st after large downward revisions to payrolls data were released in the July report. It was claimed that these adjustments to the previously reported data were politically motivated, since the general direction of the revisions had been downward throughout 2025. The reality of the situation is far more complicated than a simple explanation of nefarious political motives.

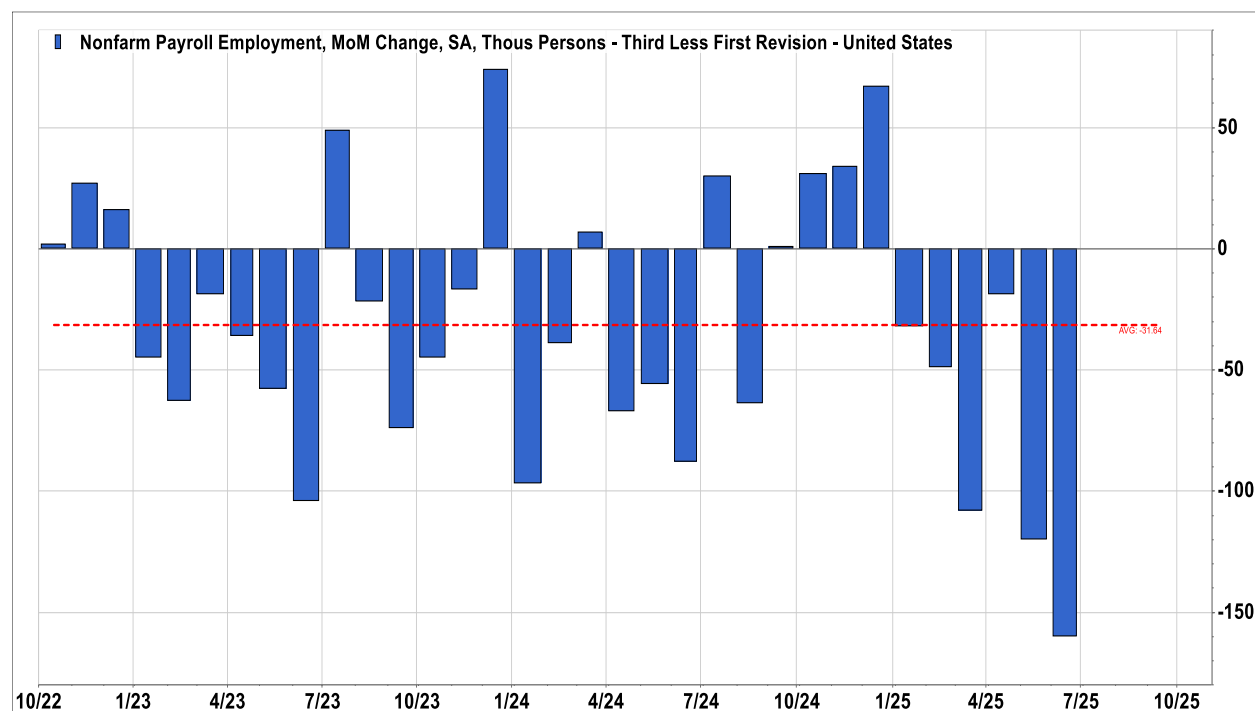
The BLS produces the Employment Situation Report on a monthly basis, typically on the first Friday of each month. The report details the number of jobs added or lost during the month, the change in sector-specific employment, and the unemployment rate. The basis for the nonfarm payroll data is the Current Employment Statistics (CES) survey, commonly referred to as the Establishment Survey. The Establishment Survey samples about 120,000 businesses and

government agencies, and covers approximately 670,000 individual worksites. The survey solicits responses from these businesses on a number of factors, but specifically how many workers are on the payroll as of the 12th of the month.

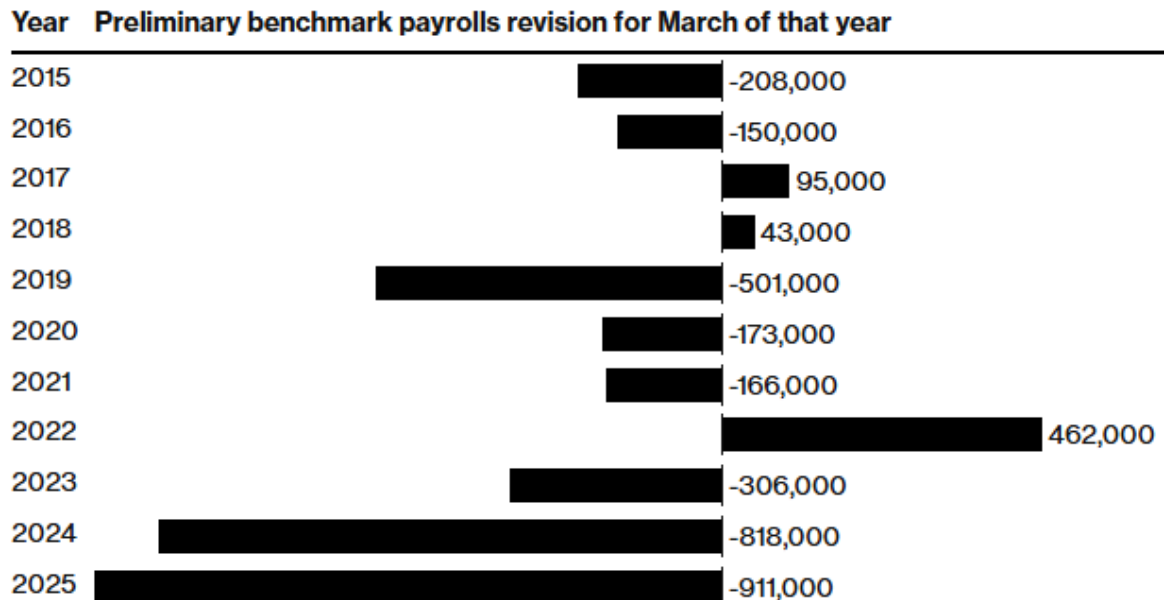
The responses to this survey are then used to infer the total change in jobs during the month. However, before the estimates can be finalized, several statistical adjustments are necessary. The BLS utilizes a *Birth/Death* model in an attempt to capture the creation of new businesses, and the closure of existing businesses. Since there is no real-time mechanism for the BLS to know exactly when businesses open or close, this needs to be estimated. The Birth/Death model has been the target of criticism in recent years, as it *seems* to have been the source for a large degree of the discrepancies in the payrolls data. The data is also adjusted for seasonality factors. The purpose of the report is to capture true trends in changes in employment. Factors like seasonal retail hiring in December, or a reduction in construction payrolls in the winter, are smoothed out in the report since they are not indicative of true changes in the health of the economy.

One final difficulty with estimating the monthly payrolls change is the initial response rates to the Establishment/CES survey. Prior to the COVID-19 pandemic, about 60% of the businesses and government agencies that were surveyed had their responses included in the preliminary data release. Post-COVID, the response rate on the initial payrolls report has fallen to about 40%, meaning more than half the businesses are not included in the monthly payroll report.

On the second and third releases, when the numbers are revised, the response rate tends to be much higher. Even on the final release, the payrolls numbers are still just an estimate derived from statistical methods based on responses from a fairly small sample. Generally, the revisions have tended to be negative over the last three years, with an average monthly downward revision of 31,000 jobs.



Once a year, the BLS conducts a “benchmarking” exercise where the payrolls data is corrected based on more reliable data. The BLS utilizes state unemployment insurance tax records, which cover about 97% of nonfarm payroll jobs. This annual revision offers insight into how well the monthly estimated payroll reports reflect reality, and the result leaves quite a bit to be desired.



Source: Bureau of Labor Statistics data compiled by Bloomberg

Even though the accuracy of the BLS’s monthly jobs reports seem to have been less than stellar, it’s important to remember that tracking the true number of jobs added each month is extremely difficult and an almost impossible task. The political motives of the BLS, or lack thereof, are best explained by Hanlon’s Razor. It states, “Never attribute to malice that which is adequately explained by incompetence.” Incompetence is too harsh of a word here, but the point remains. These revisions were not politically motivated, as the challenges the BLS has faced in trying to estimate the number of jobs created in the economy each month have grown significantly following the COVID pandemic.

The Impact of Rising Tariffs is Beginning to be Felt

There is no question that President Trump’s trade policies are beginning to have an effect on businesses and consumers, as well as the government itself.

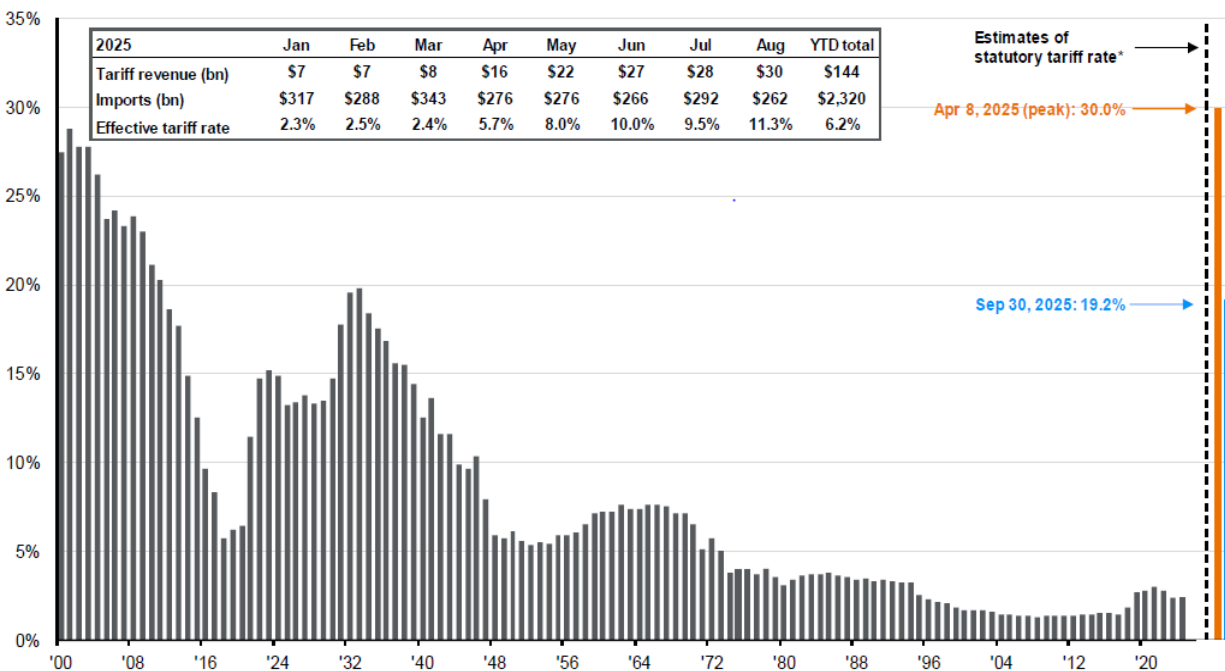
The President frequently touts the trillions of dollars of new investments that are coming into the U.S. as a result of his tariffs. But most of these investments are far into the future, if they materialize at all, while the current inflow of tariff income to the government is about \$30-billion per month. It’s currently projected that this revenue will reduce the federal deficit by about \$4-trillion between now and 2035 and will lower borrowing costs by about \$0.7-trillion annually. As large as these numbers are, they’re just a small dent in the current – and rising – federal debt

of \$37.5-trillion. And it's worth noting that the One Big Beautiful Bill that was enacted earlier this year is forecast by the Congressional Budget Office (CBO) to cost an additional \$3.4-trillion, almost entirely offsetting the projected increased tariff revenue projections.

Of course, in our large and incredibly complex economic system, such long-term projections are almost always wrong and are totally useless in forming a strategy for the present circumstances. But analysts outside of government are beginning to form a consensus on the impact tariffs will have over the foreseeable future.

Average tariff rate on U.S. goods imports for consumption

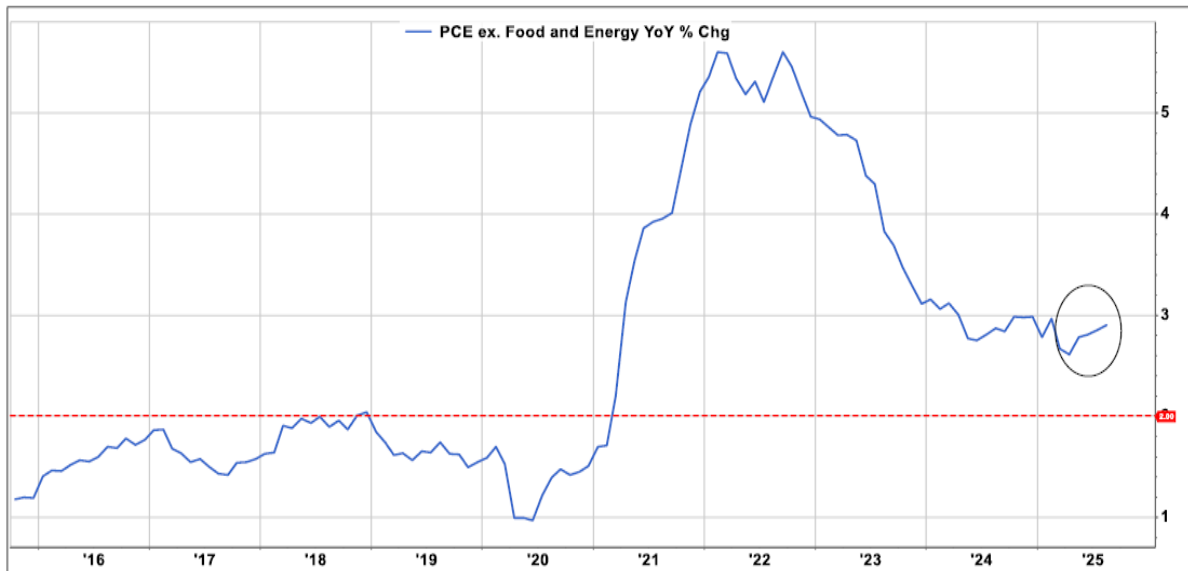
Duties collected / value of total goods imports for consumption, 1900 - 2024



The average tariff rate on imported goods has now risen to 19.2%, the highest level since the Great Depression.

Researchers at the Harvard Business School have conducted a study on the prices of more than 350,000 products at major online and brick-and-mortar retailers in the United States. They found that imported goods have become 4% more expensive since the President began imposing tariffs, while prices of domestic products rose just 2%. The biggest increases were seen in products that the U.S. cannot produce domestically, such as coffee, or that come from highly penalized countries.

These price hikes, while significant, are far lower than the tariff rates on the products in question, suggesting that either foreign producers or U.S. importers are absorbing much of the tariff impact. But Goldman Sachs economists are estimating that American consumers will eventually bear 55% of the increased cost of imported goods, with U.S. companies taking on 22% and foreign producers eating the rest by reducing prices to remain competitive. The same report estimated that tariffs had already added 0.4% to the Personal Consumption Expenditures (PCE)



Index – the Fed’s preferred measure of inflation – so far this year, and predicted that the PCE would rise to 3.0% by December.

Even Treasury Secretary Bessent has acknowledged that the President’s tariffs are being paid by American importers, who can pass them off to consumers. Some businesses, notably Wal-Mart, Adidas, Home Depot and Best Buy, have announced their intention to raise prices as a result of tariffs. Amazon is already instituting robust price increases on Chinese products sold in the U.S., particularly clothing and electronics.

The Yale Budget Lab, a non-partisan policy research center, has said that the new tariffs will cost American households an average of \$2,400 in 2025, which will have the same effect on consumers and the economy as a regressive tax increase. Tariffs disproportionately affect lower income consumers to a greater degree relative to their income levels.

The Fed’s Dilemma

Torn between rising prices and a slowing jobs market, the Federal Reserve opted to cut the federal funds rate by 0.25% at its September meeting. However, Chairman Powell noted that tariffs imposed by the Trump administration had started to push consumer prices higher. He attributed much of the slowdown in hiring to the fact that companies had so far absorbed a large portion of the tariff increases. However, Powell expects inflationary pressures “to continue to build over the course of this year and into next year, as companies pass along a greater portion of the tariff burden to consumers.”

Powell’s view is shared by most private economists. A Wall Street Journal survey of 62 economists showed that the median forecast for inflation in 2026 was for a rise of 3.1% in the Consumer Price Index, up from 2.9% currently, and trending in the wrong direction from the Fed’s 2% PCE inflation target.

The Stock Market – Priced for Perfection in an Uncertain World

While uncertainty grows on Main Street, on Wall Street stock prices continue to rise despite growing inflation, a slowing jobs market, plummeting consumer confidence, political dysfunction and tariff uncertainty.

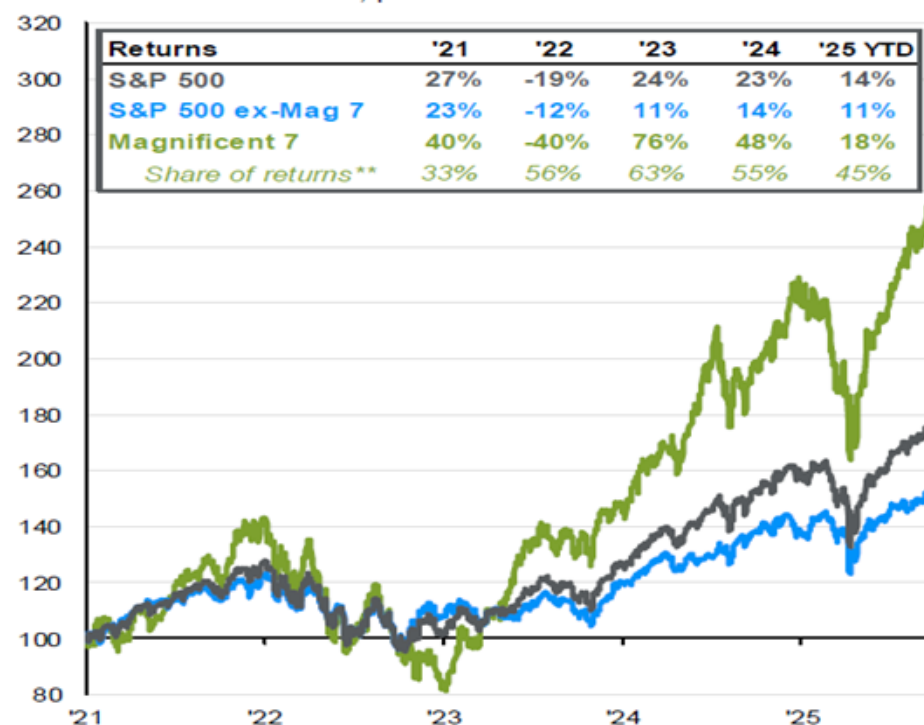
The S&P 500 Index has risen in each of the last 5 months, and is up 14.7% so far in 2025. As you recall, the Index fell about 19% in early April following the President’s “Liberation Day” rollout of his tariff plan. But it fully recovered those losses before the month of April was out, and now rests 39% above the April low.

On a price-only basis, the S&P 500 has risen 87% over the last 3 years, which represents an annualized appreciation of 23.2%. Including dividends, the Index has generated a total return of 95%, or 24.9% annualized. Going back to 1928, we have calculated the annualized appreciation rate for the S&P 500 for each of the 95 rolling 3-year returns during that period, and have found that the market has been able to generate gains greater than those of the last 3 years on just 6 occasions. One of those periods was the 3 years ending in December 2021, which was followed by a market decline of 19% in 2022. And 3 of those periods were the 3 years ending in 1997, 1998 and 1999, respectively – which led to a market sell-off of 40% from 2000 to 2002.

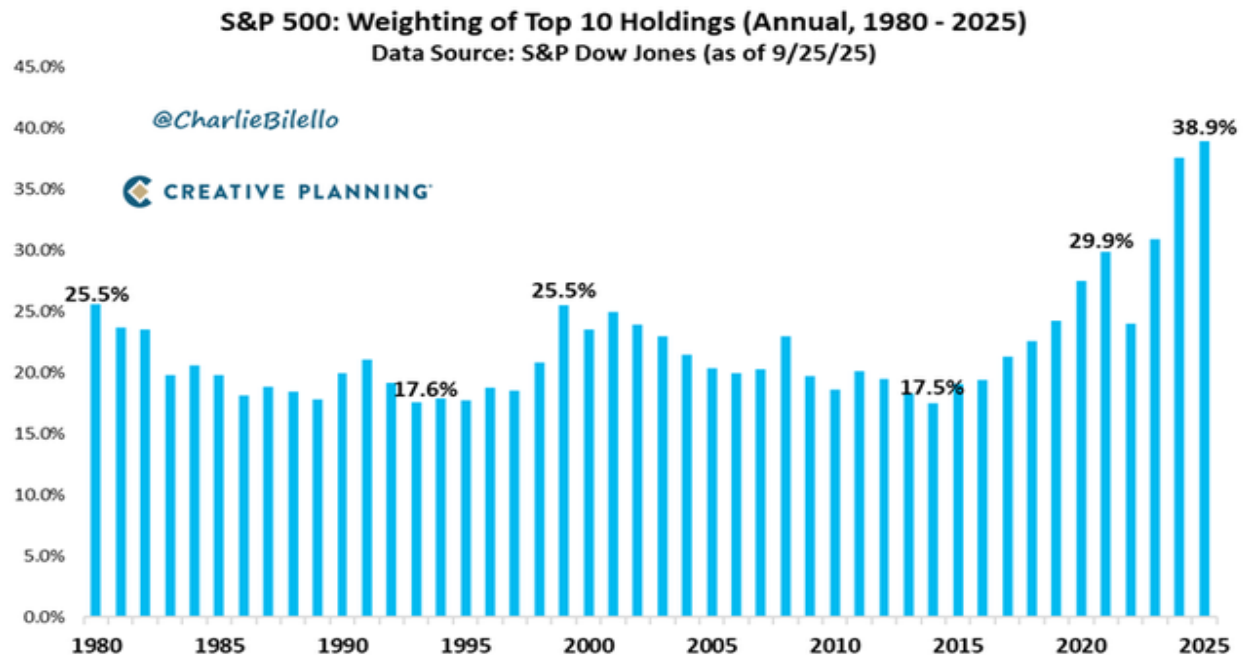
As has consistently been the case since the beginning of 2023, the market’s recent gains have been centered on that handful of Artificial Intelligence (AI) driven technology stocks who have come to be known as the Magnificent 7. Since the beginning of 2021, The Mag 7 stocks have risen 160%, while the S&P 500 is up 80% and the rest of the market is up just 52%.

Performance of “Magnificent 7” stocks in S&P 500*

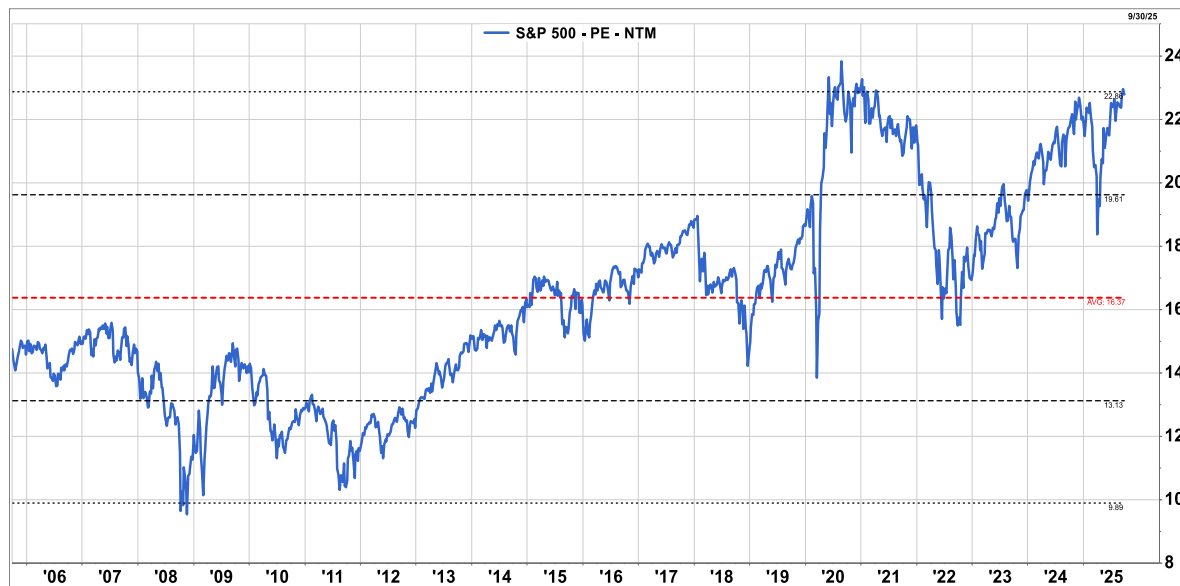
Indexed to 100 on 1/1/2021, price return



From the selloff in 2022, however, the Mag 7 stocks are up 207%, while the S&P 500 is up 73% and the rest of the market is up 40%. As a result, these 7 companies now represent more than 34% of the Index's total market capitalization, and the 10 largest stocks account for almost 39% - a concentration level that has never before been approached.

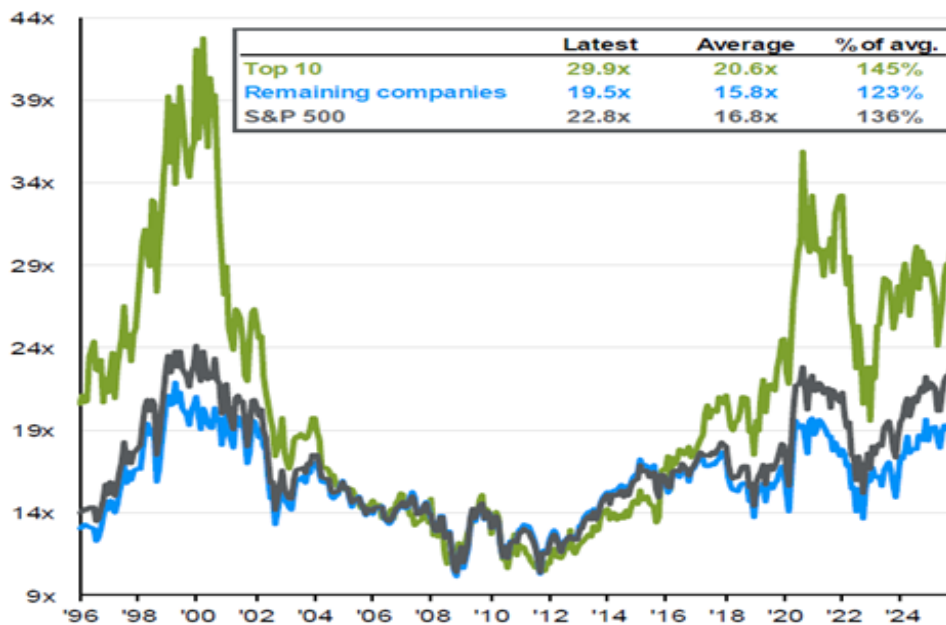


The S&P 500's forward price/earnings multiple has reached more than 22x, fully 2 standard deviations above its long term average. That same multiple was seen in the 2020-21 period, but that was due to earnings contracting during the COVID-19 recession, while stock prices rose as the government and the Fed flooded the economy with liquidity. The only other period in recent history when the market traded this richly was during the dot.com bubble of 1997-99, which we referred to earlier, and which preceded a historic market selloff.

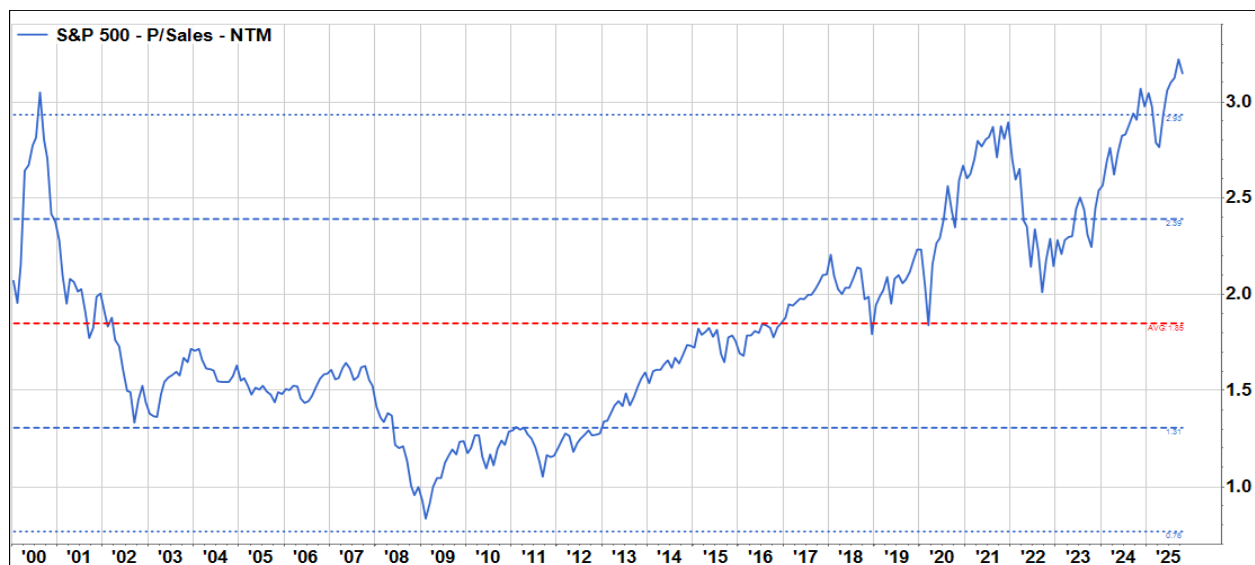


As you might expect, most of the increase in valuations is due to the historic price increases in those large technology companies that disproportionately affect market metrics. But as the market has broadened out recently, even the stocks that reside below the 10 largest are now trading at P/E multiples that are well above long term averages. The bottom 490 stocks are priced at almost 20x forward earnings, 23% above their 20-year norm – not alarming, but there are fewer and fewer bargains to be had.

P/E of top 10 and remaining companies in S&P 500
Next 12 months

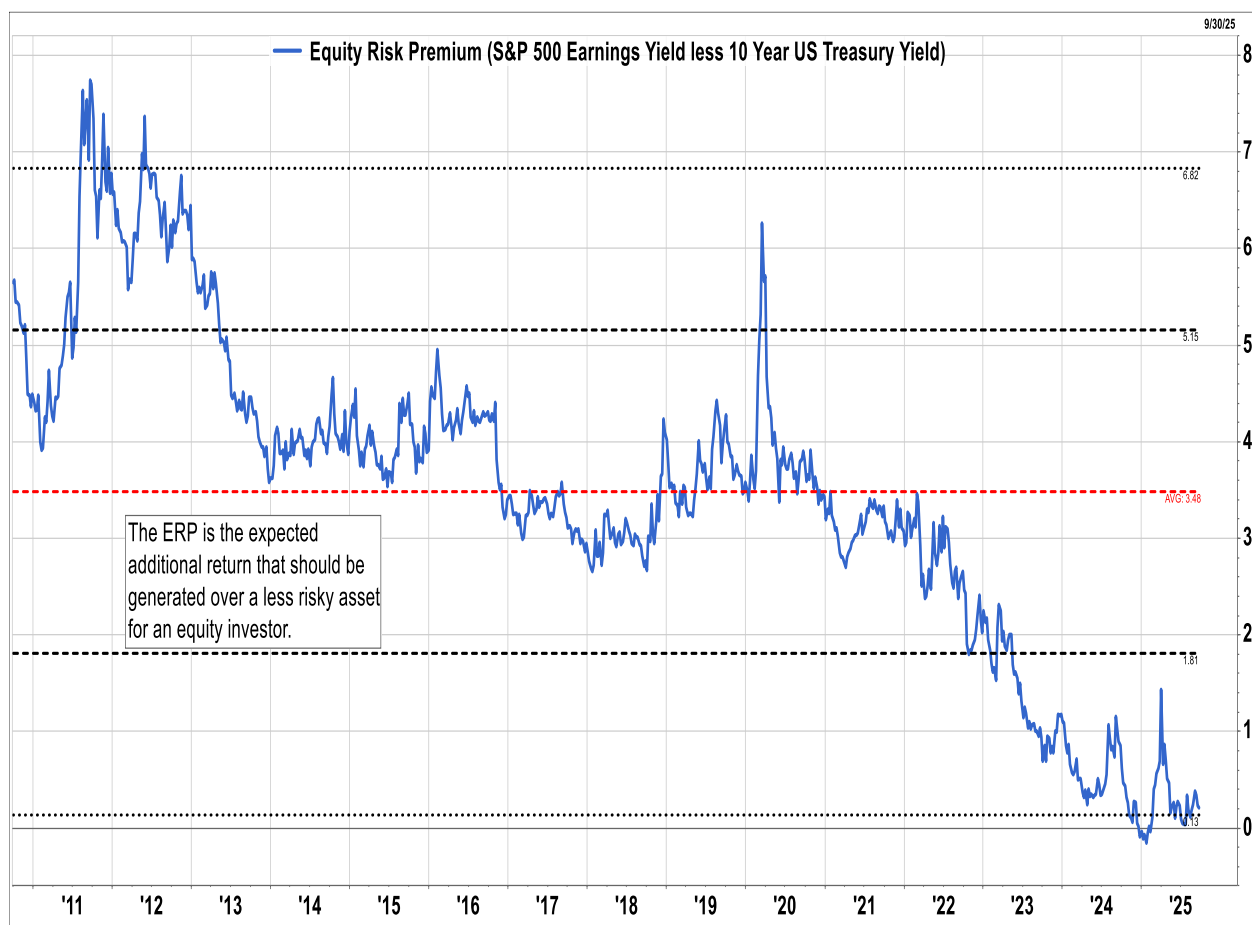


Market valuations are historically rich by other measures as well. The S&P 500 is now priced at more than 3 times sales, higher than its previous peak which was attained during the dot.com bubble of the late 1990's and early 2000's.



Finally, it is instructive to compare the market's earnings yield (the inverse of its P/E multiple) to bond yields to measure the incremental risk equity investors are assuming relative to bonds. The 10-year U.S. Treasury yield is the proxy we use for this metric, commonly referred to as the equity risk premium.

The market's current P/E multiple of 22.8 equates to an earnings yield of 4.4%, while the 10-year Treasury yield is currently close to 4.0%. The Treasury yield had been as high as 4.5% in May, before falling in response to growing signs of weakness in the jobs market. Our point is that the equity risk premium, which has historically hovered in the 3%-4% range, has essentially fallen to zero. Equity investors are bearing historically high levels of risk relative to bonds, while the potential for greater returns is diminishing.

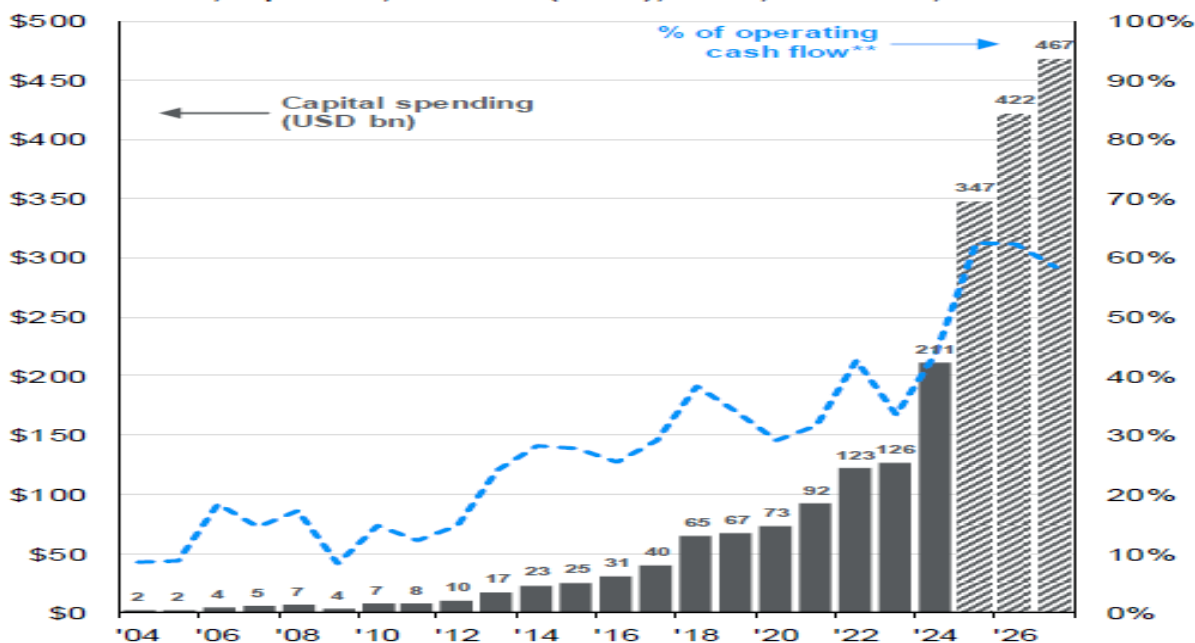


Conclusions and Outlook: 2 Economies and 2 Markets

The U.S. economy and stock market are performing well, thanks to colossal amounts of investment being made in Artificial Intelligence and related technologies. Companies are pouring hundreds of billions of dollars into data centers and investors are forking over money to

Capex from the major AI hyperscalers*

USD billions; Alphabet, Amazon (AWS), Meta, Microsoft, Oracle



start-ups and huge tech firms. ChatGPT, Nvidia and their ilk are driving half of American GDP growth, and account for about 40% of corporate earnings and nearly all of the S&P's earnings growth.

At the same time, the trade war – among other things - has led to a downturn in the manufacturing sector, which has contracted for the last 7 months. Agriculture is suffering from a lack of workers and rising equipment costs, and the housing market remains challenged by a shortage of homes and high borrowing costs. Hiring has virtually stopped in these sectors.

At the household level, while the unemployment rate remains low, companies have simply stopped hiring. The steady increase in the cost of living shows no signs of abating, and the highest tariff rates since 1934 are driving up the costs of consumer goods from food to furniture.

Mike Wilson, Chief Investment Officer of Morgan Stanley, argues that we have been in a “rolling recession” for 3 years. Downturns have affected sector after sector and region after region, while the headline economy appears robust. Technology is flourishing as agriculture, housing and manufacturing flounder.

Nationally, the unemployment rate is low, but the President's dismissal of 300,000 government workers and the cancellation of hundreds of billions of government contracts has added 0.6% to the unemployment rate in the Washington area, driving that area into recession. Some analysts have argued that as many as 22 states are already in recession.

The government shutdown shouldn't cause a national recession, provided it doesn't last much longer. As of this writing, it is just 11 days away from being the longest shutdown on record. But it will almost certainly worsen some of the smaller recessions that are already gathering force.

We don't deal in predictions, but rather in possibilities and – when our conviction level allows – probabilities.

At this point, the Fed and the bond market seem to be more concerned with weakening job data than they are with the currently strong economic activity data. The Fed lowered rates in September, and bond yields have dropped 80 basis points from their February highs.

But the stock market is priced for perfection, even as uncertainty is growing in areas outside of the technology bubble. Valuations are a poor predictor of near term performance, as risk assets can remain overvalued – or undervalued – for long periods of time. Investors who cash out now might well curse themselves next year if expectations for AI continue to expand and the Mag 7 stocks trade even higher. But history tells us that the current valuation levels are not the levels from which major market advances begin. Common sense and history suggest that market risk is higher today than it has been since we emerged from the COVID-19 pandemic, and the potential for future returns is probably diminishing.

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