Economic and Market Outlook - Third Quarter

"Future Shock." In 1970, the writer Alvin Toffler described "future shock" as the stress and disorientation people feel when they face not merely rapid change, but an accelerating rate of change. Today's zeitgeist prompts us to revisit that idea and its economic consequences. All economic actors, including households, businesses, and nations, make plans based on their expectations of the future. When economic and political policies and events force expectations to shift more rapidly than plans, institutions, and investments can adapt, decision making becomes more difficult, more costly, and more prone to error. Resources are diverted from long-term investment toward short-term adaptation, and decision-makers must devote ever more attention to preparing for the next change rather than executing the current plan. The result is not simply uncertainty, but an ever-increasing mismatch between the speed of change and the ability to respond.

As a case in point, President Trump said in March that the war he initiated in Iran would last four to five weeks; he later claimed that it could be over in "two weeks, maybe three." Ceasefires negotiated in April and June broke down soon after. In late September Trump rejected Iran's latest proposal, while saying the very next day that he expected talks to resume. The decision to prosecute the war greatly stressed U.S. political and military alliances, while the entirely foreseeable closure of the Strait of Hormuz disrupted worldwide energy and commodity markets. The December 2026 contract for Brent crude spiked from $59.35 in January to $85.87 in March, dropped briefly in April, rose back to $87.85 at the end of April, and then fell to $72 in early July, when a resolution seemed near. It climbed above $100 by September after the June ceasefire collapsed. These highly volatile energy prices magnify uncertainty for nations dependent upon imported oil and for businesses trying to plan ahead.

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Domestic policy has followed a similarly dizzying pattern. President Trump signed 229 executive orders in the first year of his second term, the most in a first year since 1933. Policy changes made this way can be revised, revoked, or blocked just as quickly. Trade policy over the last two years shows the toll of this dynamic. The defining features of Trump's tariff regime are not only its level but also its instability, characterized by repeated announcements, revisions, pauses, legal challenges, judicial reversal, and attempts to circumvent that reversal. Businesses have been compelled to manage not only tariff costs but also the risk that the rules themselves would change before inventory reached port. In Toffler's terms, the challenge is not merely adapting to a new policy, but even further, adapting to the accelerating pace of policy change itself. The resulting uncertainty affects longstanding economic partners as well as strategic rivals. In the third quarter, the U.S. chose not to extend its trade agreement with Mexico and Canada,

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leaving it subject to annual review, while imposing 50% tariffs on some Canadian goods. When the terms of economic engagement can change every year, partners have greater incentives to look for alternatives. Canada and European partners are exploring closer ties that depend less on the United States, a shift that may last longer than the policies that prompted it.

The development of artificial intelligence presents a similar challenge. Hyperscalers such as Amazon, Microsoft, Alphabet, and Meta are rapidly building out data centers in anticipation of widespread adoption, while new and more powerful AI models are being released at an ever-accelerating pace.

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Businesses must continually reassess assumptions about productivity, labor demand, competition, and the future value of existing technologies. While rapid AI adoption supports investor's earnings expectations, it raises concerns about jobs and about whether the most advanced systems can be controlled. Rather than set formal rules, Trump has pushed back against establishing new guardrails, citing competition with China.

The bond market also shows increasing signs of stress. The largest technology companies have issued sizable amounts of debt to build data centers, with the hyperscalers alone issuing over $125 billion in bonds over the past year. That debt competes for the same investors as Treasury bonds, at a time when higher spending and tax cuts are being financed with more Treasury borrowing. Together, these pressures push interest rates higher. In September, the Federal Reserve raised its policy rate for the first time since 2023. Interest rates rose steadily but gradually through July and August, before rising rapidly in September. For the quarter as a whole, the 2-year Treasury yield rose 0.73 percentage points, while the 10- and 30-year yields reached their highest levels since 2002.

Higher rates apply to every borrower, including companies that do not participate in gains from AI. Shares of smaller companies, which are more sensitive to borrowing costs, fell 7.2% as measured by the Russell 2000, and rate-sensitive sectors such as utilities and real estate lagged. Households feel the same pressure. Unlike households that can benefit from elevated stock prices and higher interest rates, households that depend mainly on wages have less protection. They spend a larger share of their budgets on fuel, and gasoline prices rose 12.8% in the quarter. Diesel rose 45.2%, a cost that tends to reach consumers later through the price of goods that must be transported. And those who waited to lock in a mortgage rate, believing rates had peaked, will now face higher monthly payments.

Essentially, accelerating rates of change not only create stress and disorientation but also create costly unpredictability. That cost falls most heavily on those with the least room to wait and adjust. Much of this change came from deliberate policy choices rather than from random shocks, which suggests that its pace, and who bears its cost, can also be chosen.

Third Quarter Performance

U.S. stocks edged higher in the third quarter, but the gains were concentrated in a small group of the largest companies. The S&P 500 returned 2.3%, while the S&P 500 Equal Weighted Index, which gives each company the same weight, declined 1.9%. Smaller companies struggled, with the S&P Small Cap 600 falling 7.9%. Value stocks held up better than growth stocks, and the MSCI USA Momentum Index, which tracks recent market leaders, fell 8.6%. The narrow advance stood in sharp contrast to the broad rally of the second quarter.

Sector returns diverged widely. Energy, which fell -13.4% in the second quarter, rebounded to lead with a 17.2% gain as Brent crude oil prices climbed 34.77%. Information Technology added 7.2%, while Utilities and Industrials dropped -12.4% and -9.7%, respectively. International stocks trailed the U.S., and bonds declined broadly, with the Bloomberg U.S. Aggregate Bond Index down -3.5% and the 1-10 year Municipal bond index down -4.12%. Looking ahead, investors are watching whether gains can spread beyond a handful of large companies, how energy prices and the conflict with Iran evolve, and where Federal Reserve policy and interest rates go from here.

Valuations

Forward earnings estimates continued to rise in the third quarter, but this time prices did not keep pace, and valuations fell. During the quarter, forward earnings estimates rose 9.2% for the S&P 500, 8.9% for the S&P 1500, and 10.0% for the MSCI ACWI, while forward P/E ratios declined: the S&P 500 from 20.2x to 18.9x, the S&P 1500 from 19.8x to 18.4x, and the MSCI ACWI from 17.6x to 16.2x. Smaller companies lagged on both measures. Their earnings estimates rose less, 4.2% for the Russell 2500 and 5.6% for the S&P 1000, and their multiples fell further, from 19.1x to 17.1x and from 16.2x to 14.2x, respectively, consistent with their greater sensitivity to borrowing costs.

Valuations now look quite different depending on whether you measure them against the future or the past. On a forward basis, all five benchmarks trade at or below their 10-year averages. The S&P 500 is at 18.9x, slightly below its 19.1x average, and the S&P 1500 is at 18.4x against 18.8x. The MSCI ACWI is at 16.2x

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against 16.7x. The Russell 2500 and S&P 1000 sit furthest below their norms, at 17.1x against 19.2x and 14.2x against 16.0x. On a backward-looking basis, the picture reverses. The S&P 500's cyclically adjusted P/E (CAPE), which compares prices with average earnings over the past decade, adjusted for inflation, stands at 40.6, about two standard deviations above its 10-year average of 32.5. The gap between the two measures reflects the growth investors expect: measured against a decade of inflation-adjusted earnings, the market looks very expensive; measured against the earnings expected over the next year, it looks reasonable.

That makes today's below-average multiples conditional. They hold up only if the expected growth arrives. If earnings fall short of estimates, forward P/E ratios would rise without any change in price, and the elevated CAPE ratio suggests there is little room to absorb a miss. In an environment where expectations change faster than plans can adjust, that's a significant yellow flag.

Outlook

Heading into the fourth quarter, the economy looks steady rather than strong. Consensus forecasts call for real GDP growth to stay near its long-run trend, with business investment, particularly in AI infrastructure, doing much of the work while consumer spending grows at a moderate rate. That makes the outlook for earnings, and the valuations that rest on it, depend on two things: whether AI investment continues to pay off for the companies building it, and whether the technology is adopted widely enough to lift productivity and generate profits across the broader economy.

Inflation remains the primary constraint. Energy flows through the Strait of Hormuz are still uncertain, and demand from AI continues to raise the cost of consumer technology. The Federal Reserve's September projections reflect this. Federal Reserve Open Market Committee members grew more confident in the economy but less willing to cut rates. They now expect the policy rate to stay near 4.1% through the end of 2027, rather than easing toward 3.6% as they projected in June, even as they expect inflation to cool next year. Longer-term borrowing costs are likely to stay elevated as well. Amid this higher rate environment, the anomalous strength of private sector investment merits consideration. Partially, it reflects optimism surrounding AI, but at the same time, it could also reflect the full expensing enacted in the One Big Beautiful Bill, which lowers the cost of capital investment. Whether recent spending is driven by a durable increase in investment demand or just an acceleration of projects that would have happened anyway will become clearer over time. For markets, another important question is whether those investments ultimately translate into higher productivity and profits to justify the capital being deployed at higher borrowing costs.

If rates stay higher for longer, the pressures of the past quarter will likely continue. Housing is the most exposed, as higher mortgage rates keep both homebuilding and existing home sales subdued. Smaller companies, utilities, and real estate, which lagged in the third quarter, likely face the same headwind. For many households, wage gains are expected to roughly keep pace with prices this year, which leaves little room to get ahead until inflation eases.

The November midterm elections add one more variable. The results will shape how much Congress weighs in on trade, spending, and borrowing at a time when federal debt continues to climb. Depending on the outcome, the election could bring additional rounds of policy change or slow the current pace.

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Conclusion

"Future shock" did not suggest that change itself is harmful, but that its pace can outrun people's ability to adapt. The third quarter tested that limit. Shifting positions on the war in Iran moved energy prices, trade policies changed frequently enough to erode confidence in their durability, and rising borrowing costs pressured

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households and smaller companies, many of which are not perceived as AI winners. These pressures are real, and they are not borne evenly. Currently, markets have reasons for confidence. Forward earnings estimates have continued to rise, the economy is expected to grow near its long run trend, and forward valuations for many benchmarks sit at or below their recent historical averages. However, that confidence is conditional. Below-average multiples are attractive if growth materializes, and the gap between forward- and backward-looking valuation measures shows how much of that bet still rests on the future: AI investment has to keep paying off, and its benefits have to spread beyond the companies building it.

Financial markets are often willing to look years ahead, but businesses and households operate in the present. When change arrives faster than economic actors can adapt, the disruption in planning horizons and the resultant misallocations of resources eventually appear in earnings, interest rates, and consumer spending. As investors, our task is to focus on companies that can create value across a range of economic and policy environments while remaining attentive to the broader social and environmental consequences of today's decisions.

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Contact Information

ContactUs@trilliuminvest.com

800-548-5684

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