

In Brief

Equity markets delivered an unusually strong September, with the S&P-500 up 3.5% (+14.3% year-to-date). Performance was driven by mega-cap technology leadership and rising expectations of a Fed rate cut, offsetting weaker labor data and declining consumer confidence. September marked the fifth consecutive monthly gain across major U.S. benchmarks. Looking ahead, year-end seasonality is favorable, but risks remain from political gridlock, labor market softness, and the market's dependence on a narrow group of large-cap leaders.

Economy

The U.S. economy continues to demonstrate broad-based strength. Real GDP grew at a 3.8% pace in Q2 and is tracking close to 4% in Q3, while S&P-500 earnings reached new highs. Consumers remain resilient, supported by rising wages, strong household balance sheets, and moderating inflation. Business investment, particularly in technology and infrastructure, is boosting productivity, and financial conditions remain favorable with stable credit markets and record equity valuations. The labor market is cooling only gradually, with unemployment near historic lows, underscoring solid demand despite restrictive monetary policy.

Monetary Policy-still restrictive

At his September 17 press conference, Chair Powell emphasized that policy remains restrictive despite the latest rate cut. With GDP growth tracking near 4%, equity and earnings at record highs, and gold surging, the Fed's current 4.0% funds rate appears closer to neutral than the FOMC's 3.0% estimate. While the committee projects gradual cuts through 2028 to reach its 2% inflation target, the "neutral rate" is unobservable and shifting. In practice, today's level may already represent equilibrium-suggesting limited room for easing without risking renewed inflation pressure.

Corporate Earnings

Corporate earnings continue to provide critical support for U.S. equities. Q2 results broadly exceeded expectations, with S&P-500 earnings reaching record highs and margins holding firm despite tariff pressures and input cost volatility. For Q3, analysts project mid-single-digit EPS growth, led by technology and financials, while defensive sectors face softer trends. Balance sheets remain strong, leverage modest, and cash flows healthy, giving corporates room to navigate a slower macro backdrop. Combined with resilient economic growth, earnings momentum reinforces market strength even as monetary policy stays restrictive.

Thoughts

September reignited debate over whether artificial intelligence is entering bubble territory. Prominent analyses compared today's enthusiasm to the dot-com era, noting stretched valuations, record capital expenditures, and narratives that justify extreme prices. Hyperscalers are projected to spend \$736 billion on data centers by 2026, with capital intensity levels approaching those seen at past speculative peaks in telecom and energy. Such overinvestment often delivers lasting economic benefits but destroys shareholder value in the near term. While AI is transformative, the current cycle shows classic bubble symptoms: expensive valuations, cheap financing, and a compelling narrative. Importantly, unlike 2008, today's boom is largely equity-funded, reducing systemic risk. A correction could be painful for investors but should not destabilize the broader economy. The likely outcome is a period of volatility, where shareholders face pressure even as end-users and industries benefit from cheaper, more powerful computing.

Argentina's latest bailout highlights the limits of external support for chronically mismanaged economies. President Milei's austerity drive has deepened recessionary pressures, drained reserves, and triggered political backlash, leaving the \$20 billion U.S. package looking more like a bridge to elections than a structural fix. At the same time, China's near 5% growth target is being met through widening fiscal deficits and mounting debt, with local governments carrying hidden liabilities of some 60 trillion yuan. These episodes underscore how political imperatives—Milei's shock-therapy austerity on one side, and Xi's GDP rat race on the other—are heightening fragility rather than resolving structural weaknesses. For U.S. equities, the risk is that rising EM volatility and China's export of deflationary pressures spill back into U.S. earnings and sentiment.

Stock Market Outlook

We expect continued resilience with moderate upsides in late October as earnings confirm strength and the Fed maintains its cautious stance. Short-term volatility should be viewed as an opportunity to add exposure, not a reason to retreat. If inflation data continues to trend lower and the Fed signals policy easing, equities could enter a fourth quarter on a positive note, driven by positioning, buybacks, and year-end inflows. The combination of earnings stability, policy normalization, and capital inflows remains a powerful driver for risk assets.

Your Terra Nova Team!