

Re: “The World is a Mess. Markets Are Ignoring Those Risks – for Now.”

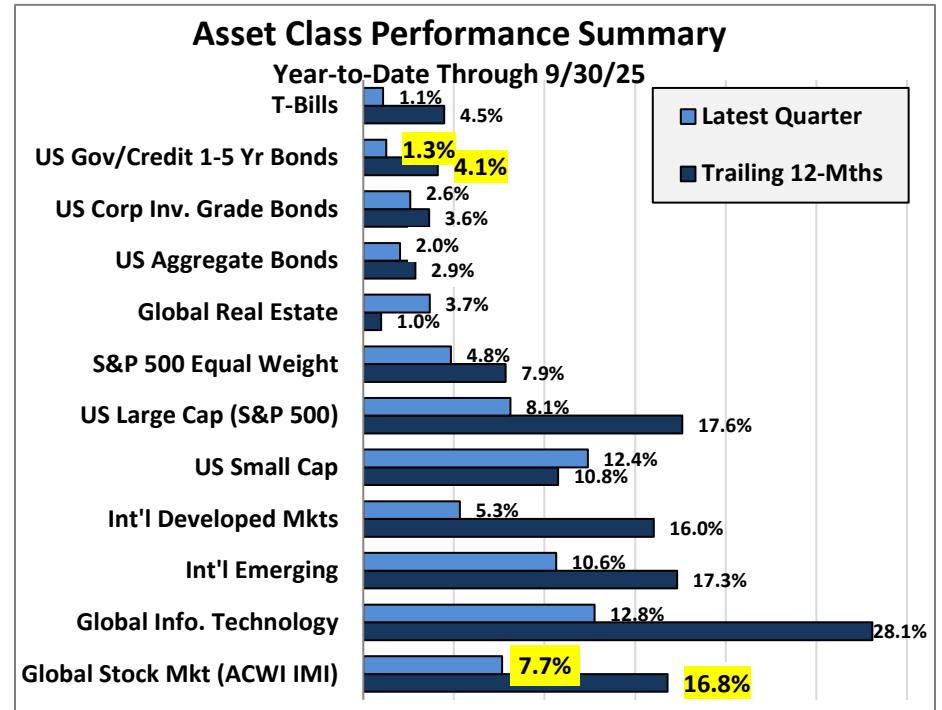
*Warmer
in your Team!*

The above quote is the title of an article from the September 12th edition of *Up and Down Wall Street* in *Barron’s Advisor* written by Randall W. Forsyth. It reflects the puzzlement by many who are wondering why the stock market has seemed to defy gravity in the face of political and economic turmoil in the U.S. and around the globe. Forsyth suggests the reason might be that which President Calvin Coolidge observed when describing the U.S. economy in 2025 when he said, “...the chief business of the American people is business. They [consumers and business] are profoundly concerned with producing, buying, selling, investing and prospering in the world. I am strongly of opinion that the great majority of people will always find these are moving impulses of our life.” In other words, consumers and businesses will find ways to adapt to changing circumstances and uncertainties. For consumers, it’s mostly about earning a living and spending to meet their needs and goals, and for businesses, it’s all about meeting customer demand and growing their earnings to maintain profitability. These economic forces work together to drive the global economy which, by most measures, remains in an expansionary mode, albeit perhaps at a decelerating rate.

In this quarterly letter, we will discuss the current attitudes of U.S. consumers and their spending which generates close to 70% of GDP. We will also review some of the major risks to the economy and for investors as we look ahead, including the extreme level of stock market concentration. First, we will review the recent performance of the investment markets which has been surprisingly favorable despite all of the turmoil over the past twelve months.

Asset Class Performance

Looking at the performance for the latest quarter ending September 30th, every major asset class posted positive results. The Global Stock Market gained 7.7% for the period with U.S. Gov’t/Credit 1-5 Year Bonds gaining 1.3%. Leading the way was the Global Information Technology Index (+12.8%) which to a large extent reflects investor interest in companies involved in the development of Artificial Intelligence (AI). The largest three components of the index are Nvidia, Apple and Microsoft, which together comprise more than 50% of the Global Technology Index. In close second place was U.S. Small Cap Stocks (+12.4%) which is a healthy indicator of expanding stock market “breadth” given that U.S.



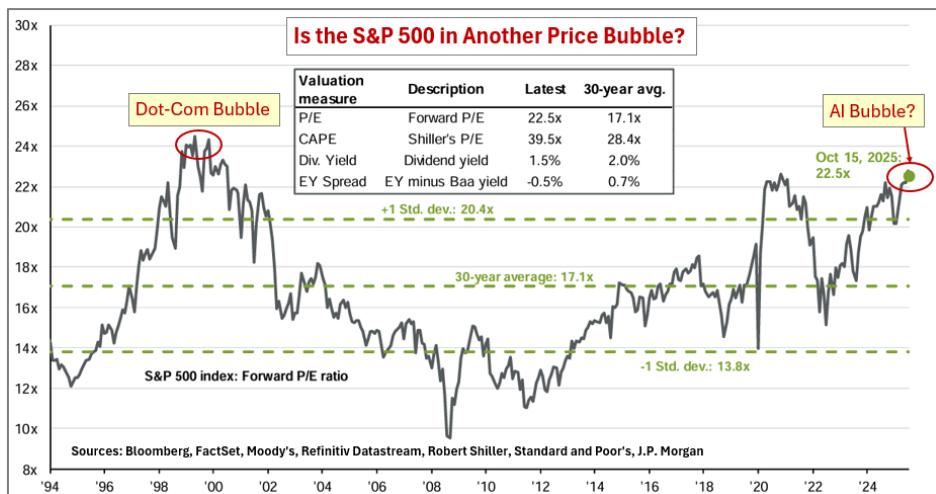
Large Cap Growth stocks dominated the performance charts for the last decade. The returns for the other stock asset classes ranged from 3.7% (Global Real Estate) to 10.6% (Int’l Emerging Markets). The market cap-weighted S&P 500 Index (U.S. Large Caps) gained 8.1% compared to the S&P 500 Equal Weighted Index which gained 4.8%. This performance discrepancy highlights the impact of the index’s largest companies (more on Concentration Risk later in this report). Within Fixed Assets, the returns ranged from 1.1% (U.S. T-Bills) to 2.6% (U.S. Investment Grade Bonds).

For the trailing 12-month period ending September 30th, the Global Stock Market gained 16.8% and U.S. Gov’t/Credit 1-5 Year Bonds gained 4.1%. Leading the way, once again, was the Global Information Technology Index (+28.1%). For the other stock asset classes, the returns ranged from +1% (Global Real Estate) to +17.6% (U.S. Large Cap Stocks). The returns for non-U.S. stocks were favorable as well in both the Emerging Markets (+17.3%) and the Developed Markets (+16%). Within Fixed Assets, the returns ranged from 2.9% (U.S. Aggregate

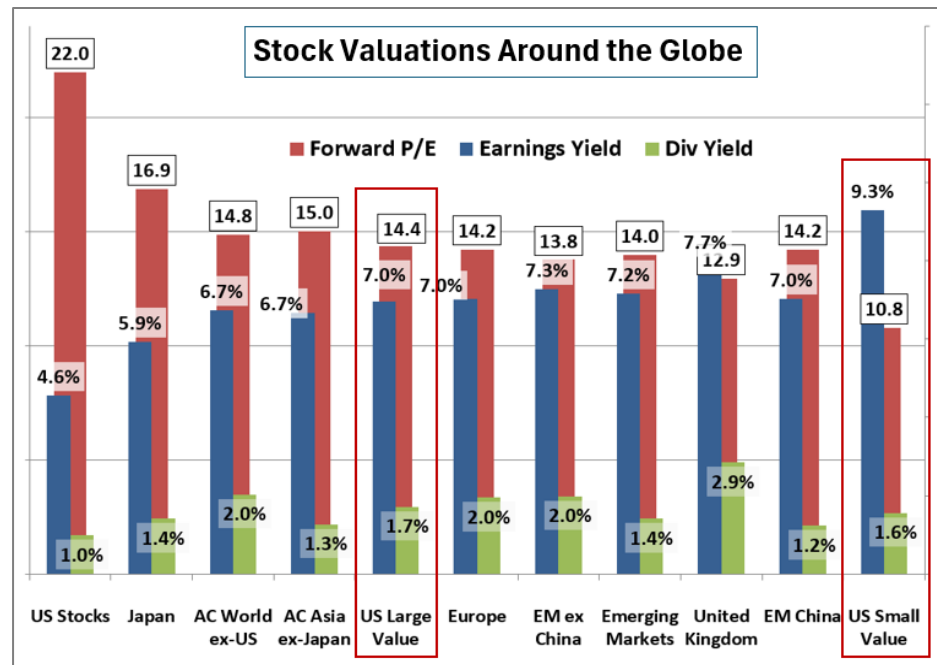
Bonds) to 4.5% (U.S. T-Bills). All in all, a great twelve months for the investment markets across the board.

Stock Market Valuations

One of the greatest concerns expressed by many investors and strategists is about the high prices of stocks relative to their earnings and the possibility of a significant price correction. Some market observers are referring to this as another stock market bubble driven by an Artificial Intelligence frenzy with parallels to the Year 2000 “Dot-Com” Bubble when the prices of internet-related stocks reached unsustainably high levels and subsequently collapsed. In the chart below, note the current Price-to-Earnings Ratio (P/E) of the S&P 500 today compared to the year 2000. While not at the same extreme level, it’s getting close. And although history might not exactly repeat itself, it does tend to rhyme, and we should take heed of some of the lessons learned in the past (partial thanks to Mark Twain for that message). Following the stock market’s peak in March of 2000, the S&P 500 Index fell by more than 40% before bottoming in October of 2002. The NASDAQ Index, comprised largely of technology stocks, plummeted by



more than 70% during this same time period. However, in 2000 not every stock in the U.S. stock market was in a price bubble. U.S. Large Value stocks and Small Cap Value stocks - having been left behind during the late 90s tech stock run-up - were priced more closely in line with their normal valuation levels, and the impact of the Dot-Com stock market crash was not nearly as severe. For example, U.S. Large Cap Value and U.S. Small Cap Value stocks had *positive returns* of 8% and 13% respectively between March of 2000 and October of 2002.



Today we see an arguably similar picture to what we saw in 2000 where U.S. Large Value and U.S. Small Value stocks appear to be priced at valuation levels which are more closely aligned with their historic averages. In the chart at the top right of the page note that U.S. Small Value stocks, for example, have a Forward P/E Ratio of just under 11 which is attractive not only in comparison to the broader U.S. stock market (P/E of 22), but also compared to non-U.S. stocks which are about 35% less expensive on average than the broad U.S. stock market. In summary, while there may arguably be a bubble within the S&P 500 Index (particularly within the AI-related components of the index), there are many asset classes in the U.S. and overseas where valuations are much more reasonable and down to earth.

How does all of this matter to investors? The two most reliable methods for predicting long-term future returns are (1) the Forward P/E Ratio and (2) the Robert Shiller CAPE 10 Ratio. The chart above utilizes the Forward P/E Ratio which when converted to an Earnings Yield (i.e., Earnings divided by Price) provides an important clue about future performance. The Earnings Yield for the U.S. stock market (about 3000 stocks) is 4.6% which is one indicator of future annualized performance. Within the broad U.S. stock market is the S&P 500 Index (500 stocks) with an earnings yield of just 3.3% compared to its historic median of 6.6%. This is a strong indicator that U.S. Large Cap stocks will underperform their historic average return in the near future. At the other end of the spectrum are U.S. Small Value stocks which have a current Earnings Yield of

9.3% which implies comparatively favorable returns in the future. They were also attractively priced at the peak of the Dot-Com bubble in 2000, so we see a similar opportunity today as we did in 2000. The average Earnings Yield of non-U.S. stocks (MSCI ACWI-ex U.S.) is 6.7% which implies potentially higher returns from non-U.S. stocks as well.

**10-Year Future Annual Rate of Return Forecasts
as of 9/30/2025**

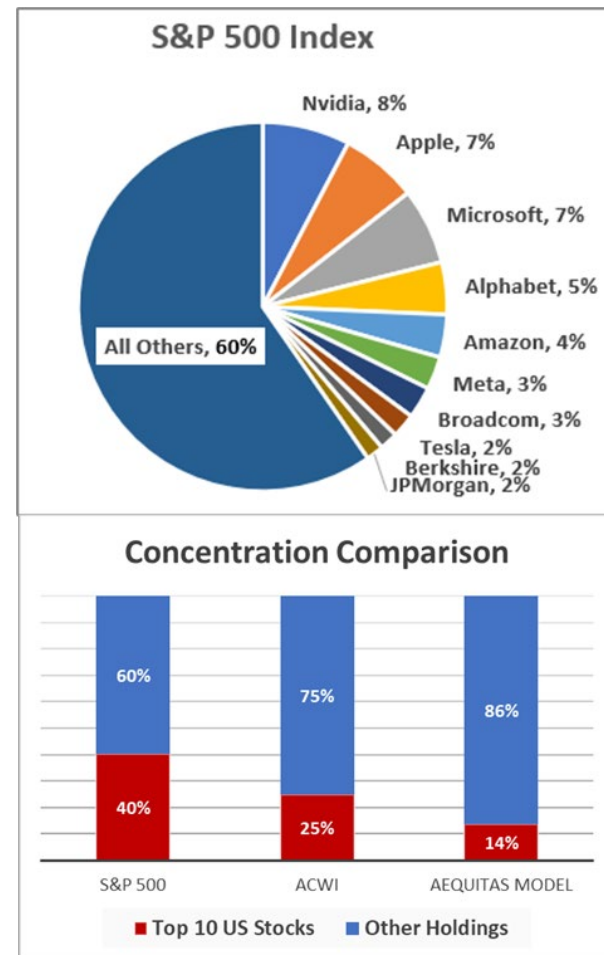
	10 Year "Expected" Return	Risk Level (Standard Deviation)
Equities		
US Small Cap Value	8.7%	19.3%
Non-US Developed Markets	8.0%	19.6%
Emerging Markets	8.0%	16.1%
Global Equities Mix	6.4%	15.9%
US Small Cap Growth	6.0%	22.4%
US Large Cap Value	4.2%	15.1%
US Large Cap (S&P 500)	3.2%	15.1%
US Large Cap Growth	1.5%	17.2%
Fixed Assets		
Diversified Bonds	4.7%	2.6%
Cash (Money Market Funds)	3.6%	0.7%
Balanced Portfolios		
20% Fixed - 80% Equities	6.2%	12.9%
40% Fixed - 60% Equities	6.0%	9.9%
50% Fixed - 50% Equities	5.8%	8.5%
60% Fixed - 40% Equities	5.7%	7.0%
Inflation	2.6%	NA

In the chart to the left, we've summarized the expected 10-year future returns for various asset classes, including bonds and stocks which were compiled by Research Affiliates (RA), a globally recognized investment advisory and research firm. A core component of RA's calculations is the Shiller CAPE 10 Ratio which has been slightly more accurate at predicting future returns than the Forward P/E Ratio (in 2013, Robert Shiller, an economist at Yale, and Gene Fama, a director of Dimensional Fund Advisors, were awarded Nobel Prizes in Economics for their separate research on stock market returns). History has demonstrated that when the CAPE 10 P/E Ratio is high, as it was in 2000, future returns tend to be low and vice versa. Given its very high valuation level today, the expected average annual return for the S&P 500 is 3.2% over the next 10 years which is comparable to its Earnings Yield of 3.3%. U.S. Small Cap Value stocks are expected to provide investors with an average annual return of 8.7% based upon RA's calculations which is also comparable to their Earnings Yield of 9.3%.

Concentration Risk

Based upon past experience, we believe that by underweighting those stock asset classes with lower rate of return expectations and overweighting those with more favorable future expectations, we can achieve a more successful investment outcome over the long term for our clients. One of the primary reasons why U.S. Large Cap stocks, including the overlapping U.S. Large Growth category, have a

less favorable outlook is due to their extreme level of concentration in a handful of companies which generally have very high prices relative to their earnings (remember that when stock prices reached extremely high levels in the past, i.e., the year 2000, subsequent returns were low). In the pie chart to the right, note that the top ten companies comprise 40% of the S&P 500's market capitalization which is a record high. While these top ten companies have been highly profitable and are likely to remain so, their prices appear to be unsustainably high based upon most valuation measures. To reduce this concentration risk, our current model portfolio diversifies across a much broader array of stocks within the U.S. as well as overseas. In the bar chart to the right, note that our current model portfolio has just 14% invested in the largest ten U.S. companies which means that 86% of our model's portfolio is invested in stock asset classes which generally have higher future rate of return expectations.



Corporate Earnings Remain Positive

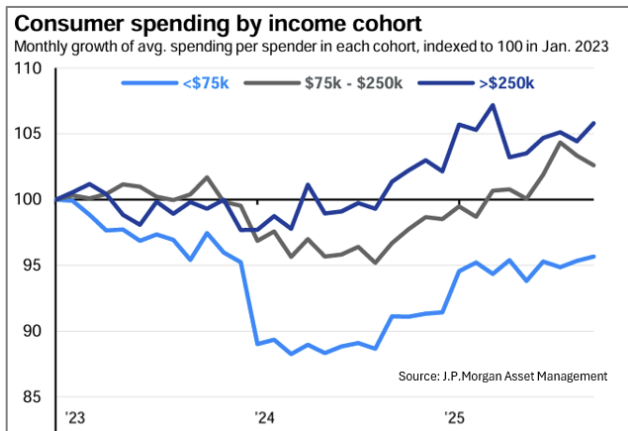
Corporate earnings are a primary driver of stock prices and when earnings are rising, as they are currently, stock prices tend to rise as long as earnings meet expectations (failing to meet expectations is typically when stock prices fall). According to the latest information from Yardeni Research, despite the headwinds from tariffs and geopolitics, corporate earnings reports are exceeding Wall Street's estimates and are expected to grow at double-digit rates for the next several quarters. This should be supportive of stock prices, at least for the short term. And while the labor market is showing signs of weakness, the Federal

Reserve's anticipated interest rate cuts may help to offset the negative impact of a slowing economy.

Consumer Spending is Running at Two Speeds

Consumer spending is a primary driver of overall economic growth accounting for about 70% of our nation's GDP. Strong consumer spending helps drive corporate earnings, which in turn helps drive stock prices higher. Currently, according to investment commentary from James Liu, CEO of Clearnomics, consumers in the upper-income levels are exhibiting relatively strong spending

patterns while consumers at the lower level are struggling. Liu refers to this bifurcation as a "two-speed" economy. According to Liu, "In practice, this means that while wealthier households continue to spend freely, many others are pulling back, creating very different experiences of the same economic environment."



Assigning numbers to the chart above, income levels of \$250K or higher represent about 10% of U.S. households. According to Moody's Analytics, the top 10% accounts for close to 50% of all consumer spending (talk about concentration risk!). They also own about 87% of the entire household stock market holdings according to the Federal Reserve. Clearly, the top 10% of households are feeling pretty good and they are driving a disproportionate share of overall consumer spending. At the other end of the spectrum, income levels of \$75K or less comprise about 50% of the household population and they are struggling under the weight of persistently high consumer prices, the impact of tariffs, sluggish wage growth and diminishing job prospects. (This growing wealth gap is clearly unsustainable and threatens our nation's social and economic development. Unfortunately, we see far too little effort in Washington to address this critical economic disparity.)

The Global Economy

The International Monetary Fund (IMF) recently published its latest economic outlook entitled, "Global Economy in Flux, Prospects Remain Dim". Their last

forecast was in April at the height of the tariff turmoil following the "Liberation Day" announcements. The good news is that the negative impact of the tariff turmoil has not been as severe as feared, although the IMF stipulates that the full impact of tariffs has yet to be absorbed. The bad news is that trade tensions are still "casting a shadow over the global economy". And while their forecast for global economic growth in 2026 remains positive (projected growth of 3.1% next year versus 3.2% in 2025), there are risks to the outlook, including reduced labor supply in the U.S. due to deportations and an aging population, the AI boom driving up stock prices paralleling the Dot-Com boom, rising government debt levels which may lead to higher interest rates to finance future borrowing, and increasing political pressure on policy setting institutions (e.g., the Federal Reserve) which may reduce their credibility and effectiveness. Despite these risks, once the trade picture stabilizes and greater certainty is achieved, the IMF suggests that the economic outlook might improve. In the meantime, however, the IMF's managing director, Kristalina Georgieva, advises us to "buckle up" given that uncertainty may remain the new normal.

The New Safe-Haven Assets?

A recent *Barron's* article entitled, "Move Over, Treasuries. These Are the New Safe Assets," opened with the following three questions: "Whom would you rather lend money to? Somebody perpetually losing money and deep in hock? Or someone who is consistently profitable and has a substantial net worth?" Or put another way, would you rather invest in U.S. government securities or in high-quality corporate bonds? Of course, while the U.S. government is deep in debt, it still has the power to tax as well as the ability to effectively print money to meet its obligations. Even the most profitable corporation doesn't have taxing power or the ability to print money. Nonetheless, given the rising level of federal debt, the U.S. government lost its last triple-A credit rating from Moody's earlier this year (Standard and Poor's and Fitch downgraded the U.S. government's credit rating in 2011 and 2023 respectively). Moody's cited concerns about the growing burden of financing the federal government's budget deficit and the rising cost of rolling over existing debt. Currently, 18% of government revenue is required to pay just the interest on the national debt and Moody's expects this to increase to 30% by 2035. And while no one expects the government to default on its debt obligations, the markets have begun pricing U.S. Treasury securities closer to high-quality corporate bonds which suggests some skepticism about the U.S. government's creditworthiness.

Recently, our investment committee approved the addition of a new global bond fund to provide additional diversification and reduce the allocation to U.S. Treasuries. The new fund is the DFA Core Plus Fixed Income Fund (DGCFX) which invests in both U.S. and non-U.S. bonds, including corporate and

government bonds. Currently about 45% of the portfolio is invested in U.S. and 55% outside of the U.S. The new fund is hedged to the US dollar, which will help reduce the impact of international currency volatility while providing increased diversification. Currently, over 96% of the holdings in the recommended fund are designated as high-quality (investment-grade and above).

DFA incorporates internal and external metrics to help identify the risk characteristics of the bonds which the fund purchases. This allows the managers to determine if an individual bond actually demonstrates high-quality characteristics based on market activity and other pricing factors rather than purely on credit ratings agencies. We believe the addition of this new fund will accomplish the following:

- Reduce concentration risk in US Treasuries
- Enhance portfolio diversification across global fixed income markets
- Maintain desirable duration and credit quality characteristics
- Potentially improve long-term risk-adjusted returns

Closing Thoughts

I met David Booth, the Founder and Chairman of Dimensional Fund Advisors (DFA), at a lunch meeting with several other investment advisors in Boston in the late 1980s. I was impressed with DFA’s philosophical approach which was and continues to be based upon sound academic research as well as their evidenced-based approach to investment management. When Aequis was founded in 1991, we utilized several DFA funds in our original portfolio models which has only expanded over time given their successful performance results. This past summer, David Booth wrote an article entitled, “The Power of Human Ingenuity”, which I will share below. In many respects, David’s message about the human spirit is similar to the words spoken by Calvin Coolidge 100 years ago!

“It’s an unstoppable optimism that leads to innovation. Human ingenuity powers the market—the many thousands of companies around the world, employing millions of people, each finding new ways to move us forward. The stock market provides the best mechanism I know of to process information, set fair prices, and allow investors to benefit from society’s collective endeavors.



The year 2020 was a particularly striking example of this. As COVID spread around the world, stocks crashed, with the S&P 500 falling 34% in

less than five weeks. But businesses got to work: on treating the virus, serving people stuck at home, and eventually finding a vaccine. By the end of December the S&P 500 had recovered its losses and then some, up 18% for 2020, showing that markets can rise even through times of global distress.

There are always plenty of surprises and fluctuations along the way. Individual stocks and sectors go up and down based on current events, earnings reports, and shifting consumer sentiment. But zoom out and the big picture becomes clear: Over the past century, the US stock market has consistently risen, returning on average about 10% a year. This is why I have unwavering faith in markets. By owning a broad slice of global markets, we can participate in the upside of human problem-solving and innovation as it takes place across a vast array of companies and the untold number of ideas their employees develop.

Whatever the difficulties, people find ways to adapt, create, and move forward. Markets reflect this reality, and investors harness the power of markets by staying disciplined, diversifying globally, minimizing costs, balancing risks, and pursuing higher expected returns. Those are timeless principles that don’t depend on predictions or guesswork—they simply allow everyone to participate in the rewards of human creativity and resilience.”

