



MARKET UPDATE

Economic Market Update – Third Quarter, 2025

October, 2025

- Growth demonstrates resiliency with recent upward revisions indicating an improving environment as the Fed looks to begin a cycle of rate cuts in the months ahead.
- Strong YTD performance is demonstrated in both Domestic and International Equities while the Fixed Income market has ample opportunity for investors to take advantage of longer term bonds with attractive coupons versus anticipated inflation.
- The AI revolution and its supporting infrastructure continues to impact the economy through dramatic increases in capital spending focusing on future productivity gains.
- There are still some competing tensions in the economic environment as wage growth and labor markets cool – perhaps indicating a “K-shaped economy” is on the horizon.

As 2025 enters its final stretch, the dominant storyline is that despite immense policy uncertainty, the economy has been surprisingly resilient. Growth slightly slowed in the first half of the year, but indications suggest the economy reaccelerated in the third quarter. Unemployment remains low, and inflation, while up a bit, has not accelerated as strongly as many feared. The Federal Reserve has successfully moved from an era of unprecedented tightening to an easing cycle without tipping the economy into recession. Markets have rewarded this outcome with a broad-based rally across both equities and bonds – an “everything rally” that has created a constructive environment for investors that was hard to envision just months earlier in the midst of the post-Liberation Day trade turmoil.

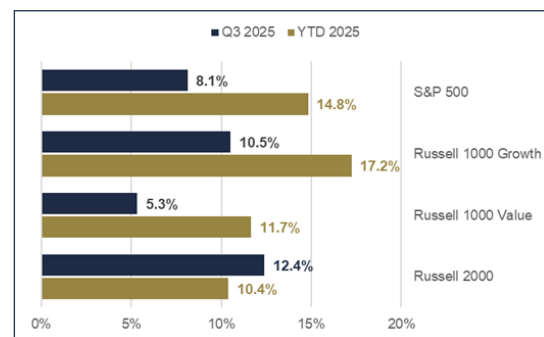
But beneath the surface, the story is more complex. The current economic environment is defined by competing tensions. On one side, an extraordinary boom in capital spending – anchored by artificial intelligence and related infrastructure – is indicative of structural productivity gains. On the other, labor markets are cooling, wage growth is decelerating, and the distribution of economic gains is becoming increasingly uneven, indicating we may be entering into a “K-shaped economy” reminiscent of the “K-shaped recovery” experienced in the aftermath of the COVID pandemic. In the markets, this has translated to elevated valuations in the most crowded segments of the U.S. equity market (e.g. the megacap names that dominate the S&P 500), while the valuation of the average stock in the index is closer to the historical average. Certain sectors, like health care and real estate, even appear downright cheap. Even as Federal Reserve Chair Powell acknowledges that stock prices are “fairly highly valued,” underneath the surface, the story is far more nuanced.

For investors, this means the playbook of simply owning concentration is losing relevance – and is appearing increasingly risky. The path forward necessitates a departure from strategies concentrated in megacap technology and communications firms that have dominated recent years; while prudence requires maintaining exposure to the biggest names, the current capital expenditure plans of these AI hyperscalers coupled with their stretched valuations is steadily increasing the risk from their concentration at the top of the market. The historical performance of these stocks has been driven by their growth rates and high profit margins, made possible in part due to their asset-light business models. As they engage in one of the largest capital spending campaigns in history, margins may become at risk, particularly if the revenue expected from the AI revolution fails to materialize as quickly as anticipated.

While the overall environment is supportive of risk assets, the easy, broad-based gains from the initial policy pivot may be behind us. The outlook as we close out 2025 and move into the new year calls for a more sophisticated approach focused on diversification, relative value, and quality. We are positioned to benefit from several key themes, including high-quality fixed income as a core portfolio anchor, broadened equity exposure beyond the megacap leaders, and strategically integrating alternative assets to navigate a world of more modest expected returns where appropriate.

U.S. Equity

Through the first nine months of 2025, the U.S. equity market has delivered a story of resilience and recalibration. Year-to-date, broad market gains have been driven by a narrow set of leadership in technology and large-cap growth, but the third quarter brought signs of rotation as investors weighed an evolving Federal Reserve stance, and the durability of corporate earnings. Beneath the headline numbers, dispersion has widened – rewarding selectivity and risk management – while the path forward looks increasingly tied to how markets balance economic data uncertainty and the risks associated with a “K-shaped” economy with the prospect of policy easing into 2026. For long-term investors, the picture is less about quarter-to-quarter volatility and more about whether current conditions mark the start of a broader, more balanced cycle of market leadership.

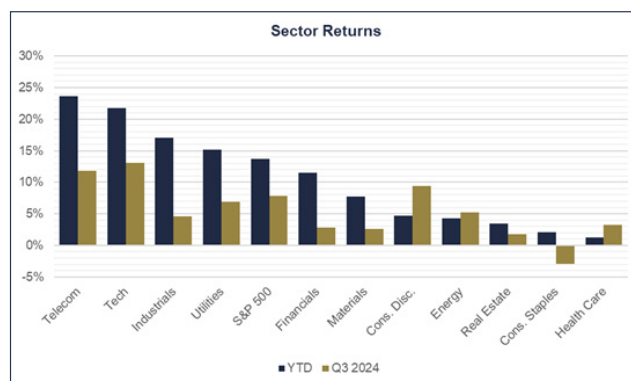


Russell Style Box			
	Year-to-Date Returns		
	Value	Blend	Growth
Large	12.9%	15.7%	17.2%
Mid	9.5%	10.4%	12.8%
Small	9.0%	10.4%	11.7%

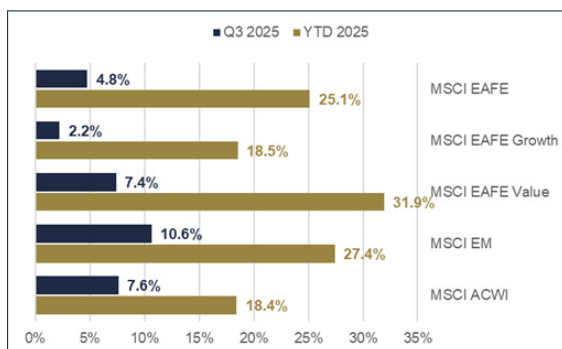
The S&P 500, the bellwether for U.S. stock returns, finished the third quarter up 8.1%, pushing the index's year-to-date gain to 14.8%. Small-cap stocks also rallied strongly in the third quarter, with the Russell 2000 up 12.4%, but still trail their large cap peers on the year, returning 10.4% YTD. All nine Russell and S&P style boxes once again finished the quarter in the green. U.S. equity performance continued to vary widely by style, however, as large cap growth stocks regained their leadership position, finishing the quarter with a strong rally. The Russell 1000 Growth Index finished Q3 up 10.5%, significantly outpacing the 4.9% return of the Russell 1000 Value Index. A strong third quarter saw large cap growth stocks regain their familiar leadership position for the year as well, with growth up 17.2% compared to the 12.9% gain for the value index.

Performance also varied widely across sectors and industries. Ten of the eleven

sectors in the S&P 500 were up during the quarter, but the concentration of technology and communications stocks in the index left the overall index return well ahead of the return of all but three sectors. Information Technology and Communications stocks were the biggest winners yet again in Q3, with the Tech sector up 13.0% on the quarter and the Communications sector up 11.8%. Communications stocks lead year-to-date, up 23.7%, followed by Tech (21.8%). Industrials and Utilities stocks are also performing better than the S&P 500 as a whole on the year, driven largely by the massive capital expenditures of Tech and Communications companies as they build out their AI infrastructure. Consumer Staples was the only sector in the red in Q3, driven by concerns over margin pressure as a result of tariffs and lack of pricing power challenging the ability of firms to pass on increased costs to consumers. All sectors are now positive on the year, but Health Care, Consumer Staples, and Real Estate stocks have remained challenged.



International Equity



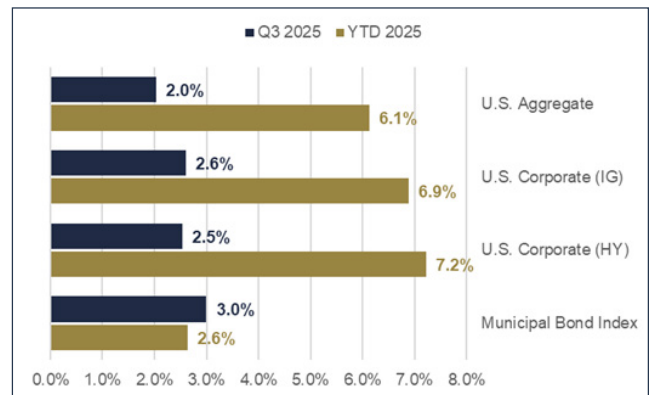
International stock markets continued to demonstrate the value of diversification in Q3 2025. Though they ceded the leadership position to the U.S. in Q3, international stocks remain firmly entrenched as the leaders on the year. The MSCI EAFE Index, which tracks developed international markets, finished the quarter up 4.8% and is now up 25.1% YTD. While the growth style continues to dominate the domestic stock market, international returns show that the value style still has an important role to play in diversified portfolios. Value outperformed substantially internationally, with the MSCI EAFE Value Index up 7.4% for Q3 and 31.9% YTD compared to the MSCI EAFE Growth's returns of 2.2% and 18.5% respectively.

Emerging markets posted the strongest international returns on the quarter and now also lead on the year, with stocks in developing countries up 10.6% in Q3 and 27.4% on the year. A key driver of international returns in 2025 has been the depreciation of the U.S. dollar, which is down 10.6% on the year against a trade-weighted international basket of securities, increasing returns for U.S. based investors. **Summing up the global stock market in Q3, the MSCI All Country World Index, which tracks the global stock market, was up 7.6% and is now up 18.4% on the year.**

Fixed Income

The fixed-income market has also quietly had a strong year.

The Bloomberg U.S. Aggregate Bond Index, a broad measure of the performance of investment-grade fixed-income markets in the U.S., was up 2.0% for Q3 and is now up 6.1% YTD. Investment-grade credit, as measured by the Bloomberg U.S. Credit Index, was up 2.6% on the quarter and 6.9% on the year. Riskier areas of the fixed income market continued the rally that began in Q2, with the Bloomberg U.S. Corporate High Yield Index up 2.5% in Q3 and 7.2% YTD. International bonds gave back some gains in Q3, finishing the quarter down -0.6%, but lead year-to-date on the back of a weaker U.S. dollar, up 9.4% on the year. Municipal bonds had a strong quarter, with the Bloomberg Municipal Index up 3.0% in Q3, but still lag on the year with a return of just 2.6%. **Summing up global fixed income markets in Q3, the Bloomberg Global Aggregate Index was up 0.6% for the quarter and is now up 7.9% for the year through September.**



The Economy

The macroeconomic consensus is coalescing around a period of moderating but resilient growth. Upward revisions to U.S. GDP, now tracking above 3.0% for the third quarter, have solidified the narrative that the economy remains on solid footing. This resilience is underpinned by two critical, yet conflicting, dynamics: the strength of the consumer balance sheet versus the slowdown in real income, and the boom in business investment versus the cooling of the labor market.

The American consumer remains the bedrock of the economic expansion, yet the sources of their strength are shifting. On one hand, a crucial risk is the deceleration of real labor income growth. Stalling job growth, combined with the inflationary pass-through from U.S. tariffs, is poised to squeeze household purchasing power, a classic late-cycle headwind.

However, a powerful counterpoint to this concern is the “wealth effect,” a theme gaining prominence in recent analysis. U.S. household net worth has surged to a record \$161 trillion, a staggering 8.2 times disposable income. This immense wealth, concentrated in equity portfolios and housing, provides a substantial cushion that allows spending to remain robust even as income growth slows. Recent economic estimates suggest this effect will add as much as 0.7 percentage points to consumption growth in 2026, primarily driven by the high-income households who hold the majority of these assets. This view is supported by bottom-up corporate intelligence, with analyst surveys and comments from management on corporate earnings calls showing continued strength in new orders and healthy consumer demand in September. For now, the consumer remains a source of stability, though the growing bifurcation between wealthy asset owners and income-dependent households is a critical fault line to monitor, contributing to the emerging risk of a “K-shaped” economic environment.

The second major tension is the striking divergence between business investment and hiring. A global capex boom is underway, with spending rising at an 11% annualized rate in the first half of 2025. This surge is almost entirely attributable to the AI investment cycle, as companies pour capital into data centers, semiconductors, and related infrastructure. This theme is not merely a market narrative; it is a fundamental economic driver, boosting productivity and, with it, U.S. potential GDP. At core, economic growth rates boil down to two principal components: the size of the labor force and the productivity of that labor. Forecasters across Wall Street have begun to update their estimates of potential GDP on the back of expectations for higher future productivity. Consensus estimates for potential GDP have risen above 2%, a material increase from the 1.7% consensus at the start of the year, and many forecasters see a path to 2.5% in short order as AI adoption accelerates across sectors of the economy.

In stark contrast to this capital investment fervor, developed market job growth has slowed to a crawl. U.S. payroll gains have moderated significantly, a trend that has prompted the Federal Reserve to adopt a “risk management” approach to easing. This juxtaposition is historically unprecedented and presents two competing narratives for the future. The optimistic interpretation is that this is the beginning of an AI-fueled productivity boom, allowing for a sustained “jobless recovery” where the economy can grow without stoking wage inflation. The more cautious view is that this could be a narrow, tech-focused bubble that will fade, leaving the economy vulnerable to the broader trend of weakening labor income and business caution.

Two structural issues will continue to shape the landscape. First, housing affordability in the U.S. is at a 40-year low, primarily due to the “lock-in effect” that has constrained the supply of existing homes for sale by around 40%, though there is significant regional variation. Modest Fed cuts are unlikely to resolve supply-side issues where they exist and could even exacerbate affordability challenges by boosting demand. Second, while the impact has been muted by significant trade rerouting and tariff evasion, the drag from U.S. tariffs is still building and will act as a persistent, low-grade inflationary pressure and a tax on the consumer.

Against this complex backdrop, the Federal Reserve is expected to continue its easing cycle. Current forecasts project 25bp cuts in October, December, and January, followed by a pause and two additional cuts sometime in 2026. This path is consistent with a cup half empty view of the economy through 2026, aligning with the more dovish camp on the FOMC, but pivots to a cup half full view thereafter, suggesting the market sees a return to a higher-growth, higher-rate regime in the long term.

Market Outlook

The start of a non-recessionary Fed easing cycle provides a historically bullish signal for equities. Historical analysis of “insurance cut” cycles – as Chair Powell recently dubbed the September decision – shows that they have been followed by average S&P 500 returns of approximately 20% over the subsequent 12 months. While the initial powerful rally may be complete, the fundamental and policy backdrop remains supportive of further gains, though those who shift from chasing concentration to embracing diversification will likely see greater rewards.

The most significant challenge for U.S. equities is valuation. The S&P 500’s headline price-to-earnings ratio is elevated, a fact acknowledged by investors and policymakers alike. However, this is a story of concentration, not broad market excess. The top 10 stocks in the index trade at a significant premium, while the remaining 490 companies – the “S&P 490” – are trading at valuations near their long-term historical average. This bifurcation is the central opportunity in the U.S. market. Similarly, U.S. small caps also appear attractively priced relative to their large-cap peers.

The valuation case is even more compelling outside the United States. International developed markets in Europe and Japan, as well as Emerging Markets, are trading at significant valuation discounts to the S&P 500. This discount provides both a margin of safety and a greater potential for re-rating, particularly if a cyclical weakening of the U.S. dollar that has already materialized has further to run, which we believe is likely.

Our base case expects the engine of market performance to shift in the months ahead. After years of earnings growth being dominated by a handful of mega-cap technology firms, forecasts for 2025 indicate a significant broadening, with the “S&P 490” expected to contribute much more meaningfully to overall index earnings growth. This fundamental shift supports a strategic rotation away from the most crowded mega-cap names. Mid and small cap earnings growth is expected to outpace the largest names by an even more significant margin. In light of the capex boom currently underway by the AI hyperscalers, this naturally makes sense; spending from the Mag. 7 translates into earnings for other U.S. companies. Further bolstering this outlook is the resurgence of corporate activity. A pickup in both Initial Public Offerings (IPOs) and Merger & Acquisition (M&A) announcements signals a return of confidence in the C-suite. This is a healthy sign for the market, improving liquidity and reflecting a belief in a stable to improving economic future.

The path forward in equities given our base case requires diversification, and our current positioning in small- and mid-cap stocks should benefit from a broadening out of the market. While a wholesale exit from US mega-cap technology is not advised given the fundamental strengths of the companies concentrated at the top of the market cap spectrum, portfolios should be rebalanced to increase exposure to the more reasonably valued segments of the market if positioning has shifted because of the summer market rally. This includes the broader “S&P 490,” U.S. small- and mid-caps, and a strategic allocation to international equities. While we continue to maintain an overweight to U.S. equities given our long-term expectations for the impact of AI (and the fact that U.S. companies are the globally dominate players in that arena), opportunities are present in Europe (cyclical recovery), Japan (corporate reforms), and Emerging Markets (demographics and a weaker dollar).

The most significant strategic shift for asset allocation in late 2025, however, is the resounding return of fixed income as a core asset class, a narrative that began to take shape in late 2022. After a challenging period during the fastest tightening cycle in decades, bonds now offer a multi-faceted value proposition that has been absent for over a decade.

The primary driver of this theme is the level of starting yields. With yields across the quality spectrum at their highest levels in over a decade, bonds once again provide a compelling source of income. An investor can now lock in yields on high-quality corporate bonds that are well in excess of inflation expectations and the eventual trough policy rate. Beyond income, the prospect of a sustained Fed easing cycle provides a powerful catalyst for capital appreciation. As policy rates fall, bond prices are expected to rise, adding a total return component that could be significant. Critically, as inflation normalizes, the negative stock-bond correlation that defined balanced portfolios for decades is re-emerging, restoring the role of high-quality bonds as a vital diversifier against equity risk (though risk remains that long rates may climb in the near-term should inflation appear to reaccelerate).

The shape of the yield curve is becoming a more consequential driver than the absolute level of rates. The market is experiencing a “bull steepener,” where short-term yields are falling faster than long-term yields in anticipation of Fed cuts. This dynamic informs a few of our key tactical fixed income views. As it relates to positioning, we favor the belly of the yield curve, which offers an optimal blend of attractive carry (yield) and roll-down (the price gain as a bond moves down the steeper part of the curve over time). While our long-term view is to own duration in a declining rate environment to capture the return premium embedded in longer duration fixed income assets, resilient near-term economic data has led us to develop near-term caution around the 10-year Treasury rate. In the current environment, it’s possible – perhaps even likely – that the 10-year rate rises even as short-term rates continue to fall. The approach to credit risk also requires nuance in light of the current environment. The “everything rally” has left headline corporate credit spreads near historical lows across the credit quality spectrum, limiting the potential for further broad-based compression from here. Alpha generation in this environment requires a more granular, relative-value approach. Tactically, the environment indicates investors should prefer fixed-rate high yield bonds over floating rate high yield loans. In a rate-cutting cycle, the fixed-rate nature and longer duration of high-yield bonds offer superior price convexity compared to floating-rate leveraged loans. Additionally, the rise of covenant-light and no covenant loans in the floating rate space likely mean far weaker credits reside in the asset class relative to the fixed rate high yield market. Relatedly, overweighting higher-quality BB bonds in the high yield space will provide more resilience in portfolios should the economy weaken materially. Finally, with corporate spreads tight, analysis points to compelling relative value in Asset-Backed Securities (ABS). While subprime consumer debt should be avoided (delinquencies have already picked up materially among subprime borrowers and is a key piece of the puzzle pointing to a “K-shaped” economy, prime auto and credit card ABS offer a significant yield pickup with strong underlying fundamentals tied to the healthy consumer balance sheets of the high income cohort most supported by the “wealth effect.”

The Path Forward

The outlook for the remainder of 2025 and into 2026 is one of cautious optimism. The achievement of a soft landing and the start of a Fed easing cycle have created a favorable environment for both equity and fixed income investors. However, the crosscurrents of a slowing labor market, stubborn housing affordability issues, and stretched valuations in market-leading stocks demand a sophisticated and active approach to asset allocation.

This is not a moment for binary risk-on or risk-off decisions. Rather, it is an opportune time for strategic rebalancing. The current moment offers a resounding opportunity to rebuild allocations to high-quality fixed income, using the current attractive starting yields as a portfolio anchor and source of income. Within equities, the focus must shift from chasing the handful of stocks that have driven the market to date to diversifying across the broader U.S. equity landscape and, tactically, taking advantage of attractively valued markets in Europe, Japan, and Emerging Markets. Finally, integrating alternative assets where appropriate can provide uncorrelated return streams and enhance long-term portfolio resilience. The “everything rally” may not last forever, but a well-diversified, quality-focused portfolio is positioned to navigate the opportunities and challenges that lie ahead.

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