

Economic & Market Update

Fourth Quarter 2025 Outlook



WORLD ECONOMY

- » Bearish economists and investors have been surprised, and perhaps frustrated, by the resilience of the U.S. economy. The ultimate effect of tariffs and previously restrictive monetary policy remains to be seen, but in the second quarter, U.S. gross domestic product (GDP) rose 3.8%, led by a 2.5% advance in consumer spending and a large drop in imports as businesses front-loaded inventory in the first quarter in anticipation of new tariff announcements. The strong second quarter growth was basically a recovery from the slightly negative first quarter, leaving growth in the first half of 2025 at roughly the long-term trend growth rate of 2.0%. Third-quarter GDP will be released at the end of October, and indications are for the momentum to continue, with the Atlanta Fed's GDPNow forecast of +3.9% at the end of the quarter. Consumer spending should remain healthy, driven primarily by higher wages and the wealth effect beginning to be seen among the upper-income portion of the population who have benefited greatly from appreciation in their financial assets and real estate portfolios. Capital spending, particularly on intellectual property investments, should also be a notable growth contributor as investment in equipment and software to run artificial intelligence (AI) applications will be needed to offset slower expected growth in the labor force. A tangential AI investment spend is also occurring in the power generation and data center spaces.
- » Looking at the fourth quarter, overall economic growth is expected to slow closer to the 2.0% trend level, as consumers begin to feel the effect of tariffs and still-tight monetary policy which should impact employment growth. The long-term secular growth theme of AI should drive capital spending higher, as companies look to productivity growth as an important offset to anticipated higher labor costs from slower population growth and more restrictive immigration policies. Fewer imports because of tariffs may also add incremental growth in the quarter while the housing sector is still trying to find a bottom in its recession. Government spending should be mildly contractive as federal government payrolls continue to decline.
- » The economic impact of tariffs is likely to be more severe on the regions and countries where trade is a bigger part of GDP. While avoiding recession, the European economy is only expected to grow about half as fast as the United States in the fourth quarter, though we've seen some incremental upward adjustment to GDP growth estimates. Some European governments have pledged to increase spending on infrastructure and defense. Germany has apparently accepted the challenge to increase its contribution to the NATO alliance by uncharacteristically allowing its fiscal deficit to increase as a percentage of its GDP. Aggressive monetary ease over the past year from the European Central Bank (ECB) should be another tailwind to growth.
- » In Asia, Japan's growth is expected to slow to just under 1.0% for the final quarter of the year, with this level of growth continuing

into 2026. The effect of U.S. tariffs on the Japanese economy will be the primary growth restraint, but higher interest rates at the longer end of the yield curve will be another source of pressure on this heavily indebted nation. The Chinese government appears committed to achieving its 5% GDP growth target even if it means worsening overcapacity in certain industries. It will likely soon understand the futility of such a goal if it is not driven primarily by domestic demand. Tariffs will likely slow export growth while the continued hangover from the property recession will dampen middle class spending.



MONETARY POLICY

- » The Federal Reserve (Fed) has developed a more distinct dovish bias over the past few months as employment growth has slowed and the apparently strong growth numbers from the last year were revised sharply lower. Since last quarter, a new Fed governor has been added who believes current policy is much too restrictive. In addition to the recent 25 basis-points (bps) cut in the federal funds rate coming out of the September Federal Open Market Committee meeting, two more 25-bps cuts are likely at both the October and December meetings. Unless inflation remains stubbornly above the target with no signs of movement toward it, we anticipate more cuts in 2026 for a terminal federal funds rate of roughly 3.00%.
- » Having gotten off to an earlier start than the Fed, the ECB appears to have completed its easing program, landing at 2.00% for its key policy rate. With inflation hovering near its 2.0% target, the ECB is probably watching for any tariff-related weakness to determine if it needs to cut rates even further. The Bank of England remains concerned about stickiness in the inflation rate, so it held rates steady in its most recent meeting after having cut by 75 bps year to date. The contractionary impact of tariffs should lead to one more cut over the remainder of the year.

- » By contrast, the Bank of Japan (BOJ) remains reluctant to raise its key policy rate despite inflation having risen above its 2% target for a while now. Its policy-setting committee is concerned about below-trend economic growth as tariffs slow exports. It has finally begun the process of gradually reducing its balance sheet through the periodic sale of government bonds and the real estate investment trusts and equity exchange-traded funds it has accumulated over the years. It appears the central bank will continue to move cautiously based on slower-than-anticipated growth, which is likely to restrain inflation.
- » The People's Bank of China is also moving slowly in easing monetary policy as it remains caught between stability in its currency and inflation, which can be difficult to control as productivity growth falters.



BOND MARKETS

- » Current and prospective monetary easing drove a shift down in Treasury yields during the third quarter despite surprisingly strong economic growth and lingering supply pressures. Some steepening of the yield curve occurred as 3-month Treasury bill yields fell more than the 10- and 30-year maturities, as the longest curve inversion in U.S. history slowly fades away without leading to a recession. Unlike what is being seen in the bond markets of high-deficit countries of the United Kingdom, France, and Japan, demand for U.S. Treasuries, among both domestic and international purchasers, remained strong during the quarter. Treasury manipulation of issuance by weighing more to the short maturities has helped alleviate supply concerns at the longer end of the curve, but the United States is still viewed as an attractive bond market regardless of the rancorous political divides and the apparent lack of will in each political party to address burgeoning deficits.

- » Market participants are eagerly anticipating the upcoming Supreme Court decision on the fate of tariff revenue, which has become important in replacing lost tax revenue from the recently passed budget legislation. The 10-year Treasury yield may have trouble breaking below the 4.00% level until investors and traders get a clearer picture of budget deficit dynamics. Continued steepening of the curve is the likely outcome as the Fed eases policy in an economy growing at its trend growth rate.
- » The strength of the economy continues to be reflected in high-yield bond spreads continuing to trade near record lows. Investment-grade yields have also remained narrow as bond investors discern little near-term credit risk. A surge in issuance of municipal bonds in anticipation of a possible loss or limitation of interest exemption from taxes caused some notable underperformance of the asset class during the first half of the year. No such changes in tax law allowed for some performance recovery, although supply may still be an issue in states with large fiscal deficits.



EQUITY MARKETS

- » Equity markets around the world registered impressive performance in the third quarter. U.S. markets were driven by the resilient economy and earnings growth that is on track to total roughly 10% by the end of the quarterly earnings season. Adding further fuel to the advance was the dovish lean at the Fed, which increased the probability of more frequent and higher magnitude rate cutting. This tilt allowed valuation multiples to continue to expand despite worries about markets approaching peak valuation. Calmer rhetoric around trade also contributed to the advance as did the apparent success of corporate tariff mitigation efforts, which have effectively protected profit margins.
- » While we see broad participation in the third quarter advance, the markets continue to be led by companies in the technology and communication services sectors that have successfully participated in the secular AI growth theme. These companies have been able to generate a level of revenue and earnings growth that appears to warrant their lofty market valuations. Continued economic growth should lead to some multiples expansion in the more cyclical sectors of the market as we move into the fourth quarter.
- » Although we are driven more by fundamental analysis in assessing the outlook for equities, attention must be paid to the technical history of markets demonstrating continued momentum into year-end after the level of advance witnessed year to date. There are legitimate concerns building around an equity melt-up to bubble valuation levels, but the fundamentals of revenue and earnings growth as well as continued corporate discipline in maintaining margins should prevent any notable valuation contraction as the Fed continues to ease monetary policy.
- » After showing strong outperformance against U.S. equities in the first half of the year, European equities must contend with the uncertain impact of tariffs on the revenues and margins of several industry champions. Management teams must show similar cost discipline as their American counterparts to maintain margins. If successful, the relatively cheap valuations should allow continued momentum.
- » An unexpected and relatively favorable trade deal with the United States helped drive outperformance of Japanese equities during the third quarter. The specter of monetary tightening and the uncertain effect of tariffs may be too much of a headwind for relative performance in the fourth quarter.
- » Meanwhile, the Chinese equity markets have been able to capitalize on the AI theme nearly to the same extent seen in the United States. Targeted government stimulus policies have also helped drive and revive interest in the mainland markets.



COMMODITIES & CURRENCIES

- » Outside of any potential supply disruptions due to heightened geopolitical tensions, global supply-demand forecasts will likely lead to further price pressure on crude oil throughout the remainder of the year. The recently announced supply increases by the OPEC countries and Russia are occurring in an environment of slower global demand. This dynamic should help restrain global inflation.
- » It is much more difficult to forecast the intersection of supply and demand in the precious metals space. Supply is relatively fixed for a commodity like gold, but demand is based largely on noneconomic factors driven by emotion. Central bank ease leading to lower “real,” or inflation adjusted, interest rates is usually a tailwind because gold has no yield. Most central bank easing appears to be ending except at the most important central bank, the U.S. Federal Reserve. Upward price momentum is expected to continue in an asset class that is likely approaching a bubble before one occurs in equities.
- » The U.S. dollar recovered some of its year-to-date losses in the third quarter. Relative economic growth fundamentals and better bond yields favor the dollar over most other currencies, but prospective Fed ease into 2026 should limit any meaningful appreciation from current levels.

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