Commentary

Quarterly Market Update: Third Quarter 2025

Executive summary

THE FOLLOWING IS AN EXECUTIVE SUMMARY FOR THE "QUARTERLY MARKET UPDATE: THIRD QUARTER 2025" REPORT BY FIDELITY'S ASSET ALLOCATION RESEARCH TEAM

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Market summary: Stocks rallied amid policy fluctuations

Sentiment around U.S. tariff policies fluctuated during Q2, leading to a major early-quarter sell-off in global stock markets, followed by a dramatic recovery amid a weakening U.S. dollar that extended the outperformance of non-U.S. equities on a year-to-date basis.

Riskier credit sectors, such as high-yield corporate bonds, led the positive returns across most fixed income categories, while commodities lagged.

The global economy remained in solid shape, and markets were underpinned by sturdy expectations for corporate earnings. The near-term outlook appears favorable for continued economic expansion, but policy uncertainty remains high and prospects for a continued dollar weakening increase the attractiveness of non-U.S. assets.

Looking ahead, we believe inflation risks may be underappreciated.

Policy uncertainty remains: High policy uncertainty has tended to coincide with elevated market volatility. Economic policy uncertainty spiked to a record high at the beginning of Q2 after the announcement of large tariff-rate hikes, and stock market volatility rose abruptly. During the subsequent weeks, stock market volatility returned to subdued levels, while policy uncertainty fell from its peak but remained high relative to history, leaving an unusually large gap between these two metrics.

The outlook for trade policy remained uncertain as of the end of Q2, but tariff hikes enacted during 2025 resulted in the highest average U.S. tariff rate since the 1930s. The tariff hikes may provoke meaningful headwinds for countries with large trade relationships with the U.S., and they pose a direct stagflationary risk to the U.S. economy.

Economy/macro: Continued business cycle expansion

The U.S. demonstrated a wide mix of cycle dynamics, including both solid mid-cycle indicators as well as signs of softening activity.

Watching U.S. inflation metrics: U.S. purchasing managers of manufactured goods have indicated rising price pressures in recent months, which has historically been a leading indicator of higher goods inflation.

Inflation remained above the Fed's 2% target throughout Q2, as sticky prices in services and housing offset deflation in goods. While inflation has come down significantly from its 2022 peak, more robust measures of the Fed's preferred inflation metric (PCE) indicate persistent inflationary pressures under the surface.

We expect inflation to remain rangebound around 3% into next year, with upside risk from tariff hikes.

Jobs and consumer spending in focus: After the pandemic, a historically tight market fueled strong wage growth and a surge in consumption spending that boosted economic growth. These trends moderated in Q2 as federal government funding cuts, layoffs, and rising uncertainty led to a decline in consumer sentiment and slower spending.

Despite the softening, the labor market remains at tight levels, and historically a consumer sentiment drop that occurs without a significant rise in unemployment claims has not typically been a precursor to recession. We believe more restrictive immigration policies and mass deportations have the potential to further squeeze labor supply and potentially renew upward pressure on wages.

Impact of the fiscal package: The GOP-led Congress debated its multiyear fiscal package during Q2. The House of Representatives approved an initial bill that would provide new tax cuts for businesses and other measures that might boost economic and profit growth in 2026. Relative to the CBO's baseline forecast, the bill would increase U.S. government debt-to-GDP ratio over the next decade. Debt is soon expected to surpass all-time highs, and it would require a combination of much lower interest rates or much higher nominal growth to stabilize it.

U.S. profits still look strong: Profit margin expectations remained robust in Q2, with hopes that sales growth will continue to outpace input-cost inflation. The largest companies have been the biggest contributors to earnings growth in recent years, and the market expects them to maintain elevated margins and strong relative earnings power in 2025 and beyond.

Policy decisions may impact the profit forecast in the coming months. Investor-friendly corporate tax cuts and less regulation could be viewed positively for growth, but higher tariffs and tighter immigration restrictions have the potential to be stagflationary. The potential crosscurrents are difficult to measure, but finalizing policies and reducing uncertainty would provide a positive impulse.

The Fed remains on hold for now: After 100-basis points (bps) of rate cuts in 2024, the Fed kept its policy rate steady for the second quarter in a row. At the end of Q2, the market expected 50–75 bps of additional easing in 2025, despite the Fed's forecast of 3% inflation. Last year's Fed cuts pushed short-term yields lower, while longer-term yields rose, moving the inverted yield curve closer to its typical shape.

Higher long-term Treasury yields may be a sign of the market's concern about large and growing public debt levels and bond issuance in the U.S. and other advanced economies.

Global cycle less synchronized: The global cycle remains in a solid, but unsynchronized expansion amid a variety of policy crosscurrents.

China, Europe, and Canada displayed some hopeful indicators of improved cyclical momentum after prolonged soft patches, but further progress may depend on continued improvement in the economic policy backdrop.

Asset markets: U.S. growth leads a broad-based rally

Large cap U.S. growth stocks bounced back sharply and spearheaded a broad-based Q2 global rally in riskier assets. Non-U.S. equities also posted double-digit gains, including both developed and emerging markets, and extended their year-to-date leadership. Credit-sensitive sectors such as high-yield corporate bonds and emerging-market debt led fixed income markets, and gold added to its stellar year-to-date gains despite weaker overall commodity prices.

Equities: Growth stocks returned 17.6% in Q2, leading all other style categories for the quarter. All major equity styles (growth, large caps, mid caps, small caps, and value) generated a positive return for the second quarter.

U.S. stock valuations rose in Q2, extending the three-year trend of the price-to-earnings (P/E) ratio remaining well above its long-term average. Conversely, non-U.S. P/Es have more reasonable valuations, near their long-term averages. The forward P/E ratio for DM and EM remained substantially lower than those in the U.S.

By S&P 500 index sector, information technology (+23.7%) and communication services (+18.5%) led the way in Q2, whereas energy (-8.6%) and health care (-7.2%) lagged the large cap index return of 10.9%.

Non-U.S. equities in both developed and emerging markets posted gains for the quarter, including Latin America (+15.2%), Canada (+14.2%), Emerging Asia (+12.4%), Europe (+11.4%), and Japan (+11.4%).

Fixed income: Credit spreads tightened significantly across most fixed income categories in Q2, recovering from a widening trend early in the quarter following the U.S. tariff-hike announcements in April. High yield spreads tightened the most during the quarter, falling to the lowest decile of their historical range.

Driven by tighter spreads, high-yield bonds (+3.6%) led the way for the quarter, followed by emerging-market bonds (+3.3%), U.S. corporate bonds (+1.8%), and investment-grade bonds (+1.2%).

Overall, fixed income yields ended Q2 around their 50th percentile, suggesting bond valuations are roughly in line with long-term averages and provide solid income within a balanced portfolio.

Nominal 10-year U.S. Treasury bond yields finished Q2 about where they began the quarter, around 4.2%. Yields remained modestly lower than where they began 2025, with real yields—the inflation-adjusted cost of borrowing—still at the high end of their range over the past decade.

Currencies: The U.S. dollar dropped to a three-year low during Q2, extending its year-to-date declines to more than 10%. After a large increase in foreign purchases of U.S. stocks and bonds during the second half of 2024, net capital flows into U.S. assets remained positive but slowed significantly during the first half of 2025.

Despite its decline, the dollar remains overvalued relative to major global currencies. Our valuation analysis suggests the currencies of both developed- and emerging-market countries are, on average, still at historically low valuation levels versus the dollar. This medium-term outlook supports the diversification into foreign assets by U.S. investors.

Outlook: Fidelity's Active Asset Allocation Board, composed of portfolio managers across a variety of asset allocation strategies, meets quarterly to discuss macro views and asset allocation positioning. Members discussed the impact of policy on growth and inflation and its potential influence on markets going forward. As of the end of the quarter, portfolio managers remain generally overweight risk assets but held smaller active allocation positions compared with earlier in the cycle.

- Portfolio managers are modestly overweight risk assets.
- A weaker dollar outlook provides support for non-U.S. assets.
- Several members mentioned gold and Treasury Inflation-Protected Securities (TIPS) to hedge stagflationary risks.

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The Asset Allocation Research Team (AART) conducts economic, fundamental, and quantitative research to develop asset allocation recommendations for Fidelity's portfolio managers and investment teams. AART is responsible for analyzing and synthesizing investment perspectives across Fidelity's asset management unit to generate insights on macroeconomic and financial market trends and their implications for asset allocation.

Fidelity Thought Leadership Vice President Mike Tarsala provided editorial direction for this article.

Indexes: U.S. equities and U.S. large cap stocks—S&P 500®; Non-U.S. equities—MSCI EAFE Index; High-Yield Corporate Bonds—ICE BoA High Yield Bond Index; Emerging-Market Debt—JP Morgan EMBI Global Diversified Composite Index; Gold—Gold Bullion Price, LBMA PM Fix; U.S. growth stocks—Russell 3000® Growth Index; Mid Cap—Russell Midcap® Index; Small Cap—Russell 2000® Index; Value—Russell 3000® Value Index; Latin America—MSCI EM Latin America Index; Canada—MSCI Canada Index; Emerging-Market Stocks—MSCI EM Index; Emerging Asia—MSCI Emerging Markets Asia Index; Europe—MSCI Europe Index; Japan—MSCI Japan Index; High Yield Bonds—ICE BofA U.S. High Yield Index; U.S. Corporate Bonds—Bloomberg U.S. Credit Index; Investment-Grade Bonds—Bloomberg U.S. Aggregate Bond Index; Treasuries—Bloomberg U.S. Treasury Index.

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