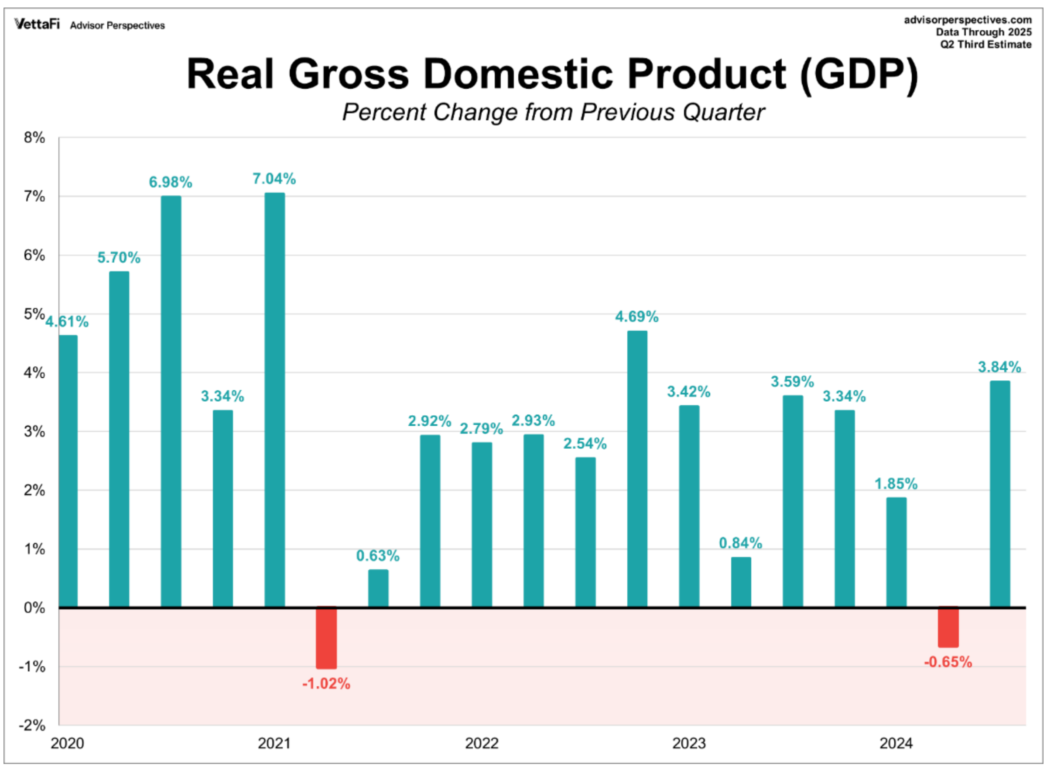
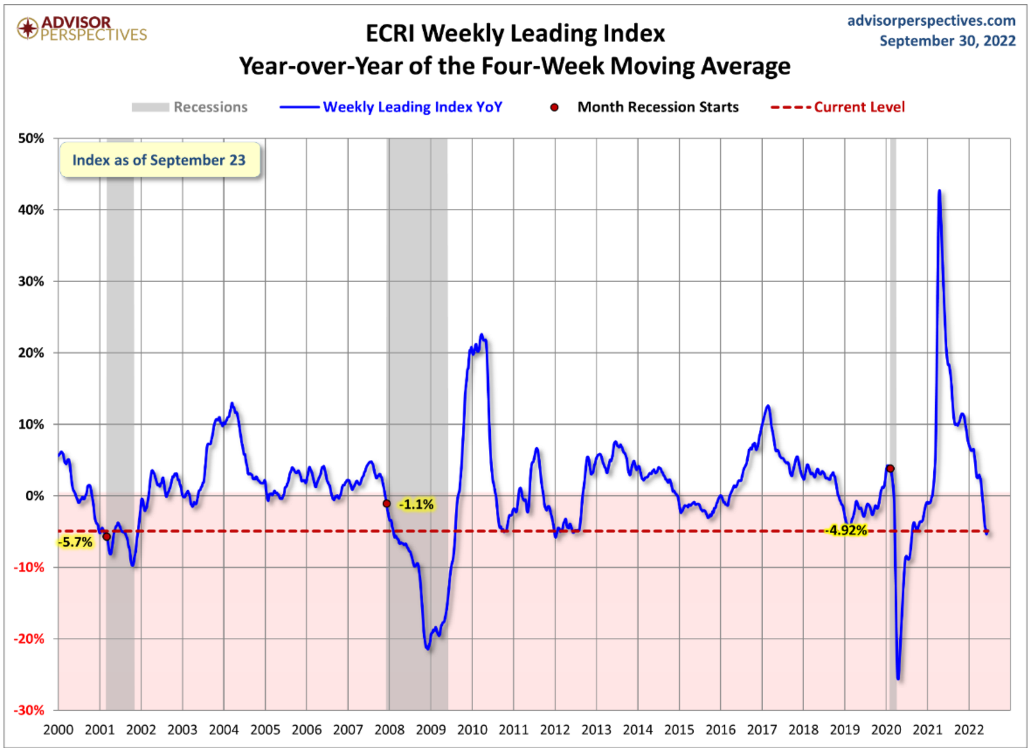
2025 Q3 Market and Economic Update

Economic Update

After a negative year-over-year change in GDP (adjusted for inflation) in the first quarter, growth rebounded strongly to 3.8% in the second quarter, which was the strongest quarter in almost two years. It's probably appropriate to think of the first half of the year together, as some of what might have been done in the first quarter was likely pushed back into the second quarter. The average year-over-year growth for the first two quarters was 1.6%, which is weak growth, but still growth. One could reasonably conclude that uncertainty drove weakness in the last quarter of 2024 and first quarter of 2025. We will have to wait and see. Clearly, we do not have a booming economy, though.



Weekly leading indicators continue to fall sharply and are now lower than they have been since 2021 at -4.92%. While these are not flawless, they are a relevant data point.



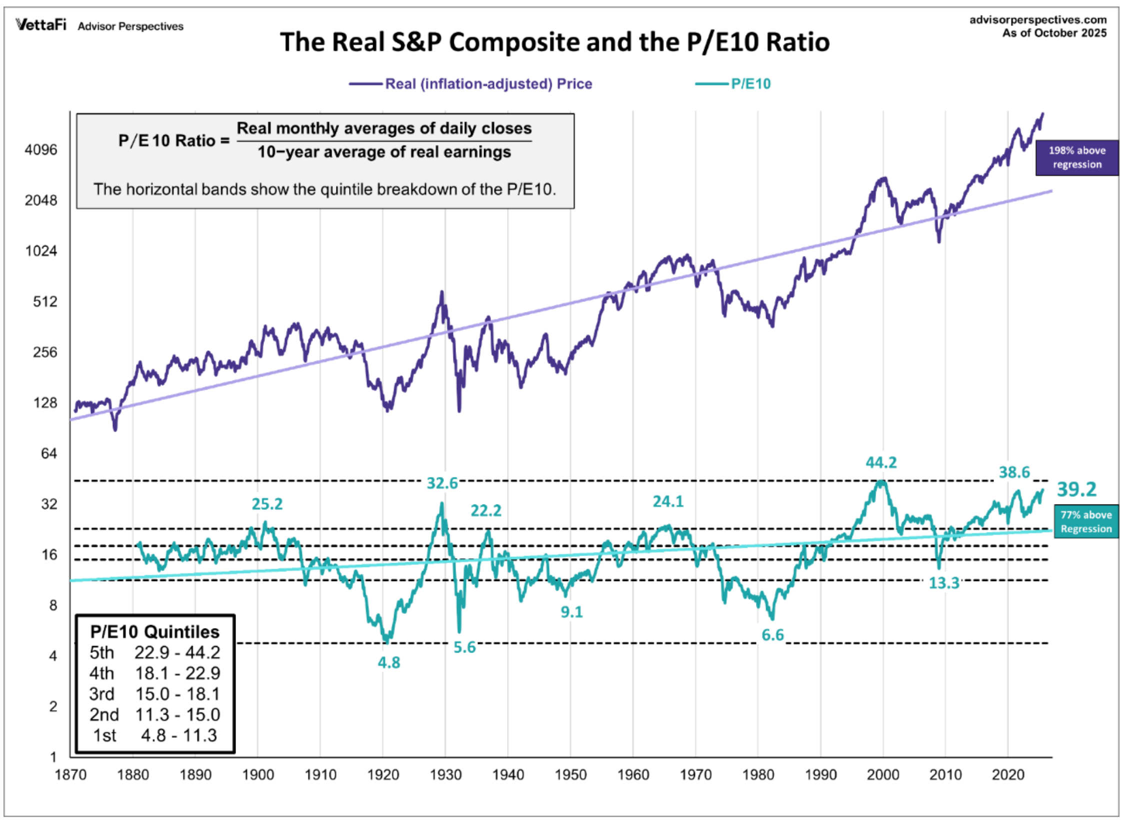
There has been some talk about fifty-year mortgages coming to the rescue of housing prices. As we've learned over the last few years, anything can happen, but I don't see this as a game-changer. First, I think banks will rightly be reluctant to offer these. Second, even if they come out, they won't make that big a difference. Consider that a 30-year mortgage generally carries a rate about 0.5% higher than a 15-year mortgage, and a 50-year would probably be about 0.5% above that. A 30-year mortgage, using recent rates, saves about 25% off the monthly mortgage, which makes the difference for many people on whether they can afford the house. Adding another 20 years, and another 0.5% only saves an additional 5%. If we were to include all other costs of home ownership (tax, insurance, maintenance) the difference would be even less. Put another way, if all homes were priced off of 50-year mortgages instead of 30 years, with an average 20% downpayment, this would only justify a 4% increase in home prices, and that's assuming buyers ignored other costs. Charlie Bilello found that there is a 57% affordability gap, which is based on the current vs. historical relationship of the median income vs. median home price.

The Fed is still mulling an interest rate cut despite hot inflation (about 3%) and record asset prices. This could be appropriate if we are about to enter a recession, but this should not excite investors. Fed watching has been an exciting endeavor recently, and stocks seem to bounce around based on whatever the latest Fed governor hint.

Loan delinquencies are becoming a concern, with credit card delinquencies continuing to climb, now higher than any time since 2011, and rising. Auto loans delinquencies are also rising, particularly for subprime borrowers.

Market Update

The US stock market continues to be strong, despite some wobbles recently. My favorite valuation metric, the CAPE, or P/E 10 ratio is now above its 2021 peak, so only the tech bubble had a higher valuation.



Some have argued that we are in a different market. Artificial intelligence will revolutionize the world, and most of the market capitalization is now in intellectual property companies, not industrial companies. While I appreciate that knowledge-based companies can scale further and faster than goods manufacturers, I'm not sure that is what is happening here. Other than Apple, the biggest tech companies (I don't include Tesla as technology) have been more software driven, which is very scalable. Servicing 1 billion users was not nearly one thousand times as expensive as servicing 1 million. As the companies grew, their incremental margins were extremely high. Artificial intelligence is different. It takes physical assets and electricity to power the computations. The high-end processors being used to build out data centers have a short shelf life. The big tech companies are spendings tens of billions of dollars each on capital expenditures for rapidly depreciating assets to drive growth in a business line that is currently a money-loser and looks to be highly competitive. “This time is different” is always a dangerous argument, and a common one when valuations reach extremes.

We continue to be cautious. We are not making any blanket recommendations about avoiding stocks, but we think it is always important, and perhaps now more than ever, to know what you own and why.