Nordwand Capital LLC

Third Quarter 2025 Market Commentary

Soft-landing cutting cycles are often good for investors; AI gets real

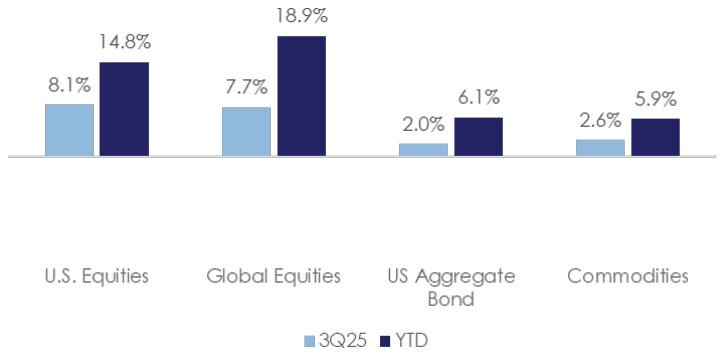
October 2025

3Q in brief: Tailwinds from AI and interest rate cuts dominate the storyline

The third quarter came to a close with the Federal Reserve shifting back into a rate-cutting mode, despite signs that inflation isn't going away. On the back of a supportive Fed and ongoing optimism about the size of AI investments buoying global growth, financial assets rose in 3Q. Lacking evidence of a recession on the horizon, the Fed is cutting rates into a soft-landing scenario; this combination of factors has been good for risk assets in prior cycles and appears poised to perform similarly this time around.

A few highlights to consider:

Figure 1: Asset Class Returns
(3Q25 & YTD)



Source: Bloomberg, Nordwand Capital as of 9/30/2025.
Note: US equities = S&P 500 Index; Global equities = MSCI ACWI Index.

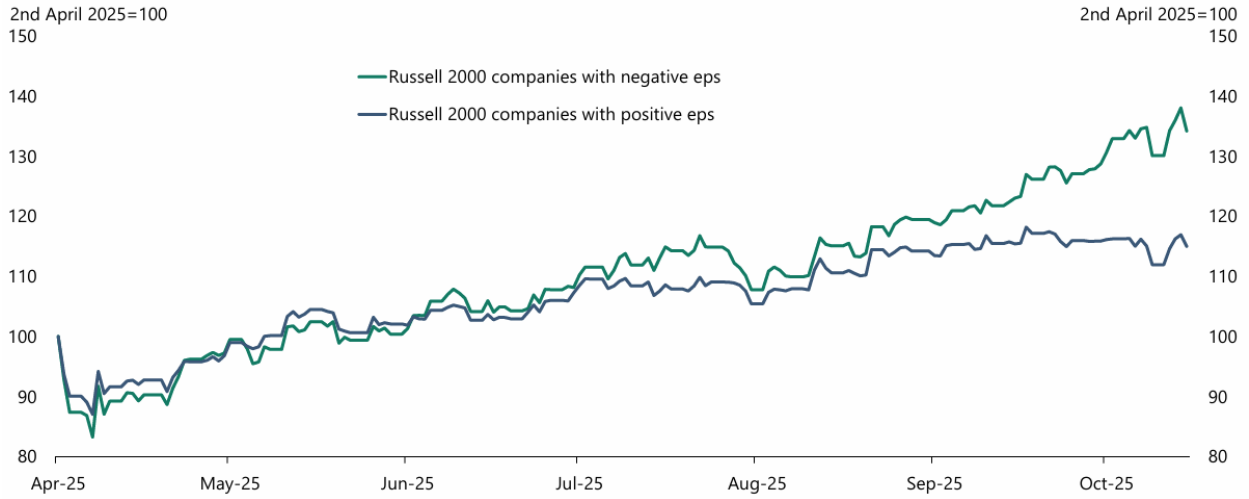
- Large cap and small cap equities rose in the US last quarter, with the S&P 500 up 8.1% (Figure 1), the Nasdaq +11.4%, and the Russell 2000 small cap stock index posting +12.4% returns.
- Global stocks in both developed and emerging markets rose, with emerging markets stocks up almost 11% in the MSCI Emerging Markets index.
- Growth stocks came roaring back to life in 3Q, almost doubling the performance of value stocks as risk-taking appetite re-emerged.
- Fixed income is on pace to post its best year in 5-6 years, as interest rates have come down modestly while credit risk remains muted overall. Large cash balances are less attractive now that rates are moving lower.
- Private equity is beginning to show signs of life, with exit activity picking up, and small cap stock performance won't hurt this trend.
- It's difficult to look at liquid markets like equities and not find them expensive. That said, measured and diversified deployment of excess cash guarding against the twin risks of negative growth surprises or upticks in inflation, makes sense given growth prospects. The AI theme is broadening out beyond chips and is embracing second-order beneficiaries like power as this rally widens out. Given the secular nature of this evolution, that pivot makes eminent sense, in our view.

Looking at Markets in 3Q & YTD

We have been outspoken about lofty valuations across areas within equity and credit markets over the last 2-3 years and today will be no exception. US equities have been expensive relative to other options owing to AI-fed exuberance and the notion – strongly supported, in our view – that the US government and Federal Reserve have worked diligently to repeal business cycles and recessions over the last 20 years. The US remains the best growth option within the developed world and that excess growth justifies a premium; the question is how much is too much?

With that backdrop, we've advocated diversifying part of equity portfolios into small cap and ex-US stocks to take advantage of their better valuations. YTD through 3Q emerging markets were up 28% and small caps caught a considerable bid in 3Q. Crucially, however, we continue to think this positioning is valuable because these markets often act differently than the US, providing the potential for downside protection if/when the US market stumbles.

Figure 2: Looking Inside Small Cap Stock Performance
(April-Oct 2025)



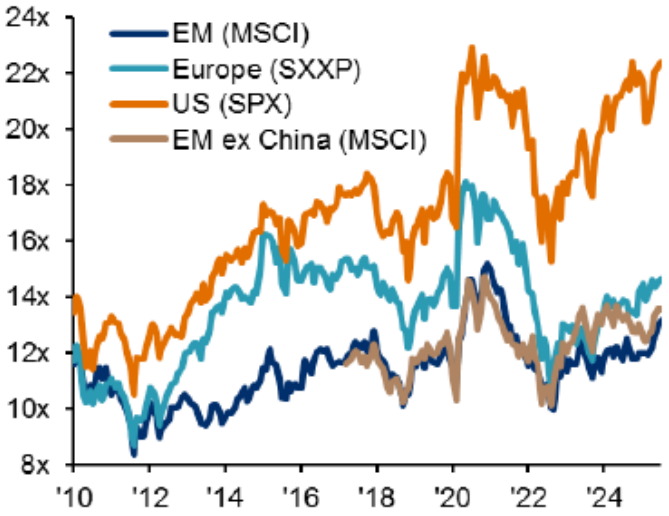
Note: Using Russell 2000 companies as of October 2025 with trailing EPS, 1120 companies have positive EPS and 806 companies have negative EPS. Source: Apollo Chief Economist, Bloomberg, as of 10/20/2025.

Figure 2 is a fascinating portrait of risk-taking by investors, and we think it's both healthy and unhealthy at the same time. On the one hand, investors are clearly reaching for risk to generate additional returns by buying unprofitable companies in greater numbers than profitable ones. Looked at another way, the small cap market for many years served as the engine of public-market innovation and growth; newly IPO'd companies came public before they turned profitable, and investors bet on their ability to deliver on their promise.

Over the last several years several factors have impeded this engine, notably a big uptick in regulatory and legislative measures designed to ferret out malfeasance that have also made it prohibitively difficult and expensive to go public in the US, and a highly successful private equity environment that encouraged companies to stay private longer. For many investors this has limited their exposure to smaller growth companies. If, however, small cap stocks can continue to generate positive returns, thereby encouraging private equity exits, this would be an encouraging sign for capital markets and liquidity. We think it is very much worth watching.

More broadly, US equities continue to be more expensive than peers. All markets are less attractive than they were before this year's rally, with EM in particular making a big move this year. The chart in Figure 3 shows the spread in valuation between the US and the rest of the world, and it also shows how this move accelerated following Covid and has stayed intact thanks to the global AI boom that has placed a focus on US stocks as the preferred way to play this global evolution.

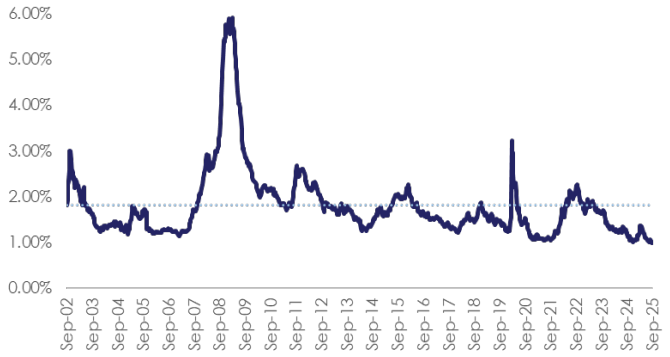
Figure 3: Equity Market Valuations
(2010-Present)



Source: Bloomberg, JP Morgan, as of August 2025.

Furthermore, the tariff scare that dominated news reports in March-April continues to normalize. While we expect lingering inflationary pressures from this policy shift, we have now been through two earnings quarters since these announcements, and companies are reporting stronger-than-expected earnings and guidance. In other words, companies are finding themselves able to pass on increased costs sufficiently to maintain margins. Coupled with a Fed moving to more accommodative policy and investors finding broader ways to gain equity exposure than just the "Mag 7" stocks – power and utilities, financials, small caps, etc. – we expect this will allow aspects of this rally to continue until policymakers show they will not be supportive in the event of a hiccup. To date, there is scant evidence this will be the case.

Figure 4: IG Yield Spreads vs. 10-Yr US Treasury
(2002-Present)



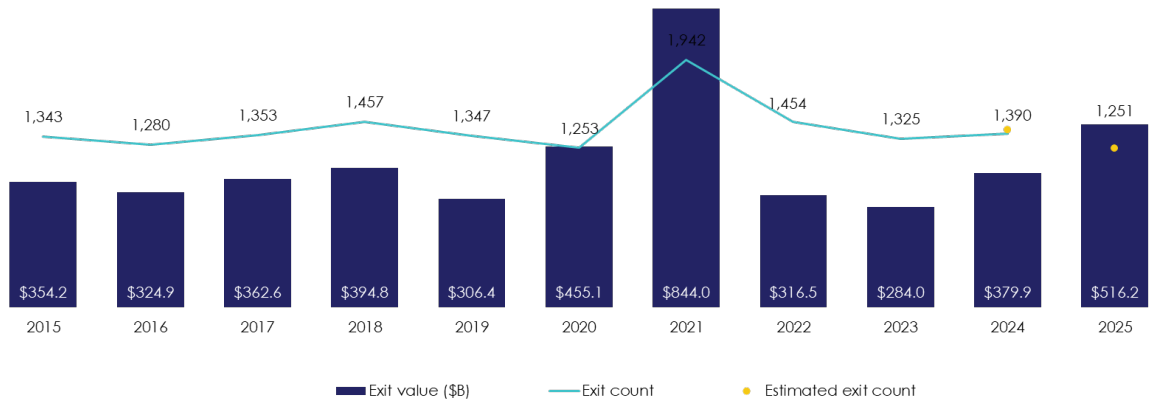
Source: Bloomberg, Nordwand Capital, as of 9/30/2025.

Credit markets have been positive returners for the year, as we noted earlier. Consistent with our broader theme that it's a challenge to find inexpensive assets for portfolio construction, yields are relatively unattractive across much of the liquid fixed income universe.

Figure 4 highlights this point for investment grade (IG) corporate bonds, although the situation is much the same for high yield bonds as well. The yield premium that investors receive for investing in IG bonds instead of US Treasuries was a meager 1.0% at the end of September. This is more than 1 standard deviation less than customary over the last 20+ years. As investors correctly read the tea leaves indicating that the Fed was likely to cut rates this fall, some bought corporate bonds in an effort to avoid collapsing cash/money market yields. Investors are therefore forced to take additional credit risk and/or less liquidity in order to build portfolios.

As our clients will know, we've been focusing on building diversified and higher-yielding credit allocations, which are sometimes accompanied by higher volatility over the short-term but produce higher income streams for the risk. We have married higher yields in leveraged loan, asset-based lending, and direct lending as complements to core and multi-sector bond holdings. Coupled with the right risk assessment and underwriting of credit and issuer risks, we believe this risk-adjusted positioning is appropriate. That said, we have been watching closely the developments and commentary surrounding private credit for rising defaults or loosening underwriting standards. We believe there are attractive pockets in these spaces, and that private credit is not a monolithic block but rather is composed of multiple areas where the right risk-reward balance can be found.

Figure 5: US Private Equity Exit Activity
(2015-Present)



Source: Pitchbook, Nordwand Capital as of 9/30/2025.

Private equity has been a conundrum for the last few years. Exit activity has been anemic, distributions have been slim, and financing has been expensive. We saw small green shoots last year, and highlighted these again in our last quarterly letter, but 2025 is seeing some significant breaks in the logjam. Exits in the first half of 2025 were more than double their pace in 2023 and 2024 leading to the highest exit volume since 2021 and we're only ¾ of the way through the year.

This is consequential for several reasons, most notably it creates liquidity for investors that has been sorely needed. In addition, it frees up investment capital to pursue other aims – whether in private or public markets – and it presents updated views of value and returns for investors. It also creates supply in public markets for new listings that are the lifeblood of public equities.

We made the point earlier that the rise in segments of small cap equities could be viewed positively in some respects; the increase in exit activity and recent strength in small cap stocks represent the possible beginning of a virtuous circle where private equity exits perform well in public markets, in turn generating increased demand and higher valuations for private holdings, which leads naturally to more exits from private funds. It is early to claim this is the case, but we remain watchful and hopeful.

Summary

Overall, through the first three quarters of the year, markets are higher as we climb the wall of worry. Developed and emerging market equities are on pace to have excellent returns this year, and core bond allocations are participating as well. Gold was up almost 50% through September, while Bitcoin continues its ascent as well. Even private equity and venture capital – areas that have seen meaningful slowdowns due to a lack of exit activity and higher financing costs – are showing positive signs that should be very encouraging to investors.

Economic growth continues at its reasonable rate and looks likely to continue on this path. Inflation remains well above the Fed's 2% target, but with significant structural changes to Western economies post-Covid that include re-industrialization, shifting trade relationships, and the rise of an AI-infused capital investment boom, 2-3% inflation may be the new normal until we reach a productivity surge. Geopolitics remains unstable as always, but conditions here have not deteriorated since our last update, which in this chaotic sphere counts as a "win".

Moreover, the AI boom is beginning to find its footing in the broader economy. In 2023 it was about chips and semi-conductors, and a narrowly-defined set of winners in '23 and '24 made many people rightly nervous about the durability of a rally with so few winners. As the scope of AI widens to include upstream and downstream participants like industrials, power, and infrastructure, it becomes increasingly possible to see how transformative this may be, even in the short term. By some estimates, in fact, upwards of $2 trillion in capital investment may be needed to fund this boom in the next 5 years alone. The vast majority of capital spending growth in the US are tied to AI right now; it is becoming impossible to overstate its impact on the global economy across multiple sectors.

This environment will produce winners and losers, and the opportunity set should make for fruitful investing over the next 5-10 years. We look forward to discussing its evolution with clients in the coming weeks and months.

IMPORTANT DISCLOSURES:

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Nordwand Advisors, LLC ("Nordwand"), or any non-investment related content, made reference to directly or indirectly in this summary will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this summary serves as the receipt of, or as a substitute for, personalized investment advice from Nordwand. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. Nordwand is neither a law firm, nor a certified public accounting firm, and no portion of the summary content should be construed as legal or accounting advice. A copy of Nordwand's current written disclosure Brochure discussing our advisory services and fees is available upon request or at www.nordwandcapital.com.

***Please Note**: If you are a Nordwand client, please remember to contact Nordwand, in writing, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services, or if you would like to impose, add, or to modify any reasonable restrictions to our investment advisory services. Nordwand shall continue to rely on the accuracy of information that you have provided. **Please Note**: IF you are a Nordwand client, **Please advise us** if you have not been receiving account statements (at least quarterly) from the account custodian.*