

Back from the Beach: Reviewing the Investment Landscape

American summers, much more so than in the rest of the world, are defined by two bookends: Memorial Day and Labor Day. As a result, the first week in September is always a time to review and plan. This is particularly important for investors this year since, facing a barrage of unsettling political and economic news, on one side, and very solid investment returns, on the other, it's tempting to ignore fundamentals altogether and leave investments on auto-pilot.

However, given elevated valuations, potential economic difficulties and portfolios that have drifted in the direction of higher risk, it is important to understand the investment landscape. So it's a good time to review performance and valuations, Washington policies, the macro outlook, prospects for interest rates and the dollar and what it all means for investing.

Performance and Valuations

Starting with the good news, it has been another great year so far for diversified portfolios. Through August 29th, the S&P 500 achieved a total return of 10.8% while the Bloomberg U.S. Aggregate Bond Index returned 5.0%, combining to provide a total return on a simple 60/40 portfolio of 8.5%. This follows gains of 18% and 15.5% from the same portfolio over the prior two years.

That being said, performance this year has been a little different from the recent past. Within the U.S. stock market, value has continued to lag behind growth and large-cap stocks have continued to outpace their small- and mid-cap counterparts, although not by huge margins. By contrast, both DM and EM international equities have strongly outperformed U.S. stocks, with the MSCI All World Ex-U.S. Index generating a total return of 13.8% in local currency terms and 22.2% in U.S. dollars, reflecting a 7.4% boost from a lower dollar.

All of this great performance has, though, left us with some serious valuation issues. The S&P 500 is selling at a forward P/E ratio of 22.4 times, 1.6 standard deviations

above its 30-year average and almost its highest since the tech bubble. Moreover, this only tells part of the story.

At the peak of the tech bubble, on March 24th of 2000, the S&P 500 *was* priced higher, at 25.2 times forward earnings. However, in March 2000, adjusted after-tax profits for the prior four quarters had averaged 6.4% of GDP. By contrast, today, adjusted after-tax profits have averaged 10.8% of GDP over the last four quarters.

Today's elevated stock prices relative to profits are built upon elevated profits relative to GDP.

Combining these issues, we estimate that the value of all U.S. corporate equity is currently equal to 363% of nominal GDP for the past four full quarters, an all-time high and substantially above the peak of 212% seen in the first quarter of 2000 or the 77% seen just before the 1987 stock market crash. Moreover, even within the S&P 500, the top 10 stocks, by market cap, now account for almost 40% of the index and trade at a forward P/E ratio of 29.8 times compared to 20.6 times for the rest of the index.

It should be stressed that valuation issues are not pervasive across all capital markets. While no sector of U.S. equity markets looks cheap relative to history, neither value stocks nor small and mid-size stocks look as expensive as large-cap growth. Overseas P/E ratios are generally in the mid-teens. And fixed income markets, while not offering much opportunity for duration or credit bets, offer a decent level of income.

That being said, the riskiness of an investment strategy depends on the relative weights of these assets in a portfolio. A strategy that, either actively or passively, has become heavily overweight in mega-cap U.S. equities will likely be severely impacted by the next bear market.

Washington Policies

As investors toast past returns and worry about current valuations, they should also consider where the economy is headed. This, in 2025, starts with the impact of administration policies.

On tariffs, on Friday, the Federal Court of Appeals upheld a lower-court ruling that the President's so-called "reciprocal tariffs" are illegal. However, the appeals court ruling left the tariffs in place until October 14th to allow the administration to appeal to the Supreme Court.

How it proceeds from here is, of course, highly uncertain. That being said, one plausible scenario is that the Supreme Court takes the case and issues an injunction leaving the tariffs in place until they rule on the issue themselves – potentially not until next spring. If so, the impact of the tariffs will still feed through to the economy in the form of higher near-term inflation and tighter household budgets even as businesses delay decisions due to continued trade uncertainty.

On immigration, there has been a further decline in encounters with people crossing the southern border to under 8,000 in July, marking a sixth straight month of dramatically lower crossings. Government data on detentions and involuntary deportations remains spotty, although the latest reporting from the New York Times¹ on arrests, detentions and deportations suggests a running rate of just over 30,000 *involuntary* deportations per month.

Data on voluntary deportations appears to be non-existent and the State Department has suspended, or at least delayed, a monthly report on immigration visas issued. However, the latest data we have show average issuance in April and May 2025 of 47,000 – down 18% from the same months in 2024.

A continuation of these trends, along with some small allowance for self deportations, suggests that net immigration may have fallen to something less than 20,000 people per month or 240,000 per year. Census Bureau projections from 2023 suggest that this would result in a roughly 300,000 person annual decline in the population aged 18-64. This would represent a significant drag on labor force growth, suggesting that even minimal payroll job growth would be sufficient to prevent any surge in the unemployment rate and keep wage growth strong.

On fiscal policy, the new tax cuts embedded in the OBBBA will boost refunds and disposable income early in 2026 but should have little impact on consumer spending this year. However, if we see a significant softening in the economy in the months ahead, Congress may well resort to another bout of fiscal stimulus before the mid-term elections.

The Macro Outlook

Given all of this, where is the economy headed?

On growth, last week's data showed a healthy 3.3% annualized bounce-back in second quarter real GDP following a 0.5% decline in the first. However, these numbers continue to be badly distorted by tariff-related swings in international trade and inventories.

While this distortion continues, a better measure of economic momentum is final sales to domestic purchasers. These grew by 1.6%, annualized, in the second quarter following a 1.5% gain in the first. Looking under the hood, consumption, construction and government spending have been relatively soft so far this year but this is being offset by a surge in capital spending on equipment and software, presumably to power the AI boom. We expect these broadly divergent trends to continue for the rest of the year, although the weakness in consumer spending could become more pronounced in the fourth quarter due to higher inflation and weaker job growth.

That being said we don't expect growth to be weak enough to be labeled a recession and activity should accelerate, albeit temporarily, with the arrival of a bumper crop of income tax refunds in early 2026.

On jobs, this Friday's employment report could be one of the most important in years. Payroll job growth has averaged just 36,000 per month over the past three months even as the unemployment rate has remained relatively subdued at 4.2%. Our models are pointing to a payroll gain bouncing back to 100,000 jobs in August, although with the unemployment rate potentially nudging up to 4.3%.

However, even if job growth strengthened in August, initial annual benchmark revisions, due out on September 9th, could reduce average monthly job growth between March 2024 and March 2025 from 147,000 to something under 100,000. Looking forward, business uncertainty continues to drag on hiring, (which should be confirmed by this Wednesday's JOLTs report), while the immigration squeeze continues to curtail labor supply. Finally, while AI spending is clearly contributing to GDP growth, any positive impact on employment is likely to be much more muted. Overall, while we don't expect the unemployment rate to rise much in the months ahead, we expect job growth to be very slow.

On inflation, we have seen a creep up in some areas of consumer prices with year-over-year CPI inflation rising from 2.3% in April to 2.7% in July. Early indications suggest that the August CPI report, due out on September 11th, could show a month-to-month increase of 0.4%, pushing the year-over-year gain to 3.0%. If the average tariff level stays at its current 19.2%, year-over-year CPI inflation should continue to rise for the rest of the year before stalling in a 3.5%-4.0% range in early 2026 and fading back to between 2.5% and 3.0% in the fourth quarter of 2026. Year-over-year consumption deflator inflation should run about 0.2% cooler than CPI.

The Fed, the Dollar and Investment Implications

For the Fed, this outlook is obviously problematic. The short-term sluggishness of the economy argues for early easing. However, with unemployment likely to be restrained by a lack of labor supply, fiscal stimulus set to arrive in early 2026 in the form of income tax refunds and inflation expected to run well above the Fed's 2.0% target over the next year, there is a strong case for making no change in interest rates at the September FOMC meeting.

However, we agree with the futures market that the Fed will ease by 0.25% in September and at least once more before the end of the year. The stated rationale will no doubt be that, if FOMC participants are right in estimating a long-run neutral fed funds rate at 3.00%, then today's rate of 4.25%-4.50% is restrictive and some relaxation is warranted.

The unstated justification is that FOMC members are likely genuinely concerned about Fed independence. The administration's attempt to fire and prosecute Governor Cook, the Treasury Secretary's suggestion that Chairman Powell should resign as governor when he is not reappointed as Fed chair, and the quick nomination of Steve Miran as a temporary successor to Governor Kugler, all suggest that the administration is trying to establish a majority on the seven-member Fed Board of Governors. Such a majority

could then, in theory, refuse to reappoint the 12 regional Fed Presidents, when their reappointment comes up in February 2026.

While such a scenario still seems unlikely to play out in full, Chairman Powell may be more anxious than usual that the Fed portray a united front and so it would not be surprising if the FOMC cut by 25 basis points in September with no dissents. However, cutting rates in a slowing economy is a slippery slope as it would reduce interest income, could convince the public that further rate cuts are on the way and so they should delay borrowing and generally raise recession fears. This being the case, a September rate cut could be the start of multiple rate cuts, potentially reducing the federal fund rate to close to 3.0% by next summer.

Finally, on the macro backdrop, global PMI data due out this week should show a degree of resilience among both developed and emerging market economies. This, combined with the potential for further Fed easing, could allow the dollar to resume its decline that began at the start of the year but stalled out over the summer.

This evolving macro story should be seen both through the lens of valuations and portfolio positioning. There is a growing disconnect between a slowing and uncertain U.S. economy and a bubbly bull market in large-cap stocks. In addition, for most investors, years of outperformance in these stocks will have led to portfolio drift, with over-exposure to the most exuberant asset class. All of this continues to suggest that, as part of a diversified strategy, investors should ensure they have sufficient exposure to international equities and alternative assets.

¹ *Deportations Reach New High After Summer Surge in Immigration Arrests*, New York Times, August 21st, 2025