

Maclura Investments

3Q25 Review - AI Investments Drives Market Higher



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All major U.S. equity indices were higher in the third quarter, continuing the market's upward trajectory that started in mid-April. Growth and value stocks performed similarly during the quarter as the market generally followed a path of least resistance, pointing to the upside, driven by the significant capital being invested in artificial intelligence (AI) infrastructure and the anticipated start of a Federal Reserve easing cycle.

Exhibit 1. Investment-Style Returns

Morningstar Index Market Returns		2017	2018	2019	2020	2021	2022	2023	2024	2025			
										1st Qtr.	2nd Qtr.	3rd Qtr.	YTD
Growth	U.S. Growth	29.52%	0.78%	35.90%	44.65%	24.79%	-36.70%	38.48%	23.42%	-9.24%	19.43%	6.89%	15.87%
	Large Growth	31.15%	2.94%	33.81%	38.86%	21.47%	-40.36%	47.26%	27.75%	-7.53%	23.05%	6.66%	21.36%
	Mid Growth	25.67%	-3.16%	36.01%	46.17%	14.97%	-32.37%	25.38%	20.33%	-6.27%	15.96%	2.53%	11.44%
	Small Growth	23.77%	-5.67%	27.60%	43.52%	-1.00%	-33.13%	26.65%	12.89%	-8.43%	13.13%	8.54%	12.43%
	US Market	21.47%	-5.05%	31.22%	20.99%	25.78%	-19.43%	26.44%	24.09%	-4.63%	11.14%	8.09%	14.57%
Value	U.S. Value	14.23%	-7.51%	25.09%	-1.31%	23.98%	-0.72%	11.98%	13.77%	4.44%	1.33%	6.36%	12.56%
	Large Value	15.09%	-5.90%	25.70%	-0.62%	21.49%	0.26%	11.82%	14.69%	5.95%	0.89%	6.61%	13.49%
	Mid Value	13.02%	-10.63%	24.81%	-3.76%	29.02%	-2.39%	10.94%	12.28%	2.15%	2.04%	6.71%	11.23%
	Small Value	8.40%	-16.61%	19.96%	1.01%	31.79%	-6.60%	14.58%	9.67%	-3.74%	4.01%	7.22%	7.35%

Source: Morningstar

Since taking office, President Trump's diplomatic approach has involved a growing list of tariffs on specific countries and commodities to position American interests at the forefront. It has been a fluid situation that has fostered significant angst among economists about the true impact on the economy. As a result of the tariffs, global supply chains and trade have been permanently changed, and companies are announcing "investment agendas" in the United States to minimize their tariff impact. Though it is difficult to determine if the investment announcements will ever come to fruition, the intention provides a tailwind for the market to continue to move higher long-term.

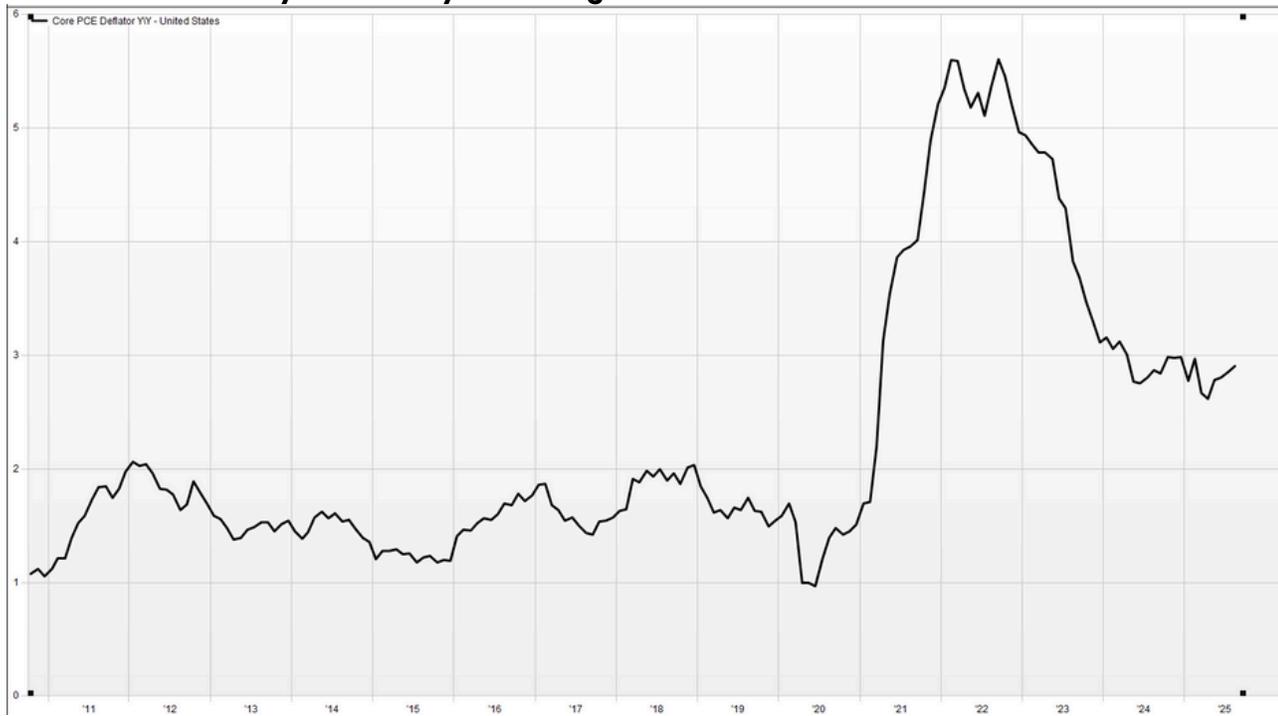
Undoubtedly, the uncertainty regarding the sustainability of the tariffs will change through every election cycle; however, businesses don't have the luxury to wait for 2028. Nonetheless, changes to the tariffs might arise quickly through the legal system with the current case before the U.S. Supreme Court that will answer the legal question of whether the International Emergency Economic Powers (IEEP) Act authorizes the president to impose tariffs via executive order. The Supreme Court will hear the case early in November, and given its importance, a ruling would likely be expedited. It is highly probable that the Trump Administration is seeking options for continuing their tariff diplomacy outside of using the IEEP Act, but the uncertainty should continue to drive volatility in the stock market.

The eventual impact of the tariffs on inflation continues to fuel caution among Federal Reserve members on lowering short-term interest rates. After months of pressure from the Trump Administration to lower rates, the Fed decided at its September meeting to lower its target range for the federal funds rate by 25 basis points, bringing the range down to 4.0% - 4.25%. This meeting also provided the updated Summary of Economic Projections (SEP) by the FOMC members, showing an expectation of an additional 50 basis points of cuts this year.

While companies haven't increased prices yet on tariffed goods, the actual tariff burden will rise in the third quarter compared with the second, and companies will be under increasing pressure to pass tariff costs on to consumers, thus impacting inflation.

As illustrated in the chart below, the preferred inflation gauge for the Federal Reserve, the U.S. Personal Consumption Expenditures (PCE), struggled for years to be higher than the preferred Fed inflation rate goal of 2%. After the global economic shutdown to “flatten the curve” of COVID-19 infections wreaked havoc on the global supply chain, inflation rose rapidly to highs in 2022 but has been in the 2.5% to 3.0% range since 2024, with the latest reading in August being reported as 2.9%. The Federal Reserve is hesitant to aggressively cut short-term interest rates for fear that tariffs will fuel inflation higher, with lower interest rates only providing an accelerant for higher inflation. Often the “real world” doesn't neatly follow the textbooks taught in academia because after a year, the inflationary impact of the tariffs will be neutralized by the year-over-year change comparison. Additionally, countries that implement tariffs typically experience higher demand for their currency from exporting countries, strengthening the tariff-implementing country's currency. In the instance of the Trump Administration's tariffs, the dollar should become stronger against exporting countries' currencies, thus minimizing the actual cost to the US consumer by having the dollar stronger.

Exhibit 2. Core PCE year-over-year change



Source: Factset

Nonetheless, the rising unemployment concerns will likely force the Federal Reserve to cut rates faster than expected. This might become another example of the “real world” veering away from the academic teaching that any historical rise in unemployment since the 1950s has been accompanied by a recession (shaded area in graph on next page). Though the September unemployment numbers have been delayed by the government shutdown, in August the unemployment rate was 4.3%.

While this, by itself, is not rising to the level of alarm since unemployment has fluctuated between 4.0% and 4.2% since May 2024, unemployment within the younger generation (16-24 year olds) is rising at a faster rate than the general population. As of September, that demographic had an unemployment rate of 10.5%, after hitting a low of 6.6% in April 2023, growing nearly twice as fast as the rest of the population.

Exhibit 3. Historical Bull Market Duration



After the September Federal Reserve meeting, Chairman Powell has stated several times that there is “no risk-free path,” by stating that if the Fed cuts interest rates too aggressively, it could leave the inflation job unfinished, and they would need to reverse course (raise interest rates) to fully achieve the Fed’s inflation goal of 2%. If the Fed maintains restrictive policies for too long (not lowering interest rates), the labor market could soften unnecessarily. The reality of the labor situation is that there will be minimal impact, if any, with whatever monetary policy the Federal Reserve decides to implement because of the impact that AI is having on the economy. Lowering interest rates will not change the secular shift of implementing AI within the economy and eliminating entry-level positions if the economy remains out of a recession, which I believe will happen.

Historically, nearly every technological advancement has negatively impacted the older experienced workforce as it was adopted by the economy. Not so with AI. While the true productivity enhancements that AI is bringing to the workforce can be debated, the reality is that, regardless of its effectiveness, AI is eliminating the need for entry-level positions as shown in the faster growth in unemployment for the 16 - 24 age demographic than the overall unemployment rate. Between the COVID-19 global shutdown and the adoption of AI into the economy, sociologists will have a lot to study over the next couple of decades. Any changes in monetary policy by the Fed to influence the employment numbers will likely be ineffective and akin to the expression “pushing on a string.”



Between tariffs and rising unemployment rate, one could conclude that the market is treading in unfavorable waters. While valuations are stretched, the amount of capital being invested into AI infrastructure and opportunities is mind-boggling. Market watchers have likened the current environment to the dot.com craze of the late 90's, a period during which companies had their stretched valuations based solely on the number of "eyeballs" visiting their website. While we aren't at that point yet, there are a significant number of companies that have yet to generate meaningful revenues that are richly valued on the promise of future earnings that may or may not materialize. The market continues to have strong tailwinds for further growth, but the volatility has increased significantly, and any misstep in earnings is met with negative ramifications in the stock market. Given the frothiness of the current environment, it is important to be well-diversified in this heightened level of volatility in the market.

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