



JAMES

INVESTMENT RESEARCH, INC.

ECONOMIC
OUTLOOK

2025



4th Quarter Outlook

An Indepth Forecast
of the Year 2025

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Executive Summary

The fourth quarter of 2025 opens with markets displaying surface strength that masks deteriorating fundamentals. Earnings growth has decelerated to the slowest pace since Q1 2024, while the forward price-to-earnings (P/E) ratio expanded well above historical averages. Valuation expansion rather than earnings growth has driven one-third of recent gains, creating stretched conditions as earnings season begins.

The Federal Reserve (Fed) faces an acute dilemma: persistent inflation colliding with sharp labor market deterioration. The September rate cut to 4%-4.25% prioritized employment over inflation, signaling willingness to tolerate higher prices to support jobs. Meanwhile, businesses absorb tariff costs through compressed margins rather than passing them to consumers, building stagflationary pressures as companies indicate eventual price increases.

A federal government shutdown appears increasingly likely as the October 1 deadline approaches, with none of the regular appropriation bills passed and lawmakers unable to reach agreement on fiscal 2026 funding. If realized, this would mark the first shutdown since December 2018, when a 34-day closure during Trump's first term became the longest since 1981. While most historical shutdowns have lasted one week or less, three notable episodes (1995, 2013, 2018) extended beyond two weeks, creating meaningful economic disruption.

The economic impact depends critically on duration. A shutdown resolved before mid-November would likely have minimal effect on fourth-quarter GDP (Gross Domestic Product) growth. However, labor market data - already deteriorating and central to Fed policy decisions - faces significant distortion.

Market Performance Update

Sustained Rally and Broadening Recovery

US equity markets continued their remarkable ascent through the third quarter of 2025, building upon the dramatic recovery that began in April. The S&P 500 advanced 14.81% year-to-date through September, with the index gaining 3.06% during the third quarter alone. This

sustained rally represents a complete reversal from the 18.75% correction experienced between February 19th and April 8th, with the recovery from those lows now totaling an impressive 35.05%.

The third quarter marked a crucial inflection point as the rally demonstrated increasing durability and breadth. While technology and mega-cap stocks initially drove the rebound from April lows, September saw growing participation across market segments, suggesting a maturing bull market. The recovery has now persisted for over five months, transitioning from a reflexive bounce to what appears to be a more fundamental reassessment of economic conditions and corporate earnings potential.

Notably, international markets emerged as surprise outperformers during this period, with MSCI World ex-USA surging 26.03% year-to-date and emerging markets climbing 28.17%, substantially outpacing domestic equity returns and signaling a potential shift in global capital flows.

Sector Performance and Outlook

Technology maintained its leadership position with exceptional 21.78% year-to-date gains, though its 7.53% September advance represented a deceleration from earlier momentum. The Magnificent Seven (Apple, Amazon, Google, Meta, Microsoft, Nvidia, and Tesla) stocks continued their dominance with 19.54% year-to-date returns, having rebounded an extraordinary 61.08% from April lows. Communication Services posted strong 23.35% year-to-date gains, benefiting from both technology exposure and improved advertising trends. Industrials and Utilities both delivered solid returns, 18.24% and 17.61% respectively, reflecting renewed confidence in economic growth and interest rate expectations.

In contrast, defensive sectors struggled to keep pace with the broader rally. Consumer Staples gained just 1.60% year-to-date and declined 2.31% in September, while Healthcare limped to a 2.50%. Energy advanced 6.88% year-to-date but slipped 0.32% in September as oil prices consolidated. Materials showed similar weakness with a 2.42% September decline despite respectable 8.06% year-to-date performance.

Size and Style Dynamics

Small-cap stocks finally participated meaningfully in the recovery, with the Russell 2000 Index advancing 10.38% year-to-date after gaining 3.11% in September.

This 39.31% rebound from April lows suggests improving economic conditions and easing credit concerns, though the index still lags large-cap peers substantially. Growth decisively outperformed value, with the Russell 3000 Growth Index up 16.81% year-to-date versus 11.47% for the Value Index, as investors renewed their embrace of high-growth companies despite elevated valuations.

Fixed Income and Alternative Assets

Bond markets delivered modest positive returns as yields stabilized, with the US Aggregate Bond Index gaining 6.13% year-to-date and 1.09% in September. Long-duration Treasuries posted similar performance, up 5.34% for the year with a notable 3.59% September gain as rate cut expectations solidified. High yield bonds advanced 7.22% year-to-date with steady 0.82% September returns, reflecting diminished default concerns.

Gold emerged as a standout performer with spectacular 47.04% year-to-date gains, including an 11.92% surge in September alone, as investors sought inflation protection and safe-haven assets amid geopolitical uncertainties. Cryptocurrencies remained volatile but positive, with the Bloomberg Galaxy Crypto Index up 16.41% year-to-date despite wild intra-year swings. The US dollar weakened significantly, down 8.34% year-to-date, providing tailwinds for international investments and commodity prices.

Earnings and Valuation Concerns

US equity markets continued their advance through the third quarter of 2025, with the S&P 500 reaching 14.81% year-to-date gains through September. However, this price appreciation has occurred alongside deteriorating earnings fundamentals, creating an increasingly stretched valuation environment that warrants careful scrutiny as the market enters earnings season.

Q3 Earnings Outlook and Corporate Guidance

According to FactSet, S&P 500 companies are expected to post Q3 2025 earnings growth of 7.7% and revenue growth of 6.3%. While this marks the ninth consecutive quarter of earnings gains, it represents the slowest pace since Q1 2024, down from Q2's 12.0% growth rate. Despite this deceleration, corporate sentiment remains optimistic -

50% of companies issuing Q3 guidance provided positive outlooks, well above the historical average of 43%.

Mixed Sector Performance Expected

Eight of eleven sectors are projected to report year-over-year earnings growth, led by Information Technology (20.9%), Utilities (17.5%), Materials (13.8%), and Financials (11.0%). Two sectors face earnings declines: Energy (-3.4%), pressured by oil prices averaging \$65.02 in Q3 versus \$76.06 in the prior year, and Consumer Staples (-3.2%), reflecting pricing and volume pressures. On revenues, ten sectors are expected to grow, with only Energy projecting a decline (-1.2%).

Estimate Revisions Show Divergence

Since June 30, Q3 earnings estimates increased 0.6% overall - an unusual pattern as estimates typically decline during quarters. However, this improvement was concentrated in just three sectors: Information Technology (+4.3%), Financials (+3.2%), and Communication Services (+2.8%). Five sectors experienced downward revisions, notably Health Care (-6.5%), where managed care providers saw dramatic estimate cuts, and Materials (-4.7%).

Valuations Remain Stretched

According to FactSet, the forward 12-month P/E ratio stands at 22.5, well above the 5-year average of 19.9 and the 10-year average of 18.6. The trailing 12-month P/E of 28.3 also exceeds historical norms. Since June 30, the index price increased 6.4% while forward earnings per share (EPS) estimates rose just 4.3%, indicating valuation expansion drove one-third of recent gains - a concerning dynamic given decelerating earnings growth.

Limited Margin for Disappointment

The combination of elevated valuations, decelerating earnings growth, and optimistic forward projections creates a limited room for execution shortfalls or disappointing guidance. Historical patterns show forward estimates typically decline as forecast periods approach, suggesting current projections may prove optimistic. Any negative surprises could trigger multiple compression as investors reassess whether premium valuations remain justified in a slower-growth environment.

Economic Indicators and Growth Trajectory

Federal Reserve Signals Caution Despite Growth Upgrades

The Federal Reserve's September rate cut reflects growing concern about labor market conditions, even as policymakers modestly upgraded their growth outlook. The Federal Open Market Committee (FOMC) raised its median growth estimate to 1.6% by end-2025 (from 1.4% in June) and 1.8% in 2026 (from 1.6%), though these projections remain well below the administration's 3% growth target. Chair Powell characterized the economy as being in a "highly unusual" situation, suggesting the Fed has become "laser-focused on the employment side of its mandate" amid concerns the economy could stall.

Consumer Spending Shows Resilience, But Cracks Emerging

Consumer spending came in well above expectations following strong retail sales data, with sales rising for the third consecutive month through August. However, this strength may prove unsustainable as aggregate labor income growth decelerates, suggesting consumers will become increasingly selective in their spending decisions going forward.

Labor Market Deterioration Accelerates

The labor market has shifted decisively lower, with multiple indicators signaling weakness beyond normal cyclical cooling:

- **Job Growth Collapses:** Nonfarm payrolls rose just 22,000 in August, with employment growth averaging a mere 29,000 over the three months ending August - the weakest stretch since the pandemic.
- **Historic Downward Revisions:** Preliminary benchmark revisions through March 2025 show payrolls will likely be revised down by 911,000 jobs (0.6%), the largest markdown since at least 2000. This suggests the labor market deteriorated well before the summer slowdown became apparent.
- **Unemployment Rising:** The unemployment rate climbed to 4.3% in August, the highest since 2021, with particularly acute weakness among Black Americans, whose unemployment rate surged 1.5 percentage points over three months to 7.5% - a development rarely seen outside recessions.
- **Demand Cooling:** Job openings fell to 7.18 million in July, the lowest in 10 months, pushing the vacancy-to-unemployed ratio to 1.0, the lowest since 2021. Initial jobless claims jumped to 263,000 in early September, the highest in nearly four years, as firms adopt a "no fire, no hire" posture.



- **Supply Constraints:** Reduced immigration and lower labor force participation have contributed to slower job growth, though this offers little comfort as demand-side weakness dominates.

Housing Market Remains Depressed

Chair Powell acknowledged housing activity “remains weak,” with multiple indicators confirming the sector’s struggles. Mortgage rates averaging 6.3% keep affordability stretched, constraining demand despite modest home price gains of approximately 3% year-over-year. Home sales remain below pre-pandemic levels, with inventory accumulating as buyer activity stagnates. Building permits and activity have increased modestly but remain below historical averages as builders adjust to elevated costs and tepid demand. The administration’s efforts to influence the Fed’s “third mandate” of moderate long-term interest rates appear aimed at stimulating housing and reducing ownership costs.

Business Cycle Indicators Signal Caution

Our JIR Internal composite indicators demonstrate preliminary weakness across multiple areas. The Financial composite indicator reached historic lows during the past year, while the Housing Market indicator recently plummeted as data deteriorated. Although Industrial and Consumer indicators have remained strong, initial signs of weakness have emerged in both. The overall composite indicator currently registers the “Mid” stage of the business cycle, but the trajectory remains uncertain and warrants close monitoring.

The Federal Reserve’s Dual Mandate Dilemma

Inflation Remains Elevated Amid Labor Market Weakness

The Federal Reserve faces an increasingly difficult balancing act as inflation persists above target while the labor market deteriorates - a combination that raises stagflationary concerns. Core CPI (Consumer Price Index) rose 0.35% in August, the fastest monthly pace since January, driven primarily by used cars, hotels, and airfares.

While goods prices have accounted for most or all of the inflation increase this year, services disinflation appears to be continuing. Overall inflation remains “somewhat elevated” relative to the Fed’s 2% target, with officials now delaying their forecast for reaching that target until 2028.

Delayed Tariff Pass-Through Creates Margin Pressure

Evidence suggests the inflationary impact of tariffs is emerging slowly and being absorbed primarily by American importers and businesses rather than consumers. Foreign exporters have generally maintained steady prices, meaning US importers are bearing essentially all additional costs from tariff increases, with tariff-inclusive import prices rising roughly in line with imposed levies. Margins at wholesalers and retailers fell 1.7% in August, matching the biggest drop since 2009, as businesses have been “eating tariff costs in recent months.” The tariff pass-through rate - the extent to which the cost of a tariff on imported goods is passed on to consumers in the form of higher prices, rather than being absorbed by foreign producers or domestic importers - plummeted to just 0.03 in August from 0.23 in July, indicating minimal translation to consumer prices thus far.

Chair Powell noted that pass-through from tariffs to consumer prices has been slower and smaller than anticipated. However, many Fed officials believe full effects may be delayed as businesses work through pre-tariff inventory and remain reluctant to pass on costs without better visibility. Businesses have indicated they will eventually begin selectively hiking prices, suggesting the inflation impact may be building beneath the surface.

Stagflation Fears Mount

The simultaneous presence of upside inflation risks and employment risks has strategists suggesting the Fed expects “stagflation” - a particularly challenging environment for financial assets. Chair Powell’s acknowledgment of risks to both sides of the dual mandate indicates these stagflation concerns are “spooking him,” forcing the Fed to choose which mandate takes priority. Despite near-term inflation pressures, Powell noted that long-term inflation expectations remain “rock solid,” though University of Michigan surveys represent an “outlier”.

September Rate Cut Prioritizes Employment

The FOMC's decision to cut rates by 25 basis points to a range of 4%-4.25% in September 2025 marked a decisive shift toward prioritizing employment concerns over inflation risks. Powell framed the move as a "risk management cut" focused on increased labor market risks, effectively signaling the Fed's willingness to tolerate higher near-term inflation to support employment. The decision came despite the "hot" August inflation reading, underscoring the severity of labor market concerns.

Internal Dissent Reflects Policy Uncertainty

Governor Stephen Miran, newly confirmed from the White House Council of Economic Advisers, was the sole dissenter, favoring a 50-basis-point cut. Powell stated there was "not widespread support at all" for a larger reduction, suggesting disagreement over both the magnitude of labor market risks and the appropriate policy response. This dissent highlights the difficulty of calibrating policy when facing conflicting signals from the dual mandate.

Forward Guidance Signals Continued Easing

The median dot plot projection - a chart displaying where each Federal Open Market Committee (FOMC) member individually forecasts the federal funds rate will be in the

future - shows officials expect an additional 50 basis points of cuts by end-2025 (two more cuts) and a quarter-point reduction in 2026. The lowest dot suggests a "terminal" rate of 2.4% in 2027, indicating some officials see the need for substantially more accommodation. However, Powell stressed that future actions will be "data dependent" and policy is "not on a pre-set course," preserving flexibility to adjust if inflation accelerates or labor conditions deteriorate further.

Political Pressure Intensifies

The Fed operates under relentless political pressure from the Trump administration, including repeated criticism of Chair Powell and efforts to influence the "third mandate" of moderate long-term interest rates - particularly to stimulate housing markets. Powell repeatedly asserted the Fed's commitment to independence, emphasizing decisions are based solely on data and economic analysis rather than political considerations. This political environment complicates an already difficult policy environment, as the Fed must balance dual mandate tradeoffs while maintaining credibility and independence.



Equity Market Outlook: Caution Warranted Despite Constructive Backdrop

Surface Calm Masks Underlying Vulnerabilities

Market conditions appear benign on the surface, with the VIX (an index used as a barometer for market uncertainty) below 17, tight credit spreads, and optimism surrounding AI monetization and the Fed's easing cycle. Historically, when Fed cuts resume after a pause of six months or more, the S&P 500 averages 15% gains over the following year, and expectations for a housing rebound with lower interest rates in early 2026 support bullish sentiment. However, this "bad news is good news" mentality - where weak economic data is cheered as accelerating rate cuts - creates a fragile foundation for further gains.

Valuation Premium Leaves Little Room for Error

The equity rally has been driven more by multiple expansion than earnings growth, with the S&P 500 forward P/E at 22.5 versus historical averages of 19.9 (5-year) and 18.6 (10-year). This premium valuation already prices in optimistic assumptions about earnings reacceleration, successful AI monetization, and a soft economic landing. International markets may offer better opportunities, as US stocks carry stretched valuations relative to overseas alternatives - US equities actually underperformed international markets during 2024's rate cut cycle.

Forward Outlook Projects Reacceleration

Analysts forecast Q4 2025 earnings growth of 7.3% and full-year 2025 growth of 10.7%. Looking further ahead, estimates call for reacceleration to 11.7% in Q1 2026 and 12.7% in Q2 2026.

Credit Market Signals Growing Selectivity

Credit flows reveal investor caution beneath the surface optimism. In investment-grade credit, heavy selling concentrated in technology, media and telecom and utility sectors, while only financials saw solid net buying. High-yield credit experienced broad-based net selling across almost every sector, led by financials and basic materials. These flows suggest investors are becoming more discriminating despite tight spreads, potentially positioning for deteriorating conditions.

Stagflation Scenario Particularly Challenging

The combination of persistent inflation and weakening employment creates a stagflationary backdrop that typically proves difficult for financial assets. With the Fed now prioritizing employment over inflation concerns and businesses indicating they will eventually pass through tariff costs, equity investors face the prospect of slowing earnings growth alongside sustained inflation. The delayed tariff pass-through - currently absorbed in compressed margins - represents building pressure that will eventually impact either consumer demand or corporate profitability.

Structural Risks Accumulate

The sustainability of the current expansion depends on several increasingly fragile assumptions: consumers must absorb tariff-driven price increases despite slowing labor income growth; the AI boom must continue supporting capital spending despite uncertain return on investment (ROI) timelines; and corporate earnings must reaccelerate from the current 7.7% growth rate to justify premium valuations. The combination of overvaluation and signs of weakening labor poses substantial downside risk, particularly if any of these assumptions prove incorrect.

Small-Cap “Opportunity” Carries Elevated Risk

While small caps (Russell 2000 Index) are anticipated to benefit most from rate cuts given greater valuation room to stretch, approximately 25% of Russell 2000 constituents remain classified as “zombie” borrowers unable to generate sufficient operating income to cover interest costs. Rate cuts may provide relief, but these companies remain vulnerable to any revenue shortfall or credit market disruption.

Narrow Leadership Signals Fragility

The Magnificent Seven’s 19.54% year-to-date return and 61.08% rebound from April lows substantially outpaces broader market performance, indicating concentrated leadership. Technology’s forward P/E of 30.0 embeds high expectations for continued execution, yet the sector accounts for the largest S&P 500 weight. Any disappointment in Technology earnings or AI monetization timelines could trigger disproportionate market impact given this concentration and elevated valuation.

The current environment demands caution rather than complacency. While the Fed’s easing cycle and resilient consumer spending provide near-term support, the convergence of elevated valuations, decelerating earnings growth, deteriorating labor conditions, building inflation pressures, and concentrated market leadership creates an asymmetric risk profile. Investors positioned for continued gains may find themselves exposed to downside volatility if any component of the optimistic consensus fails to materialize.

Fixed Income Outlook: Political Risk Meets Market Caution

Credit Markets Signal Defensive Positioning

Despite historically tight credit spreads that typically indicate investor confidence, fixed income flows reveal growing caution beneath the surface. Buyside investors are moving defensively, selling long-duration investment-grade paper and rotating into the front end (under 3 years). High-yield selling has been broad-based across maturities and sectors, with net outflows led by financials and basic materials. This defensive rotation suggests sophisticated investors are positioning for potential credit deterioration or duration risk despite seemingly benign spread levels.

“Third Mandate” Invocation Raises Yield Curve Manipulation Concerns

Treasury Secretary Scott Bessent and newly appointed Fed Governor Stephen Miran have invoked the Fed’s “third mandate” - the statutory goal of pursuing “moderate long-term interest rates” - alarming some investors who interpret this as signaling the administration’s intent to influence long-end yields through monetary policy. Potential policy actions could include the Treasury ramping up buybacks of long-dated bonds or the Fed resuming quantitative easing (QE), creating artificial demand that suppresses long-term rates regardless of underlying inflation dynamics.

This focus on controlling long-term rates introduces significant uncertainty into fixed income markets. If the Fed resumes QE or the Treasury implements aggressive buyback programs, traditional relationships between economic fundamentals and bond yields could break

down, making it difficult for investors to price duration risk appropriately. The pressure for lower long-term rates - particularly to stimulate housing markets - conflicts with the Fed's inflation-fighting credibility and creates the prospect of financially repressive policies that benefit borrowers at the expense of savers and creditors.

Duration Risk Compounds Inflation Concerns

The anticipated Fed cuts under pressure incentivize borrowers to reduce duration and take on more floating-rate risk, increasing the economy's sensitivity to inflation shocks. This creates a risky dynamic: if politically influenced Fed policy prioritizes lower rates even with sticky inflation, real returns for fixed income investors could become negative for extended periods. The delayed tariff pass-through represents building inflationary pressure that will eventually emerge either through consumer price increases or reduced corporate credit quality.

Some investors are purchasing short-dated Treasury inflation-protected securities (TIPS) as a hedge against this scenario, reflecting concern that politically motivated rate suppression combined with persistent inflation could erode nominal bond returns. With core CPI (Consumer Price Index) rising 0.35% in August (the fastest pace since January) and businesses indicating they will eventually pass through tariff costs, the inflation risk appears substantial even as the Fed cuts rates to support employment.

Stagflationary Environment Particularly Challenging

The combination of weakening labor markets and persistent inflation creates a particularly difficult backdrop for fixed income investors. Traditional safe-haven demand for Treasuries during economic weakness may be offset by inflation concerns and political interference risks. Credit investors face deteriorating fundamentals as labor income growth slows and tariff costs pressure margins, yet spreads remain historically tight, offering minimal compensation for these building risks.

The forward rate path implied by the dot plot - an additional 50 basis points of cuts by end-2025 and further easing into 2026 - may prove insufficient to prevent further labor market disruptions yet could prove excessive if inflation fails to moderate. Fixed income investors must

navigate this uncertainty while contending with political pressure that threatens to distort traditional market signals and price discovery mechanisms.

Strategic Implications

The defensive rotation toward short-duration positioning appears prudent given the confluence of political risk, inflation uncertainty, and tight credit spreads offering minimal risk compensation. Investors may find better risk-adjusted returns in short-dated TIPS, front-end investment-grade credit, or international fixed income markets less exposed to political interference. The traditional role of long-duration Treasuries as portfolio ballast faces significant headwinds if the "third mandate" focus leads to yield curve management that suppresses returns while inflation persists.

International Markets and Geopolitical Risk

Emerging Markets Rally and Dollar Weakness

Emerging markets are experiencing their strongest rally since 2017, driven by falling long-end Treasury yields and Fed rate cut expectations. The rally has broadened beyond technology shares, with healthcare and telecommunication stocks now serving as major drivers. The US dollar has weakened substantially - down 8.34% year-to-date - a development at odds with historical precedent for a soft-landing scenario.

The dollar's decline carries significant implications for the reserve currency's stability. As political interference and monetary accommodation pressure the dollar, central banks are accelerating diversification efforts - manifested in record gold purchases (up 47.04% year-to-date) and exploration of alternative settlement mechanisms. The administration's use of sanctions and tariff policies risks undermining the dollar's privileged position in global finance.

Geopolitical Fragmentation and Regional Challenges

The international landscape is fracturing along multiple fault lines. US-China decoupling continues through technology restrictions and supply chain reshoring.

The administration's tariff policies have strained traditional alliances, with partners increasingly pursuing independent trade arrangements. These tensions create hidden correlations that could trigger synchronized market disruptions.

While international markets may offer better valuations than stretched US equities (MSCI World ex-USA up 26.03% year-to-date, emerging markets up 28.17%), significant challenges remain. Europe faces energy security concerns, competitiveness challenges versus US subsidies, and potential export damage from euro strength. Asian markets outside China face supply chain disruption risks, while China's property sector weakness, debt burdens, and demographic challenges create headwinds for commodity-dependent emerging markets.

Strategic Implications for International Allocation

The case for international diversification rests more on US overvaluation than compelling international growth stories. Many overseas markets face structural challenges equal to or exceeding US concerns. Investors considering international exposure should focus on markets with strong rule of law, limited exposure to US-China tensions, demographic tailwinds, and sectors less vulnerable to technology restrictions and trade barriers. Currency hedging strategies remain important to manage dollar volatility. Gold's strong performance suggests the most compelling "international" allocation may be to assets uncorrelated with any single regime or policy framework.

Conclusion & Strategic Recommendations

The fourth quarter of 2025 presents a uniquely challenging environment where elevated valuations meet decelerating fundamentals, creating asymmetric risk that demands defensive positioning. The 35.05% recovery from April lows has established a "bad news is good news" mentality vulnerable to reversal if deteriorating labor conditions trigger recognition of an economic slowdown rather than simply faster Fed cuts.

Key Strategic Themes:

1. **Quality and Defense:** Emphasize high-quality companies with strong balance sheets, proven pricing power, and minimal tariff exposure.
2. **Technology Selectivity:** Maintain exposure to genuine AI beneficiaries with visible monetization while reducing momentum-driven positions. Technology's concentrated leadership creates disproportionate downside risk if execution disappoints.
3. **Fixed Income:** Short Duration, Inflation Protection: Favor short-dated TIPS over long-duration Treasuries given political interference risks ("third mandate" invocation), delayed tariff pass-through building inflation pressures, and tight credit spreads offering minimal compensation.
4. **Stagflation Positioning:** Establish hedges through selective commodities, gold, and international diversification benefiting from dollar weakness, while maintaining inflation protection as businesses eventually pass through compressed margins.
5. **Earnings Season Vigilance:** With 50% positive guidance versus 43% historical average but markets pricing substantial optimism, prepare for volatility if Q3 results or forward guidance disappoint.

The Critical Question

Can earnings reaccelerate in the coming quarters while consumers absorb tariff costs, labor income decelerates, margins compress, and the Fed prioritizes employment over inflation? Historical patterns of declining estimates, and multiple fragile assumptions suggest substantial risks this consensus proves too optimistic.

The convergence of stretched valuations, deteriorating labor markets, building inflation, and concentrated leadership demands heightened risk management. However, further gains remain possible if earnings surprise positively, and the Fed continues its easing policy.

Quality emphasis and selective positioning should take priority over aggressive growth-seeking in an environment where multiple systemic risks converge with elevated valuations.

For Investors:

Equities

- Emphasize high-quality companies with strong balance sheets, proven pricing power, and minimal tariff exposure to withstand margin compression pressures
- Maintain selective technology exposure focused on genuine AI beneficiaries with visible monetization paths, while reducing momentum-driven positions
- Evaluate international markets offering better valuations than stretched US equities
- Approach small-cap exposure with extreme caution despite potential rate cut benefits, as approximately 25% of Russell 2000 constituents remain “zombie” borrowers vulnerable to revenue shortfalls
- Prepare for earnings season volatility, as high valuation and optimistic guidance leave limited room for disappointment

Fixed Income

- Prioritize short-duration positioning over long-duration Treasuries given political interference risks from “third mandate” invocation and potential yield curve management through QE resumption or aggressive Treasury buybacks
- Consider short-dated Treasury Inflation-Protected Securities

(TIPS) to hedge against delayed tariff pass-through building inflation pressures while politically influenced Fed policy suppresses nominal rates

- Exercise caution with credit exposure despite historically tight spreads, as buy-side defensive rotation signals growing concern about credit deterioration with building tariff margin pressures
- Avoid broad-based high-yield exposure given limited spread compensation for deteriorating fundamentals, weak labor income growth, and approximately 25% “zombie” borrower composition in small-cap universe

International Diversification

- Consider international markets capitalizing on dollar weakness
- Explore emerging markets benefiting from their strongest rally since 2017, driven by falling Treasury yields
- Evaluate European assets, though mindful of energy security concerns, competitiveness challenges versus US subsidies, and potential export damage from euro strength
- Consider gold allocation as uncorrelated asset benefiting from reserve currency diversification and geopolitical fragmentation

Potential Risks to Our Outlook

- Federal government shutdown extending beyond mid-November, creating meaningful economic disruption and labor market data distortion critical to Fed policy decisions
- Earnings disappointment as Q3 results miss optimistic projections or forward guidance underwhelms
- Multiple compression as premium valuations prove unjustified if earnings fail to reaccelerate from current deceleration trajectory
- Labor market transition from current “low hiring, low firing” equilibrium to widespread layoffs
- Accelerating inflation as businesses pass through compressed margins to consumers, reversing current minimal pass-through and challenging Fed’s employment prioritization
- AI monetization disappointment impacting Technology sector concentration, given sector’s high forward P/E and disproportionate S&P 500 weight creating systemic vulnerability



Disclosure

This information is of a general nature and does not constitute financial advice. It does not take into account your individual financial situation, objectives or needs, and should not be relied upon as a substitute for financial or other professional advice to assess, among other things, whether any such information is appropriate for you and/or applicable to your particular circumstances. In addition, this does not constitute an offer to sell, or the solicitation of an offer to buy, any financial product, service or program. The information contained herein is based on public information we believe to be reliable, but its accuracy is not guaranteed.

Investing involves risks, including loss of principal. Past performance is no guarantee of future results.

Definitions

*Basis Point: one hundredth of one percent, used chiefly in expressing differences of interest rates.

*Consumer Price Index (CPI): An index of the variation in prices paid by typical consumers for retail goods and other items.

*Gross Domestic Product (GDP): a standard measure of the total value of all goods and services produced within a country's borders during a specific period, typically a year.

*Growth: A company stock that tends to increase in capital value rather than yield high income.

*Price/Earnings Ratio: ratio for valuing a company that measures its current share price relative to its earnings per share (EPS).

*Quantitative easing (QE) is a monetary policy used by central banks, such as the Federal Reserve, to stimulate economic growth by purchasing securities and increasing the money supply.

*Russell 3000 Index tracks the performance of the largest 3,000 U.S. companies, representing 98% of the investable equity market.

*Russell 2000 Index: a stock market index that measures the performance of the 2,000 smaller companies included in the Russell 3000 Index.

*S&P 500 Index: S&P (Standard & Poor's) 500 Index: is a market-capitalization-weighted index of the 500 largest US publicly traded companies.

*Stagflation: an economic condition characterized by simultaneous high inflation, high unemployment, and slow economic growth.

*Treasury Inflation-Protected Securities (TIPS) are a type of Treasury bond that is indexed to an inflationary gauge to protect investors from a decline in the purchasing power of their money.

*U.S. Aggregate Bond Index: Designed to measure the performance of publicly issued US dollar denominated investment-grade debt.

***Indexes are not managed. One cannot invest directly in an index.**



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