Market Update: Q3 2025

A Look Back

Markets Broadly Higher

Equity markets continued their upward trajectory in Q3, with nearly every major index advancing. U.S. small caps led domestically—rising 12.4%—while overseas, the MSCI China Index gained 21%. Contributing factors included improved clarity around trade negotiations with the EU and Japan, solid second-quarter corporate earnings (S&P 500 earnings up 12% YoY), the passage of the One Big Beautiful Bill Act, and the Federal Reserve's first rate cut in nine months. A weaker U.S. dollar and subdued inflation (below 3%) further supported global risk assets.

Small Caps Regain Momentum

After years of stagnation, small caps broke out. The Russell 2000 reached its first all-time high since 2021, closing at 2,470 on September 18. While large caps and tech stocks have long outperformed, falling rates and attractive valuations could set the stage for a sustained small-cap resurgence.

Federal Reserve Policy

Following its September meeting, Fed Chair Jerome Powell characterized policy as "still modestly restrictive." With the Fed Funds rate between 4.0%–4.25%, markets anticipate two more quarter-point cuts before year-end, potentially extending into 2026. The Bloomberg U.S. Aggregate Bond Index gained roughly 2% in Q3 as investors priced in lower rates.

Something to Think About

Earnings and Interest Rates

Equity markets continue to respond most to two drivers: corporate earnings and interest rates. The Fed has already begun easing, and the S&P 500 has posted three consecutive quarters of double-digit earnings growth. A fourth would reinforce confidence in both valuations and the broader economic outlook.

Gold's Strong Run

Gold—often dismissed as a "barbarous relic"—has delivered an impressive 46% gain year-to-date. Its trajectory remains tied to the direction of the U.S. dollar and interest rates heading into year-end.

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U.S. Debt and Fiscal Health

Federal debt now stands at $37 trillion, roughly 120% of GDP, with a $1.8 trillion deficit for FY2025. While this remains concerning, the U.S. continues to benefit from the scale of its economy and the dollar's reserve-currency status. Notably, yields abroad (U.K., France, Japan) have risen this year even as U.S. yields have declined.

A Look Ahead

Trade Policy in Flux

Trade outcomes may hinge on upcoming Supreme Court decisions regarding tariff authority under the 1977 International Emergency Economic Powers Act. The U.S. currently maintains an effective tariff rate near 17%, up from 2.5% pre-2025. A definitive policy resolution could provide stability for businesses and markets alike.

Risks to Watch

Key risks include elevated equity valuations (S&P 500 at 22× forward earnings), a softening labor market, ongoing government shutdown, persistent 3% inflation, and unsettled global trade dynamics. Additionally, Europe's delayed infrastructure and defense investments and continued geopolitical instability—particularly surrounding Ukraine—add uncertainty.

Reasons for Optimism

Despite headwinds, several tailwinds remain in place:

- Historically strong seasonality in November and December
- Significant AI investment (Alphabet, Meta, Amazon, Microsoft—over $400B in AI CapEx this year)
- Uptick in M&A activity (Electronic Arts' record buyout)
- Record $7.6T in money market assets that could re-enter equities
- Earnings growth projected around 8% in Q3
- Tight investment-grade bond spreads, signaling stability

Closing Thoughts

The backdrop heading into Q4 remains cautiously optimistic: cooling inflation, renewed rate-cut momentum, resilient corporate earnings, and robust liquidity levels. While valuation and policy risks persist, the overall setup suggests continued support for both stocks and bonds into year-end.