Optimism and Risk are Rising in Tandem

by John E. Chapman

Overview

The third quarter for 2025 is now behind us, and while it has historically been the weakest quarter of any given year, the S&P 500 ended up adding another 8% in gains during the quarter to push its year-to-date gain up to a little more than 14%.

A well-known Wall Street adage advises investors to “not fight the tape”. This simply refers to the market momentum often observed in both bull and bear markets. In the case of bull markets, history shows that they typically last much longer than bear markets, and once they pass the 1,000-day mark (as the current bull market has), they can keep pressing higher for longer periods of time. For example, the bull market that followed the 1987 crash (1987-2000) lasted nearly 4,500 days, and the one that followed the Great Recession (2009-2020) lasted nearly 4,000 days (BESPOKE).

Since this bull began in October 2022, the S&P 500 has gained a total of 88%. The historical average bull market gain has been 114%, although the median bull market comes in a bit lower at 76%.

Fundamentals Hold Steady, While Technicals Become Increasingly Stretched

It is true that “overbought” or “oversold” conditions in the market can remain in place for periods of time much longer than seems logical. However, markets do not typically move in straight lines. The longer price movement favors one direction over the other, the more probable reversals can become. While momentum can propel market direction for extended periods of time, eventually it wanes, and markets can reverse direction quite suddenly.

The relative strength index (RSI) measures overextension in the equity markets (either direction) by comparing the magnitude of recent gains to recent losses. Known as a “momentum oscillator,” it measures the velocity and magnitude of price changes on a scale from 0 to 100. Readings above 70 are often flagged as “overbought,” while readings below 30 are considered “oversold.”

The current Relative Strength Index (RSI) level for the S&P 500 is approximately 64.6 on the 14-day timeframe, as of this writing. This signals moderately strong momentum, just below the typical overbought threshold of 70 that often marks potential pullbacks. This RSI reading reflects ongoing bullish sentiment in the market, but not yet an extreme condition.

Historically, elevated RSI levels typically precede notable corrections within bull market cycles. The problem is in knowing “when” to expect the downturns. The RSI will frequently flirt with high RSI readings repeatedly while markets continue higher, sometimes for weeks or even months, before the reversal or correction finally arrives. Downturns, however, do eventually arrive.

Beware Over-Concentration in Growth Equities

The stock market is comprised of many sub-asset classes and sectors. The current bull market has been dominated by large growth equities – particularly the names of the country's biggest technology companies. Sometimes referred to as the Magnificent 7, these stocks have contributed a disproportionate share of recent market gains. Value stocks, which typically represent less exposure to technology and more to sectors like energy and financials, have not matched the returns powered by growth stocks in this bull cycle.

In 2024, growth stocks outperformed value stocks by about 19 percentage points (Morningstar). However, just two years earlier, value stocks outperformed growth stocks by a record margin, with the MSCI World Value Index delivering a 6.1% gain while the MSCI World Growth Index declined by 20.1%, resulting in value outpacing growth by 26.2 percentage points (Cowan).

Historically, market leadership between growth and value is cyclical. Extended periods of dominance by one category over the other often give way to long stretches of outperformance by the other. Another way to think about this is "today's leaders are often tomorrow's laggards, and today's laggards are often tomorrow's leaders".

The longest period of sustained outperformance by value stocks (over growth stocks) in the past 50 years occurred from the early 1970s until about the mid-1990s, lasting roughly 25 years. During this multi-decade stretch, value stocks consistently delivered higher returns than growth stocks, helped by several market cycles favoring companies with lower valuations and higher dividends.

The Speculative Phase of Innovation

Investors who are familiar with the long and storied history of how disruptive innovations have impacted our society are aware of the significant wealth creation these innovations can often bring. They are also aware of the S-curves defining adoption rates and the irregular phases these new technologies often experience as they move from disruption to normalization in our daily lives.

The emergence of Artificial Intelligence as a dominant force in our lives has been impressive. Many companies have announced massive investments in this new technology with the anticipation of significant future gains in projected revenue. The question remains, however, when and how will these higher revenue streams materialize? Understanding the importance of these simple questions can help put extreme valuations into context.

Brian Wesbury, Chief Economist for First Trust, has written a fascinating article taking readers through the many twists and turns of disruptive innovations over the past one hundred years. For those interested in a sobering account of the various periods of innovation boom and bust, the article can be found here: History Rhymes – Don't Forget It.

Conclusion

As the title of this month's Private Client Letter suggests, risks in the market tend to rise alongside growing optimism. Enthusiasm for what is positive in the economy often emboldens investors to take on more risk while ignoring overbought conditions. It appears that this may be happening today.

With valuation metrics currently stretched and macro uncertainties rising, we suspect the market may be closer to a correction than another leg of the bull market higher. That said, it is certainly possible this market can push higher into year-end. Earnings remain positive, corporations are increasing stock buyback programs, and there is sufficient liquidity in the markets to support higher prices.

Putting it all together, we believe it is prudent to remain neutral on equities while guarding against complacency. The risk of a pullback appears to be higher now than it has been in months.

As always, thank you for your continued confidence in our abilities to help you navigate the many challenges associated with growing and protecting your wealth.

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