Third Quarter 2025

Portfolio Insights

If You or AI Build it, They Will Come

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In Brief

The third quarter of 2025 saw the continuing surge of the Artificial Intelligence (AI) economy as AI capex and the associated knock-on effects buoyed earnings and stock prices broadly during the period. This was in no way limited to “the Magnificent 7” (Microsoft, Amazon, Apple, Meta, Alphabet, Nvidia, and Tesla) at the heart of AI’s transformations, as utilities, data centers, and some areas within software got a strong lift. Small caps also had a robust quarter as earnings seem to have bottomed. Against the backdrop of the Federal Reserve (the Fed) cutting interest rates by 25 basis points in September, hopes for continued equity market strength were sustained and some fixed-income segments were able to deliver modestly positive returns. Key areas of focus include:

- **A broadening market:** As mentioned last quarter, FEG believes investors would do well to consider pockets of opportunity outside of U.S. large cap stocks, including small caps and non-U.S. markets. Combining passive U.S. large cap exposure with differentiated strategies that focus on less efficient areas of the market is one way to capture general market upside potential with more idiosyncratic opportunities that can support income and growth objectives when markets move in a less linear fashion.
- **Cost of capital:** It is important to watch the Fed, but the need for scrutiny is particularly strong today given the economic and political pressures that might move the dial on the Fed’s decision-making. At the moment, the market is pricing in two additional rate cuts for the remainder of 2025. If policymakers continue to cut, investors need to consider the prospects for asset class winners and losers. We believe a cutting cycle should generally support risk assets since it would lower the cost of capital, giving further momentum to the bull market in equities, despite rich valuations in U.S. large cap stocks.
- **Manager access:** Many investors’ allocations to alternatives are at or above their long-term targets, due to a continued lack of distributions from private investments. FEG believes this presents an opportunity to gain exposure to managers who historically have been difficult to access.

Although corporate spending and venture capital funding for AI has soared, that will not always make AI an ironclad investment thesis or necessarily generate an attractive return on investment. The trend, however, shows no signs of slowing down. New, innovative use cases and companies will continue to be born out of this cycle, but there will also be misallocation of capital and poor subsequent returns for some companies and use cases. As investors, we must do our best to figure out the difference and position portfolios accordingly.

Public Markets Overview

The Fed Fails While the Market Sails

Enthusiasm surrounding the current and proposed applications of AI, as well as the related expenditures required for development, remained a primary driver of the favorable set of conditions that supported financial markets in the third quarter. From traditional asset classes such as stocks and bonds to alternative assets such as gold and bitcoin, it was difficult to identify a major pocket of the public markets that failed to generate positive returns during the quarter.

The demand for labor capital has fallen sharply in recent months and may be a sign of things to come in an AI-driven world.

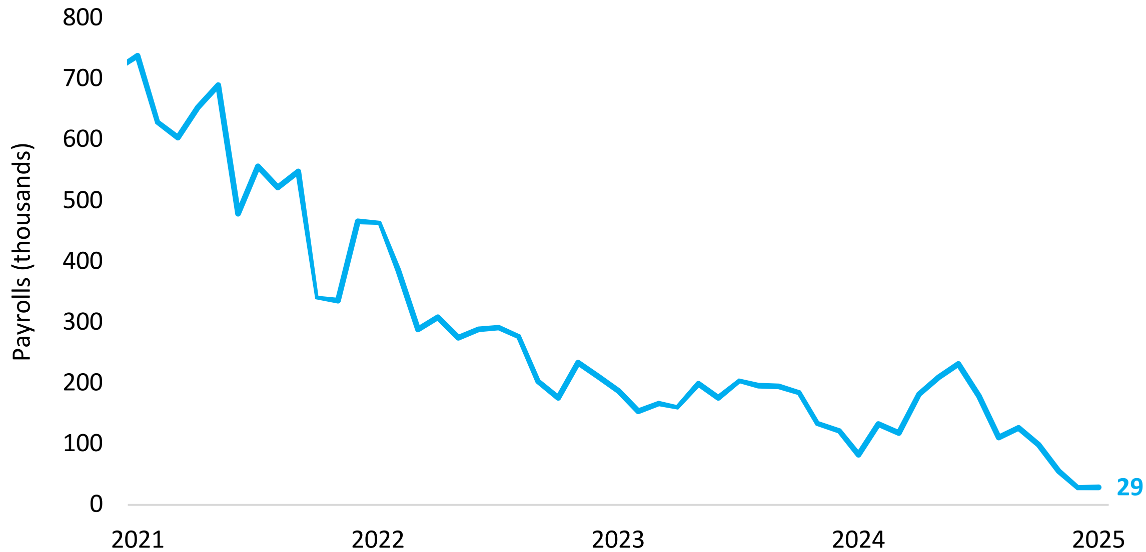
The fervor with which U.S. stocks, particularly mega cap tech names, have ascended to record high levels has stoked concerns that the market is getting frothy, with some market pundits drawing parallels to the dot-com bubble of the late-1990s. While certain measures reflect similar levels of excess valuation like those witnessed during the first era of internet exuberance, the fundamental picture today is vastly different. Current market leaders, among them the Mag 7, may have elevated valuations, but they enjoy significant earnings growth and lofty profit margins, and generally maintain healthy balance sheets. This was not the case for the darlings of the late 90s and 2000, which famously showed sky-high valuations and delivered lavish returns within days—and sometimes hours—of their IPOs, despite offering little to no promise of eventual profitability.

While many examples of excellent business models exist today (and their respective share prices appropriately reflect this sentiment), the demand for labor capital has fallen sharply in recent months and may be a sign of things to come in an AI-driven world.

During the third quarter, nonfarm payrolls growth slowed to just 29,000 jobs added per month over the trailing 3-month period ending in August, the weakest growth rate in the post-pandemic era. Moreover, federal government reports could be delayed or canceled pending resolution of the U.S. government shutdown that began on October 1. This includes the monthly payrolls report from the *Bureau of Labor Statistics*, in the absence of which markets may have to speculate regarding the true state of labor.

Job Growth Has Been Heading for Stall Speed

Nonfarm Payrolls Rolling 3-Month Change



Sources: BLS, Bloomberg, L.P.; data as of August 2025.

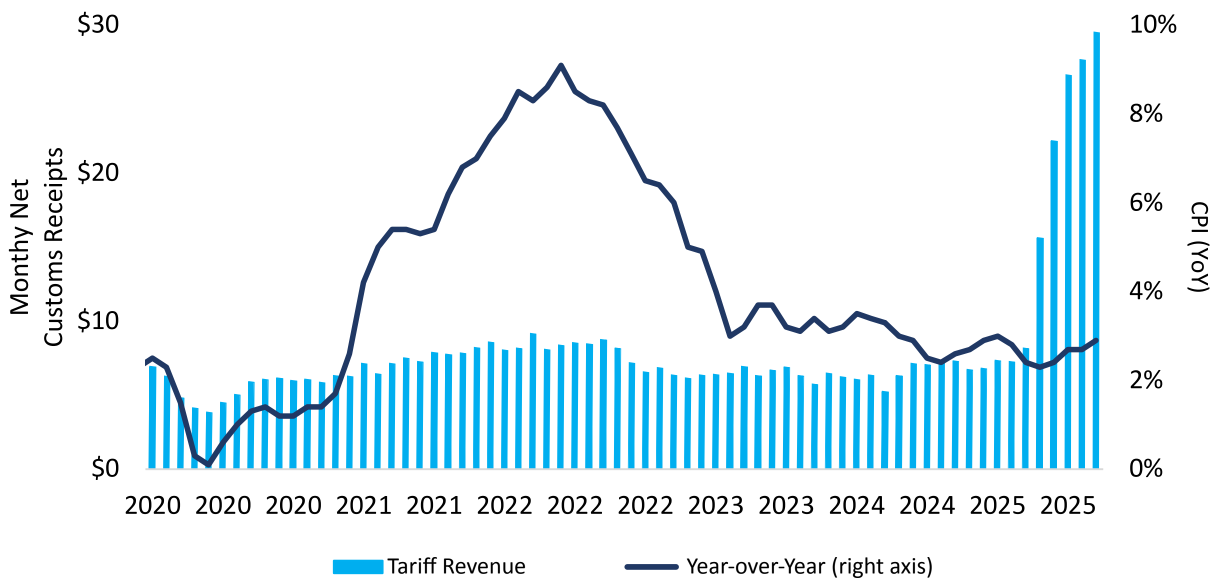
In addition to growing uncertainty regarding the health of the labor market, which is presumed to be operating at or close to stall-speed, investors may face a familiar foe that last reared its ugly head just a few years ago: accelerating inflation.

Data received during the quarter showed the Fed's ongoing inflation fight appears far from over. Realized rates of both headline (inclusive of food and energy) and core inflation remained stubbornly above the Fed's 2% target. The Fed's preferred inflationary gauge, the core personal consumption expenditures (PCE) price index, ended August at a 2.9% annual rate, which marked the 54th consecutive month that inflation was running hotter than the Fed's mandate.

Moreover, not only has the Fed failed in returning inflation to its 2% target, the Fed's very own projections for the path of core PCE in the coming years—last updated at the Federal Open Market Committee (FOMC) meeting in mid-September—show the Fed does not expect inflation to return to mandate until 2028, a potential outcome that would represent seven consecutive years of failing at containing cost pressures to a more tolerable pace.

Tariff Revenue Has Surged, but Will Inflation Follow?

Monthly Net Customs Receipts (LHS) versus the Consumer Price Index (CPI) (RHS)



Sources: U.S. Treasury, BLS; data as of August 2025.

Needless to say, the Fed's recent loss of control of seemingly both sides of their dual mandate—as both unemployment and inflation have trended higher in recent months – is fodder for consternation.

On the one hand, recent market trends provide us with evidence for optimism—smaller cap stocks have rallied, higher quality fixed income sectors have proved their worth in uncertain times, and gold bullion and related mining stocks have ascended to record highs.

On the other hand, we must ask ourselves, what are we hoping for? "Cautious optimism" has been the FEG mantra in recent years, and that posture is affirmed through the third quarter as markets seemingly "melted up." While some of our opportunistic positions are expected to add value when markets are melting *down*, such as the dynamic allocation across gold and gold mining stocks, (nominal) Treasury exposure in bond portfolios, and overweights to small cap stocks versus strategic targets—which we continue to emphasize—FEG remains optimistic while hedging our bets in the event market conditions turn sour, forcing us to flex our longstanding defensive positioning.

Global Equity

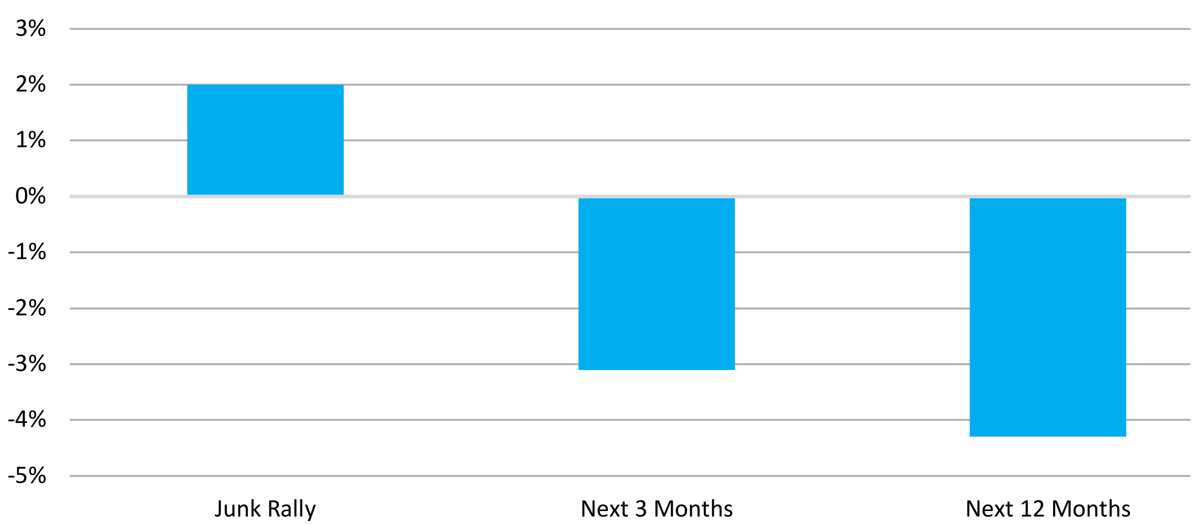
The Meltup Spreads Out

The global equity rally that followed the market swoon caused by the "Liberation Day" tariff announcements extended into the third quarter of 2025, supported by a dovish pivot from the Fed and persistent enthusiasm around AI. The major U.S. equity indices reached several record closing highs following strong quarterly corporate earnings. U.S. markets once again led developed markets, though performance broadened with U.S. small cap stocks producing strong returns and outperforming large cap stocks for only the fourth quarter of the last 18 quarters. Broadening leadership can be a positive signal for U.S. equity performance, since U.S. equity returns have relied heavily on a small number of large cap stocks for several years. With Mag 7 stocks producing a hefty portion of equity market returns, valuations in that group have become elevated.

Looking down the cap spectrum to smaller company stocks, we think there could be signs that the market's broadening performance may support positive momentum within equities. The small cap Russell 2000 Index benefited in the third quarter from investors' increasing appetite for risk due primarily to rising expectations for future interest rate cuts. As is often the case when small cap stocks rally after a prolonged period of underperformance, lower quality and higher beta stocks within small cap were notably the best performers. This proved challenging for active managers in U.S. small cap, as the median manager in the eVestment Alliance universe underperformed the Russell 2000 Index by more than 2.5 percentage points for the three-month period ending August 31, 2025. Moves like this among low-quality stocks are typically unsustainable and often revert back quickly.

Small Caps May See the Return of Quality

Three largest low quality rallies in U.S. small cap stocks since 2006



Source: Acadian Asset Management; data as of July 31, 2025. Junk rallies are identified based on the largest three rolling quarters of index-relative outperformance of the bottom quality quintile in the Russell 2000 Index since January 2006 (January 2021, December 2019, and September 2009).

Elsewhere, the MSCI Emerging Markets Index outperformed the S&P 500 Index, buoyed by a rebound in Chinese equities. Renewed optimism about economic stabilization, easing trade tensions with the United States, and government support for domestic chip and AI sectors helped lift sentiment in Chinese equities. Asian technology stocks continued to bounce back, including Taiwanese and South Korean technology stocks that benefit from the AI theme.

Among non-U.S. developed markets, Japan's Nikkei 225 also reached several all-time high levels, although until the third quarter, new highs were a rarity in Japan over the last 35 years. Overall, corporate reforms and a weak yen supported company earnings. A focus on improving corporate governance and taking measures that should be more supportive of shareholders may support further gains in Japan.

European equities were positive but were restrained by Germany's sluggish recovery and French political volatility following the ouster of Prime Minister Bayrou—turmoil that continued into October with the sudden resignation of Bayrou's successor, Sébastien Lecornu, who resigned on October 6 after a record-short 27 days in office. Bright spots included improved sentiment toward European banks, which supported several companies in the financials sector, specifically in the United Kingdom. Notably, Europe maintains a significant valuation discount relative to the United States given the region's relative lack of technology and innovation tied to the AI theme.

Japanese Stocks Get a Rare Lift

Nikkei 225 Index, September 1979–September 2025

Source: FactSet; data as of September 30, 2025.

Fixed Income

Fed Cuts Rates, Credit Demand Remains Strong

The yield curve remained upward sloping through the third quarter of 2025, with the 10-year/2-year Treasury spread fluctuating within a modest range and ending the quarter at 56 basis points, up 4 basis points from the prior quarter's end.[1] The continued steepening reflects a mix of front-end yields falling on further Fed cut expectations and softer data, and longer yields staying higher amid sticky inflation.

The Fed lowered its benchmark interest rate by 25 basis points at its September meeting, bringing the new federal funds target range to 4.00%–4.25%. This decision represented the first rate cut in nine months. The Fed cited rising downside risks to employment and a marked slowdown in both the supply and demand for workers. Its "dot plot" of individual FOMC member expectations indicated further rate cuts were likely by the end of the year.[2]

Fixed income markets outside the U.S. were mixed to slightly negative. European government bonds fell in the third quarter, with the gap between 10-year French and German bond yields reaching its widest level since January 2025, as France faced political obstacles addressing its budget. UK inflation concerns remain in place, leading to 30-year gilt yields reaching their highest level since May 1998. Japanese government bonds were the laggard of the quarter, down 1.5% on political and fiscal uncertainty.[3]

High-yield bonds generated a solid return for the third quarter, gaining 2.5%. Technicals remained supportive amid strong demand, as September saw high-yield return 0.76% amid supply of new issuance totalling nearly $50 billion, ranking among the busiest Septembers on record.[4] High yield spreads remained tight at 2.80% due primarily to continued demand from investors for what is deemed to be a safe yield and a general view on the asset class as reflecting higher quality than in recent years.

At 2%, bank loan returns were more modest relative to high yield during the quarter. Bank loans tend to perform well in rising-rate environments because the debt "floats" or periodically resets its coupon rate paid to investors. First Brands, a large U.S. automotive-aftermarket supplier, filed for Chapter 11 at the end of September amid a heavily levered balance sheet and controversial off-balance-sheet financing. Its first-lien term loans were broadly held by CLOs and bank loan funds, with PitchBook estimating $2 billion of collateralized loan obligation (CLO) exposure across 69 managers. While this situation came late in the quarter, it sparked concerns of additional defaults as the economy gradually weakens.

Corporate default rates in the U.S. remained mixed before the First Brands default, with trailing 12-month defaults easing to 4.8% in August from 5.2% in July. Fitch maintains its 2025 default forecast at 5.5% to 6% for loans and 4% to 4.5% for bonds. Importantly, stress in the bank loan market is somewhat understated due to distressed exchanges and liability management exercises accounting for an unusually large share of restructurings in 2025, a trend that may continue into the fourth quarter.[5]

1 Source: Resource Center | U.S. Department of the Treasury

2 Source: Fed approves quarter-point interest rate cut and sees two more coming this year, CNBC, September 2025.

3 Source: Review of markets over the third quarter of 2025 | J.P. Morgan Asset Management

4 Source: High Yield Monthly Update - October 2025 - Nomura Asset Management U.K. Ltd.

5 Source: U.S. Corporate Distressed and Default Monitor: September 2025

Real Assets

Higher rates have been a headwind, but recent cuts (and future cuts) should provide some relief

U.S. real estate investment trusts (REITs) posted modest gains in the third quarter of 2025, as the 25-basis-point interest rate cut by the Fed in September provided relief to the broad real estate sector. Given their underlying leverage, real estate securities generally benefit from a lower interest rate environment. Sentiment around real estate shifted to cautious optimism in anticipation of further rate cuts into year-end. U.S. REIT property sectors posted mixed returns, with healthcare and retail companies showing gains, while cell tower REITs fell on concerns that sales of spectrum licenses could impact demand for tower space.

Publicly listed real estate performance may remain closely tied to changes in interest rate expectations.

Oil prices remained volatile during the quarter, reflecting uncertainty around oversupply and increased production by OPEC. These concerns were partially offset by the global supply impact stemming from the war between Russia and Ukraine and sanctions on Russian oil. Nevertheless, the U.S. oil rig count continued to drop, down 17% from 2024 levels, which could set the stage for higher prices should demand recover. Natural gas prices fell, driven by an increase in the rig count, resulting in increased production, as producers anticipated growth in demand from data centers. Although natural gas prices declined during the quarter, prices year to date rose on expectations for continued growth in demand from liquefied natural gas (LNG) exports.

Looking ahead, publicly listed real estate performance may remain closely tied to changes in interest rate expectations. Any further decline in U.S. Treasury yields could positively impact the asset class, particularly for rate-sensitive sectors. Concerns about a potential slowdown in the domestic economy, however, may lead to a divergence in performance across property types, with more economically sensitive sectors potentially facing significant headwinds.

FEG believes natural gas remains well-positioned to benefit from increased demand driven by growth in LNG exports and growing power demand in the United States.

Diversifying Strategies
Hedge Funds Climb High

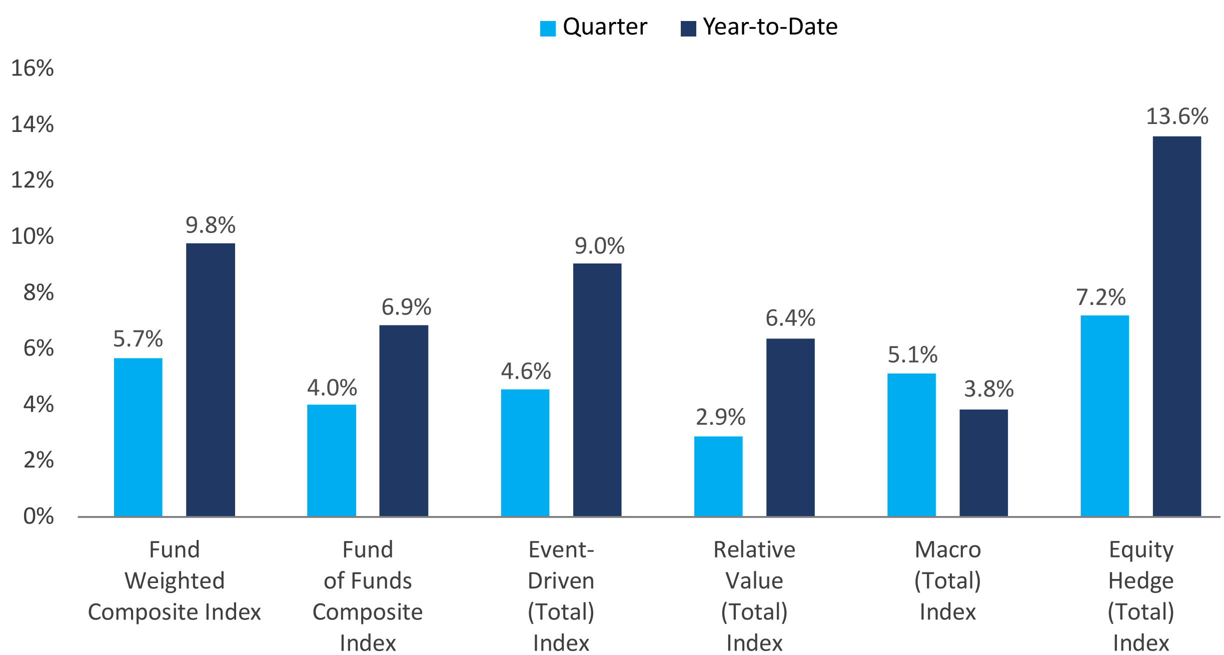
Hedge funds delivered strong returns during the third quarter, exceeding those seen in the first and second quarters. Positive results were recorded across all three months, bringing the broad HFRI Fund Weighted Index to a return of approximately 10% year to date.

In equity hedge strategies, gains were broad-based, with healthcare leading performance, followed by energy and fundamental growth. Event-driven strategies also posted widespread gains, led by activist investors and distressed/restructuring funds.

Macro strategies experienced a strong rebound, with both systematic and discretionary funds delivering gains. The recovery in trend-following strategies and a strong opportunity set amid heightened volatility and market uncertainty provided further support. Lastly, among relative value strategies, the largest contributors were convertible arbitrage and sovereign debt.

Hedge Funds Make a Solid Advance

HFRI Indices Performance Returns in U.S. Dollars



Source: Hedge Fund Research; data as of 9/30/25.

Private Markets

Approaching AI Opportunities with Caution

The three trends in the private capital markets include the AI buildout, the return of the exit markets, and the challenged return environment. While AI has dominated headlines across private capital markets as businesses prepare to capitalize on its expected economic impact, the quiet trend in the second half of the year has been the healthier exit markets for private capital companies.

Early data indicates that this year could be the most meaningful year for private equity exits since the peak in 2021.

Early this year, FEG eagerly anticipated green shoots while experiencing the late frost impact of tariffs and public market volatility. Early data indicates that this year could be the most meaningful year for private equity exits since the peak in 2021. Aggregate private equity exit value increased from $379.9 billion in calendar year 2024 to $516.2 billion through the first three quarters of 2025. Venture funds experienced a similar though less dramatic path as aggregate exit value increased from $152.6 billion in 2024 to $199.3 billion through September of this year. AI-related businesses accounted for 40% of the total exit value generated by venture funds.

AI disruption to existing businesses, workflows, and how we live has been meaningful. As with any disruptive technology, the long-term impact is unknown. There is potential that AI is overhyped in the short-term, and underappreciated over the long-term. The question that remains is how to allocate capital to a disruptive technology that will likely generate winners as well as losers.

FEG's approach is to remain nimble and invest across the private capital landscape in opportunities that benefit from strong AI use cases. Within private equity, virtually every software company is either AI-native or is replacing workflows and coding with AI models and AI-driven business processes. FEG has a steady and robust pipeline of managers seeking capital for real assets, including data centers, power generation, and digital infrastructure such as spectrum rights. Private debt funds are also judiciously providing financing that enables the creation of this critical AI infrastructure.

Speaking with leading private capital managers, it becomes clear that AI is being assessed and utilized in far more ways than just the next large language model (LLM), such as ChatGPT or Anthropic. Companies that can harness and utilize AI to capture a high return on investment (ROI) for their customers could drive attractive returns to their investors.

Private Equity
Activity Remains Mixed

Buyout

Private equity fundraising remained subdued through the first half of 2025, suggesting a continuation of the slowdown observed in 2024. U.S. PE funds had raised almost $150 billion through June 30 (latest data available), putting the year on track to fall short of prior-year totals. Deal activity showed resilience, with over 2,100 completed transactions in the second quarter, representing a 5% decline quarter-over-quarter but a 6% increase year-over-year. Total deal value exceeded $500 billion through mid-year, up almost 30% year-over-year, supported by a resurgence in megadeals and strong add-on activity, which accounted for the vast majority of deal volume.

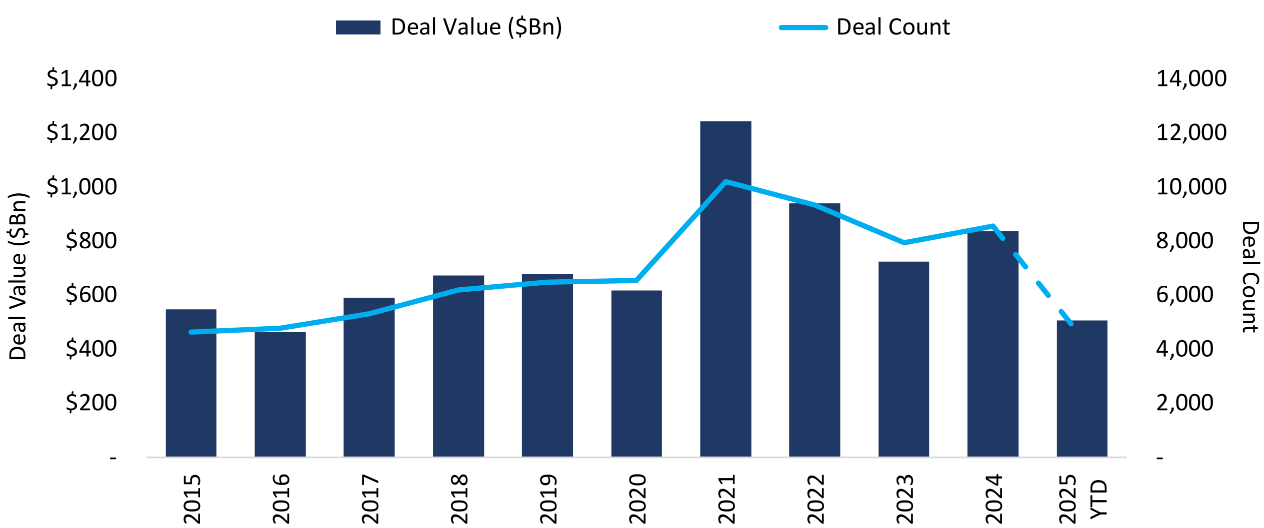
Middle-market purchase price multiples hovered near record highs as sponsor competition intensified. Buyout valuations remained elevated, with median EV/EBITDA multiples near 13x—above long-term averages.

Exit activity softened in the second quarter, totaling a bit above 300 exits, yet 2025 remains on pace to exceed 2024 in aggregate exit volume, supported by momentum earlier in the year. The median hold period for exited companies declined to six years through mid-2025, down from seven years in 2023. PE-backed inventory reached a record of over 12,500 companies, equivalent to roughly a nine-year supply at 2024 exit levels.

FEG believes investors should remain selective, prioritizing lower and middle-market, operationally focused managers capable of value creation amid persistent liquidity constraints.

Private Equity Fundraising Could Lag the Prior Year

U.S. Private Equity Deal Activity ($B) by Year



Sources: FEG; PitchBook "Q2 2025 U.S. PE Breakdown Summary"; data as of 6/30/25, which is the most recent data available.

Venture Capital

Venture capital activity in 2025 continues to reflect caution among both LPs and GPs, despite early signs of stabilization. Through the first half of the year, $27 billion was raised across just under 240 funds, on pace for the weakest fundraising environment in over a decade. Capital formation remains concentrated among established managers, while approximately 77% of those who raised in 2021–2022 have yet to launch successor funds.

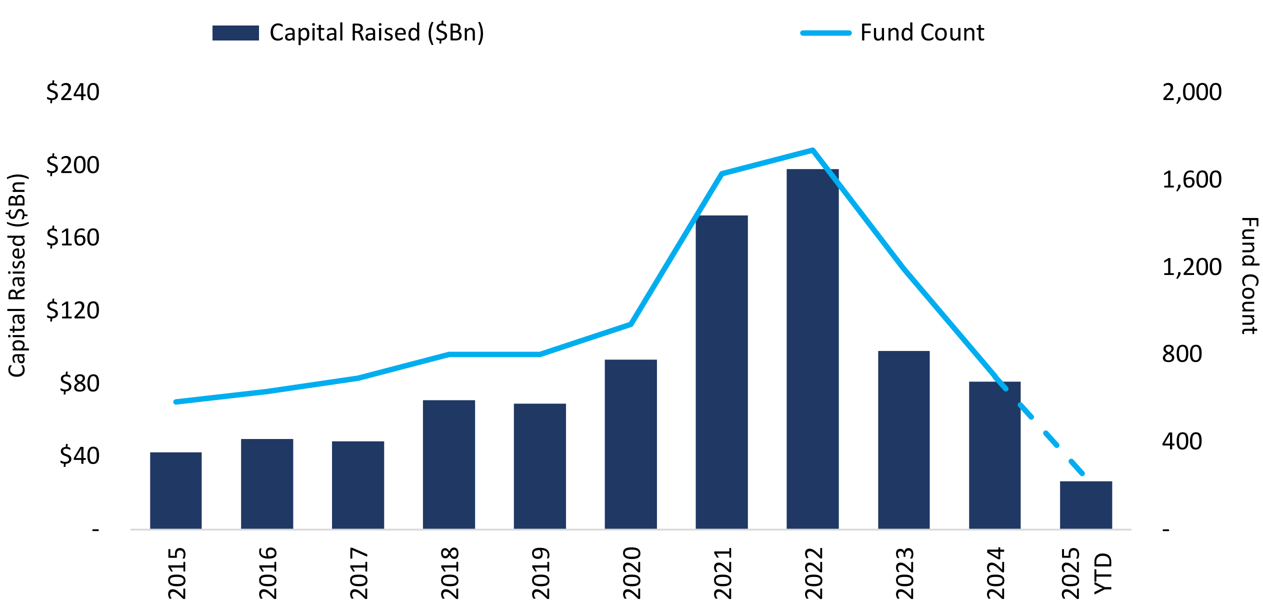
Deal activity improved modestly, with Q2 2025 seeing $67.7 billion in exit value across almost 400 deals—the strongest quarter since Q4 2021—driven by an uptick in IPOs, including Circle Internet Group, Figma, and CoreWeave. AI and machine learning investments dominated new deal flow, accounting for more than 60% of total deal value.

However, distributions as a share of NAV remain well below historical norms, and net cash flows across venture funds remain negative. Down rounds represented nearly 12% of total deals, underscoring continued valuation pressure.

We maintain a cautious stance on venture allocations, favoring disciplined exposure to high-conviction managers with differentiated sourcing and track records. For patient investors, current market conditions may offer attractive entry points at more favorable valuations.

Venture Funding Has Been Subdued

U.S. Venture Capital Fundraising ($B) by Year



Sources: FEG; PitchBook “Q2 2025 PitchBook-NVCA Venture Monitor Summary”; data as of 6/30/25, which is the most recent data available.

Private Debt

Tight Spreads Keep the UMM in the Spotlight

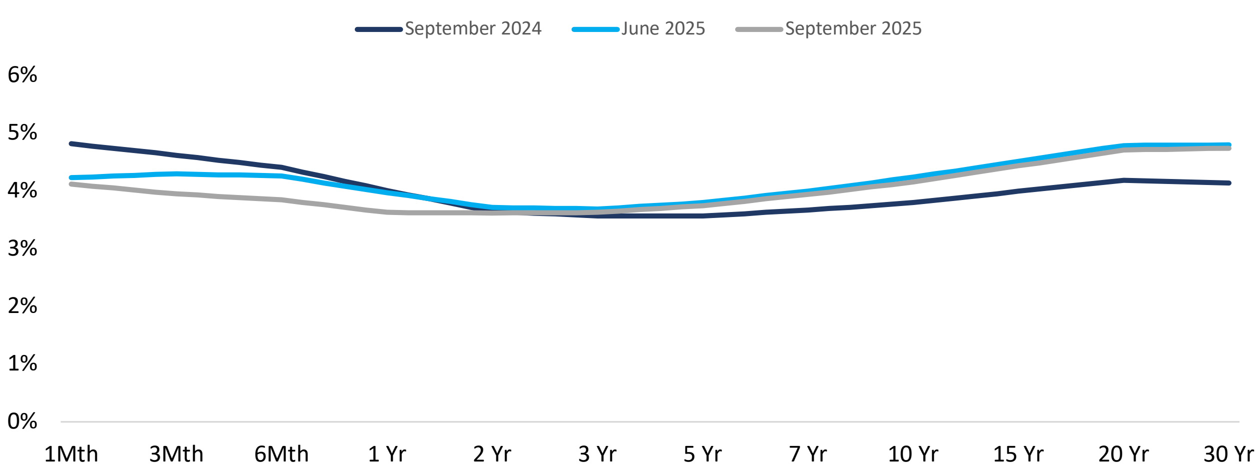
Spreads stayed tight in the third quarter, keeping the upper middle market (UMM) highly competitive. Convergence with the broadly syndicated loan (BSL) market continued as syndicated private deals and covenant-lite terms remained common amid resurgent BSL issuance and a busier merger and acquisition pipeline. Even with the Fed easing in September, unlevered yields remain compelling, as spreads remained firm and base rates, while drifting lower, were still elevated versus pre-2022 norms. As floating rates reset down over time, the relative appeal of fixed-rate mezzanine carry is improving.[6]

With sponsors and lenders focused on structure versus headline coupons, mezzanine debt pricing was broadly steady in the third quarter. As in earlier quarters, many borrowers continued to manage cash interest burdens via cash/pay-in-kind (PIK) toggles and documentation tweaks while they wait for exit markets to normalize.[6]

FEG favors strategically allocating to private lending strategies to exploit the persistent illiquidity premium. In the event of a recession, a new wave of distressed investment opportunities could be ushered in, making a case to favor both private lenders and distressed managers.

Longer Yields Stayed Higher Amid Sticky Inflation

U.S. Treasury Yield Curve



Source: Fact Set; data as of 9/30/2025.

6 Source: Credit Conditions, Q3 2025, McDermott, Will & Schulte, October 2025.

Private Real Assets

Risks Remain for Real Estate, While Natural Gas Looks Well Positioned

Private real estate stabilizes following a three-year downturn

Private market real estate values saw a slight increase in the second quarter of 2025 (the latest available data). According to the NCREIF Property Index, real estate values rose slightly, led by the residential and retail sectors. Following the downturn that began in 2022 when the Fed raised interest rates, real estate values have stabilized.

Looking ahead, cuts to short-term interest rates would equate to cheaper borrowing costs for property owners facing debt maturities. Despite a potential boost from lower interest rates, real estate could still face headwinds from inflation and slower economic growth in the coming quarters.

AI emerges as the key driver of demand for power

Oil faces a potential supply glut heading into year-end, which may push prices lower, while the demand picture for natural gas remains favorable. LNG exports, combined with power demand from data centers should support higher natural gas prices. While the supply/demand outlook for oil remains uncertain, natural gas should benefit from abundant domestic supplies, which can be exported to meet global demand.

Spending on AI infrastructure is projected to grow, which should contribute to power demand. This may directly benefit the energy infrastructure sector, with natural gas positioned as the most readily available source of power for data centers.

Looking Ahead
A Field of Dreams

The consensus on AI is that it is the future. It will impact our daily lives and be woven into personal and professional activities for years to come. From an investment standpoint, views are mixed. Those with a proclivity to focus on growth and innovation believe it to be a field of dreams. Others, with more of a contrarian and value mentality, are predicting nightmares for returns on invested capital. But as we wake up to reality, we will likely find ourselves somewhere in the middle.

Let's not forget there are a myriad of other factors driving markets as well. We can not predict what the future will hold, but we can prepare. Ensuring policy asset allocation is aligned with risk tolerances and return objectives may be a wise thing to do when times are good. Hope for the best but prepare for the worst. Across public and private markets, there will be new opportunities and talented managers where astute investors can profitably deploy capital. Disciplined portfolio management and rebalancing will continue to be a prudent course of action. Much like the voice encouraged Ray Kinsella in the classic movie *Field of Dreams,* we aspire to build portfolios that can "go the distance."

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All data is as of September 30, 2025 unless otherwise noted.

Indices

The HFRI Monthly Indices (HFRI) are equally weighted performance indexes, compiled by Hedge Fund Research Inc., and are utilized by numerous hedge fund managers as a benchmark for their own hedge funds. The HFRI are broken down into 37 different categories by strategy, including the HFRI Fund Weighted Composite, which accounts for over 2000 funds listed on the internal HFR Database. The HFRI Fund of Funds Composite Index is an equal weighted, net of fee, index composed of approximately 800 fund of funds which report to HFR. See www.hedgefundresearch.com for more information on index construction.

The FTSE Gold Mines Index Series is designed to reflect the performance of the worldwide market in the shares of companies, the revenues of which are primarily derived from the mining of gold. A company's eligibility is based on it being able to consistently produce a minimum quantity of gold per annum, and on a minimum percentage of its revenues being derived from mined gold.

The S&P 500 Index is a capitalization-weighted index of 500 stocks. The S&P 500 Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Information on any indices mentioned can be obtained either through your advisor or by written request to information@feg.com.