

# Quarterly Commentary

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**3<sup>rd</sup> Quarter 2025**

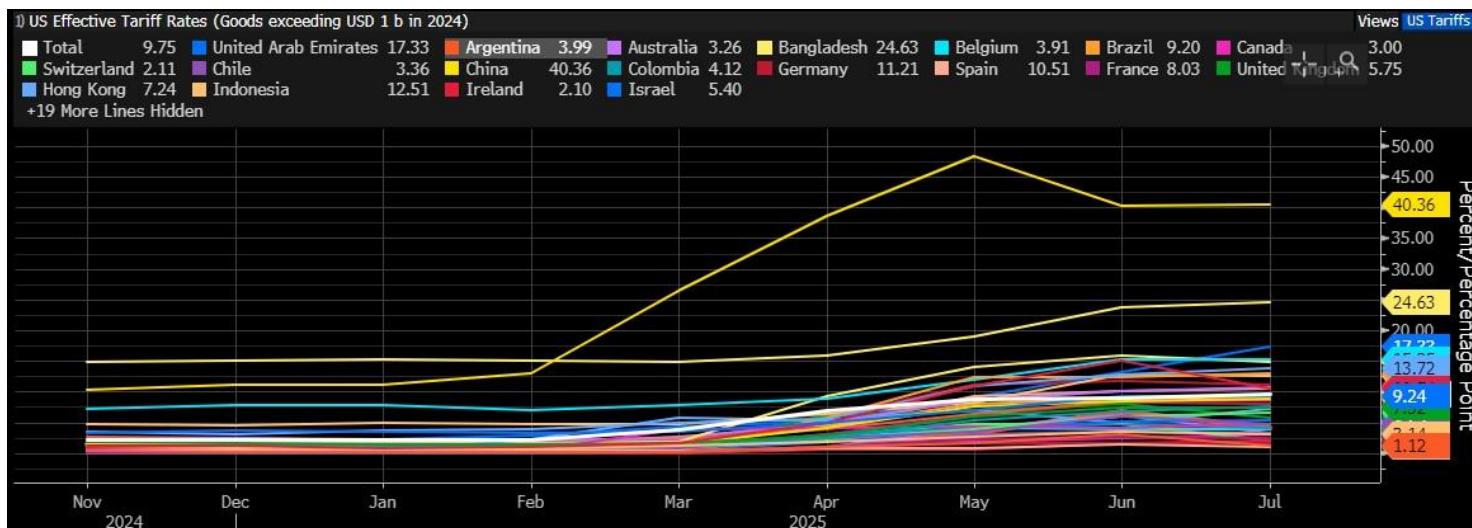


## Summary and Implications

- The U.S. economy remains resilient, but labor market conditions are softening enough to prompt the Federal Reserve to begin cutting interest rates. The risk of an enduring recession remains at low probability levels. Global markets are enjoying a continued surge in risk appetite, especially for AI-fueled technology plays.
  - Overseas cyclical tailwinds and AI-driven productivity gains will likely continue supporting long-term corporate profitability and economic growth while slowing labor market conditions should help reduce interest rate volatility and support business borrowing.
- Long-term investors should remain neutral on equity positioning with a preference for high quality U.S. stocks with strong balance sheets and reasonable valuations. We would likely need to see a broadening in market breadth outside of the narrow leadership of Mag7 and speculative high beta technology stocks for the bull run to continue. Hard assets like real estate and natural resources can still provide inflation protection.
- Fixed income remains attractive from a real yield standpoint. Investors still have an opportunity to lock in moderately high real rates by extending the maturity profile of their fixed income allocation, although maturities could be scaled back with the decline in real rates.

## Investment Summary and Outlook

For the 3<sup>rd</sup> quarter of 2025, global stocks continued their rallies following the initial Liberation Day sell-off in early April. Investors are looking past tariff policy risk as the Trump Administration has negotiated trade agreement frameworks with key partners and/or extended moratoriums on reciprocal tariffs. A looming Supreme Court decision on the legality of the International Emergency Economic Powers Act (IEEPA 1977) framework used to justify reciprocal tariffs is expected in November with the expectation that the Trump Administration would resort to Section 232 (1962 Trade Expansion Act) to impose tariffs on national security grounds (narrower in scope), which has already been imposed on steel, copper, aluminum, autos, select consumer goods. Should SCOTUS rule against the Trump administration, then current trade policy frameworks negotiated under IEEPA could be invalidated and collected tariff revenue would likely need to be refunded as well as disrupting supply chains that have been rerouted to minimize the tariff impacts. Per Bloomberg, the current U.S. effective rate is 9.75% with east Asia (mostly China) bearing the brunt of higher tariffs.



Source: Bloomberg

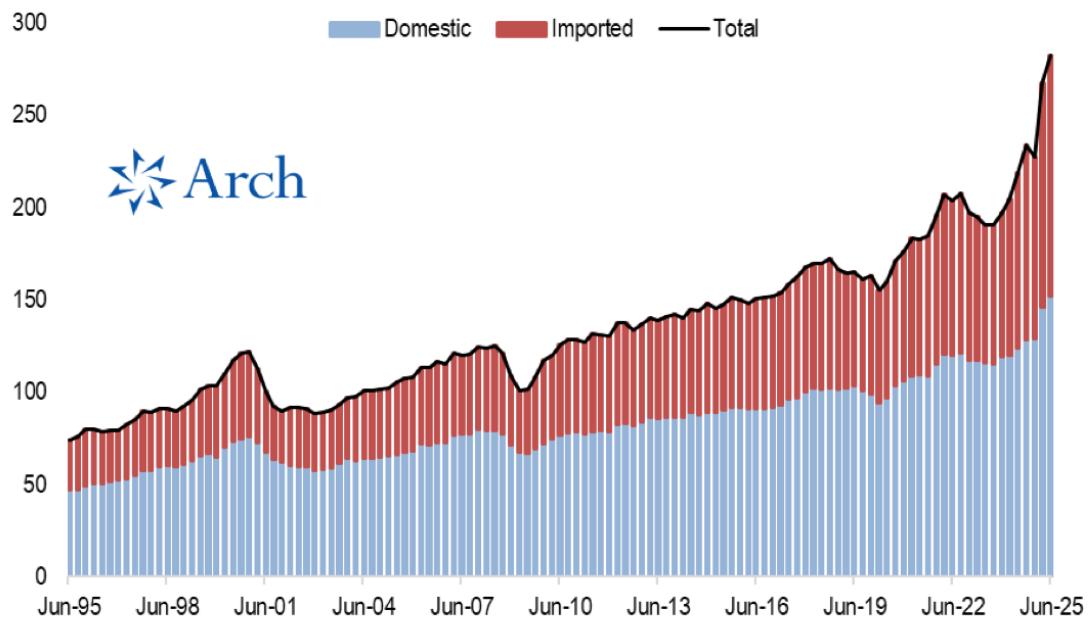
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The early April sell-off was short-lived as investors 'bought the dip' despite the negative implications of a historic hike in U.S. tariffs on consumer inflation and company profit margins. The 2<sup>nd</sup> quarter ended on a strong note, with major stock market indexes reaching record highs while long-term interest rates settled back down following an initial spike over the threat of foreign capital outflows from U.S. assets. The S&P 500 rose 8.1% and the Nasdaq Composite rose 9.0%, while the Russell 2000 surged 12.4% helped by the start of Federal Reserve rate cuts. Multi-billion capital commitments from hyperscalers and leading technology companies such as Oracle led to a frenzied chase into AI- and computer cloud-focused stocks, somewhat reminiscent of the late stages of the dotcom boom in the late 1990s. According to Arch Global Economics, total investment in technology capital goods is approaching \$300 billion on a seasonally adjusted basis.

## Investment in Technology Capital Goods by Source (\$B, sa)



Source: U.S. Census Bureau, U.S. Bureau of Economic Analysis, Arch Global Economics

Technology and AI stocks continue to lead the rally, along with industrials and utilities to provide the materials and infrastructure supporting the massive data center buildouts now estimated to amount to trillions of cumulative investments over the next 5-10 years. Global AI infrastructure spending is expected to reach \$375 billion in 2025, far exceeding earlier year estimates. Longer-term projects are expected to add 125-200 gigawatts of incremental data center capacity (how the necessary energy inputs will be sourced is another matter). McKinsey estimates up to \$8 trillion in total ecosystem investments through 2030<sup>1</sup> depending on advanced chip development whose processing power (and requisite power needs) are expected to increase asymptotically. The buildout is massive at current scale – according to Citrini Research, Meta's Louisiana Hyperion facility would stretch across about half of Manhattan.

<sup>1</sup> ["The cost of compute: A \\$7 trillion race to scale data centers,"](#) McKinsey Quarterly April 2025

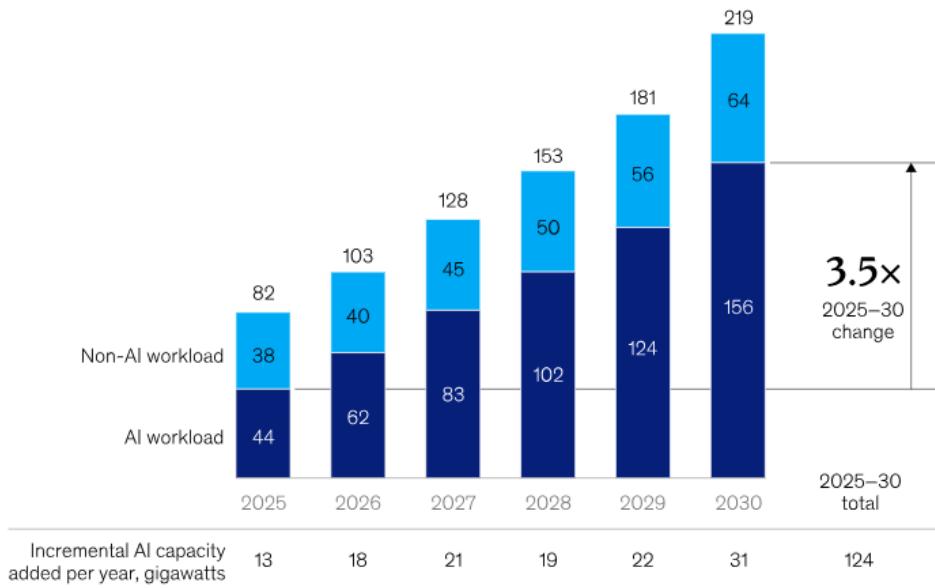
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**Both AI and non-AI workloads will be key drivers of global data center capacity demand growth through 2030.**

Estimated global data center capacity demand, 'continued momentum' scenario, gigawatts

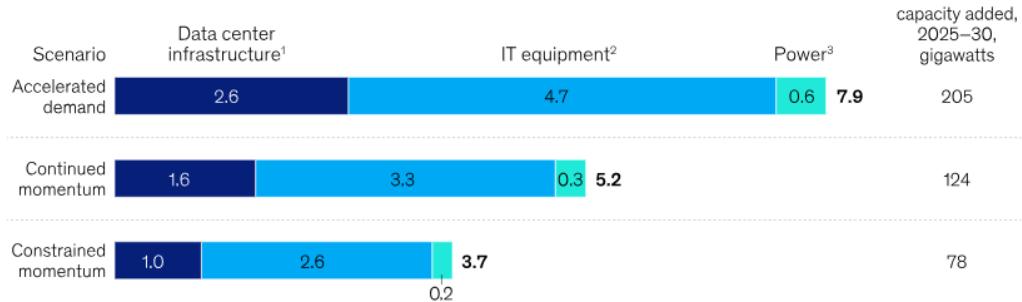


Note: Figures may not sum to totals, because of rounding.

Source: McKinsey Data Center Demand Model; Gartner reports; IDC reports; Nvidia capital markets reports

**Capital investments to support AI-related data center capacity demand could range from about \$3 trillion to \$8 trillion by 2030.**

Global data center total capital expenditures driven by AI, by category and scenario, 2025–30 projection, \$ trillion



Note: Figures may not sum to totals, because of rounding.

<sup>1</sup>Excludes IT services and software (eg, operating system, data center infrastructure management), since they require relatively low capex compared with other components.

<sup>2</sup>Includes server, storage, and network infrastructure. IT capex also accounts for replacing AI accelerators every 4 years.

<sup>3</sup>Assumes \$2.2 billion–\$3.2 billion/gigawatt (including power generation and transmission cost) to account for a range of power generation scenarios (eg, fully powered by gas, a combination of gas power and storage, and solar) and regional cost differences. Distribution cost is neglected, as most AI centers are expected to be >50 megawatt scale and connected to a transmission grid.

Source: McKinsey Data Center Capex TAM Model; McKinsey Data Center Demand Model

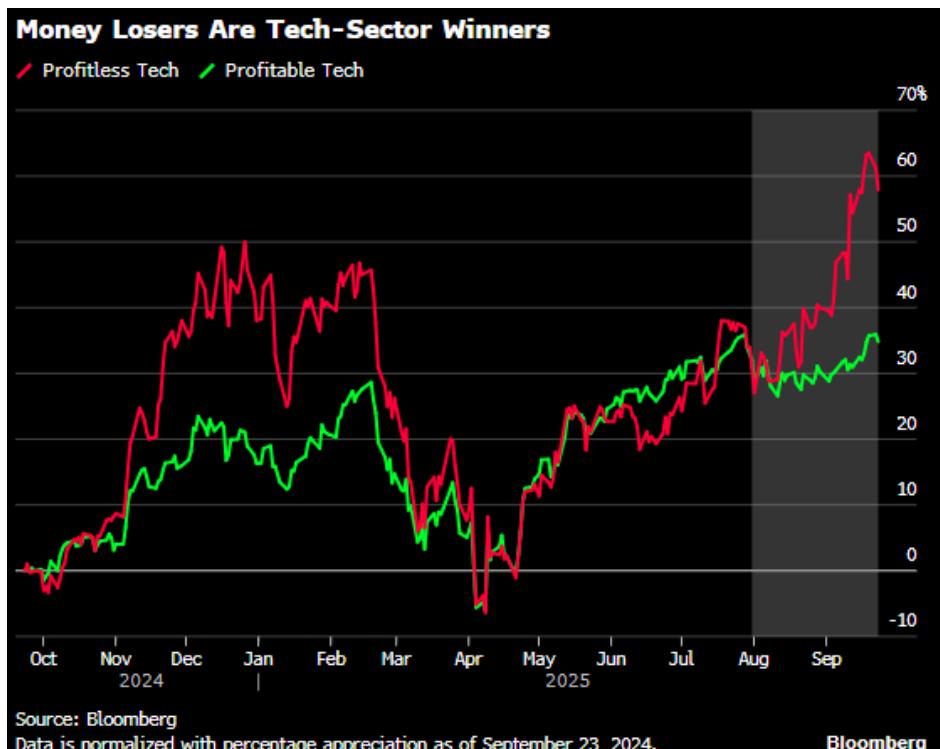
And this doesn't include the capital investment into researching quantum computing which has the potential to unlock new data sources (i.e. found across nature and physics) unavailable to current computational resources, not to mention rendering current prime number-based encryption obsolete. Although significant breakthroughs are some time away, one could envision an arms race between major superpowers to develop advanced artificial intelligence trained on unheard of data sets sourced from quantum computing.

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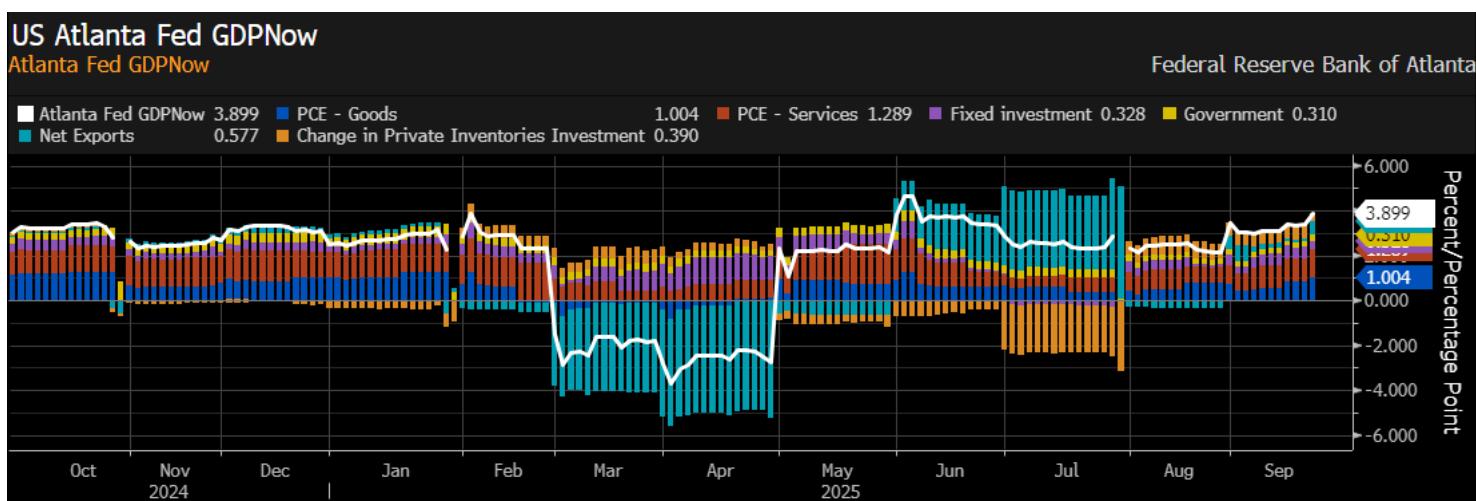
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Indeed, the speculative fervor over the growth potential of AI spending is reflected in the outperformance of profitless technology stocks versus profitable technology stocks as tracked by UBS.



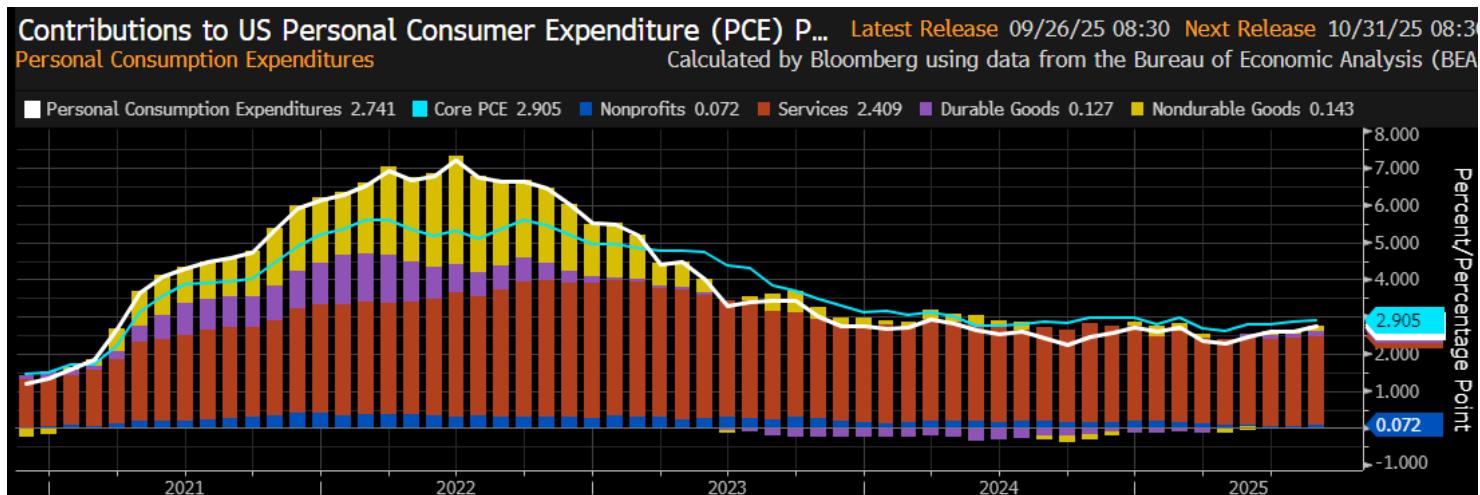
The massive capital spending is starting to appear in the aggregate economic data as 3<sup>rd</sup> quarter real gross domestic product (GDP) is tracking just under 4%, driven by strength across all major categories led by personal spending. Labor market weakness has yet to show up in a decline in retail spending and consumer demand, as consumers appear to be absorbing tariffs reflected in higher costs of goods and services. Current Core US Personal Consumer Expenditure (PCE) is tracking 2.9%, much of it driven by services inflation (primarily shelter but also health care and leisure).



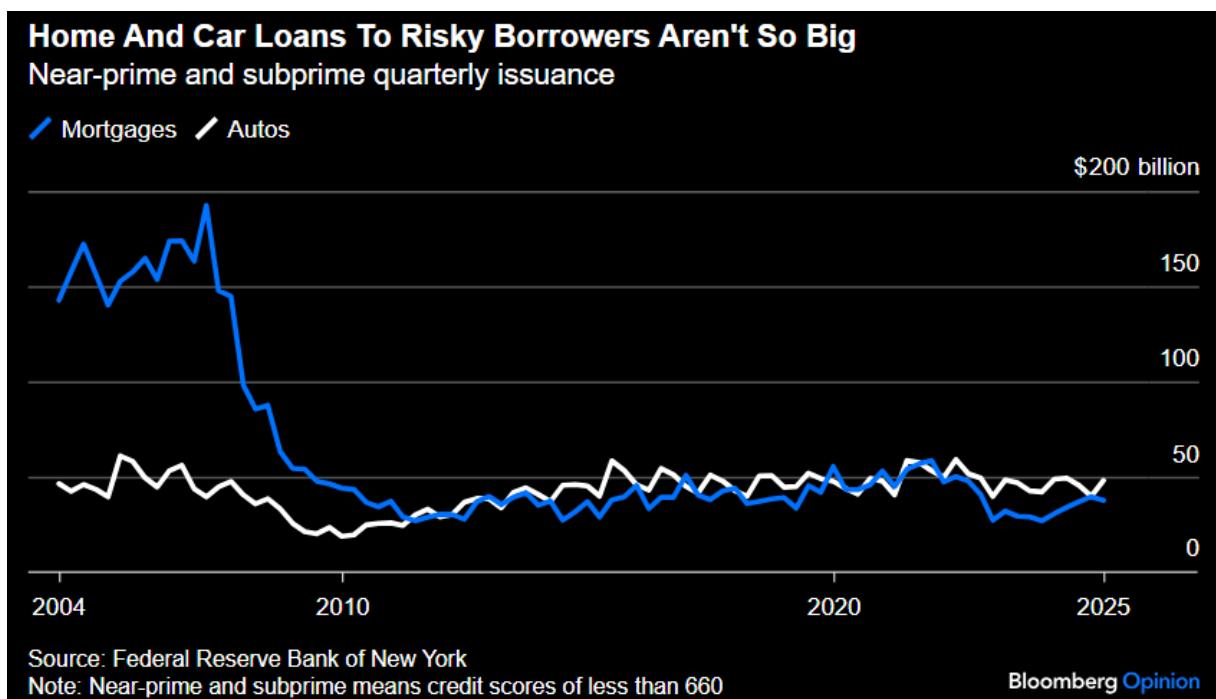
Source: Bloomberg

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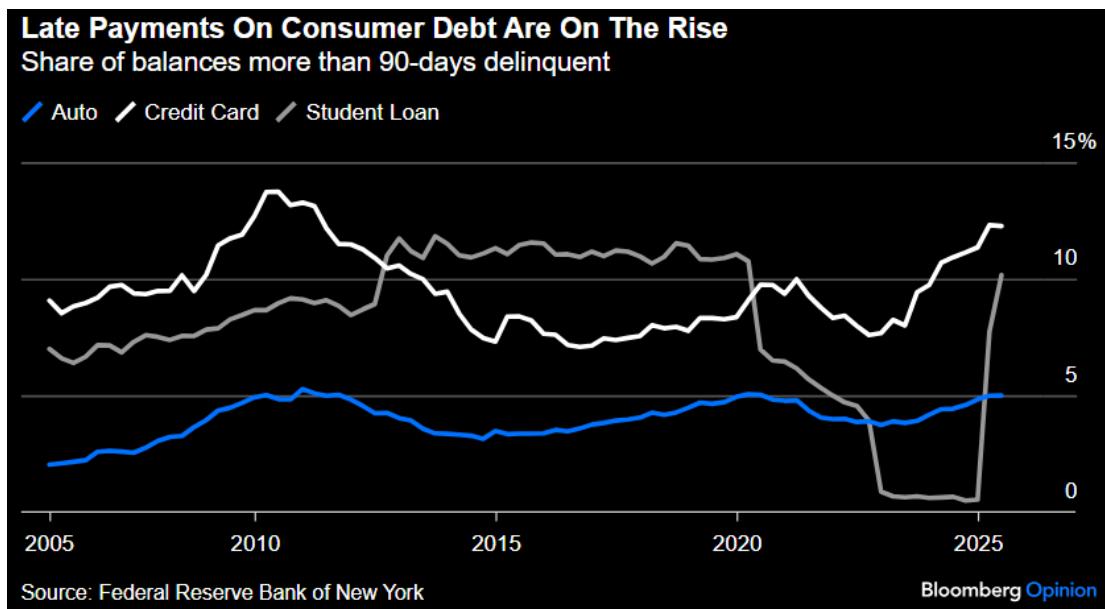
That's not to suggest there aren't economic pressures underneath the rosy surface. The bottom income demographics are facing increased cost of living pressures and higher borrowing costs and are at greater risk of getting caught in the labor market slowdown. However, the size of total subprime borrowing, including recent stress areas such as autos, remain at a level far below what was observed during the 2008 Great Financial Crisis. But stress is building as is evident by rising delinquencies across consumer debt categories.



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Some strategists attribute the sudden rotation into speculative small caps as another indicator of 'animal spirits' awakened by Fed policy that saw a notable dovish shift following the August Jackson Hole symposium where the Federal Reserve signaled it was ready to end its year-long pause and would likely start cutting rates starting in the fall given increasing signs of a labor market slowdown. Fed officials have made few public comments on how animal spirits are feeding into asset prices, as several officials have expressed concerns over weakening labor market conditions and/or sticky inflation growth caused in part by tariffs.

The Federal Reserve did cut rates by a quarter point at the September FOMC and signaled a more tempered economic outlook on growth and employment although they acknowledged the ongoing inflation risks from trade tariffs, characterizing the rate cut as a 'risk management exercise' to preempt any further deterioration in the labor market. Following the September rate cut, Fed Funds futures indicate two rate cuts in 4Q2025 followed by two more cuts through the 1<sup>st</sup> half of 2026 while the consensus Fed projection calls for a long-term terminal rate of 3%. Fed governors remain split between whether the risks to employment conditions and price stability are 'balanced' or are greater towards the former versus the latter.

The Fed also updated its Summary of Economic Projections (SEP) at the September meeting to account for lower economic growth and sticky inflation throughout 2025 and into 2026. Specifically, the Fed lowered its 2025 GDP forecast from 2.1% growth last December to 1.6%, while 2026 was revised from 2.0% to 1.8%, although these projections are higher than the June meeting. For 2025 inflation, core PCE projections remain at 3.1%, with progress towards reaching the Fed's long-term target expected to stall due to tariff risks. The Fed raised its inflation projections for 2026 and 2027 core PCE projections (2.6% and 2.1%, respectively from 2.2% and 2.0%, respectively last December).

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Region: United States »		Instrument: Fed Funds Futures »			
Target Rate	4.25	Pricing Date	09/30/2025	Cur. Imp. O/N Rate	4.094
Effective Rate	4.09				
Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate	A.R.M. ▲
10/29/2025	-0.967	-96.7%	-0.242	3.853	0.250
12/10/2025	-1.743	-77.6%	-0.436	3.659	0.250
01/28/2026	-2.127	-38.4%	-0.532	3.563	0.250
03/18/2026	-2.529	-40.2%	-0.632	3.462	0.250
04/29/2026	-2.777	-24.8%	-0.694	3.400	0.250
06/17/2026	-3.319	-54.1%	-0.830	3.265	0.250
07/29/2026	-3.607	-28.9%	-0.902	3.193	0.250
09/16/2026	-3.920	-31.3%	-0.980	3.114	0.250
10/28/2026	-4.077	-15.7%	-1.019	3.075	0.250
12/09/2026	-4.243	-16.5%	-1.061	3.034	0.250
01/27/2027	-4.307	-6.5%	-1.077	3.018	0.250
03/17/2027	-4.476	-16.8%	-1.119	2.975	0.250

Source: Bloomberg World Interest Rate Probability

For the remainder of 2025, the bullish case hinges on 1) the U.S. economy remaining resilient in the face of slowing labor market conditions, 2) corporate earnings continuing to grow and exceed expectations despite the potential impact on profit margins from tariffs, and 3) Fed policy easing throughout the 4<sup>th</sup> quarter and into next year. The narrowness of tech leadership will need to give way to a broadening in market breadth for this bull cycle to continue, which may enjoy some additional tax and spending tailwinds from the Big Beautiful Bill currently debated in Congress. The long-term capital commitments boasted by leading tech companies will eventually need to be realized through revenue recognition and profitability.

The bearish case emphasizes risks from ongoing tariff issues that have yet to be resolved and the continued narrowness of technology leadership without a broadening of corporate growth prospects. Investors should monitor trade negotiations (especially after the SCOTUS ruling on the legality of IEEPA tariffs), unexpected shifts in Fed policy, and further deterioration in labor market data.

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## U.S. Fixed Income Markets

Index Performance as of 9/30/2025	3Q2025	YTD	1-Year	3-Year (Ann)
Bloomberg US Agg Bond TR USD	2.03	6.13	2.88	4.93
Bloomberg US Treasury Bill 1-3 M TR USD	1.10	3.25	4.47	4.87
Bloomberg 1-5 Yr Treasury TR USD	1.14	4.63	3.77	4.42
Bloomberg Treasury 5-7 Yr TR USD	1.42	6.78	3.17	4.51
Bloomberg Treasury 7-10 Yr TR USD	1.76	7.20	2.29	3.64
Bloomberg US Treasury 20+ Yr TR USD	2.45	5.09	-4.80	-0.69
Bloomberg US Agency TR USD	1.42	5.18	3.86	4.79
Bloomberg U.S. Agg ABS TR USD	1.64	4.62	4.57	5.34
Bloomberg US MBS TR USD	2.43	6.76	3.39	5.05
Bloomberg US Corporate TR USD	2.60	6.88	3.63	7.07
Bloomberg US Corporate High Yield TR USD	2.54	7.22	7.41	11.09
Bloomberg Municipal TR USD	3.00	2.64	1.39	4.74

Source: Bloomberg

U.S. fixed income continues its steady run in 2025 as interest rate volatility settled down and corporate/mortgage-backed spreads narrowed to some of their pre- and post-pandemic shutdown levels. U.S. fixed income posted strong positive returns with the U.S. Aggregate Bond Index up 2.03% for the quarter, as U.S. interest rates reacted positively to the Federal Reserve's September rate cut as well as increasing signs of labor market softening despite elevated inflation readings. U.S. long maturity bonds outperformed the broader maturity curve, as monthly and annual benchmark revisions to the BLS non-farm payrolls report had reduced cumulative job gains of approximately 1.1 million from April 2024 through August 2025. Economic uncertainty has also increased over U.S. trade policy that saw additional tariffs imposed on furniture, pharmaceutical, lumber/timber imports although most Fed officials maintain that the pass-through price hikes from tariffs are short-term nature rather than leading to sustained price increases.

Corporate bonds (both investment grade and high yield) continue to outperform the broader fixed income market as borrowing spreads narrowed to some of their tightest levels (both pre- and post-pandemic). U.S. mortgage-backed spreads also performed well, benefiting from a drop in interest rate volatility and increased appetite from financial institutions. Municipal bonds reversed their 1<sup>st</sup> half underperformance, with the Bloomberg Municipal Bond Index up 3.00%, helped by monetary easing and increased investor demand meeting a moderation in issuer supply that weighed on 1<sup>st</sup> half performance.

### Implications: Real Rates Continue Decline Even as U.S. Inflation Remains Sticky as Fed Begins Easing Cycle

Duration or Rate-Sensitivity and Narrowing Credit Spreads drove the bulk of this quarter's strong performance as long maturity corporate bonds and high yield benefited the most from the fall in interest rates as well as an economic backdrop that is slowing but not contracting. The 10-Year Treasury yield rose as high as 4.48% in mid-July before settling at 4.15% at the end of the quarter. The spread between short-term and long-term borrowing rates remains wide as short-term rates dropped in anticipation of the Fed easing cycle while long-term rates remain elevated, reflecting uncertainty over U.S. fiscal policy and sticky inflation. Long-term break-even inflation rates remain near the high end of their post-COVID range at 2.32% but remain under current core inflation readings.

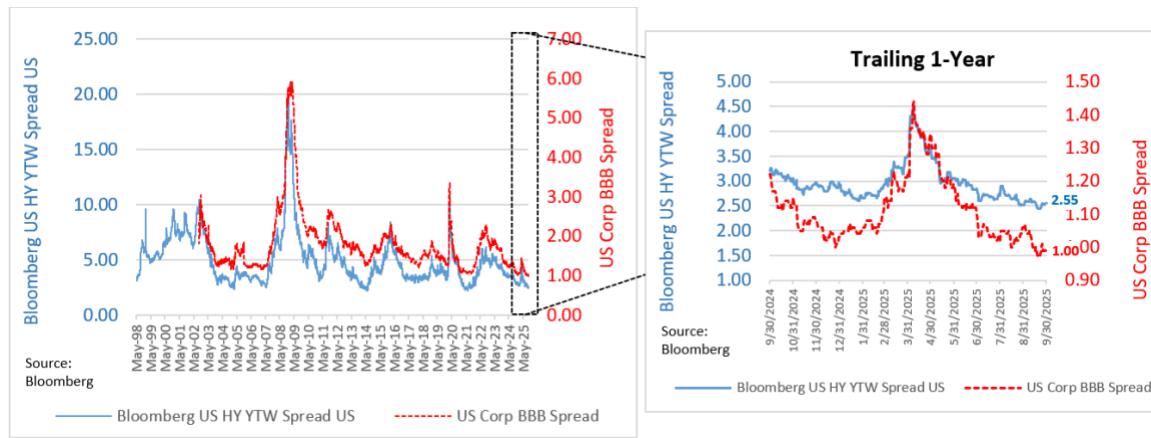
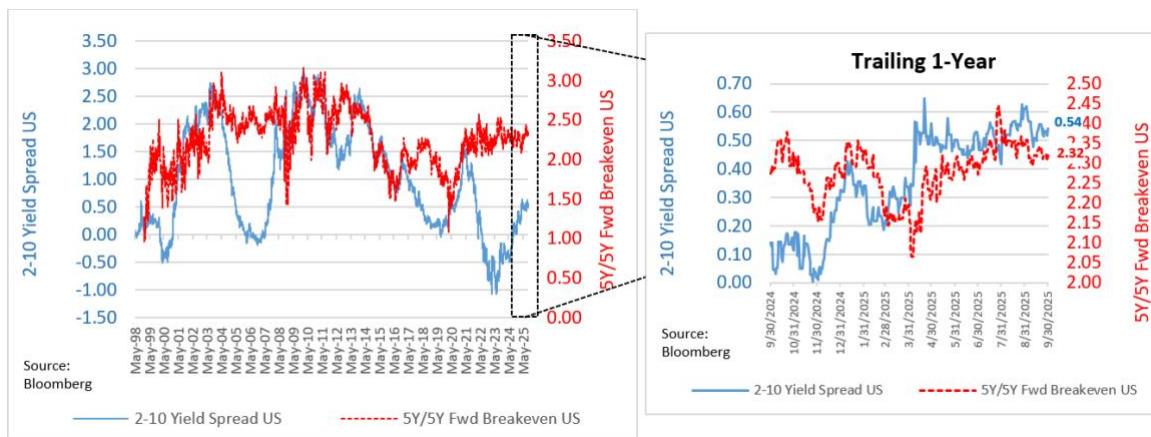
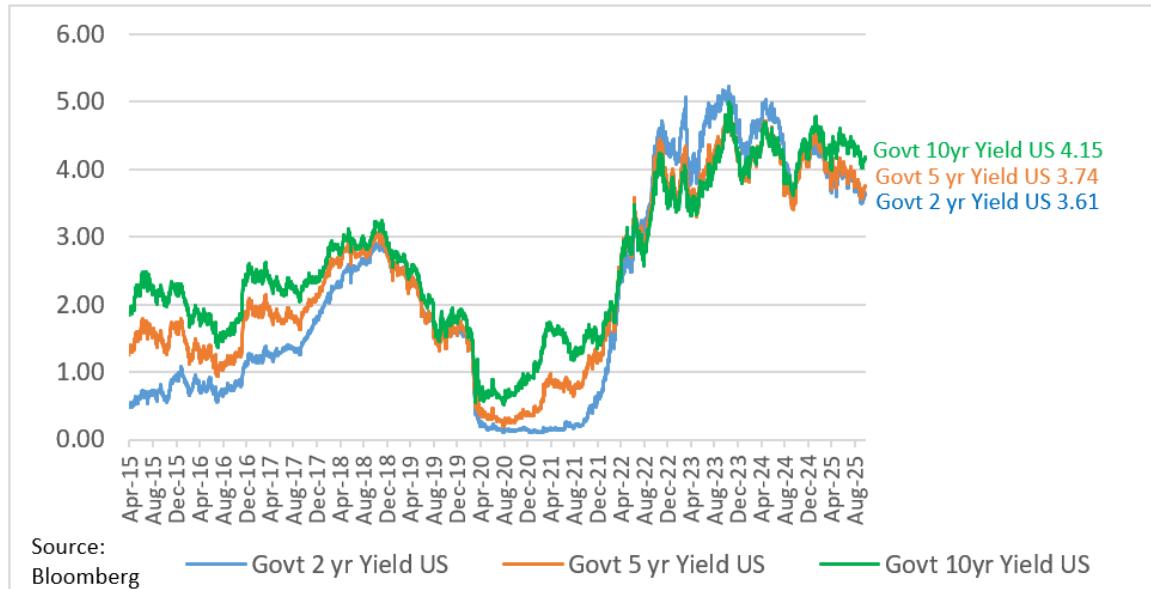
Long-term inflation-adjusted (real) rates dropped below 2%, reflecting increased confidence that inflation risks remain contained as the Fed adjusts monetary policy in the face of a softening labor market, portending a decline in future demand. Further fixed income gains would likely need to see a significant economic slowdown that would prompt the Fed to cut rates more aggressively than what the market is anticipating. Corporate bond valuations remain stretched as

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borrowing spreads have narrowed to pre-COVID levels. Fixed income remains attractive from a real yield standpoint and as a diversifier for pro-cyclical assets such as equities and commodities. Investors still have an opportunity to lock in moderately high real rates by extending the maturity profile of their fixed income allocation, although duration overweights could be scaled back with further declines in real rates. Asset- and mortgage-backed securities also remain attractive as high-quality alternatives to U.S. Treasuries.



## International Fixed Income Markets

Index Performance as of 9/30/2025	3Q2025	YTD	1-Year	3-Year (Ann)
Bloomberg Global Agg ex US TR USD	-0.59	9.36	1.87	5.75
Bloomberg EuroAgg TR USD	0.26	14.61	6.49	9.61
Bloomberg Asian Pacific Agg TR USD	-1.53	3.71	-2.81	1.33
Bloomberg EM Local Currency TR USD	3.97	17.14	8.75	12.03

Source: Bloomberg

In U.S. dollar terms (“USD”), international developed market bonds underperformed U.S. bonds in the third quarter, while Emerging Markets outperformed on the strength of local currencies with the latter benefiting more from the prospects of U.S. monetary easing that has weakened the U.S. dollar. The Bloomberg Global Aggregate Bond ex US Index (USD) and the Bloomberg EM Local Currency Index (USD) returned -0.59% and 3.97%, respectively. Japanese bonds drove the bulk of underperformance as long maturity rates continue to rise in the face of diminished demand from domestic financial institutions and savers, rising political uncertainty over the ruling LDP’s electoral losses, and higher debt servicing costs from widening fiscal deficits. Similarly, Europe is also struggling with political uncertainty, notably France which is facing a hung parliament

Both The 10-year German Bund yield and Japanese 10-year bond yield rose throughout the third quarter reflecting greater fiscal expansion, with the former ending its “debt break” embarking on increased defense spending. Despite narrowing rate differentials between the U.S. and international developed bond markets as well as higher U.S. tariffs on global trade, the Bloomberg Dollar Spot Index, returned 0.86% for the quarter as euro appreciation was offset by yen weakness.

Emerging market fixed income benefited from U.S. dollar weakness and narrowing credit spreads, as investors were attracted to higher yields, reflecting greater comfort with the global economic landscape. Emerging market economic growth is outpacing that of international markets as global trade activity recovers following the 90-day pause extension in most Liberation Day tariffs.

### Implications: The USD to Remains Under Pressure Over U.S. Trade and Fiscal Policy and Narrowing Rate Differentials

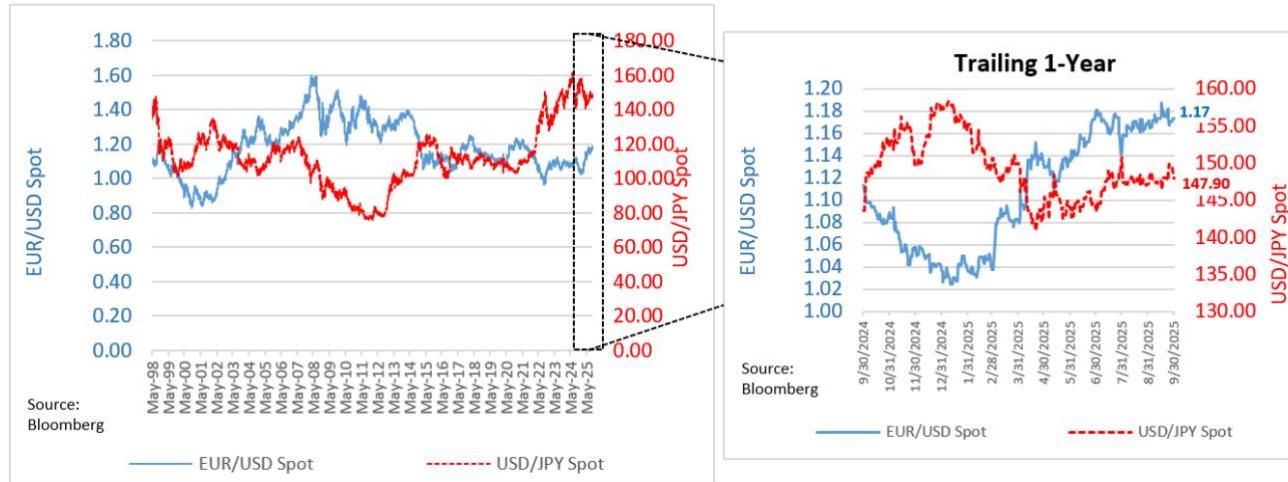
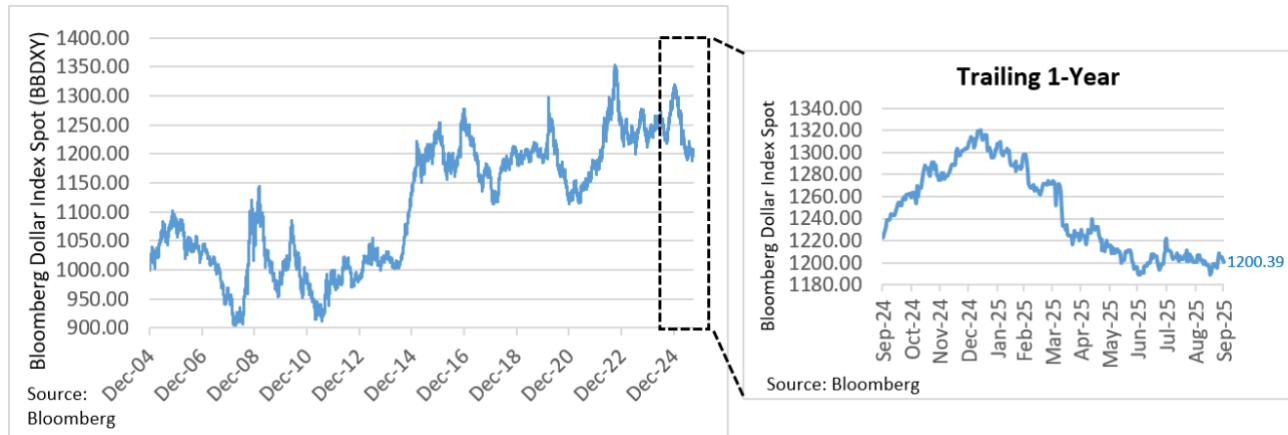
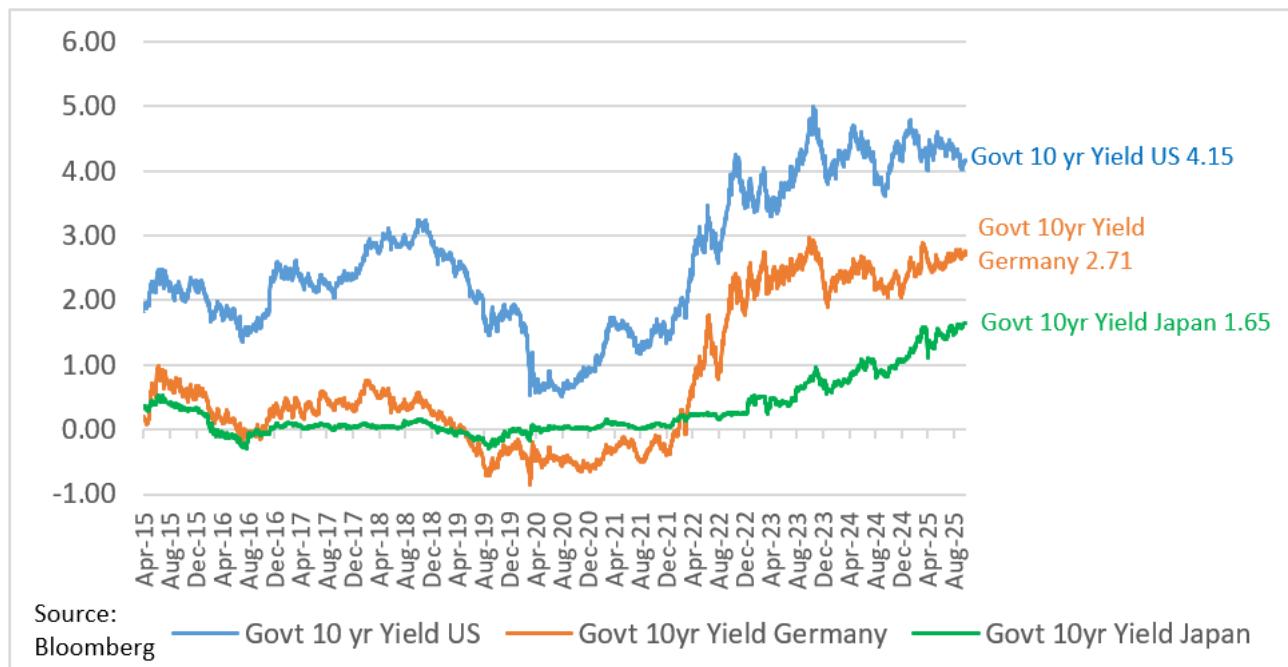
We expect ex-U.S. fixed income performance to be influenced by the timing and scope of U.S. trade policy especially with a looming Supreme Court decision on the legality of the IEEPA tariffs (a decision expected in November). Should the Supreme Court rule against the Trump Administration, resulting in 1) a rebate of tariff revenue (estimated at \$320 billion) and 2) throwing uncertainty into trade agreements negotiated under IEEPA, then the U.S. dollar could benefit with the sudden reduction in trade barriers and increase in capital flows from major exporters. However, this could be offset by reduced confidence in the U.S. fiscal picture with the loss of IEEPA tariffs that are expected to generate \$1.2-2.0 trillion over the next 10 years. U.S. trade policy has clouded the outlook for global trading activity, partly explaining the continued strength in hard asset safe havens such as precious metals.

Another risk to USD-denominated international fixed income is that the U.S. economy remains on firmer footing despite the Fed embarking on a rate cut cycle, which could steepen the yield maturity curve even further, causing U.S./non-U.S. rates differentials to widen. Upcoming U.S. employment releases should help signal the pace of Fed rate cuts through the end of the year and into 2026, a quickened pace would likely exert even more pressure on the U.S. dollar.

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## US Equity Markets

Index Performance as of 9/30/2025	3Q2025	YTD	1-Year	3-Year (Ann)
S&P 500 TR USD	8.12	14.83	17.60	24.94
Russell 1000 Growth TR USD	10.51	17.24	25.53	31.61
Russell 1000 Value TR USD	5.33	11.65	9.44	16.96
Russell Mid Cap Growth TR USD	2.78	12.84	22.02	22.85
Russell Mid Cap TR USD	5.33	10.42	11.11	17.69
Russell Mid Cap Value TR USD	6.18	9.50	7.58	15.51
Russell 2000 Growth TR USD	12.19	11.65	13.56	16.68
Russell 2000 TR USD	12.39	10.39	10.76	15.21
Russell 2000 Value TR USD	12.60	9.04	7.88	13.56
S&P Comm Svces Select Sector TR USD	12.04	24.51	35.55	38.95
S&P Cons Staples Select Sector TR USD	-2.36	3.89	0.51	10.58
S&P Consumer Disc Select Sector TR USD	9.54	5.30	20.31	20.57
S&P Energy Select Sector TR USD	6.21	7.04	4.43	11.10
S&P Financial Select Sector TR USD	3.11	12.37	20.20	22.67
S&P Health Care Select Sector TR USD	3.76	2.61	-7.95	6.61
S&P Industrial Select Sector TR USD	5.02	18.38	15.69	25.12
S&P Materials Select Sector TR USD	3.10	9.32	-4.27	12.26
S&P Real Estate Select Sector TR USD	2.59	6.19	-2.24	9.24
S&P Technology Select Sector TR USD	13.15	22.14	27.99	39.98
S&P Utilities Select Sector TR USD	7.57	17.69	11.20	13.61
S&P 500 Dividend Aristocrats TR USD	2.97	5.46	-1.09	11.61
S&P 500 Low Volatility TR USD	1.47	6.69	4.60	10.96
S&P 500 High Beta TR USD	12.94	24.83	24.22	25.48
S&P 500 Momentum TR USD	7.80	28.06	34.32	35.26
S&P 500 Quality TR USD	3.05	10.39	10.29	24.53
DJ US Select Dividend TR USD	8.09	11.50	9.44	14.52

Source: Bloomberg

U.S. stocks continued their strong recovery from the early April Liberation sell-off as key market indices made new highs, helped by the outlook for AI-fueled spending (data centers, cloud computing) as several high-profile investment deals were announced by large technology companies across semiconductors, software developers, and hardware makers. The S&P 500 rose 8.12% for the quarter, with large growth handily outperforming value, although small caps, which had been lagging large caps this year, outperformed large caps. Much of this outperformance came after the August Jackson Hole symposium followed by the Fed's decision to begin its easing cycle by cutting rates at the September meeting. Growth stocks benefited from high profile capital commitments across the hyperscaler and tech infrastructure complex as investors are now penciling in asymptotic exponential growth paths for datacenter investments to keep pace with the advancements made in computer processing power. Q3 earnings for the technology sector grew 18% year-over-year (YOY) versus 4% for traditional value-heavy sectors such as financials and energy.

Speculative stocks, as measured by high momentum and high beta, handily outperformed the broader markets, while higher quality, more defensive stocks lagged, largely in response to the risk-on response to Fed easing and lower interest rates. Investors are also excited about the growth prospects of artificial intelligence in terms of productivity impact that should help U.S. companies maintain cycle-high profit margins and capital efficiency. With U.S. stocks trading at or exceeding multi-decade valuation levels, approaching the late 1990s dotcom era, investors do not seem to be overly concerned of a top-line demand-driven slowdown should labor markets continue to soften as expected by economists and the bond market.

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## Implications: Stick with High Quality and Value and Hedge Tariff-Driven Inflation Risk with Hard Assets

As U.S. stocks continue to advance, especially across speculative high-risk segments, the S&P 500 Index now trades at the high end of its 10-year valuation range with the forward price/earnings ratio hovering at 22.8x next 12-month earnings according to Bloomberg estimates. U.S. valuations could be at risk of earnings disappointments, although profit margins remain resilient even in the face of a negative impact on final demand stemming from tariff costs. The valuation gap between large cap and small cap also remains historically wide with the former trading at 5.46x price/book versus 1.93x price/book for the latter.

Although Freedom Investment Management remains of the view that we are in the mid-cycle to late-cycle phase of the post-pandemic period, we hold our neutral position on U.S. equities versus the rest of the world. We continue to favor U.S. stocks with strong balance sheets and durable profitability trading at reasonable valuations even as investor sentiment has shifted towards highly speculative stocks. We also advise investors to investigate hard asset plays across natural resources and real estate as a potential hedge against inflation re-accelerating should the tariff impact on goods and services prove to be more than 'transitory'.



## International Equity Markets

Index Performance as of 9/30/2025	3Q2025	YTD	1-Year	3-Year (Ann)
MSCI ACWI NR USD	7.62	18.44	17.27	23.12
MSCI ACWI Ex USA NR USD	6.89	26.02	16.45	20.67
MSCI ACWI Ex USA Growth NR USD	5.71	22.51	12.85	18.33
MSCI ACWI Ex USA Value NR USD	8.13	29.64	20.17	23.11
MSCI ACWI Ex USA Mid Growth NR USD	5.52	27.06	17.76	19.58
MSCI ACWI Ex USA Mid NR USD	5.86	27.76	18.27	20.60
MSCI ACWI Ex USA Mid Value NR USD	6.15	28.32	18.66	21.55
MSCI ACWI Ex USA Small Growth NR USD	5.95	24.12	15.14	17.73
MSCI ACWI Ex USA Small NR USD	7.24	29.54	19.35	19.98
MSCI ACWI Ex USA Small Value NR USD	7.43	26.98	16.73	21.00
MSCI China NR USD	20.70	41.62	30.76	19.46
MSCI Japan NR USD	8.02	20.70	16.36	21.21
MSCI AC Asia ex Japan NR USD	10.76	26.82	17.19	18.78
MSCI Europe NR USD	3.51	12.36	9.31	15.69
MSCI EM NR USD	10.64	27.53	17.32	18.21

Source: Bloomberg

In USD terms, international equities marginally underperformed the U.S. market in the 3<sup>rd</sup> quarter, but this masks the narrow contribution from Asian tech stocks, notably the Chinese tech sector over prospects of domestic investment in the AI infrastructure from homegrown chip development to data centers and energy infrastructure. The MSCI All-Country World ex-USA Index (ACWI Ex USA) returned 6.89%, underperforming the U.S. market (the S&P 500 returned 8.12% for the quarter). Unlike the U.S., growth underperformed value across all cap bands although much of growth's outperformance came from Asian tech (China's Big 8, Korean and Taiwan semiconductors). European industrials and financials continue to ride the tailwinds of fiscal expansion and easing monetary policy as inflation trends are tracking lower than in the U.S.

MSCI China handily outperformed the world market, returning 20.70% for the quarter while broader Asia and Emerging Markets also outperformed, mostly on the strength of the semiconductor infrastructure feeding into the AI buildout. However, there is still some debate on overall market resilience as the broader Chinese economy continues to suffer from state/local debt overhang and moribund domestic consumption. Investors will likely focus on upcoming holiday retail periods such as Golden Week as well as signs of further government stimulus and progress on trade discussions with major trading partners (USA, Europe).

European stocks continue to benefit from a stronger currency, fiscal stimulus/defense spending commitments led by Germany (50-60 bln euro commitments to infrastructure and green energy), and monetary easing with the European Central Bank (ECB) reducing its key rate to 2.15%. European banks and industrials maintained their leadership while consumer sectors have lagged partly due to euro appreciation and ongoing trade tensions. French stocks, dominated by industrials and banks, have largely shrugged off ongoing parliamentary turmoil following the resignation of Prime Minister Michel Barnier after losing a no-confidence vote. A fragmented French Parliament risks stalling market liberalization, limiting productivity improvements, and could have reverberations across the European Union sovereign bond markets.

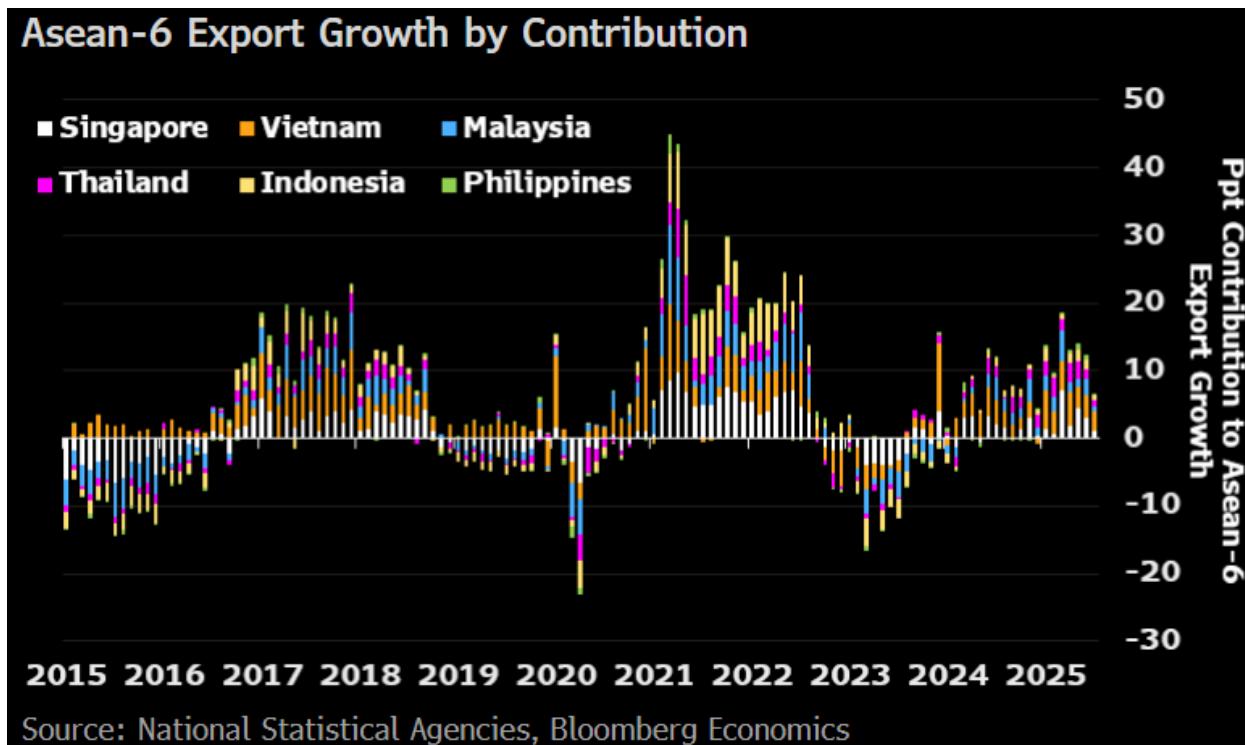
Across pan-Asia, despite rising trade tensions, such as the U.S. threatening services tariffs on India as well as raising the cost of H1-B visas, most equity markets outperformed led by the technology and services sectors as well as currency appreciation against the U.S. dollar. However, Southeast Asia's exports are starting to weaken, reflecting the impact of 19% reciprocal tariff that took effect in July.

## Implications: Uncertain U.S. Trade Policy and Political Uncertainty (Japan, France) More than Offset by Robust Fiscal Expansion and AI Infrastructure Buildout

The global equity market has tilted definitively towards 'risk-on' as indicated by the outperformance of global technology, beneficiaries of fiscal expansion and monetary easing (industrials, financials, small/mid-caps), and the outperformance of cyclicals versus defensive sectors. This has led market valuations (multiples to future earnings) rise to the high end of the 10-year range as the consensus veers away from global recession risk and fallout from geopolitical conflicts (Russia/Ukraine, the Middle East).

Despite this year's outperformance, global markets continue to be valued at a discount to the U.S. although those discounts have narrowed this year. Developed markets, as proxied by the MSCI EAFE Index, and emerging markets, as proxied by the MSCI EM Index, are now trading at 15.5x and 13.8x forward 12-month earnings, respectively. This valuation discount will likely persist as the rest of the world is expected to grow earnings at a slower rate versus the U.S. due to the dominance of U.S. tech sector earnings growth, although Emerging Asia is also expected to keep pace with the U.S. as the world races to build out its AI capacity. Overall, international stock markets are projected to see earnings growth in 2025 ranging from mid-single digits (e.g., 3-5% in Europe and 6-8% in Japan) to 15-18% for emerging markets, but much of this presumes a moderation in U.S. trade tariffs targeting 10-15% effective rates post-negotiations.

Attractive valuations offset by weaker profitability keep us neutral on regional allocations, although the outperformance of emerging markets is building momentum due to strong earnings growth outlook and currency appreciation against the U.S. dollar. As with the U.S. market, we emphasize positioning in high quality stocks trading at reasonable valuations.



## Conclusion

Investor risk sentiment has turned euphoric as can be seen by the strong quarterly rally across global risk assets, whether pro-cyclical equities, fixed income credit, and hard assets, especially precious metals. We remain cautiously optimistic on global equities although elevated market valuations (especially for U.S. stocks) mean future earnings growth have a higher hurdle for meeting expectations, much of which has ratcheted up exponentially following high profile AI-driven capital commitments. Our consensus outlook remains mid- to late cycle, as there are some signs of a hiring slowdown as consumers and businesses weigh the impact from tariffs on final demand. Cyclical tailwinds should continue to favor overseas markets across Europe and Asia, although political uncertainty should cloud the outlook for Japan and France.

Even with lower rates and narrower credit spreads, fixed income investors continue to have opportunities to secure moderately high real rates by extending maturities, although high grade sectors (corporate, asset- and mortgage-backed securities) are trading at post-pandemic premium valuations. For investors with significant foreign currency exposure, hedging to the USD or reallocating to U.S.-based fixed income is advised, as USD weakness appears to have incorporated much of the tariff uncertainty and will likely be driven by narrowing interest rate differentials between the U.S. and international markets.

Although we are neutral across major equity regions, we continue to favor U.S. equities, particularly those with strong balance sheets and sustainable profitability, trading at reasonable valuations. Until the earnings landscape broadens out beyond AI-driven sectors, small and mid-caps may remain challenged to match the pace of large caps even with the tailwinds of lower interest rates from monetary easing. In addition, investors are encouraged to explore hard assets like natural resources and real estate to hedge against inflation risks as current inflation readings remain elevated and above the Fed's implicit long-term targets.



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