SMITH AFFILIATED CAPITAL

4Q25 INVESTMENT COMMENTARY

Signs of Strength with Undercurrents of Risk

September 2025

Stronger Growth Meets Policy Caution

The economic tailwinds continue to gather strength, pushing the early-year slog in activity further back in the rear-view mirror. Even the latest sales data on the downtrodden housing sector was upbeat, joining a bevy of other reports that show the economy is riding a wave of momentum more powerful than thought. There is still a key missing link to the chain of positive events on the growth front, as a lackluster job market is a major restraining force. While the economy's top-line performance and its main drivers—consumer spending and AI investments—continue to forge ahead, there is little sign of renewed life on the labor front. The "no hiring/no firing" narrative remains firmly in place.

The Federal Reserve prefers to look through the windshield rather than the rear-view mirror in making policy decisions; but as in American football, momentum can often be hard to stop. We still expect the next move will be a rate cut following the quarter-point reduction implemented at the September FOMC meeting. We suspect, however, that the Fed might be more inclined to bolster the defensive line with one rather than the two cuts this year signaled by the dot plots at that meeting. For one, inflation continues to run above the 2 percent target and heading in the wrong direction. For another, the economy does not appear to be buckling under the modestly restrictive rate regime currently in place. Treasury markets are beginning to reflect that balancing act: yields drifted modestly lower across the curve in Q3, with the 10-year falling to 4.15% from 4.23% and the 2-year slipping to 3.61%. Upcoming jobs reports could still be the pivotal influence on the Fed's decision, but the government shutdown is keeping the September reading in the dark for a while.

Highlighting the tailwind at the economy's back was the eye-opening revision of the second quarter's GDP, which now sports a 3.8 percent growth rate for the period, up from the previous estimate of 3.3 percent and the initial tally of 3.0 percent. Importantly, the upward adjustment was not due to more complete data on volatile swing factors—such as inventories and trade—that can mask fundamental trends. The two main cyclical drivers, consumers and business investment, were primarily responsible for the upgrade. However, the top-line growth conceals fissures in the labor market that are poised to deepen. The Fed is taking a risk-management approach to policy. What it sees now is the greater risk of a jobs meltdown than an inflation flareup, and it decided to take out an insurance rate cut to mitigate that risk.

Low Unemployment, Just Not for Everyone

On the surface, it would seem the Fed is making a mountain out of a molehill. After all, the unemployment rate, at 4.3 percent in August, is near historic lows, suggesting a healthy job market. But as they say, the devil is in the details. The unemployment rate provides a valuable snapshot of labor market conditions, but it's a summary measure that overstates the health of the job market.

Fed Chair Powell astutely pointed out that the low unemployment rate reflects a "curious balance" between the demand for and supply of labor. This Sherlockian notion reflects the fact that both sides of the ledger are falling at about the same pace, keeping the unemployment rate steady. But rather than seeing that balance as an equilibrium, Powell fears that it is unsustainable. The supply side, i.e., the labor force, is being restrained mainly by reduced immigration, which is shrinking the number of foreign-born workers available to hire. But that shortage has not increased the demand for native-born Americans, as businesses are in a hiring freeze, worried primarily about the impact of tariffs on sales. The good news is that they are not laying off workers as they are just as worried about rehiring difficulties if sales hold up better than expected.

The bad news about this "no hiring/no firing" mentality is that people searching for a job are out of luck. The percent of jobless workers on the unemployment lines for more than six months is the highest since December 2021, stretching the average duration of unemployment to the longest in more than three years. Most workers know someone experiencing a long bout of unemployment and are staying put out of growing insecurity over retaining their own paychecks. This is not only reducing the voluntary quit rate, it is also dampening worker bargaining power, pointing to slower wage growth. Fears of job losses over the next six months have surged in recent surveys, as have buying plans for lower- and middle-income workers, particularly for big-ticket discretionary items.

Profit Squeeze

Despite the outsized upward revision in overall growth for the second quarter, the one blemish on the headline GDP report is that the revisions also cut a full percentage point from the income side of the ledger. However, the haircut was not taken from households but from corporations, where an outsized $58.7 billion was sliced from profits. That still left margins above their historical average, but there has been no improvement over the past four quarters. Margins actually narrowed a bit in the second quarter for nonfinancial corporations and slipped considerably from their peak in the fourth quarter of 2022, when the post-pandemic inflation surge drove revenues up much faster than costs. That confluence reversed with the subsequent disinflation cycle, and the second-quarter mild compression may reflect an early hit to costs from tariffs.

Odds are the higher costs linked to tariffs will become more visible in the data for the second half of the year. That, in turn, will increase pressure on companies to pass the duties on to customers. Then the question is how much of the passthrough price sensitive consumers will accept. More acceptance signals higher inflation—and a slower pace of Fed rate cuts. Alternatively, more resistance by consumers points to more cost-cutting efforts by companies, suggesting that layoffs would become more widespread in coming months. The latter would no doubt tilt the Fed's assessment of the "curious balance" in the labor market, nudging it towards the need for faster rate cuts.

That said, incoming data indicate that the economy still has a good deal of wind in its sails. On the heels of the outsized revisions that pumped up the second quarter's growth rate, the third quarter is taking the baton on running at full speed. That's the message from the August report on personal income and spending, which is dialing up the speed tracker for the July-September period. We are still waiting for the September reports (and revisions) to see if the pace of the first two months has legs. With a government shutdown underway, an ADP report showing a drop in private sector payrolls in September, another downbeat reading on consumer confidence from both the Conference Board and the University of Michigan, and the president's new tariff threats on trucks and pharmaceuticals, the stage is set for some prospective headwinds to brake momentum as the calendar turns to the fourth quarter.

Like Jobs, Consumer Spending Masks Underlying Weakness

For that to pass, however, consumers would need to start zipping up their wallets, something they have shown no inclination of doing this summer. Robust retail sales confirmed that households still have a voracious appetite for goods, and that hunger extended into the service sector as well, according to the more comprehensive personal income and spending report for August. Consumers spent a robust 0.6 percent more on goods and services last month, the strongest in four months, and were little swayed by higher prices. Adjusted for inflation, real purchases increased by a sturdy 0.4 percent, and that follows sharp upward revisions to previous months.

Simply put, the slog in spending seen earlier in the year, which many thought was a recession signal, was more of a head-fake than a portent, caused mainly by uncertainty over tariffs and fiscal policy. Since the Liberation Day tariff announcements, however, the fog of uncertainty has lifted somewhat, albeit full clarity on the tariff front still awaits. Meanwhile, the One Big Beautiful Bill Act was passed by Congress in July, removing a source of uncertainty over tax and spending prospects that loom in 2026. Hence, consumers reopened their wallets in the second quarter and spending is tracking even stronger growth in the third quarter.

But a look under the hood of the spending rebound reveals that there is more afoot than meets the eye. Yes, aggregate sales staged a healthy increase, but not all consumers went on a spending binge. As has been the case for some time, upper-income individuals are driving the gains. Keep in mind that the top 20 percent of income earners account for more than 50 percent of total spending in the economy. This cohort has been thriving, nurtured by surging stock portfolios and home values. That wealth effect has been reinforced by market performance, with the S&P 500 advancing 8.1% in Q3 and nearly 18% year-over-year, while the Dow gained 5.7%. Meanwhile, lower-income households have struggled under the weight of higher prices and slower income gains. Indeed, the poorer segment of the population spends more of their budgets on items most affected by tariffs. The bottom line is that the robust gain in personal spending is masking a bifurcated consumer that could run into a wall if a market setback dings the wealth effect.

Confidence Signals and Market Fragility

Unless the government shutdown extends for weeks, its direct economic impact should remain limited. More concerning are the optics of mounting fiscal stress and political dysfunction, which are fueling questions about U.S. policy credibility. A softer dollar has become the clearest signal—seen by some as an erosion of confidence in U.S. discipline, by others as a sign of easier financial conditions. Either way, the currency's trajectory now serves as a barometer of global trust in U.S. monetary and fiscal management.

Currency markets and gold's move reflect these shifting signals. The dollar weakened in Q3, while the euro gained more than 5% year-over-year and the yen climbed nearly 3%. Gold surged nearly 17% in the quarter, reinforcing its role as a hedge against both inflation pressures and dollar weakness. Together, these moves highlight how confidence is being recalibrated globally, with investors balancing faith in U.S. policy against alternatives abroad.

Given the weak ADP report and the heightened risk that labor conditions may be weakening faster than thought, there is a good chance the Fed will cut rates at the October meeting, a preventive move that would align with its risk-management approach. The divergence underscores both the opportunities and the fragility beneath the surface of the economy's momentum—reinforcing why the Fed remains cautious and why volatility risk is rising.

U.S. Treasury Market				Total Return (%)	
	9/30/2024	6/30/2025	9/30/2025	3rd Qtr	1Yr
6 Mo Bill	4.41	4.25	3.84	1.17	4.45
2 Year Note	3.64	3.721	3.61	1.03	3.60
5 Year Note	3.56	3.798	3.74	1.18	3.16
10 Year Note	3.78	4.23	4.15	1.84	1.46
30 Year Note	4.12	4.78	4.73	2.10	-5.53

Municipal Bonds	Yield (%)			Total Return (%)	
	9/30/2024	6/30/2025	9/30/2025	3rd Qtr	1Yr
BB General Obligation Index	3.11	3.71	3.42	2.96	1.46
BB New York Bond Index	3.34	4.01	3.73	2.98	0.91
BB California Bond Index	3.10	3.79	3.44	3.15	1.40
BB Revenue Index	3.42	4.07	3.77	3.03	1.33

Equities	Levels			Total Return (%)	
	9/30/2024	6/30/2025	9/30/2025	3rd Qtr	1Yr
S&P 500	5,762	6,205	6,688	8.11	17.56
DJIA	42,330	44,095	46,398	5.67	11.50
Nikkei (Tokyo) US $	37,920	40,487	44,933	9.07	16.94

Commodities	US $			Percent Change (%)	
	9/30/2024	6/30/2025	9/30/2025	3rd Qtr	1Yr
Gold Comex Spot ($ per oz)	2,635	3,303	3,859	16.83	46.47
Commodity Futures (CRB) Index	285	297	301	1.12	5.50
W. Tx Int. Crude ($ per bbl.)	68	65	62	-4.21	-8.51

Currencies	Levels			Percent Change (%)	
	9/30/2024	6/30/2025	9/30/2025	3rd Qtr	1Yr
Yen	143.63	144.03	147.9	2.69	2.97
Sterling	1.34	1.3732	1.3446	-2.08	0.53
Euro	1.11	1.1787	1.1734	-0.45	5.38

Global Bond Markets**	Levels			US $ Terms (%)	
	9/30/2024	6/30/2025	9/30/2025	3rd Qtr	1Yr
German 10 year	2.12	2.61	2.71	0.02	4.04
Japanese 10 Year	0.85	1.43	1.64	-3.79	-7.53
UK 10 Year	4.00	4.49	4.70	-2.19	0.67
BB US Emerging Market	6.28	6.32	6.01	3.40	6.91