

# Doll's Deliberations<sup>®</sup>

## Quarterly Investment Commentary



**Bob Doll, CFA**  
PM/CIO/CEO

### 3Q market action

Equities gained again in 3Q25, as most averages hit multiple closing record highs (S&P 500 +7.79%, NASDAQ +11.24%, and Russell 2000 +12.02%). The biggest theme during the quarter was the shift in the Fed rate-cut forecast to the emergence of more dovish voices and broadening expectations for more cuts, even as inflation remained well above the Fed's 2% target. Corporate earnings for 2Q25 came in well ahead of expectations, and are expected to remain strong in 3Q. Treasuries improved with short-end yields moving lower on Fed rate-cut expectations. President Trump continued to push his trade agenda even as the geopolitical backdrop became more unsettled. AI optimism continued. Best sector performers were technology (+13.04%), communication services (+11.82%), and consumer discretionary (+9.36%); the only sector that was down was consumer staples (-2.90%). Other underperformers included real estate (+1.73%) and materials (+2.63%). As the quarter ended, a Federal government shutdown began.

### The labor market

Hiring data continue to paint a gloomy picture of the labor market. The economy produced only 22,000 net new jobs in August. The three-month moving average slipped to 29,000 from 35,000. Adding insult to injury, the benchmark revision reduced the estimate of aggregate net job gains in the 12 months through March by just over 900,000, when the consensus was looking for a little less than 700,000. Job growth is flirting with stall speed, and the August employment report reinforced our view. Since the 1960s, whenever year-over-year nonfarm payrolls growth has fallen below 1%, the economy has already been in a recession or on the cusp of entering one. Across June, July, and August, year-over-year payrolls have grown 0.97%, 0.96%, and 0.93%, respectively. The move hasn't been decisive enough to say that the series has broken through support, but it's sure testing it.

We believe the state of the labor market is critically important for consumption, and the economy will suffer an aggregate demand shortfall if it remains in a state of weakness. As anemic as job growth has been since May, it would have been considerably worse were it not for healthcare and social assistance. Those functions led the way again in August and now account for a whopping 86% of all net year-to-date additions (45% for healthcare and 41% for social assistance), five times their share of total payrolls. They have been the only game in town over the last four months, creating 249,000 net new positions, while aggregate nonfarm payrolls have only expanded by 107,000. Without them, nonfarm payrolls would have contracted for four straight months at an average rate of 36,000.

### Consumption

Though the ranges of consumption shares are narrow, consumption in the top quintile has grown slightly faster (3.3% annualized) than in the middle three quintiles (3.2%) and bottom quintile (2.9%) over the four decades covered by the Bureau of Labor Statistics' Consumer Expenditure Survey (CES). The top quintile's gains are consistent with widening income and wealth inequality – households that earn and have more can spend more – but investors shouldn't get carried away with the idea that only the wealthy can move the consumption needle.

### Earnings

Now that we have completed 3Q, optimism around 3Q earnings growth remains strong. Estimates have been revised higher throughout the quarter, now projecting an 8.8% increase, defying the historical trend of downward revisions. Seven of the 11 sectors are expected to report positive earnings growth, with four of those sectors projected to see growth in the mid-to-high teens. Technology is anticipated to be the strongest-performing sector, up 22%, while

energy remains the biggest laggard, expected to land at -5.1%. On the revenue side, growth is expected to come in at 5.7%, and excluding energy, it could be closer to 6.5%. Overall, fundamentals continue to show strength. It appears the economy may be at an inflection point, with the potential to reaccelerate from current levels, and those companies that increased prices earlier in the year could be in that much of a better position. If that's the case, the fourth quarter could finish the year on a very strong note.

## The Fed and consequences of its actions

Boosted by hopes for a significant easing of Fed policy in the coming year, as well as ongoing accommodative monetary conditions in other developed markets, global risk asset prices have remained well bid. A bull market driven by positive macro forces will continue for as long as no opposing force develops. Stretched valuations and technical conditions are not the catalyst for a trend reversal, but they impact the magnitude of the downside once a change in the backdrop appears likely, so stocks will likely remain firm until bonds protest or economic growth stumbles. (It is important to note that longer-dated bonds have sold off since the Fed cut rates.)

In view of the sizable gains in almost all risk-asset markets in recent years, it remains clear that monetary conditions were never restrictive, in contrast with the belief of central bankers. Monetary policy, in fact, has become steadily more accommodative in the past year. While global economic data have ebbed and flowed, corporate profits have risen steadily, underscoring that it was premature to bet on a recession.

Plentiful liquidity has sustained historically rapid asset-price inflation. The investment loser this decade has been government bond markets, down relative to inflation and versus cash returns. Government bond yields have tracked sideways this year at levels that are not constraining corporate profits and, thus, the economic expansion.

Gold prices have been rising due to a variety of factors, including plentiful liquidity, a deteriorating geopolitical backdrop, an erosion in the inflation credibility of central banks, and a weaker U.S. dollar. The last time gold prices soared in such an open-ended fashion was in the late 1970s, when inflation was out of control and faith in government institutions had declined significantly.

High-flying U.S. AI and related stocks are extended, with valuations only ever seen during the tech boom of the late 1990s. Today's fundamentals appear constructive, but extrapolating ever-higher sales and profits eventually becomes dangerous. To have stood aside in 1999 and missed out on the last upleg in tech stocks might have felt foolish at the time, but it paid off when the bubble burst.

The consensus is that the Fed has already more or less committed to easing once or twice more this year, almost regardless of incoming economic data. At some point, the window to ease will close due to stickier-than-expected inflation. More accommodative monetary conditions and upcoming fiscal stimulus should more than offset tariff-related drags in 2026. Rate-cut expectations for 2026 will unwind if our economic/inflation view pans out.

## The path forward

It is always easier when markets are going up. Indeed, it is difficult to poke holes in the bull case; the path of least resistance is likely higher, but we find ourselves increasingly worried that traditional risk assets (stocks and bonds) appear priced for perfection. Prevailing equity valuations are in the top decile of their historical range and corporate credit spreads are the best in a generation. Perhaps an air of complacency has crept into investors' outlook. It is time to remain vigilant. Policy uncertainty has arguably been reduced on tax and tariff clarity but the implementation considerations are still working through the system. Inflation remains sticky. A one-time tariff-related shift? Perhaps.

Political pressure aside, the Fed will want to remain vigilant as well. Growth in the U.S. economy has moderated but is not in a position to need emergency support. Profit growth has been strong, re-accelerating from downward revisions related to so-called Liberation Day. The outlook for earnings remains strong. Technology and financials have seen notable upward revision, while industrial and healthcare have seen downward revisions. The AI capex narrative has recaptured investors' attention, and the mega cap names have responded. AI remains an important theme for the economy. We remain neutral U.S. equities, however – happy to ride the momentum, but mindful that the market's disregard for prevailing multiples could turn on a dime.

The elephant in the room

A long-standing concern remains the deficits of the U.S. federal government. Debt has swelled to \$37 trillion, is on track to hit \$52 trillion within 10 years, and more than \$100 trillion by 2055. Elon Musk says America’s ballooning deficit is the “biggest threat by far.” Warren Buffet calls it a “looming fiscal cliff.” Ray Dalio warns that debt spirals have destroyed past empires. One WAG said, “That’s not a forecast; it’s a nightmare.”

Consensus thinking

1. Economy sails through just fine and Fed eases.

Risk: Core GDP/final sales slow noticeably, making the Fed too late.

2. Inflation is mostly tariffs and will fade early 2026.

Risk: Inflation remains 3%-ish, not slowing to 2% without a recession.

3. Tech/AI create a sustainable secular story.

Risk: Tech suffers cyclically, bringing valuation down.

A high-risk bull market

We believe we are in a “high-risk bull market.” Bull market means you have to participate, as the path of least resistance is higher. High risk means be careful what you own. Here is a list of some of the positives and negatives to buttress these assertions:

	Positives	Negatives
1	Earnings are very good.	Valuations are elevated.
2	The Fed has begun lowering rates.	Inflation remains sticky.
3	AI and other productivity factors are boosting profit margins.	The tariff impact on growth and inflation is concerning.
4	Sentiment is neutral at worst.	Job growth has slowed noticeably.
5	Credit markets are signaling a strong economy.	Consumer spending has weakened noticeably down income cohorts.
6	There is more clarity around tariffs.	Speculation has increased (margin debt, IPO activity, return of SPACs).
7	Cash flow and dividend growth are improving.	Tensions are escalating between Russia and the U.S./NATO, the U.S. and China, etc.

We are focusing on companies with below-benchmark price-to-free-cash-flow and above-benchmark return on equity.

Conclusion

High valuations and extreme market concentration have prompted companies to a dot.com bubble level, but key differences exist. Unlike the late 1990s, today’s growth stocks are delivering robust earnings growth, strong profit margins, good cash flow, and are returning capital to shareholders. While elevated valuations and crowded trades may signal risk, a sizable correction is more likely to be triggered by macroeconomic weakness than by valuation alone.

It is hard to justify the resumption of a Fed rate-cutting cycle when the U.S. economic expansion is durable and growth is above potential, the labor market remains tight and is leading to wage gains, and inflation remains well above target. While the upside case for stocks is getting increasingly difficult to make, downside risk is rarely realized when earnings are advancing and the Fed is easing.

Sources: BCA, MRB, Strategas, Stifel, Crossmark

## 10 Predictions for 2025: Review and update (4Q 2025)

### Introduction (written December 2024)

Investors continue to enjoy the bull market, but remain somewhat nervous about valuation. Policy uncertainty is higher than usual, in part because there are so many policy changes at the same time. Donald Trump campaigned on a mix of policies that are both economy-supportive (tax cuts and deregulation) and economy-disruptive or negative (tariffs and deportation). As a result, the election outcome has created fatter tails for the U.S. economy. It is possible that a mix of pro-growth and disruption policies will occur simultaneously and/or the administration will toggle back and forth, thereby heightening uncertainty as well as economic and financial market volatility. The main policy downside risks are related to trade and immigration policies. This could be negative for growth and push up inflation. That could lead to the Fed ceasing the cutting cycle and potentially even restarting rate increases, putting upward pressure on bond yields and negative pressure on stock valuation. Trump 2.0 may drive higher uncertainty around inflation and deficit risks. Immigration and tariffs may be inflationary, but corporate tax cuts are disinflationary as benefits get passed onto the consumer. Lower oil prices from increased energy production could also help. Lighter regulations will be positive for financials (especially banks), which now have relatively strong balance sheets and are focused on cash returns and potential loan growth. A pickup in merger-and-acquisition activity may occur with lessened regulatory scrutiny.

#### Key:



Heading in the right direction



Heading in the wrong direction



Too soon or too close to call

1 ?	<b>Economic growth slows as the unemployment rate rises past 4.5%.</b> As goes the labor market, so goes consumer spending. And as goes consumer spending, so goes the economy. Consumer spending is holding up due to the wealth effect (both stocks and housing), the absence of significant labor market weakness, and the promise of a stimulative tax bill. However, there is evidence that low-income consumers are curbing spending. We still expect the unemployment rate to inch up to 4.5% before year-end.
2 ?	<b>Inflation remains sticky, fails to reach the Fed's 2% target, and causes Fed funds rate to fall less than expected again.</b> Inflation is generally moving away from the Fed's 2% target. There is evidence that tariffs have impacted the inflation rates. A 2% inflation rate (Fed target) remains unlikely absent a recession (the probability of which has declined). The consensus still anticipates two more Fed cuts before year-end. While economic weakness could make that possible, cutting rates while inflation remains sticky (or rises) has its opponents. We guess only one more rate cut this year (which would make this prediction accurate). Certainly, the administration will continue to put pressure on Chairman Powell and the Fed to lower rates.
3 ?	<b>10-year Treasury yields trade primarily between 4% and 5% as credit spreads widen.</b> As we write, the 10-year Treasury yield has moved up from its recent low of 4% to 4.2%. We expect a 4-4.5% range for the balance of this year. The quality spread part of this prediction remains uncertain. Credit spreads rose a bit during the tariff concern days but have narrowed again as those concerns have lessened. An economic slowdown (which is our assumption) is probably a necessary condition for that half of the prediction to be realized.
4 ✓	<b>Earnings fail to achieve consensus a) 14% growth and b) every sector has up earnings.</b> While earnings have remained reasonably solid, the 14% growth expected on Jan. 1 is not possible. Profit margins can generally expand if topline growth is double-digit. But the revenue growth slowdown could even put negative pressure on margins. In terms of the second half of the prediction, earnings estimates for energy and several other sectors have turned from positive to negative for the full year.
5 ✓	<b>Equity volatility rises (VIX average approaches 20 for only the third year in 14).</b> While volatility has calmed noticeably, confusion and uncertainty have wreaked havoc from time to time on investors. Uncertainties related to a potential government shutdown, a myriad of geopolitical hot spots, inflation stubbornness, and economic and Fed uncertainties are fodder for potential additional volatility.

6 ?	<b>Stocks experience a 10% correction as stocks fail to keep up with earnings (i.e., P/Es contract).</b> As we know, the market corrected nearly 20% rather abruptly around the tariff noise. The rebound to all-time highs was almost as furious. The race between earnings gains and stock market gains continues (will P/E's have contracted or exploded this year?). Nevertheless, relative to history, multiples still remain high. As we note in our essay, the risk-reward from current levels does not appear favorable. Having said that, the "high risk" bull market we believe we are in could continue.
7 X	<b>Equal-weighted portfolios beat cap-weighted portfolios (average manager beats index), and value beats growth.</b> We looked like geniuses on this prediction at the end of the first quarter. By June 30, it was a flip of a coin. Now, we are behind on both parts of this prediction as large and mega cap growth stocks have powered higher at the expense of the average stock.
8 X	<b>Financials, energy, and consumer staples outperform healthcare, technology, and industrials.</b> Similar to prediction #7, our sector call looked like a sure winner on March 31 and was nip and tuck by June 30. Here at Sept. 30, we are behind (hopefully, not hopelessly). Technology and industrial stocks have come on strong at the expense of energy and consumer staples.
9 ?	<b>Congress passes the Trump tax-cut extension, reduces regulation, but tariffs and deportation are less than expected.</b> Scoring this one at year end may be difficult. It is true that the tax extension (passed during the summer) will likely spare the U.S. economy of an almost assured recession (if bill hasn't passed) and regulation has been reduced at nearly every turn. The strength of the tariff and deportation puts an accurate prediction in question. A candidate for a half correct?
10 ✓	<b>DOGE efforts make progress but fall woefully short of \$2 trillion per year of savings.</b> The retreat of Elon Musk and the sheer magnitude of the hoped-for cuts make this prediction a nearly definite "correct." Ring-fencing so many parts of the budget (e.g., entitlement programs) made even a trillion dollars of savings nearly impossible. As we continue to state, the ONLY way to begin to solve the increasingly acute debt and deficit problem is to tackle the entitlement programs – that, at the moment, comes with political suicide!

Final Tally:

✓ 3

X 2

? 5

In summary (written December 2024)

U.S. equities should remain supported by continued economic expansion and earnings growth, ongoing easing by global central banks and a likely 1Q wind down of the Fed's quantitative tightening. Consumers are largely flush with cash and record wealth, although there is evidence of fraying at the low end and some mid-level consumers. The Fed is in easing mode, but will likely dial its dovish intent down in 2025 due to sticky inflation, with potential upside risks due to continued economic growth and trade/tariff issues. The stock market is already pricing in an optimistic backdrop and carries high valuations creating risks as we enter 2025. An early-in-the-new-year 5-10% pullback is possible (if not probable) given the sharp gains, froth in sentiment, and stretched valuations, leaving the market vulnerable to bad news or simply in need of consolidation. Note that stocks tend to be strong in November/December, but weaker in January/February.

Crossmark Global Investments Inc. (Crossmark) is an investment adviser registered with the Securities and Exchange Commission that provides discretionary investment management services to mutual funds, institutions, and individual clients. Information and recommendations contained in market commentaries and writings are of a general nature and are not intended to be construed as investment, tax or legal advice. Investment advice can be provided only after the delivery of Crossmark's firm Brochure and Brochure Supplement (Form ADV Parts 2A and 2B) and Form CRS, and once a properly executed investment advisory agreement has been entered into by the client.

All investments are subject to risks, including the possible loss of principal. Past performance is no guarantee of future results.

These materials reflect the opinion of Crossmark on the date of production and are subject to change at any time without notice. Where data is presented that was prepared by third parties, the source of the data will be cited, and we have determined these sources to be generally reliable. However, Crossmark does not warrant the accuracy of the information presented.

Not FDIC Insured — No Bank Guarantee — May Lose Value