"Mr. Market's Euphoria"

Market Commentary – October 2025

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The third estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 3.8% in the second quarter of 2025. This is greater than the advance estimate of 3.0% and the second estimate of 3.3%. On September 17, the Federal Reserve updated its economic projections that were last released in June. It now sees GDP growth of 1.6% in 2025, 1.8% in 2026, 1.9% in 2027, 1.8% in 2028, and 1.8% in the "longer run" (beyond 2028). It projects inflation to be 3.0% in 2025, 2.6% in 2026, 2.1% in 2027, 2.0% in 2028, and 2.0% in the longer run. As for unemployment, the Fed expects 4.5% in 2025, 4.4% in 2026, 4.3% in 2027, 4.2% in 2028, and 4.2% in the longer run. With the Fed initiating a new monetary policy easing cycle, GDP growth should be stimulated. Economists will be keenly watching for sparks of inflation.

As expected, the Federal Open Market Committee (FOMC) slashed its benchmark federal funds rate by 0.25% to a range of 4.0% to 4.25% on September 17. In its statement, the FOMC "judges that downside risks to employment have risen", which helped drive the decision to cut the rate. Looking ahead, the Fed sees the federal funds rate at 3.6% in 2025 (implying two more 0.25% cuts this year), 3.4% in 2026, 3.1% in 2027, 3.1% in 2028, and 3.0% in the longer run. As for the Fed's balance sheet, it had $6.608 trillion in assets on September 24, *up* $5 billion from August 27 (much different from the Fed's monthly *reduction* target of $40 billion). This is likely due to a lack of securities maturing over the past month, but it is curious that the deviation from target is so large.

Technical factors of the market are bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) through September 30, 2026 is $291.61, which implies a price-to-earnings (P/E) ratio of 22.9 with the S&P 500 at 6,688. The earnings yield (E/P) of 4.36% represents fair value relative to the 10-year U.S. Treasury note yield of 4.16%. The yield spread is only 0.20%. The eight largest companies in the S&P 500 make up $22.3 trillion of the $59.7 trillion index market capitalization with a weighted P/E of 41.8. If 37.3% of the index has a P/E of 41.8, then 62.7% of the index has a P/E of 11.7 for the overall P/E to be 22.9. A P/E of 11.7 is an E/P of 8.57%, which is attractively priced compared to the 10-year Treasury note yield of 4.16% (a yield spread of 4.41%).

The uptrend for the S&P 500 continues with a pattern of higher highs and higher lows. Since bottoming on April 8 at 4,983, the S&P 500 has not pulled back more than 5%. The index hit an all-time high of 6,694 on September 22. When a correction happens, there should be support around 6,475 (50-day moving average), 6,100 (February 2025 high), and 6,020 (200-day moving average). It should be noted that the divergence between the market cap-weighted S&P 500 and the equal-weighted S&P 500 has magnified in 2025. Since April 8, the market cap-weighted S&P 500 is up 34.2%, while the equal-weighted S&P 500 is up 24.1%. Both versions of the S&P 500 include the same companies.

"Mr. Market", the fictional character created by legendary value investor Benjamin Graham to describe market movements, is on a euphoric high. Mr. Market represents the cumulative psychological thoughts of market participants, who individually tend to be emotional. Suffering from bipolar disorder, fear and greed cause Mr. Market to drive valuations to extremes that are not logically justified. In April, Mr. Market was terrified that tariffs would plunge the global economy into recession or worse. Nearly six months later, Mr. Market is intoxicated on a potent cocktail of artificial intelligence and mega-cap technology, further spiked by the prospect of lower interest rates. Other stocks are enjoying solid rises in 2025, so the party is not limited to technology. We do not know how long this will continue. Since we cannot *predict* the future, our next best alternative is to *plan* for various outcomes. Therefore, our preference is to maintain a balance between stocks and cash, emphasizing value stocks spanning all market caps (micro through mega) with attractive dividend yields, low debt, and low betas.