The third quarter marked another period of attractive returns. The S&P 500 finished up 8.1%, and the Bloomberg Aggregate Bond Index (AGG) gained 2.1%. Gains were fueled by AI optimism, Fed rate cuts, and solid economic growth. Risk assets' year-to-date returns have been exceptional as investors continue to pour capital into the bull market, brushing off tariff concerns and the recent government shutdown.

Soaring asset prices coincide with rising student loan, auto loan, and credit card delinquencies. This dichotomy highlights a "tale of two consumers" in the U.S., with lower- and middle-income households struggling while wealthier consumers contribute disproportionately to spending growth. In fact, the top 10% of U.S. consumers by wealth now account for roughly 50% of total consumer spending. This wealth inequality has worsened as inflation persists, and asset prices rise. The recent bankruptcy of auto lender Tricolor and a weak Q3 earnings report from CarMax underscore the growing financial stress among lower- and middle-income consumers. Still, overall consumption remains relatively resilient, as the wealth effect continues to support spending among higher-income households.

The job market is showing signs of moderate slowing, characterized as a slow to hire environment. With continuing jobless claims stubbornly elevated, finding work has become increasingly difficult, especially for younger workers. That said, real GDP growth for Q2 came in at a strong 3.8%, and the unemployment rate remains low at 4.3%. Together, these factors have some economists questioning whether the Fed's current rate cuts may be premature. Markets are currently pricing in two additional Fed rate cuts in 2025, which will likely materialize barring a significant inflation spike or exogenous shock. We do not view the ongoing government shutdown as a major risk, as these events have historically had little impact on markets.

In equities the AI trade remains the dominant theme. The optimism surrounding interest rate cuts has also helped broaden participation, with small- and mid-cap stocks joining the rally. However, market concentration remains elevated, with the "Magnificent Seven" companies now representing roughly 36% of the S&P 500—a figure that continues to grow. The market's forward P/E ratio of about 24 times is a level not seen since 1999, suggesting limited room for error as AI adoption and future earnings play out. That said, U.S. corporations are stronger than ever, boasting healthy profit margins, durable competitive advantages, enhanced use of technology, and robust free cash flow generation. Put simply, perhaps these elevated valuations are justified for now.

Treasury yields have declined on shorter maturities as markets have priced in two additional rate cuts by year-end. The 10-year Treasury, however, has remained rangebound between 3.8% and 5%, reflecting concerns about persistent inflation driven by a growing fiscal deficit and expectations of government overspending. These concerns are showing up in rising precious metal prices, as investors seek inflation hedges with low market correlation. This “debasement trade” poses a longer-term risk for sovereign debt markets if fiscal discipline does not improve globally. Meanwhile, the spread between U.S. corporate debt and Treasuries has tightened to levels not seen since the 1990s, signaling a somewhat complacent view of corporate credit risk. In our view, recent moves have created a less attractive environment for corporate loan investment, and we expect to remain cautious until all-in yields move higher.

We believe periods like the current one reward investors who remain patient and focus on underappreciated opportunities in markets. Please do not hesitate to contact us if you have any questions, or if you’d like to schedule a portfolio review.

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