

# DANGER ZONE

COMMENTARY

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OCT 2025



SIM has heard a number of comparisons between the markets the last two quarters and the dot.com era – largely due to equities seeming to ignore the potential for economic slowdown, persistently high PE ratios and spending driven by the promise of nirvana brought on by AI spending. Since the market has experienced a number of dislocations over the last several decades, SIM thought it might be instructive to look at the dot-com era and see if the comparisons are valid.

### ***High Valuation***

The ratio most often cited as proof that the market is high is the PE ratio. Below, SIM provides the PE ratio of the S&P 500 for the period January 1962 – September 19, 2025. As you will note, the PE ratio is certainly elevated and is nearing the “danger zone”, yet it is not over the one standard deviation from the mean that marked the last three “substantial” downward market moves of the past thirty years: the “dot com” bust, the “Great Recession” and the “Covid dislocation”. (see Figure 1 below)

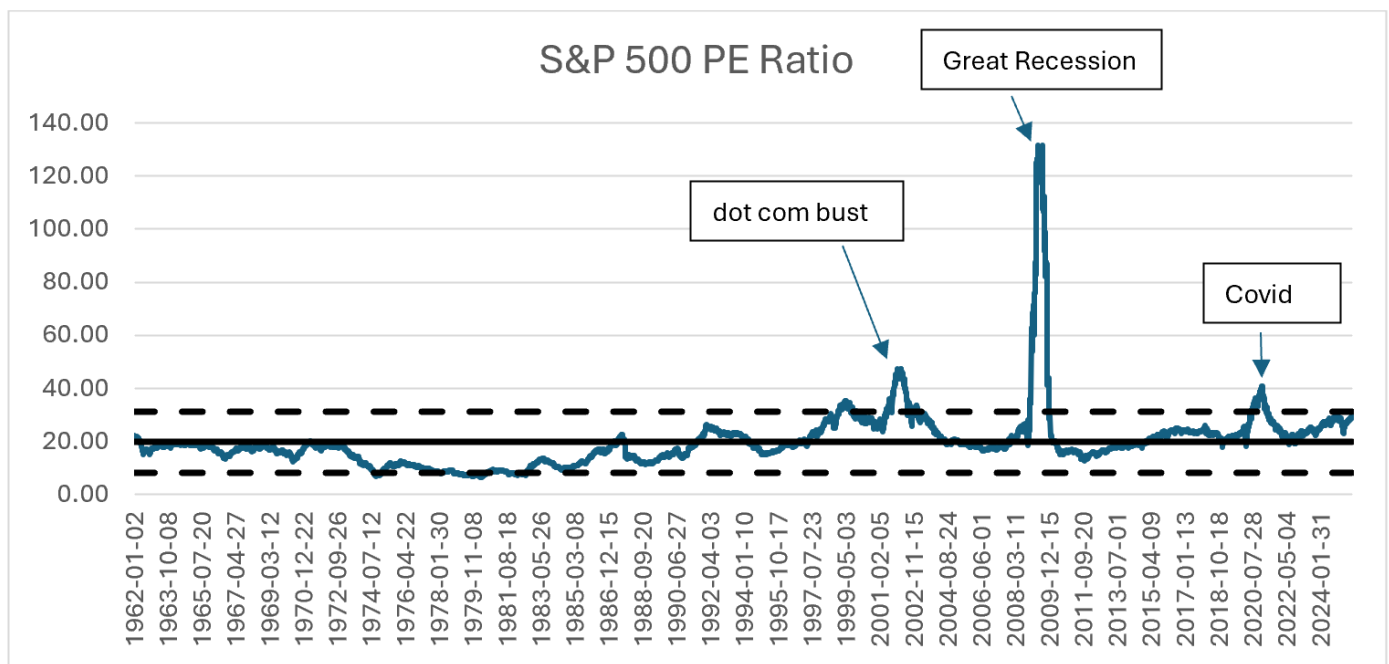


Figure 1: Source - Gurufocus.com

What can we deduce from the chart above? The first thing is that the market (which for purposes of this paper we have defined as the S&P 500) has generally been fairly valued<sup>1</sup> with a few exceptions – specifically – the dot com era, the Great Recession and during Covid. The second thing is that in all cases the biggest extremes in value have all occurred since 1999. What is different about the period since 1999? In a nutshell, interest rates.

Figure 2, on next page, shows the same data as Figure 1, but it also includes the 10-year Treasury yield. You should note that the period of most extreme valuations (as determined by PE ratio) coincides with a period when the 10-year Treasury fell and stayed below its long-term average (marked by the green line). To SIM, at least, this makes a certain degree of sense. This is because interest rates are one of the inputs into valuation. Perhaps an example will help illustrate:

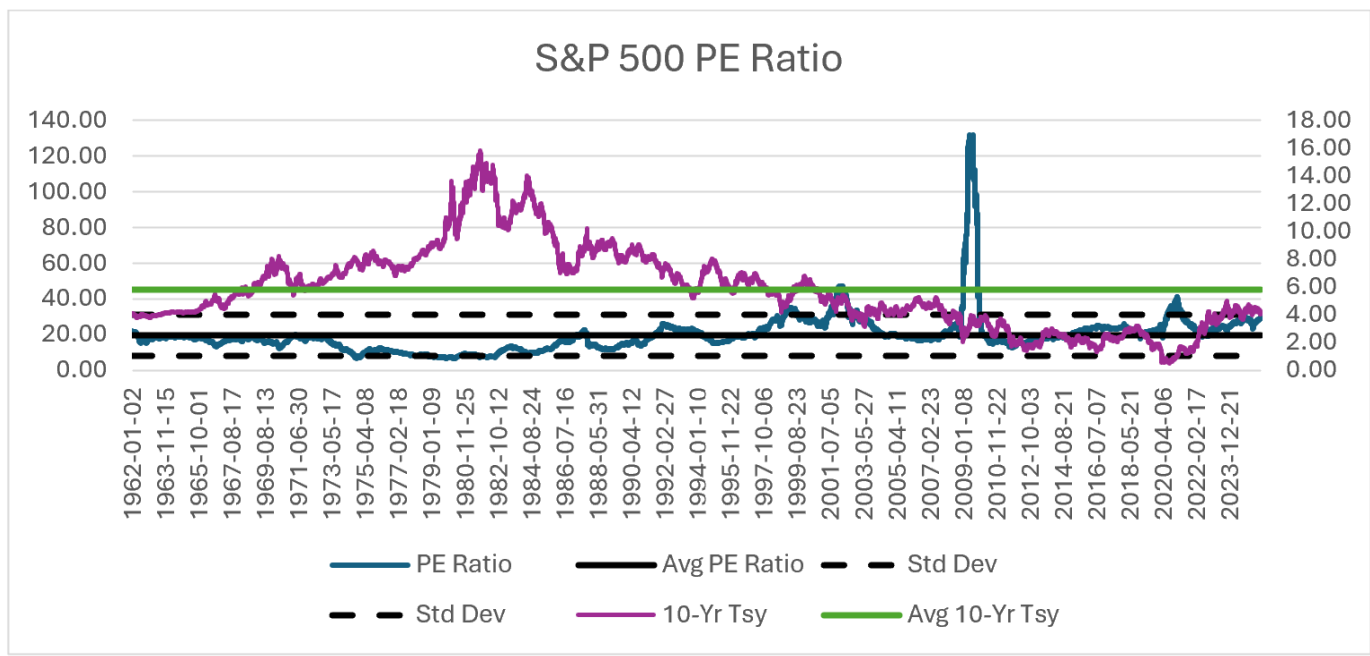


Figure 2: Source - Gurufocus.com

Investors need three broad inputs to value an asset. They are: 1) cash flows/ earnings received from the investment; 2) the growth rate (if any) assumed on those cash flows; and 3) the discount rate which will be used to value each future cash flow to present. (In actuality there would also be a fourth input – time. Because companies are assumed to exist indefinitely into the future, time is assumed to be infinite.)

Let us assume that a company (FictCo) will earn \$10 per share and that earnings are expected to grow 8% per year. Our required return on an investment in FictCo is 10%, which is the 10-year Treasury yield (assumed to be 4%) plus a 6% “risk premium”. To figure out the “value” of FictCo, we first calculate next year’s expected earnings ( $\$10 \times (1+8\%)$ ), getting expected earnings of \$10.80. We then divide next year’s earnings by the difference between our required return (in this case, 10%) and the expected earnings growth rate (8%) to arrive at an expected value for FictCo of \$540 per share. We now know what FictCo should be worth at current interest rates, but how do interest rates impact the value of the company? In general, as interest rates fall, values rise. Furthermore, as the (discount) rate approaches zero, values approach incalculable levels. Using our FictCo example, let us now assume that interest rates fall to 8.1%. Assuming all other inputs remain the same, the value for FictCo will rise to \$10,800.

In the first example the PE ratio of FictCo would be 50X earnings, and in the

second example its PE ratio would be 1000X earnings. In other words, as interest rates declined, values and PE ratios rose. Given that interest rates had declined from above average in the 1980's and 1990's to below average in the late 1990's and 2000s, it makes a degree of sense to us that more extreme PE ratios should (roughly) coincide with below to well below average interest rates. (This is intended to be a simplistic example. We can also impact value if we assume a change in the growth. In general value rises as the growth rate rises, and falls as the growth rate falls.)

While the above example doesn't tell us whether or not the current PE ratio is abnormally high, it does give us enough information that we can (hopefully) reach reasonably educated expectations. For instance, we know that the 10-year Treasury has fallen this year from a high of 4.78% on January 14th to its quarter-end level of 4.15%. We also know that earnings next year (2026) are expected to grow to \$302.02 per share from an estimated \$265.93 per share for 2025. While this represents growth of 13.6% versus 2025, earnings estimates tend to fall over the course of the year. SIM doesn't expect 2026 to be any different.

If the earnings growth rate falls and interest rates rise then, according to the rules outlined above, it shouldn't be too big of a stretch to believe that current values might be a bit stretched. As Kenny Loggins sang years ago, we may be on the "highway to the danger zone."

### ***The Economy***

Which gets us to interest rates and the economy. Are we headed for a recession? That is the fear – particularly with tariffs pushing up prices for many things and retaliatory tariffs from abroad impacting demand for agricultural goods.

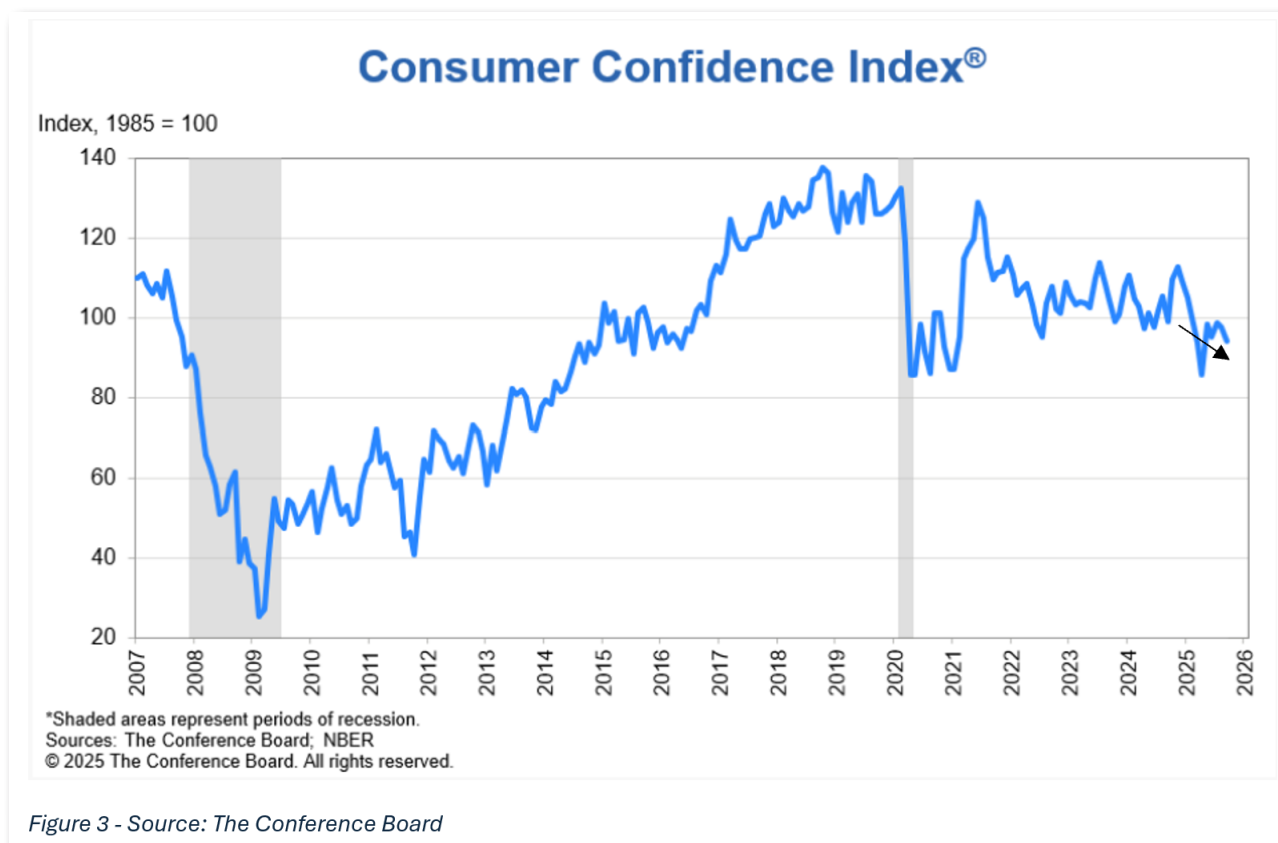
The Fed (specifically the Federal Open Market Committee or FOMC) has been, in SIM's view, particularly deliberative (data dependent) when deciding whether to modify their rate policy. As proponents of the Phillips Curve, which states that unemployment and inflation have an inverse relationship, it shouldn't be too surprising that as job openings began to trend down the market began clamoring for a rate cut to stave off a recession. We would argue that while job openings are half a million lower than at the beginning of the year and the number of unemployed people now surpasses the number of job openings, it looks as if job openings may have stabilized.

Unfortunately, with the Federal government currently in a shutdown, we

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won't have any "official" economic data until Congress can decide on a continuing resolution to fund the government. This means that the market will need to parse the available data and company earnings reports for signs on the direction of the economy. We also won't get any official government confirmation on job openings until the shutdown ends. (As an interesting aside, markets tend to do reasonably well during and immediately after a government shutdown<sup>2</sup>.)

In today's economy, much like economies of the past, how well or poorly it goes will come down to how the consumer feels about both their current and future selves. This is because the consumer currently represents nearly 70% of economic activity<sup>3</sup>. From that perspective, while it looked as if consumer confidence had stabilized in a range, it now looks as if confidence has been waning since the beginning of the year. Driving the fall in Confidence was



a decline in both the Present Situations Index (declining by 3.6 points in September – its largest drop in a year) and the Expectations Index (falling 1.3%). Declining confidence was most notable in those over 35 years old and in the lowest earning cohort, those making \$25,000-\$35,000 per year. (Oddly enough, confidence also fell for those earning more than \$200,000 per year.) Will declining confidence be enough to push the economy into a recession? We will need to parse back-to-school and Christmas shopping data as well as

earning reports as we begin third quarter earnings season.

Meanwhile, on the inflation front, we get more troubling data. Consumers' responses to the confidence questionnaire indicated that rising prices were among their biggest concern. Given that the Fed had been (and remains) focused on a 2% inflation target, it is interesting that the FOMC has resumed cutting rates with a quarter-point cut to its Fed Funds rate and is expected to cut an additional fifty basis points during the fourth quarter while inflation remains a concern of consumers. Are they talking out of both sides of their mouth? We don't think so. Rather, SIM has believed for some time that a target of closer to 3% makes more sense as that is more closely tied to the historical average (see Figure 4 below).

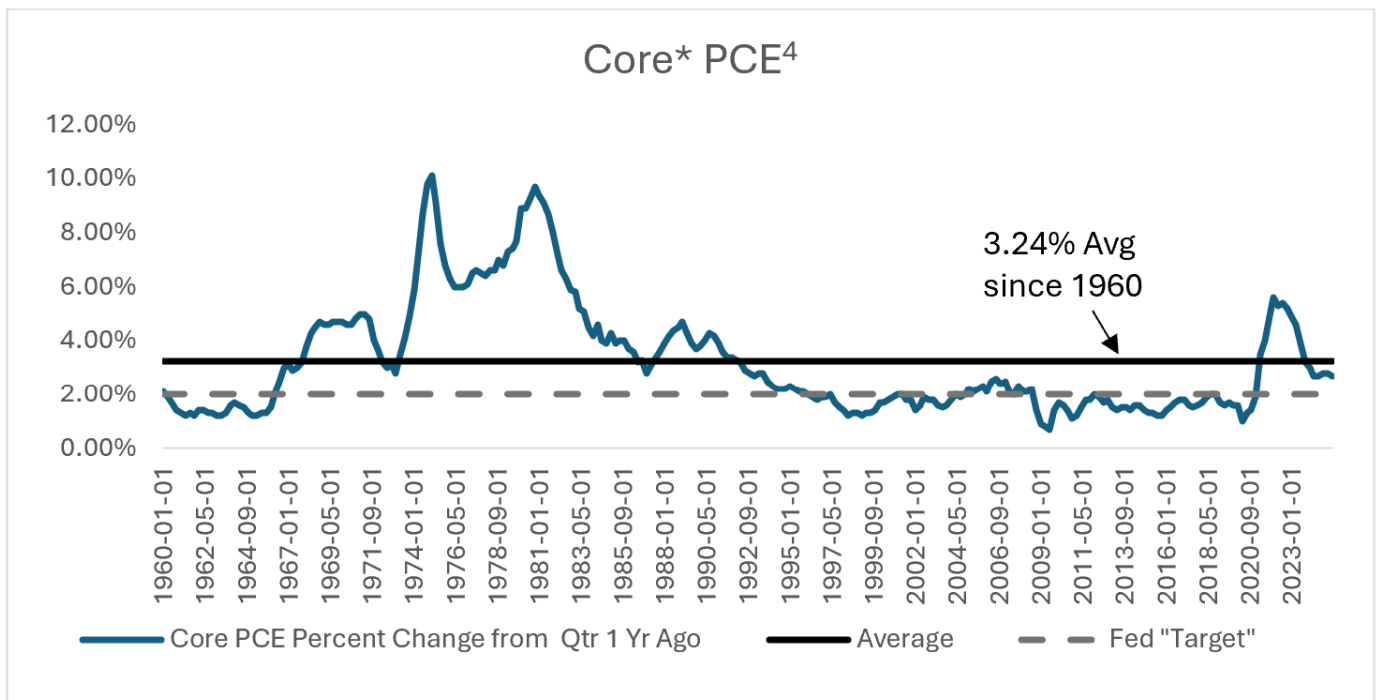


Figure 4 - Source: Federal Reserve Bank of St Louis, FRED database

But why has the Fed been so reluctant to cut (or raise) rates over the past couple of decades or so? We think that the chart below may hold a clue. This chart shows CPI<sup>5</sup> inflation from 1913 to the present.

What we found interesting is that the relative stability in the quarterly

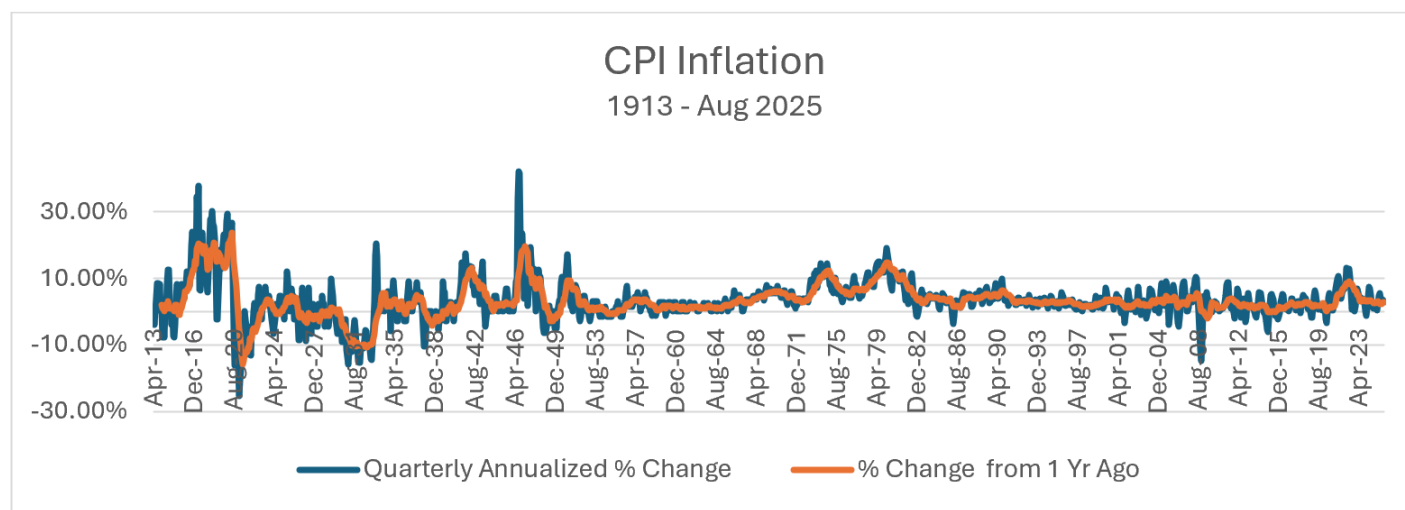


Figure 5 - Source: USinflationcalculator.com

readings we had enjoyed since the 1950's seems to be gone and the quarterly readings (beginning with the end of the last century) are now much more volatile. Is this volatility in the quarterly inflation data the reason why the Fed has been so data dependent when making changes to its interest rate policy? Possibly.

The Fed has been fighting the inflation bogeyman since the late 1970s as they worked to get it under control after policy mistakes had let it loose. Not wanting to repeat the policy mistakes of the past that led to the inflation of the 1970s, the Fed has tried to be more deliberate in its decisions. Will this lead to recession? We don't think so, though it could lead to slower than desired growth.

## Markets

Its been a reasonably good year for investors this year as both stocks and bonds have provided positive returns through the third quarter. In our view, bonds have been the big surprise with strong single digit returns as yields have come off their beginning of the year highs (see Figure 6 below). This has, however, resulted in a yield curve that has developed a bit of a belly as investors expect the Fed to provide additional rate relief over the balance of this year and next year.

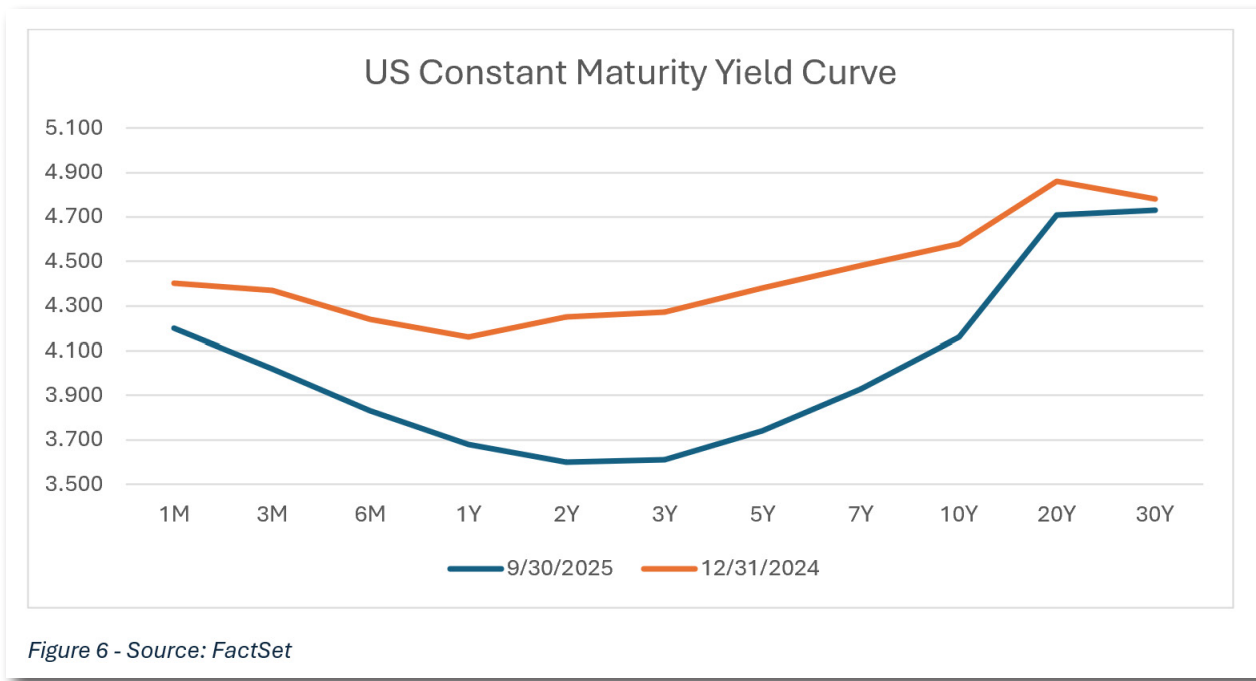


Figure 6 - Source: FactSet

Equities have followed suit. Stocks have continued their climb with solid double-digit returns through the end of the third quarter. The surprise, however, has been that the market seems to have broadened out as small-cap stocks were the real stars of the quarter. Small cap stocks, as explained by the Russell 2000 index, zoomed to the quarterly performance winner with a third quarter return of 18.5%. This was followed by the broad-based Russell 3000 at 15.67% and, close on its heels, the S&P 500 with a quarter-end return of 13.62%. The exceptions to double-digit equity returns for the quarter were mid-cap stocks, as represented by the Russell Mid Cap Index (up 9.26%) and global dividend paying stocks as described by the MSCI World High Dividend Yield Index which gained 6.14%.

On a year-to-date basis performance is led by global stocks (MSCI All World Index up 18.25%) and large(r) cap stocks with the S&P 500 (up 14.83%) and the Russell 3000 (up 14.40%). Assuming the S&P 500 doesn't decline in any meaningful way through the end of this year, it is quite likely that the S&P 500 ends the year with its third successive year of double-digit performance. In our beginning of the year piece, we stated that if 2025 provides us with a third double-digit performance year, we get concerned about what 2026 may provide.

## **SIM Outlook**

While equities tend to do well during and immediately after a government shutdown, it doesn't mean that some expectations aren't suspect. Take earnings, for instance. Current expectations are that 2026 earnings on the S&P 500 will be more than 13% above 2025's results. The market has also been heartened that for the first time in a long time, earnings expectations for the succeeding year have started to rise (the market changed focus from 2025 to 2026 at the end of the second quarter). Indeed, while the change in estimates for 2026 have fallen since the end of 2024 (off by 1.92%), those estimates bottomed at the end of May (\$297.60 per share) and have risen by 1.49% off that low. Is that a green shoot? Perhaps. In fact, we do expect that the market will likely finish the year above where it ended the third quarter. That doesn't mean, however, that we don't have any concerns.

If the S&P 500 does end the year providing a double-digit return for the year, this will be only the eighth time since 1926 that US markets have experienced three consecutive double-digit return years. While the average return in year four is 2.66%, year four provides negative returns more than sixty percent of the time (an average of -9.34%).

We are concerned about equity performance in the year ahead. We are also concerned about the risks investors are taking.

In a paper SIM wrote last summer, we showed that the S&P 500 had a higher beta than the market beta (the market beta, by definition, equals 1), which is important as the S&P 500 is often used as a proxy for the market. To see if risks may have diminished, we calculated the S&P 500 beta (again as a weighted average of the individual company betas) and discovered that the weighted average beta has increased and the top ten companies, by market capitalization, now represent slightly more than 40% of the market capitalization of the S&P 500.

Driving this growth, in SIM's view, is the excitement around AI. While we don't believe that the comparisons to the dot com era are accurate, like the dot com era, markets are being driven by the potential for new technology. It has been our experience that when the market looks at new technology as a positive change agent for the market and the economy, its expectations ignore the risks. What happens if the upgrade cycle for the chips that power AI shortens and customers don't upgrade or upgrade as fast? What if the expected returns on the capital invested into AI don't happen or are smaller than expected? Are we overbuilding data centers and their needed infrastructure? What happens if the economy continues to slow? All good

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questions and all, particularly the first three questions, could negatively impact the market.

Something else that has been largely overlooked, which could negatively impact government funding and debt, are two cases working their way through the courts involving the constitutionality of the administration's tariffs. The first of the two is slated to be heard by the Supreme Court in November and if the administration loses, it could result not only in the elimination of the current tariff regime but refunding more than \$100 billion in tariff revenue. This would likely, in our view, increase Treasury funding costs. Oddly enough, and on a more positive note, because a tariff is a tax, it could also help consumers by reversing tariff driven inflation and helping business margins by reducing their costs.

While Kenny Loggins' song "Danger Zone" was about flying F-14s, we believe that the US economy acts more like a ship. You may spot danger on the seas, but your evasive maneuvers must happen with sufficient enough time and distance.

While risk, by itself, isn't necessarily a bad thing, we do need to make sure the compensation we receive for taking risks is adequate. We are not sure, however, that the market is being sufficiently compensated.

The earnings yield for the S&P 500 is below 3.5%, a level that has been a danger point and a level that could indicate a risk premium that is negative. (One way to determine the risk premium is to subtract the yield on the 10-year Treasury from the Earnings Yield.) Indeed, the equity risk premium using the method above turned negative in early 2024 and has moved modestly more negative in the ensuing year and three quarters. Can it get more negative? Yes, as it was through the 1980's, 1990s and the period including the dot com debacle.

As Sim has stated in past commentary, the biggest mistakes we have seen are investors focusing too much on the upside without understanding the risks being taken or focusing too much on the risks while staying too long on the sidelines. Understanding that time in the market is more important than timing the market, and that proper diversification and appropriate asset allocation helps to align risks with return expectations can put investors in a much better position to weather potential investment storms.

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**End Notes and Definitions:**

1. For this paper, we define fair value as a PE ratio that lies within one standard deviation above and below the average. In Figure 1 this would be a range from 8.20X to 31.08X the trailing twelve months earnings as determined by Gurufocus.com.
2. "How the S&P 500 performed after 10 previous government shutdowns", Annie Nova, CNBC.com, October 7, 2025.
3. The Consumer, as of the second quarter of 2025, represented \$16.45 trillion out of a total GDP of \$23.77 trillion or 69.18% according to the final estimate of 2025 second quarter GDP data from the US Bureau of Economic Analysis.
4. Core PCE: The PCE Price Index Excluding Food and Energy, also known as the core PCE price index. The core index makes it easier to see the underlying inflation trend by excluding the food and energy categories where prices tend to swing up and down more dramatically and more often than other prices.
5. CPI: The Consumer Price Index is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

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