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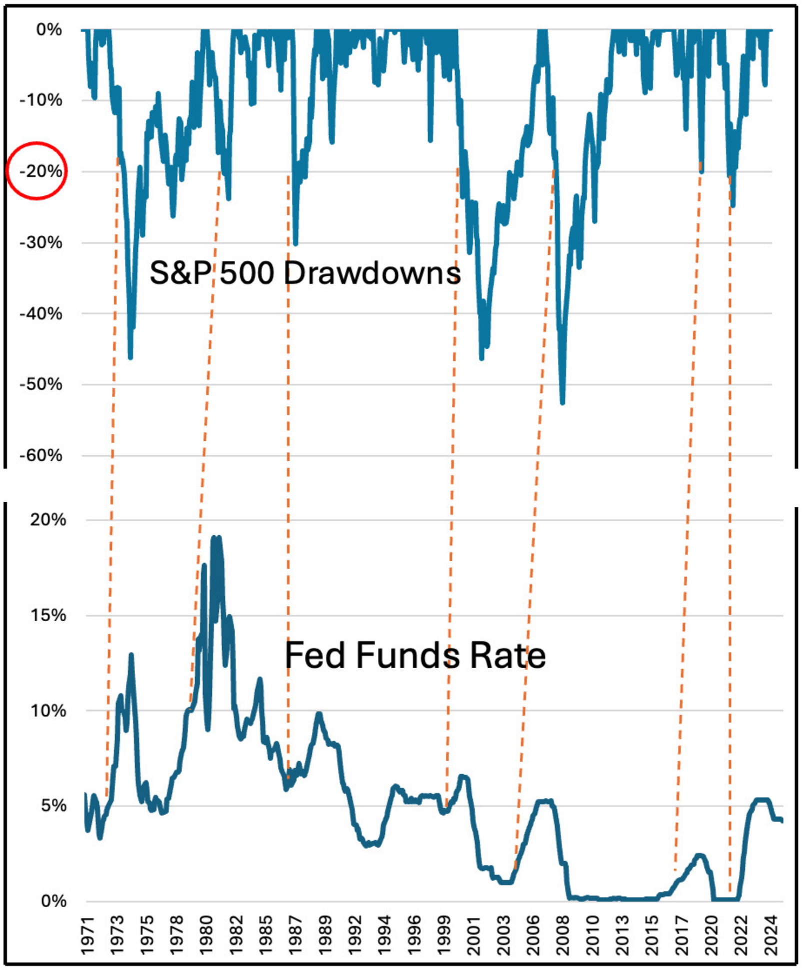
Asset Allocation
Chart of the Month

Authors: Crit Thomas, CFA, CAIA / Erik M. Aarts, CIMA / Tim Paulin, CFA

October 27, 2025

The Fed is Moving in a Market Friendly Direction

- **Market Concerns.** As we travel and meet with advisors, we sense widespread caution. Even bullish advisors tend to be hesitant, while many clients remain on the sidelines, still holding large cash positions. Concerns range from high valuations and market concentration to slowing growth and potential policy missteps. While we share some of these worries, we are supportive of fully invested positioning as a recession is unlikely and don't expect the Fed to turn hawkish anytime soon.
- **Easing ≠ Bear Market.** Historically, bear markets have coincided with or followed the Fed shifting toward a tighter money stance and hiking rates (even the dot-com boom was preceded by a tightening cycle). We view a new hiking cycle in the next year or two as unlikely, as it would require both a strong economic rebound and a resurgence in inflation.
- **Easing Cycles.** As we highlighted in a past Chart of the Month (link), rate cuts during periods of economic expansion have historically supported equities. Looking back to the early 1980s, we identified five such non-recessionary easing cycles. On average over those cycles, the Russell Top 200 index returned 15.8% and the Russell 2000 returned 15.4% in the subsequent 12 months.
- **High Valuations**. While valuations are elevated, they can remain high as long as the economy and earnings grow. That said, rich valuations increase stock-specific risk. When valuations are extended, sell-offs of individual stocks can be harsher when a negative catalyst emerges. Diversification and active management can help mitigate this risk.
- **Skepticism.** We would be more worried if optimism were widespread. Instead, sentiment remains cautious, and many investors are hoping for a market pullback as an opportunity to deploy cash – not the hallmark of euphoria.
- **Consider Mid Caps.** Over the past five years, mid caps have significantly outperformed small caps, breaking their historical high correlation. The shift reflects mid caps' stronger exposure to higher-growth sectors like industrials, tech, and health care, as well as superior profitability and financial strength. With sector weights and quality metrics now resembling the equal-weighted S&P 500 but at a discount, mid caps present a compelling alternative to broad large cap exposure.
- **Consider International.** After 15 years of lagging U.S. equities, we believe the prospects for international equities are improving. Much of the past underperformance stemmed from U.S. dollar strength and multiple expansion in U.S. stocks. These headwinds are unlikely to persist, leaving international equities on more even footing.



Source: Bloomberg. Monthly data since 1971 through September 2025.

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For Index Definitions see: TouchstoneInvestments.com/insights/investment-terms-and-index-definitions

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