

# COLONIAL TRUST *Quarterly*

Quarterly Performance —

Looking Ahead —



# PERFORMANCE FOR THE QUARTER

**THE S&P 500 ENDED THE THIRD QUARTER CLOSE TO ALL-TIME HIGHS, WHICH IT THEN BROKE THROUGH ON THE FIRST DAY OF OCTOBER.**

This all-time high coincided with a government shutdown, with Congress unable to pass a continuing resolution. Concerns about trade policy, the government shutdown, slower job growth, and geopolitics were discounted as the S&P reached 23 new record highs in the quarter. Ten of the eleven sectors of the S&P 500 were higher for the quarter. As we have become accustomed, the market was led by the technology, communication services, and consumer discretionary sectors.

The Nasdaq, with large representation of the aforementioned sectors, outperformed the S&P 500's 8.1% return for the quarter, being up 11.4%, while the DJIA gained 5.7%. Of note, the small-cap Russell 2000 outperformed its large-cap brethren for the quarter, returning 12.4%. This index reached a new all-time high on September 18th, eclipsing the prior high from November 2021.

International markets, which outpaced domestic markets in the 1H25, posted positive returns. However, the developed markets trailed US markets with the MSCI EAFE index returning 4.9%. European markets were the laggard as concerns about growth and fiscal issues weighed on Germany and France. Emerging markets continued to post strong results, with the MSCI EM index returning 10.9%.

Fixed-income markets returned 2.0% as measured by the Bloomberg US Agg. Bond index. Interest rates fell across the yield curve, with short-term rates down sharply after the Federal Reserve restarted its interest rate cutting cycle.

| Total Returns         | 3rd Quarter | Year-to-Date |
|-----------------------|-------------|--------------|
| S&P 500               | 8.1%        | 14.8%        |
| DJIA                  | 5.7%        | 10.5%        |
| Nasdaq Composite      | 11.4%       | 18%          |
| Russell 2000          | 12.4%       | 10.4%        |
| MSCI EAFE             | 4.9%        | 25.8%        |
| MSCI Emerging Markets | 10.9%       | 28.2%        |
| Bloomberg Agg Bond    | 2%          | 6.1%         |

Source: Bloomberg LP, total return

# THE MARKETS HAVE MOVED PAST THE DISTRACTION IN WASHINGTON.

In our last newsletter, we discussed the markets' reaction to the ever-changing policy from Washington and its impact on the economy and markets.

As we consider the third quarter, we cannot say it was devoid of policy uncertainty. Nevertheless, the capital markets seemed to look past policy changes and uncertainty. The VIX measures the implied volatility of the equity market, and the ICE Move Index does the same for the Treasury market. They can be considered the fear gauges of the equity and bond markets and they historically spike in times of uncertainty. Both surged around Liberation Day in April, but both fell during the quarter and had few concerning spikes.

The markets are looking through policy uncertainty and concerns about a weakening labor market. Rather, markets are focused on strong corporate earnings, a Fed rate cutting cycle, and optimism about artificial intelligence (both the spending to bring it online and its eventual productivity enhancements) and continuing to move higher.

## VOLATILITY

● Vix ● Move Index



Source: Bloomberg, LP

## EARNINGS RELEASES FOR THE MOST RECENT QUARTER SHOWED STRENGTH, WITH REVENUE GROWTH OF 5.4% FOR THE S&P 500.

Revenue growth accelerated over the first half of the year; a trend projected to continue with fourth quarter expectations for 6.8% revenue growth. Profit margins for the index reached 13.6%, up sharply over the last year and approaching the 2021 Covid highs of 14.0%. Revenue growth and margin expansion led to operating leverage and strong earnings growth, with S&P 500 EPS growth of 12% according to FactSet. Perhaps more interestingly, 81% of the companies in the index beat Wall Street's earnings expectations, a level above the 5yr and 10yr averages. Of the eleven S&P 500 sectors, eight reported positive second quarter earnings growth, led by communication services

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and technology, with 45.6% and 23.0% respectively. As has been the case for several quarters, companies leveraged to artificial intelligence posted incredible results, with Nvidia, Microsoft, and Meta posting earnings growth of 45.2%, 38.0%, and 23.9%, respectively. This upbeat earnings season has resulted in Wall Street increasing earnings estimates for the remaining quarters of 2025 and for full year 2026.

### **THE RESUMPTION OF FED RATE CUTS BUOYED MARKETS DURING THE QUARTER AFTER THE FED HAD PAUSED RATE CUTS FROM DECEMBER 2024 UNTIL SEPTEMBER 15TH.**

The Fed spent much of 2025 concerned about stubborn inflation and the tariff impacts on inflation going forward. President Trump spent much of this year disagreeing with Chairman Powell and taking every opportunity to argue for lower rates. The Fed flipped the script in August and began to refocus on its employment mandate and not solely prices. The employment report released in early August showed weaker job growth, and more importantly, much of the job growth in May and June was revised away. This led to Trump's dismissal of Erika McEntarfer as the BLS Commissioner and caused the Fed and markets to worry the employment situation was weakening quickly. A few weeks later in Jackson Hole, Chairman Powell signaled rate cuts would resume, and the first one came on September 15th. The markets are now anticipating two 0.25% reductions in the Fed Funds Rate in 2025, with more to follow in 2026. Lower interest rates are a positive for equity markets, but they also have positive economic impacts by lowering the cost of borrowing for businesses with floating rate debt or homeowners undertaking a renovation using a HELOC. Neither we, nor the markets, expect we will return to the zero Fed Funds Rate of the prior decade, but lower short-term rates could spur economic activity.

### **THE OTHER SIGNIFICANT DRIVER FOR RETURNS IN THE QUARTER WAS OPTIMISM ABOUT ARTIFICIAL INTELLIGENCE.**

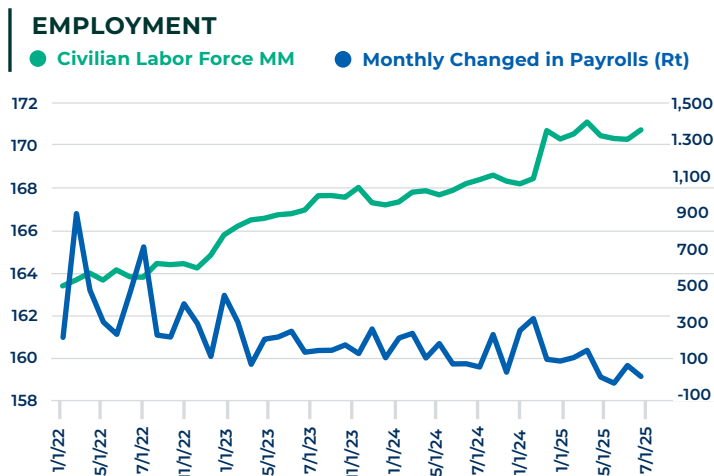
We are in the early innings of the AI revolution, where the infrastructure is constructed to host AI models. This requires enormous capital expenditures to both bring the data centers and computing online and model training to drive productivity growth in the next phase of AI. In keeping with this theme, we asked ChatGPT "What were the capital expenditures for AI in the 2nd quarter for S&P 500 companies?" ChatGPT responded that the four hyperscalers (Amazon, Microsoft, Alphabet, and Meta) spent \$95bn. Wall Street projects between \$400bn to \$500bn in capital spending from these four companies, which equates to greater than 1% of US GDP. These hyperscalers are the most visible players associated with AI spending, but this buildout is not exclusive to these four firms. Other hardware and software companies are investing in or benefiting from these AI investments. But it is not just technology companies, power management firms, HVAC manufacturers, and utilities that are part of the AI story. Capital spending is expected to increase in the next few years, with Citi estimating cumulative spending will surpass \$2.8T by 2029, as investment spreads to the electrical grid to bring an additional 55GW of power online to support the insatiable energy demands of AI. The most relevant analogy to this type of investment is the railroad buildout in the 1850s, which equated to 3% of GDP. The railroad system remade the US economy and dramatically increased US productivity over the next several decades. We don't yet know the economic, social, and societal impacts of AI over the next several decades; but optimism abounds, and capital investments continue to ratchet higher. The market has bid stocks higher for companies both making and receiving these capital investments.

The positivity about these three drivers of market performance remains as we enter the fourth quarter; however, risk also remains for the economy and markets. GDP growth rebounded sharply

in the second quarter, up 3.8%, after falling 0.6% in the first quarter. Most of this swing was tariff front-running, as a flood of imports depressed GDP in 1Q and lower imports led to flatter activity in 2Q. The backbone of our economy, consumer spending was positive in both quarters and accelerated to 2.5% growth in the second quarter.

## THE LARGEST ECONOMIC CONCERN IS THE LABOR MARKET.

Notwithstanding the politics about data revisions, the labor market has weakened in 2025. The three-month moving average of monthly job gains was 209,000 in December 2024 and has fallen to 29,000 in the most recent reading (Editor's Note: September data is unavailable due to the government shutdown). While job growth has slowed, initial claims for unemployment insurance remain modest and the unemployment rate is 4.3%, up from 4.1% in December. From January through July, the number of job openings to unemployed workers has fallen from 1.1 to 1.0. Additionally, the median duration of unemployment has risen 18% and the percentage of those unemployed for 27 weeks or longer has increased to 25.7% over the last year. Weak job growth and longer unemployment, with a low unemployment rate is unusual. This is the result of a changing labor force due to lower rates of all types of immigration. From 2022 through 2024, the labor force grew by 7.1 million people; however, it is flat in 2025. Employed individuals are benefiting from real wage gains, with the Atlanta Fed Wage Growth Tracker showing 4.1% wage gains in August. But the unemployed are finding it difficult to find work. It is possible the slowdown in job gains is due to tariff uncertainty causing hiring to pause. If so, we will see an acceleration in hiring in the next few quarters. It is also possible that productivity gains from AI are reducing companies' demand for labor. We suspect this may be occurring on the margins but can't fully explain the weak hiring seen since April.



Source: Bloomberg, LP

## THE FUTURE PATH OF THE LABOR MARKET IS THE CRITICAL FACTOR FOR THE DIRECTION OF THE US ECONOMY.

Consumer spending is nearly 70% of economic activity and requires a resilient labor market. The Fed is attuned to this weakness, which is why they restarted the rate-cutting cycle. It is too early for this change in policy to manifest in hiring, but historically, lower interest rates spur economic activity. While markets react quickly to changes in policy, the economy reacts with long and variable lags. The transmission mechanism is two-fold, with higher asset prices enhancing the wealth effect, first by improving confidence and secondly by improving consumer spending. This creates higher demand, and the second order effect is greater economic activity, particularly in interest rate-sensitive areas like housing, autos, and capital expenditures. The Fed is undertaking this policy change while inflation remains above its 2.0% target, with core CPI running at 3.1% in August. The Fed is in an unenviable position of balancing the weakness in the labor market against stubborn inflation. They will gauge their pace of rate cuts on incoming information about the labor markets and inflation.

# WHERE DO WE GO FROM HERE?

We believe the worst of the tariff turmoil is behind us. The average US tariff rate in March was 2.4%, and if those announced on Liberation Day were implemented, we would be at 30%.

Negotiations have brought this number to 19.2% in September according to JP Morgan. While much higher than March, companies have more clarity on policy going forward and are adjusting supply chains and pricing. More certainty is positive for economic participants, and we expect this will cause growth to reaccelerate. The most recent reading on third quarter GDP from the Atlanta Fed GDPNow estimates growth to be 3.8%. Moreover, the internals of this report show consumer spending growth of 2.2%. This is well above Wall Street consensus of 1.7% GDP growth and 1.5% consumer spending growth for the quarter.

If the Fed can lower rates and inflation resume its downward trend, we should see the moribund housing market come to life after several years of depressed activity. Mortgage rates are 6.3% according to Zillow, near the lowest levels seen since early 2023. Housing's contribution to GDP is only 3.9% but moving into a new home drives spending on a variety of other goods and services as homebuyers get settled.

## **RETAIL SALES HAVE BEEN ROBUST, AFTER FALLING IN FEBRUARY.**

Weaker job growth has not dented spending, with August retail sales up 3.5% over the prior year. There has been strength over the

last few months in online retail, restaurants, and clothing, which are discretionary items. Spending has been sustained by record household net worth, reaching \$176 trillion, up 6.1% over the last year. Boomers account for \$83.3 trillion of this wealth and are wealthier and healthier than any retired generation in history. We expect this cohort to continue to use their nest eggs for consumption, travel, healthcare, and gifting to their heirs.

The business sector remains mixed. Manufacturing, as measured by the ISM Purchasing Managers Index (PMI) remains below expansion levels of 50, but at 49.1 it is at the highest level since February. Services PMI sits at 50, signaling neither expansion nor contraction. The business sector is being impacted by the AI buildout. Capital spending from hyperscalers, mentioned above, is forecast to continue to increase. One company's capital spending is another company's revenue and those in the supply chain for hyperscalers and data centers will see strong demand for the next several years.

This paints a picture of an economy that continues to grow. The trends around consumer spending and AI capital expenditures will continue to power economic growth. The addition of more policy certainty and lower interest rates should spark parts of the economy that have not contributed to growth. We believe this could cause the labor market to rebound from the summer lows.

## **THE EQUITY MARKET IS DISCOUNTING STRONGER ECONOMIC ACTIVITY IN THE FOURTH QUARTER AND INTO 2026.**

The S&P 500 finished the quarter trading at 22.8x next year's earnings. This is above its 30-year average of 17.0x forward earnings. As has been the case for the last several years, the market is trading at a premium valuation and the largest companies in the market are trading at a larger premium. The largest ten companies in the S&P trade at 29.9x forward earnings and the remaining 490 companies trade at 19.5x. These ten companies comprise

40.4% of the S&P's market valuation and account for 32.5% of the earnings of the index.

These companies include the Mag-7 and Broadcom, Berkshire, and JP Morgan – with the Mag-7 stocks the epicenter of AI and technology. Over the last forty years, the top ten companies have accounted for between 17% and 21% of the value of the market, compared to 40.4% today. This is a cause for introspection, because too much of a good thing can be a bad thing. We hesitate to say, “This time is different,” but the network effects of Microsoft, Meta, Alphabet, Amazon, and Apple are unlike anything we have seen in history. These companies control how we access and use technology and are some of the leaders in the next wave of technology with AI. They have some of the highest margins, returns on invested capital, and economic moats in the economy. We expect these companies to continue to be an important part of the market in the fourth quarter and next year.

**WE ALSO EXPECT OTHER SECTORS OF THE MARKET TO BENEFIT FROM THE ECONOMIC BACKDROP.**

For example, healthcare companies and pharma have lagged the market over the last few years. The Pfizer agreement with Trump may have reduced uncertainty about drug pricing and cleared the deck for this laggard. Pfizer, Merck, Lilly, and J&J all rallied between 6% and 16% over the last month after the Pfizer announcement. Financials have returned 3.2% for the quarter and 12.8% year-to-date. This group will benefit from lower interest rates and from a reduction in regulation, which drives capital markets and investment banking activity. Other sectors projected to show strong earnings growth over the next year include materials, industrials, and consumer discretionary stocks.

Our assessment going into the fourth quarter is the markets are not cheap. But earnings growth for the third and fourth

quarters is projected to be 13%, according to S&P. As we mentioned, Wall Street is raising estimates for both quarters as we approach earnings season. If the economy continues to outperform expectations, earnings should outperform these estimates. We expect, and frankly hope, the market to broaden out from the Mag-7 and AI plays to benefit other parts of the market due to strong earnings.

We expect the fixed-income market, beyond short-term interest rates to be range-bound. Interest rates for terms six months and shorter will fall over the next few quarters as the Fed normalizes short-term interest rates. This will push money market rates lower and could force cash from the sidelines in search of yield. The 10-year Treasury yield has been between 4.0% and 4.8% for 2025 and now sits at 4.12%. We expect it to trade in the 4.0% to 4.5% range over the next few quarters. This will continue to offer bonds investors positive real yields, adjusted for inflation, but not as attractive as what was available over the last few years. Bonds should continue to offer investors yields and ballast against equity market volatility.

As we begin the final quarter of 2025, we have been pleasantly surprised by the resilience of the US economy and capital markets. We have overcome a Liberation Day, stalled payroll growth, a pivot in Fed policy, and now a government shutdown (so far). The US consumer and the ingenuity of businesses continue to prove themselves in difficult times. We expect the traits that have powered our economy and markets to continue to be present as we move into the rest of the year. We thank our clients and friends for your support and confidence as we prepare to turn the page on another year, the 112th year for Colonial Trust Company.

## OUR LEADERSHIP

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H. Walter Barre

Bert D. Barre, CFA

Barry D. Wynn

Camp R. Wynn, CFA

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Joe P. Anderson III, CPA, CFP®

Lorie L. Barton

Henry E. Batts III, AWMA®

Brittany C. Bynum

Charles W. Clementson

James C. Fiske, CFP®

Jamison W. Hinds, JD

Thomas S. Ledbetter, Jr., CFA

Karen H. Longhurst, ATFA, CTFA

Pamela G. McCauley

Ansley J. Mitcham

Matt Van Name, CFP®, CRPS®, AIF®

Kathryn A. Smith, CPA/PFS, CFP®

Brittany E. Nethercutt

W. Charlton Wieters, CTFA

## LOCATIONS

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### SPARTANBURG

233 S. Pine St.  
Spartanburg, SC 29302

864.582.3356

### GREENVILLE

101 E Washington St.,  
Suite 200

Greenville, SC 29601

864.370.0737

### COLUMBIA

6 Calendar Ct.,  
Suite 1  
Columbia, SC 29206

803.782.7646

### CHARLESTON

578 East Bay St.,  
Suite B  
Charleston, SC 29403

843.577.0444

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