Third Quarter 2025 – Investment Commentary

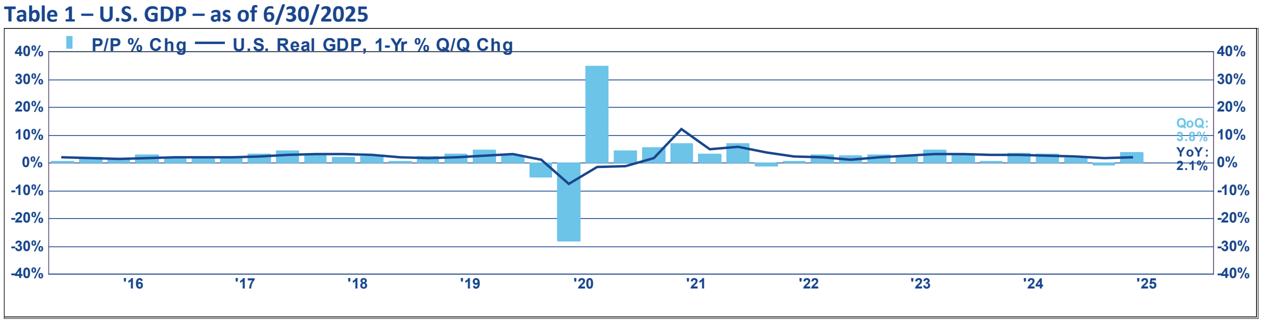
WEST SHORE BANK

Summary

Economic growth in 2025 showed resilience after a slight contraction in Q1, with the Federal Reserve shifting focus towards supporting employment through rate cuts amid subdued inflation and a moderating labor market. Stock markets benefited from improving trade conditions, optimism around AI, and strong earnings forecasts, while bond markets responded to Fed easing and economic growth concerns.

- **Economic growth rebounds strongly:** The U.S. economy expanded by 3.9% in Q3 2025, surpassing earlier estimates, driven by consumer spending and business investment, following a 3.8% growth in Q2. This reduces near-term recession risks but complicates Fed policy decisions.
- **Labor market shows signs of softening:** Unemployment rose to 4.3% in August 2025 with slower job creation, though wage growth remains above inflation. The labor market's weakness may pose risks to consumer spending but could regain strength given recent economic expansion.
- **Fed prioritizes employment over price stability:** The Federal Reserve cut rates by 0.25% in September and projects two more cuts in 2025, reflecting a shift to support employment amid moderating inflation and labor market concerns.
- **Technology and AI influence labor dynamics:** Similar to productivity gains in the 1990s, advances in AI may enable higher growth without inflation, affecting labor supply and demand, and potentially leading to a more cautious Fed approach to rate cuts.
- **Bond market reacts to Fed easing:** Treasury yields declined across maturities with short-term yields dropping more sharply due to expected further rate cuts, while credit spreads narrowed, benefiting credit instruments over government bonds.
- **Inflation remains above target:** Consumer Price Index rose 2.9% year-over-year in August 2025, driven by energy and shelter costs, with core inflation steady at 3.1%, complicating Fed policy and raising risks of renewed inflation acceleration.
- **Monetary policy outlook depends on inflation and labor:** The Federal Reserve's future rate decisions hinge on inflation trends and labor market conditions, balancing risks of inflation reacceleration against supporting growth and employment.
- **Equities favored over fixed income:** Strong economic fundamentals, easing trade concerns, accommodative monetary policy, and expected earnings growth support further stock market gains, while bond strategies anticipate a steepening yield curve with lower short-term rates and moderated long-term rates.

Table 1 – U.S. GDP – as of 6/30/2025



Following a negative reading of -0.6% in the first quarter of 2025, attributed to tariff and inflation concerns, the subsequent two quarters demonstrated resilient economic growth, with inflation remaining subdued yet above target, and a labor market showing signs of gradual softening. The Federal Reserve's dual mandate shifted towards prioritizing maximum employment over price stability, resulting in a quarter-point (0.25%) rate cut in September and projections for two additional cuts by year-end. Improvements on the trade and tariff front, optimism surrounding artificial intelligence, anticipated Federal Reserve rate reductions, and robust earnings forecasts have contributed to significant upward movement in stock markets. Although a pullback is likely after recent strong gains, underlying fundamentals remain supportive of further market expansion.

Table 2 – Stock Index Total Returns – as of 9/30/2025

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
MSCI Emerging	7.15	10.64	27.53	17.32	18.21	7.02	7.99
MSCI Developed	1.91	4.77	25.14	14.99	21.70	11.15	8.17
NASDAQ	5.68	11.41	17.93	25.42	29.92	16.07	18.32
S&P 500	3.65	8.12	14.83	17.60	24.94	16.47	15.30
Dow Jones Industrial	2.00	5.67	10.47	11.50	19.63	12.98	13.50
Russell 2000	3.11	12.39	10.39	10.76	15.21	11.56	9.77
S&P 400	0.46	5.55	5.76	6.13	15.84	13.61	10.82

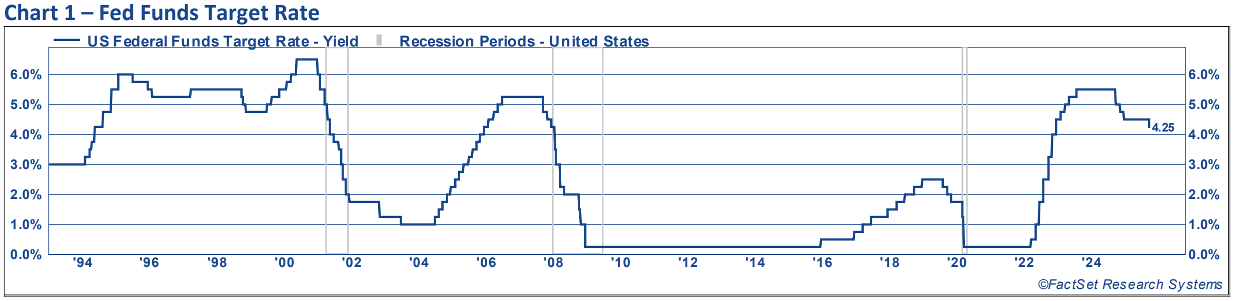
In the third quarter of 2025, the U.S. economy exhibited stronger-than-anticipated growth, dispelling previous concerns regarding a potential slowdown. Real GDP for this period is currently projected at 3.9% on a seasonally adjusted annual rate basis, surpassing mid-quarter estimates of 3.3%, primarily driven by robust consumer spending and increased business investment. This performance follows a 3.8% expansion in the second quarter of 2025, highlighting an accelerated economic trajectory. While this growth reduces near-term recession risks, it also introduces further considerations for the Fed as it seeks to balance its dual mandate.

The labor market experienced further moderation, with the unemployment rate increasing to 4.3% in August, approaching a four-year peak, as job creation declined markedly. While wage growth pressures have moderated slightly, they continue to outpace inflation. The uptick in unemployment may indicate emerging risks to consumer spending; however, this trend has not yet materialized. Considering the robust economic expansion observed over the previous two quarters, there is reason to suggest the labor market could regain strength moving forward.

Despite robust economic growth over the past two quarters, the labor market has shown signs of weakness and is not expanding as anticipated. As noted by Federal Reserve Chair Powell in his opening statement at the press conference, "the marked slowing in both the supply of and demand for workers is unusual. The downside risks to employment appear to have risen." Factors such as lower immigration rates and decreased labor force participation may account for a reduced labor supply; however, diminished labor demand may also stem from businesses exercising caution in hiring amid uncertainties related to tariffs, government workforce reductions, and productivity improvements driven by artificial intelligence (AI).

Advancements in technology-driven productivity during the mid-1990s presented a challenge for economists and the Federal Reserve. The period was characterized by strong economic growth and a resilient labor market, yet wage growth remained subdued. A similar scenario may occur with ongoing progress in artificial intelligence. The Federal Reserve back then expressed significant concern regarding potential inflation, as many members anticipated substantial wage increases and higher costs resulting from tight labor market conditions.

Chart 1 – Fed Funds Target Rate



The positive impact of productivity gains brought about by technological innovation was underestimated. Records from the July 1996 FOMC meeting highlight the Federal Reserve's apprehension over inflationary wage pressures amid robust economic expansion and elevated employment levels:

> *"Several members commented that the levels of utilization of capital and labor resources that had prevailed over the past couple of years would have been expected, on the basis of past historical patterns, to foster rising cost pressures and greater inflation. Despite the continued low rate of unemployment and widespread anecdotal reports of tight labor markets across the country, there were only limited indications in national data that wage inflation might be increasing. Whether greater labor cost pressures would emerge in the context of the members' consensus forecast for economic activity was a critical issue in the outlook for prices. Even if greater price inflation were averted under that scenario, the members saw a substantial risk that if economic growth did not slow in line with their current forecasts, the resulting added pressures on resources would at some point translate into higher price inflation. Accordingly, the factors bearing on the outlook for resource use and inflation need to be monitored with special care in this period."*

Employment may experience renewed momentum in the coming months, and advancements in AI could fundamentally transform the economy, enabling higher growth without triggering inflation. Should employment indeed recover, this concern would diminish for the Fed, potentially recalibrating mandate risks and, similar to the mid-1990s, mistakenly result in a more measured pace of anticipated rate cuts. Earlier this year, the Federal Reserve adopted a similar strategy for expected tariff-driven inflation, which has yet to significantly appear.

In response to the cooling labor market and continued subdued inflation, the Federal Open Market Committee (FOMC) reduced the federal funds rate by 25 basis points (0.25%) on September 17, establishing a new target range of 4.00%–4.25%. This decision, which did not garner unanimous support among committee members, reflects confidence in moderating inflation alongside continued vigilance regarding labor market conditions. The Federal Reserve projects two further rate reductions in 2025, a forecast that is presently mirrored by bond market expectations.

The bond market experienced price gains in response to the Federal Reserve's rate cuts and a shift in investor attention from inflationary pressures to concerns regarding economic growth. Treasury yields decreased across the curve, with short-term yields reflecting expectations of additional monetary easing. In contrast, long-term yield declines were moderated by ongoing fiscal uncertainty. The 3-Month

T-Bill yield fell from 4.28% to 3.93%, while the 10-Year Treasury yield decreased from 4.22% to 4.14%. Additionally, credit spreads narrowed, leading credit instruments to outperform government bonds.

Table 3 - Fixed Income Total Returns – as of September 30, 2025

Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Bloomberg High Yield	0.82	2.54	7.22	7.41	11.09	5.55	6.17
Bloomberg U.S. Aggregate	1.09	2.03	6.13	2.88	4.93	-0.45	1.84
Bloomberg Inter Gov't/Credit	0.42	1.51	5.70	4.01	5.18	0.81	2.10
Barclays Michigan Muni	2.09	2.82	2.76	1.48	4.70	0.80	2.47
Bloomberg Municipal	2.32	3.00	2.64	1.39	4.74	0.86	2.34

Inflation increased, with the Consumer Price Index (CPI) rising 0.4% month-over-month in August and 2.9% year-over-year, marking the highest rate since January. This change was primarily influenced by energy and shelter costs. Core CPI, which excludes food and energy, remained at 3.1%, staying above the Federal Reserve's 2% target and adding complexity to monetary policy decisions. The Fed must remain vigilant about the risk of inflation reaccelerating. Should inflation persist above target, the Fed may be forced to reconsider the pace of future rate cuts or even pause easing measures to prevent further price instability.

Like employment, the trajectory of inflation will play a critical role in shaping monetary policy decisions. If price pressures continue to build, policymakers could face renewed debates about the timing and magnitude of additional rate cuts. Conversely, if inflation stabilizes or begins to fall back toward target, the Fed may feel more comfortable supporting growth and employment with further easing. Ultimately, the interplay between inflation, labor market conditions, and economic growth will drive the Fed's policy path for the remainder of 2025 and into 2026.

From an asset allocation standpoint, equities are currently preferred over fixed income, given robust economic fundamentals that support further gains in the stock market. Recent developments have reduced tariff and trade concerns, the U.S. economy is projected to maintain steady growth, monetary policy has become more accommodative, and corporate earnings are expected to increase by 11% to 14% this year and next. Additionally, inflation remains subdued, and there is growing optimism and investment in artificial intelligence, all of which contribute to a favorable outlook for continued market progress. Regarding bonds, we continue to recommend strategies that anticipate a steepening yield curve and the normalization of yield spreads, expecting lower short-term rates driven by potential Federal Reserve rate cuts, while longer-term rates may be moderated by persistent inflation above target and current fiscal policies.

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Sources: FactSet, Federal Reserve, U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis, Federal Reserve Bank of Atlanta, FactSet Earnings Insights