

Q3 Review and Year End Outlook- Bubbles and Cockroaches

Executive Summary

- Paraphrasing Jesse Livermore'sⁱ character in *Reminiscences of a Stock Operator*, who was himself quoting H.H. Rogers, Q3 was a quarter when making money was as easy as getting wet in a rainstorm. Nearly every asset class jumped in Q3 propelling many to record highs.
- While geopolitical risk subsided on the quarter, most notably with the Gaza peace plan announced on September 29th, it remained near all-time highs. Like Q2, many assets jumped despite troubling warning signs.
- This leaves many investors, including the International Monetary Fund (IMF)ⁱⁱ, wondering if we are in a bubble. The term "stock market bubble" neared record-highs on Google Trends. We will discuss our thoughts on bubbles below. In short, they generally do not occur when liquidity is cheap and abundant as it is now, but they are impossible to time. We advise clients to confirm their risk tolerances, stay diversified, and proceed with caution.

Cash- abundant and cheap

Cash in US dollars earned just over 1% in Q3, ranking near the very bottom of the various asset classes we track. Notably, though, cash became cheaper and more abundant. Money supply grew 5% year-over-year most recently. Investors now hold a record level of over \$7.3 trillion in money market funds. Interest earned on cash deposits fell in Q3 with the Federal Reserve cutting interest rates by 0.25% in September and signaling another 0.5% of cuts by year end. What troubles us most with these cuts is that they come at a time when inflation is above the Federal Reserve's targets while unemployment remains near historic lows. The Federal Reserve cited weak job growth and diminishing inflation risks as factors in its decision. We wonder if weak job growth stemming from immigrants leaving the workforce and artificial intelligence (AI) replacing workers can be abetted through rate cuts.

In terms of bubbles, cheaper and more abundant cash generally helps to fuel bubbles rather than popping them. Whereas investors could "t-bill and chill" earning 5% on cash just last year, they now earn ~4%. The blistering returns from the asset classes noted below leave investors wondering why they have so much or any cash earning just 1% per quarter and this mentality can often push bubbles higher. Signs of speculation, froth and irrational exuberance seem to be popping up daily. Day trading meme stocks is back in vogue. Penny stock Beyond Meat was off 75% last week and up 600% this week, with 2.2 billion shares traded yesterday against just 400 million outstanding. Newly issued stocks, like Circle, are immediately packaged into leveraged funds offering two times the exposure.

Former Federal Reserve Chairman Alan Greenspan's infamous "irrational exuberance" speechⁱⁱⁱ questioning asset prices and the S&P 500's 60% two-year return came in December 1996. From there, the S&P jumped 31% in 1997, 27% in 1998 and 19.5% in 1999. Surprisingly, Greenspan and company cut rates and expanded money supply along the way. It was not until September 2000, nearly four years after Greenspan's speech and ultimately after he raised rates by 1.75% in late 1999 and 2000 that the "tech bubble" finally popped. Interestingly, he went on to warn of "froth" in the housing market in May of 2005. That bubble also did not pop until three years later and again after another 2.5% of Federal Reserve interest rate hikes.

Greenspan later concluded^{iv} that it is nearly impossible to know when a bull market becomes a bubble. Sir Isaac Newton also learned this the hard way. He bought and sold his South Sea stock for a quick £7,000 profit in 1719 spotting a bubble. The share price then jumped 200%. Newton feared missing out, jumped back in with a lot more of his wealth, and ultimately suffered a £20,000 loss when the bubble popped. He reportedly noted, "I can calculate the motion of heavenly bodies, but not the madness of men." Our two main points here are (1) bubbles are impossible to time, but (2) they generally don't pop when money is becoming cheaper and more abundant.

Bonds- stretching for yield

One reason cash is abundant, and money supply is growing is government largesse. Despite near record low unemployment, the United States is still running a deficit of 6% of GDP. The average deficit in advanced economies is expected to be over 4%. Gross public debt as a share of GDP in advanced economies is near record highs at 110%. Despite these troubling signs, bonds rallied in Q3 with the broad-based Barclays US Aggregate up over 2%. While investors typically demand more yield for countries with deficit and debt issues, the US 10-Year US Treasury bond yield at 3.95% is near its lowest for the year.

Part of the explanation here is that the US remains the cleanest, deepest dirty sheet in the world. Britain's 30-year bond yields reached their highest levels since 1998 due to their budgetary issues. Japanese bond yields touched their highest levels ever, given their high levels of debt and recent inflation. France is not only dealing with the embarrassment of le Louvre heist, former president Sarkozy's imprisonment and its fourth prime minister change in a year, but its bond yields now trade north of Italy's. Argentina, with its nine defaults since 2000 and twenty IMF bailouts since 1950, may be heading for trouble again with \$18 billion due in 2026. While the US is working toward a \$40B lifeline, we would be wise to study the long-term relationship between debts, deficits and bond yields before a US bond bubble pops.

For now, low yields on abundant cash and "safe" US Treasury bonds have many investors stretching for yield. In Q3, high yield US bonds gained 2.5%. The added compensation high yield bond investors receive over Treasuries stands near record lows. This seems odd again given some worrying signs. Student loan and subprime auto loan delinquencies both stand near record highs. Toward the end of Q3, the bonds of auto-parts supplier, First Brands Group, and "buy here, pay here" subprime auto lender, Tricolor Holdings, collapsed from near par to pennies on the dollar. In a scene reminiscent of the subprime housing collapse in 2008, Tricolor's previously AAA rated asset backed securities immediately re-rated to CCC or below. While many investors are calling these "idiosyncratic events", we tend to agree with JPMorgan Chase's CEO, Jamie Dimon, who noted "when you see one cockroach, there are probably more" after his bank took a \$170 million charge-off on Tricolor. While cash is abundant and cheap, we think it pays to move up in quality and liquidity rather than stretching for yield.

Global Stocks and the potential for an AI bubble

In Q3, the everything rally extended to equities. US stocks jumped 8% and just recently completed their third best six-month return since 2000. If US stocks have a similar Q4, we'd see three straight years of 20+% gains for the first time since 1997 and the tech boom. There are many important similarities and differences between today and the tech boom/bubble to highlight.

First and foremost, in terms of similarities are the blistering returns and eye-popping valuations. We noted the strong public returns above, but on the private side, OpenAI's valuation jumped from \$157 billion to \$500 billion in less than a year, while its rival Anthropic nearly tripled to a \$170 billion valuation in just six months. On valuations, the S&P just reached 39X cyclically adjusted earnings. The last time the market reached above these levels was in 1999 during the final burst of the tech bubble. Just as investors paid high valuations for zero revenue stocks like Pets.com back then, investors are assigning \$10-20 billion valuations on zero or near zero revenue companies in AI related sectors like nuclear small modular reactors (SMRs) and flying taxis.

Also, like the tech bubble, the US market is now highly concentrated in a handful of names and sectors. The share of Technology, Media and Telecom (TMT) stocks of the S&P 500 is now roughly 45%, exactly where it stood in 2000. Just as these companies drove a capex boom in the 90s to build out internet fiber, they are doing so today. Investments in information processing equipment & software (think data centers and chips) were responsible for 92% of GDP growth in the first half of 2025. Excluding these investments, the economy grew at just 0.1% very near recessionary levels.

These investments are likely just getting started, but are growing more circular and debt-financed just like the tech bubble. OpenAI recently signed a string of deals with Nvidia, AMD, Broadcom, and Oracle to spend roughly \$1.5 trillion on chips and data centers. It is important to note that despite OpenAI's massive growth and valuation, it is expected to earn just \$13 billion this year, leaving some questions as to where the money will come from. Also, OpenAI isn't going at this alone. A recent Bain & Company report^v estimated a need for \$500 billion in capital investments each year to meet anticipated AI demand. For this spending to work for these companies, Bain further estimates they would need \$2 trillion in additional annual revenue per year by 2030. For context, that is about what the "Magnificent Seven" (Amazon, Alphabet, Apple, Meta, Microsoft, Nvidia, and Tesla) now make combined.

While this seems like a daunting task and may leave many running from what may be an AI bubble, we will end with some important differences and notes. Unlike the tech bubble, these firms are delivering real revenues and cash flows. The Magnificent Seven grew their earnings 34% in 2023, 37% in 2024 and an expected 19% in 2025. While the Magnificent Seven drove a large portion of the market returns and earnings growth over the past few years, the remaining 497 companies in the S&P are more fairly valued and are expected to close the earnings growth gap moving forward. Q2 overall was in fact one of the best earnings seasons in years with 80% of S&P 500 companies beating estimates.

In sum, timing a bubble, as noted previously, is nearly impossible even for the best of them. Before running to cash, long-term investors should consider that we may be on the precipice of a 1997-1999 post "irrational exuberance" run. We may also be much closer to the post-1999 period. Investors heavily concentrated in the Magnificent Seven, AI, and SMRs should consider how much they are prepared to lose if the AI bubble pops. Post-tech bubble, the tech-heavy Nasdaq fell roughly 78% from its peak while the broader S&P 500 lost close to 50%. Finally, investors should consider diversification. As noted, ex-Magnificent Seven US stocks are more fairly valued. Whereas the Nasdaq and S&P delivered five years of cumulative losses post tech bubble, the S&P 600 Small Cap and 400 Mid Cap Indexes grew annually at 11.5% and 7.8% respectively.

On diversification, international stocks delivered a strong quarter, up roughly 7%. Depending on Q4 results, they may be on track to have one of their best years since 2009 or even 1999. Despite their own political issues noted above and a lack of Magnificent Seven AI-related stocks, international markets offer both cheaper valuations and again diversification. Whereas the S&P 500 currently trades at 23X next year's expected earnings, international shares trade at just 15X. Earnings were also strong internationally and, like the US, are expected to close the gap on the miraculous earnings growth of the Magnificent Seven lately. Finally, international stocks give US investors some diversification against the US dollar, which is having one of its worst years since 1979.

Alternative Assets

Related to the dollar, it has been said that stocks are partying like 1999 while gold is partying like 1979. Gold was up nearly 50% through Q3, delivering its best year-to-date performance since 1979, when it jumped 143% in dollar terms. These are odd bedfellows, as gold often shines during difficult times for equities like 2008 and 2011. Gold's rise has been parabolic and recently volatile. While gold is up in October as of this writing, it just experienced one of its best and worst days in decades in back-to-back sessions. Volatility often begets volatility. This everything rally driving often uncorrelated assets may be a function of the abundant and cheap liquidity currently in the system. Gold is a notoriously difficult asset to value. While it has generally maintained its purchasing power for thousands of years, it too has bubbles and experienced four decades of cumulative losses after 1979.

Given the strong correlations driven potentially by cheap and abundant liquidity, we continue to look for other alternative assets that can provide less correlated returns driven more by manual efforts. We continue to be pleased with our uncorrelated hedge funds and continue to look for managers that can make money come what may.

On the private capital side, we've seen a strong pick up in liquidity events. In Q3, initial public offerings (IPOs) were up 19% by volume and 89% by value year-over-year. IPOs have been well received by a market with abundant

liquidity and perhaps given these single stock leveraged funds. Globally, mergers and acquisitions (M&A) activity has also been strong, reaching \$3.1 trillion of deals and up 35% versus last year. We continue to largely focus on putting our new money out with smaller managers who focus on growing businesses through manual efforts rather than financial engineering. We think playing small ball and selling up to the larger players will continue paying dividends.

Conclusion

We are thankful as always for your trust in us and for the strong returns generated by nearly all asset classes in Q3. We are constantly thinking about and watching out for bubbles and cockroaches. Like Alan Greenspan and Sir Isaac Newton, we think it is impossible to time bubbles. We are in unprecedented times with heightened geopolitical risk. Also, autonomous cars, flying taxis, AI assisted agents and coders, and Jetson-like robots that can cook, clean and fold laundry are all coming to market. We may very well be on the verge of a 1997-99 type run or the Gilded Age where H.H. Rogers' made money like getting wet in the rain. We may also be closer to 1999 for stocks or 1979 for gold.

Although Sir Isaac Newton died a wealthy man, it is estimated that he lost nearly the value of his estate on the South Seas bubble. Post-bubble, the term "South Seas" was never to be mentioned within his earshot. Jesse Livermore's story is much more tragic, but a valuable lesson in avoiding concentrated bets in bubbly times. H.H. Rogers, on the other hand, gradually diversified his investments, grew his wealth, and lived a full, prosperous, and philanthropic life. We advise clients to stay diversified, understand and commit to their risk tolerances, proceed with added caution and liquidity, and focus on the long-term.

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ⁱ https://en.wikipedia.org/wiki/Jesse_Livermore

ⁱⁱ <https://www.imf.org/en/Publications/GFSR/Issues/2025/10/14/global-financial-stability-report-october-2025>

ⁱⁱⁱ <https://www.federalreserve.gov/boarddocs/speeches/1996/19961205.htm>

^{iv} <https://www.federalreserve.gov/boarddocs/speeches/2002/20021219/default.htm>

^v <https://www.bain.com/insights/topics/technology-report/>