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## EQUITY INSIGHT

### FRONT RUNNING THE CYCLE

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- **Macro at a turning point**

Growth has stabilized but not yet picked up. U.S. manufacturing and services PMIs remain below 50, indicating subdued activity. The cycle is transitioning from downturn to early recovery.

- **Inflation proving sticky**

Headline CPI near **2.9% YoY** and core **3.1%** reflect easing pressure but no re-anchoring. Shelter and tariff effects keep short-term inflation momentum near **3.5%-4%**, complicating full policy normalization.

- **Liquidity, not fundamentals, driving markets**

The Fed's shift from restrictive to reactive, cutting rates toward **4%**, and expectations of continued easing have **compressed discount rates**, triggering a **valuation-led rally** across equities and credit.

- **Equities ahead of the data**

The **S&P 500** and **small caps** are hitting new highs even as macro indicators stay weak. Markets are **pricing the recovery phase early**, extrapolating a soft landing and future productivity gains.

- **Narrative over fundamentals**

The dominant theme: **“soft landing + Fed put + AI-driven margins”** is sustaining risk appetite. Yet earnings breadth remains narrow and macro momentum fragile.

- **Front-Running the Cycle**

The **economy is still late-cycle**, but **markets are behaving like early recovery**. The rally rests on policy confidence and liquidity rather than confirmed growth, a setup that leaves valuations **stretched and vulnerable to disappointment**.

## Summary

The global and U.S. economic cycle is sitting at a delicate inflection point: growth has stopped deteriorating but is not yet expanding. Purchasing Managers' Index (PMI) readings have edged higher, but remain below the 50 threshold that marks broad expansion. Inflation, meanwhile, has turned sticky again, complicating policy normalization. Despite this late-cycle backdrop, equity markets continue to make new highs. The Fed's pivot toward rate cuts, a surge in liquidity expectations, and an enduring belief in the "soft landing plus AI productivity" narrative have powered a valuation-led rally across risk assets. Markets are not reflecting current macro data; they are pricing what investors hope the next phase will look like: a recovery that remains unconfirmed. This creates a tension between what the economy is (late cycle) and what markets want it to be (early recovery).

Figure 1. Regime Dashboard

Indicator	Latest Reading	Trend	Signal
PMI	49.1	Rising from 48.7	Early-cycle stabilization but below trend
CPI (Core)	2.9%	Re-accelerating (3-mo annual. ~ 3.5 %)	Inflation risk remains
Yield Spread (10y-3m)	+0.14 pp	Steepening from prior inversion	Cycle inflection; easing recession risk
Risk Indicator	+0.64	Rising	Elevated macro fragility
Policy Rate (Fed Funds Upper Bound)	4.00%	Easing	Dovish bias; cuts expected through 2026

Source: Procyon

## Macro Landscape - Late-Cycle Stabilization, Not Expansion

Global growth has stabilized but remains below trend. The U.S. manufacturing PMI stands at 49.1, marking a modest improvement but still consistent with contraction. Services PMI is hovering near 50, suggesting that output is holding but momentum has stalled. Together, these levels signal an economy that is bottoming rather than rebounding.

Inflation complicates the picture. Headline CPI has firmed to roughly 2.9% year-on-year, with core at 3.1%. On a short-term annualized basis, inflation is running closer to 3.5-3.7%, reflecting sticky shelter costs and tariff-related pass-through. The re-acceleration in inflation makes it difficult for the Fed to declare victory, even as growth cools.

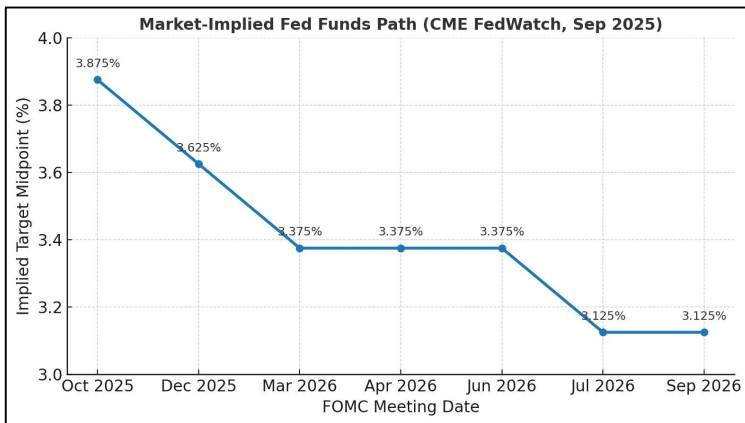
The yield curve has re-steepened for the first time in two years, the 10-year minus 3-month spread is now positive at +0.14 percentage points. Historically, this turning point signals that monetary tightening has peaked and that recession risks are receding. Yet the level of real rates and credit spreads indicates that financial conditions remain restrictive.

In short, macro indicators point to a **regime transition: from policy-driven contraction to liquidity-driven stabilization**. The underlying economy remains subdued, but the perception of policy relief is fueling optimism.

### Policy and Liquidity - Markets Front-Run the Fed

Monetary policy has clearly pivoted from restrictive to reactive. Following a series of cuts from the mid-2024 peak, the Fed funds rate now stands near 4%, modestly restrictive in real terms but well off the highs. Policymakers have adopted a data-dependent tone with a dovish lean, suggesting that further cuts are possible through 2026 if inflation eases.

Figure 2. Market-Implied Fed Funds Path



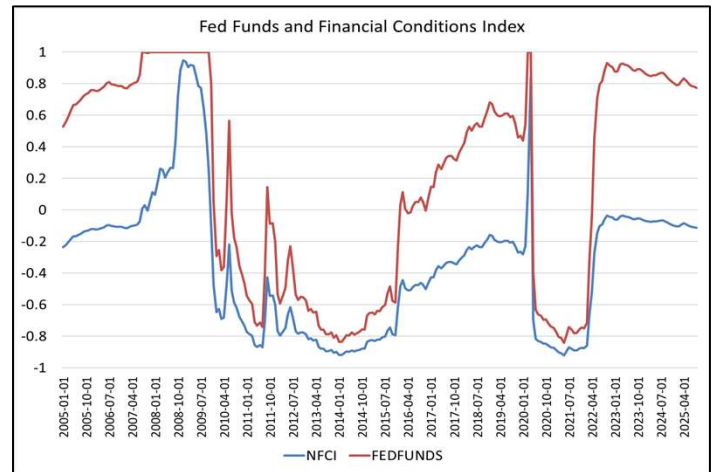
Source: FedWatch, CME

**This shift mirrors previous liquidity repricing rallies, notably 1995 and 2019, when timely rate cuts averted recessions and triggered powerful valuation expansions.** In both cases, growth had slowed but not collapsed; easing policy restored confidence and compressed discount rates, lifting asset valuations even as earnings remained flat.

That dynamic is repeating now. Real policy rates remain high (around +2%), credit growth is soft, and small-business credit availability is near post-GFC lows, all signs of underlying tightness. Yet market-based financial conditions have loosened sharply: equities at new highs, credit spreads near cycle highs, yields falling, and the dollar easing.

In essence, **policy is still tight, but markets have already priced in the easing cycle.** This divergence between real and financial conditions is the core driver of the current rally: liquidity expectations are being monetized before the liquidity itself has arrived.

Figure 3. Fed Funds And Financial Conditions



Source: Federal Reserve

Figure 3 displays two lines: the Fed Funds Rate and the Financial Conditions Index. The federal funds rate is the benchmark interest rate banks charge each other for overnight loans of reserves held at the Federal Reserve. It's the base cost of short-term money in the U.S. financial system and the main tool the Fed uses to guide overall monetary policy. The Chicago Fed's National Financial Conditions Index (NFCI) provides a comprehensive measure on U.S. financial conditions in money markets, debt and equity markets and the traditional and "shadow" banking systems. Positive values of the NFCI indicate financial conditions that are tighter than average, while negative values indicate financial conditions that are looser than average.

Figure 3 highlight a **clear divergence** between the Federal Funds Rate (red) and the National Financial Conditions Index (blue) - a relationship that has become increasingly important in the current cycle.

**Despite the Fed funds rate remaining near cyclical highs, the National Financial Conditions Index has loosened sharply, showing that markets are easing ahead of policy.** This divergence mirrors past "liquidity repricing" phases (1995, 2019), where tight policy coexisted with easy market conditions and fueled valuation-driven rallies.

## The Investment Clock - Late Cycle Meets Early-Recovery Pricing

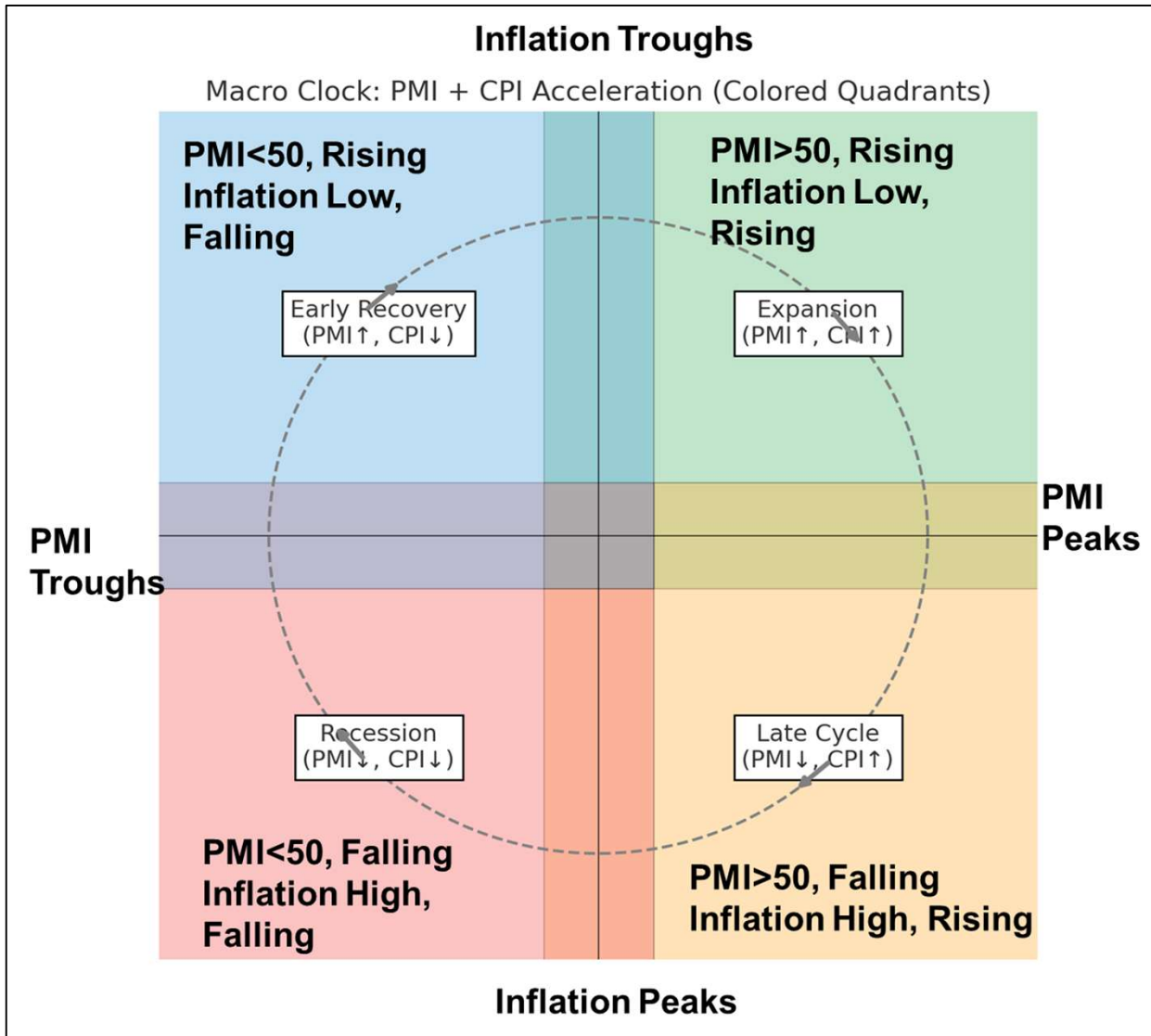
By traditional macro indicators, the U.S. economy is late cycle: PMIs below 50, EPS flattening, inflation above target, and real rates restrictive. Yet asset prices behave as if we are in the early stages of recovery.

This inconsistency is best understood through the investment clock framework. We are sitting in the **bottom-right quadrant**: the transition from late cycle to early recession. Growth is weakening, inflation is easing, and policy has turned reactive. **Historically, this stage precedes a full recovery by several quarters.**

However, financial markets have chosen to price that next phase now. Investors are discounting a future rebound in profits and liquidity rather than responding to current fundamentals. The market is thus temporally ahead of the economy, **front-running the policy cycle rather than the business cycle.**

**This helps explain the coexistence of weak macro data and record-high equity prices:** policy optimism is pulling forward risk appetite even as real activity remains constrained.

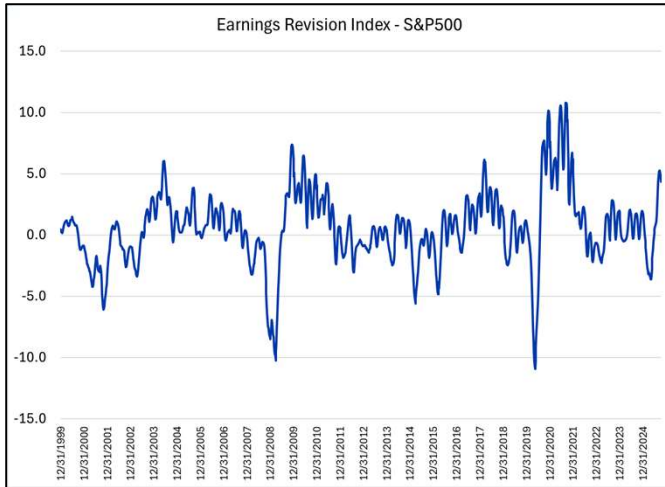
Figure 4. The Investment Clock



### Earnings Landscape - Concentrated and Uneven

Earnings trends remain constructive but narrow. The S&P 500 EPS revision index has turned decisively positive, reflecting rising analyst estimates (Figure 5).

Figure 5. Earnings Revision Index - S&P 500



Source: Factset

However, the **gains are heavily concentrated** in the **mega-cap Technology and Communication Services**.

Figure 6. Sector Contribution to Second Quarter 2025

Sector	Market Value	Market Earnings	Market %	Earnings %	Earnings/Market
Cons. Discret.	5,410,644	46,792	10.3%	8.7%	0.84
Cons. Staples	2,889,589	31,983	5.5%	5.9%	1.07
Energy	1,561,662	25,210	3.0%	4.7%	1.57
Financials	7,367,881	109,522	14.0%	20.3%	1.44
Health Care	4,891,332	60,815	9.3%	11.3%	1.21
Industrials	4,506,952	45,030	8.6%	8.3%	0.97
Technology	17,380,477	122,003	33.1%	22.6%	0.68
Materials	986,532	12,245	1.9%	2.3%	1.21
Real Estate	1,073,060	7,227	2.0%	1.3%	0.65
Comm Services	5,141,717	66,264	9.8%	12.3%	1.25
Utilities	1,256,447	13,160	2.4%	2.4%	1.02
Total	52,466,293	540,251	100.0%	100.0%	1.00

Source: S&P Global / Dow Jones

In the second quarter of 2025, three sectors, Technology (22.6%), Financials (20.3%), and Communication Services (12.3%), accounted for over half of total S&P 500 earnings. Energy and Financials are the most efficient earners, generating EPS well above their market-cap share, while Technology, despite its size, continues to under-earn (Earnings %/Market % = 0.68).

The “Magnificent 7” collectively account for one-third of market capitalization but only one-quarter of operating earnings (Earnings %/Market % = 0.77), and that ratio has been below 1 for every quarter since 2023 (Figure 7).

Leadership, therefore, remains valuation- and narrative-driven rather than fundamentally broad. Outside the mega-caps, earnings breadth is modestly improving in Financials, Energy, and parts of Healthcare, but cyclicals remain subdued and volumes soft. Overall, earnings resilience exists, but it is concentrated and fragile.

Figure 7. Magnificent 7 Contributions to Earnings

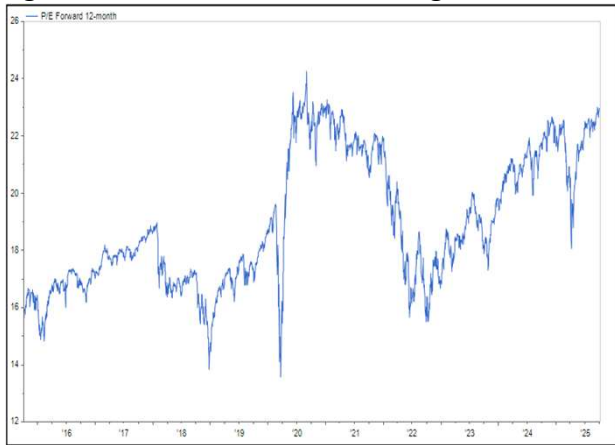
Quarter	% of Market	% of Earnings	Earnings / Market
Q2 2025	32.5%	24.9%	0.77
Q1 2025	29.9%	26.1%	0.87
Q4 2024	33.5%	27.6%	0.82
Q3 2024	31.3%	24.3%	0.78
Q2 2024	32.3%	21.6%	0.67
Q1 2024	28.8%	22.1%	0.77
Q4 2023	28.0%	23.9%	0.85
Q3 2023	27.5%	20.8%	0.76

Source: S&P Global / Dow Jones

## Valuation: Liquidity Repricing, Not Fundamental Rerating

The equity market's strength is a valuation story, not an earnings story. The S&P 500 trades around 23 times forward earnings, at the top of its post-pandemic range and well above the ten-year median of 18x.

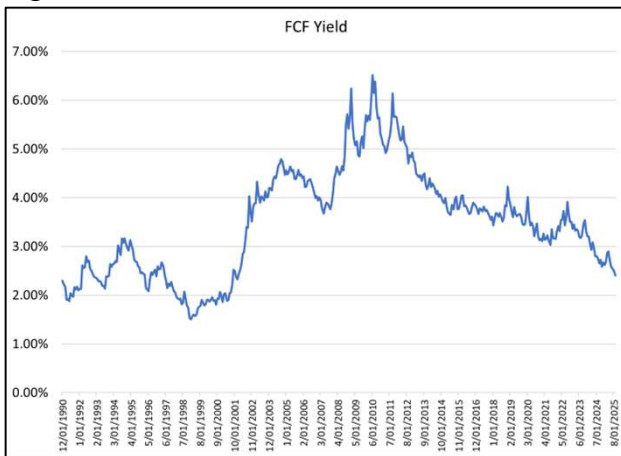
Figure 8. Forward Price-to-Earnings Ratio - S&P 500



Source: Factset

Free cash flow yield sits near 2%, a multi-decade low and below both investment-grade bond yields and real Treasury yields.

Figure 9. Free Cash Flow Yield - S&P 500 Ex Financials



Source: Factset

In effect, the equity risk premium has almost vanished. Investors are paying higher multiples for modestly rising earnings, **betting that falling rates and enduring liquidity will sustain valuations**. This is not a broad rerating of fundamentals. It is a liquidity repricing, similar to what occurred in 1995 and 2019. Momentum and positioning can sustain such rallies for several months, especially when rate expectations keep declining and

liquidity measures expand. But these valuations are inherently fragile: **if PMIs and earnings fail to confirm a durable recovery, or if inflation re-accelerates and forces the Fed to pause, multiples could compress sharply.**

In this regime, duration trades dominate: long-duration equities (growth, quality, technology) outperform on lower discount rates. But the margin for policy error is thin. Markets are essentially buying time and liquidity, not growth.

## Tactical Implications: Play Defense, Not Euphoria

The current market represents a liquidity-led, late-cycle rally: powerful, yet precarious. Growth is stabilizing but not accelerating; inflation is sticky; the Fed is easing into deceleration, not expansion.

## From an allocation standpoint:

- Overweight quality equities, high free cash flow generators, and duration-sensitive assets.
- Underweight deep cyclicals and low-quality beta until PMIs and margins show sustained recovery.
- Maintain exposure to Financials and Energy, which are over-earning relative to size, while managing concentration risk in mega-cap technology.

The strategy is to ride liquidity but not mistake it for growth. In this phase, portfolio resilience comes from balance-sheet strength, earnings quality, and disciplined valuation control.

## Conclusion. Faith Over Fundamentals

Equity markets are trading on faith. Faith in policy easing, faith in disinflation, and faith that AI-driven productivity will sustain profits. Yet the macro evidence still speaks the language of late cycle: sub-50 PMIs, tight real rates, and narrow earnings leadership. This tension defines the current regime. The rally can extend, but **its durability depends on the transition from liquidity narrative to earnings confirmation**. Until then, investors are buying duration and hope, not growth. In our view, this is a market priced for perfection but vulnerable to gravity, a phase to stay engaged, but disciplined.

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