AVITY Investment Management Inc.®

PERSPECTIVE

October 2025

U.S. equities advanced during the third quarter and have registered above-average gains for the year, boosted by strong corporate earnings and prospects for monetary and fiscal stimulus. Fixed income investments also recorded positive returns for the quarter and year-to-date as interest rates fell for bonds of all maturities. The resilience that characterized the U.S. economy over the past year persisted through the recent quarter, while many overseas economies struggled to achieve meaningful growth. The investment outlook will be shaped importantly by evolving trade policies, inflation trends and AI's impact on productivity, but a continuation of the global economic expansion appears likely.

ECONOMIC BACKDROP

The domestic economy expanded at a healthy rate in recent months as businesses and consumers took trade tensions and political discord in stride. Retail sales have remained strong with households demonstrating the wherewithal and confidence to spend, particularly at the higher income levels. Wage growth continued to outpace inflation, jobs remained relatively plentiful and consumer net worth increased 9% over the last year to reach an all-time high. The service sector and technology industry have been areas of strength. Small businesses, which account for much of the job creation, showed notable optimism at the advent of the new presidential administration. Business confidence waned at the height of tariff uncertainty last spring but has improved with the July passage of the major tax and spending bill, which includes valuable incentives for capital investment. The manufacturing sector has been sluggish, with little evidence so far that tariffs are delivering the intended domestic lift. The unemployment rate inched up in recent months to 4.3% for August. The September reading was delayed by the government shutdown, which we don't expect to have a material economic impact. The rate of joblessness is still low by historical standards, potentially benefitting from lower immigration which has constrained the labor supply, but a slowdown in hiring prompted the Federal Reserve to cut its target interest rate last month for the first time this year. The housing market, which has been challenged by affordability, may see a boost from lower interest rates, as might other interest rate sensitive sectors. Overseas, the trade war has weighed on economic activity while strained fiscal conditions are stirring political strife. Growth in Europe is subdued and many of the continent's governments are contending with serious budget concerns which have pushed interest rates on many of the region's sovereign bonds to the highest yields in over a decade. Japan's stagnant growth and rising living costs forced the resignation of its prime minister last month. Growth in China continues to outpace other major economies, but the nation faces challenges including high U.S. tariffs, a protracted property downturn, deflationary pressures and elevated youth unemployment. Looking ahead, we expect the U.S. to remain a key engine of global growth and gradual resolution of trade disputes should help lift international activity.

S&P 500 Index —Past Five Years

Source: Bloomberg

TECHNOLOGY TENSION WITH CHINA

The U.S. and China, the world's two largest economies, are locked in a high-stakes race for artificial intelligence supremacy that has broad investment and geopolitical consequences. Entrenched in economic and military rivalry, each country holds certain strategic advantages. China is an important source of sales and manufacturing for U.S. companies, controls critical minerals, and threatens to annex Taiwan, an independent democracy that is the global epicenter of advanced semiconductor output. The U.S. is China's largest export market and benefits from its dominance in global finance and an advantage in technological innovation. While commercially interdependent, the two nations compete fiercely for industrial superiority, especially in technology. Semiconductors, in particular, have become a central battleground with elevated strategic im-

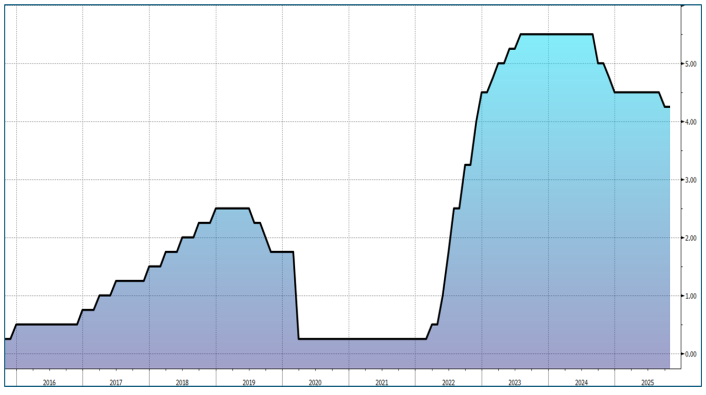
portance in the age of artificial intelligence.

The semiconductor industry is comprised of an extraordinarily complex global supply chain, with western companies like Nvidia, Broadcom, Applied Materials, and ASML in control of the most advanced technologies. In the U.S., there is a policy debate over the merits of limiting China's access to advanced chips, to impede their progress in AI, versus exporting western technology, to promote U.S. standards and limit China's motivation to pursue their own innovation. Restrictions imposed in 2022 curtailed China's ability to acquire cutting-edge tools and chips. The Trump administration further blocked the sale of Nvidia's lower-tier processors in April before reversing that decision in July. In response, China has discouraged the use of western hardware to promote homegrown innovation from the likes of Huawei. The result is a likely bifurcation of the global technology landscape. At stake are the future standards upon which AI will be developed and the ability for the U.S. to maintain technological leadership. AI stands to unleash economy-amplifying productivity and confer military advantage, with investment implications across a wide spectrum of businesses.

FIXED INCOME

U.S. bonds produced excellent returns over the third quarter and year-to-date, buoyed by the Fed's dovish pivot towards rate cuts, easing tariff concerns, stable credit conditions and slower job creation. Yields on the ten-year U.S. Treasury Note finished the quarter at 4.1%, down from 4.6% at the start of the year.

Federal Funds Rate —Past Ten Years



Source: Bloomberg

The Fed's 0.25% rate cut is expected to be followed by up to two additional such reductions this year, though it's not assured that yields on longer-term bonds, which are dictated by market forces, will fall in lockstep. Indeed, yields on ten-year bonds have drifted higher since the Fed's cut last month as investors await confirmation that inflation is tamed. The federal budget deficit is projected to expand as a result of the One Big Beautiful Bill, potentially limiting the decline in long-term government borrowing rates. Yields on money market funds, which exceeded rates on longer term bonds for several years, are expected to fall steadily as the Fed Funds Rate declines. Municipal bonds performed particularly well last quarter, supported by healthy credit perceptions and high demand for their tax-exempt income. We extended maturity durations in client bond portfolios over the past year and expect to be well positioned for the rate-cutting cycle that has resumed.

EQUITIES

U.S. stocks performed well last quarter, driven by strong corporate earnings, new tax legislation and anticipation of Fed rate cuts. The S&P 500 recorded an 8.1% return in the third quarter and is now up 14.8% for the year, swiftly overcoming a 20% plunge last spring. Much of the growth in corporate earnings is driven by a relatively narrow group of large companies, predominantly from the technology sector. The momentum of those stocks has lifted the overall market to new highs but may be masking less robust fundamentals for the average business. The historic magnitude of capital spending on AI is driving profits beyond the technology sector, including industrial businesses providing cooling and electrical equipment, utility companies supplying the massive energy needs and real estate and construction companies developing datacenters. While there are few signs of the AI investment pace abating, we remain cognizant that there is potential for excesses to emerge as has occurred in previous technological revolutions. Less glamorous sectors of the market, such as healthcare, consumer staples and energy, have lagged, but offer compelling valuations and important portfolio diversification at a time when multiples for the overall market are near the high end of the historical range. Beyond the highly valued large companies, the average stock does not appear excessively valued in the context of the moderate economic growth environment that we anticipate in the period ahead. Client portfolios are structured to capture opportunities emerging from the AI buildout while maintaining balance through investments in a variety of high-quality businesses across sectors to deliver durable, risk-adjusted returns through the economic cycle.