

QUARTERLY REVIEW

June 30, 2025

Q2 Economic and Market Commentary

In the second quarter of 2025 the S&P posted a return of 10.9%, bringing the full year return to 6.2%. Someone who had been on a desert island and recently returned to civilization might observe that it was a stellar quarter that must have seen stock prices rise consistently upward from beginning to end. But as we know that couldn't be further from the truth. It's exceptionally rare to quote a socialist in a commentary geared for a capitalist audience, but in the words of Lenin, "**there are weeks where decades happen**", and that was certainly true in Q2. We started the quarter with "Liberation Day" on April 2 where a worst-case scenario of larger than expected tariffs was announced to the world. **The market reaction was a 12% decline over the next 6 days along with a 5% drop in the US dollar.** In fact, based on intraday prices the market entered a bear market, declining by 21% as of April 8th from its highs in February. And did anyone mention volatility? **From April 4th through April 11th the Dow Jones had 6 consecutive days of over a 1000-point swing from high to low intraday, with April 9th seeing a low to high range of 3500 points!** But the announcement of the highest tariffs since Smoot Hawley was only the beginning of the fireworks. On June 13th Israel struck the Iranian nuclear sites beginning a tit for tat of missiles flying between the two countries. And barely a week later the US struck the most hardened Iranian nuclear sites with bunker busting bombs, causing fear of a more widespread conflict with oil spiking on the news. However, just as quickly as tensions had escalated, they reversed with a cease fire beginning on June 23, and oil prices dropped from just over \$80 back into the high \$60's as it appeared that Iran would not strike oil facilities or attempt to shut the straits of Hormuz. **At the end of June, the S&P 500 had set an all-time high, along with the NASDAQ index.** The technology and AI related stocks which had suffered in Q1 reasserted their leadership as capital spending on AI remained on track. The market once again seemed to shrug its shoulders and look through what were major policy and geopolitical events, instead apparently focusing on anticipated easing of monetary, fiscal, and regulatory conditions in the back half of the year that would create a more conducive environment for risk assets.

The Economy

The US economy contracted in Q1 with GDP declining -0.5% and was the first quarterly contraction since Q1 of 2022. The decline was attributable to a surge in imports, which subtract from GDP and were a result of companies trying to receive products ahead of tariff increases. While uncertainty regarding the economic outlook remains high and has dampened both consumer confidence and business spending, the worst-case tariff scenario is now off the table. The worst-case scenario would have created an approximately 30% tariff rate, which we now expect will settle at near 15%. Nevertheless, forecasts for 2025 GDP have come down, with the Fed reducing their 2025 growth estimate from 1.7% to 1.4%. Evidence of slowing is apparent in the labor market as 2024 saw average monthly job gains of 186,000, and YTD 2025 monthly job gains are running at 131,000 per month. We would also expect the unemployment rate to rise as DOGE impacts have not yet been felt and the Challenger Job Layoff announcements YTD are 744,000, which is a 92% increase year over year. Initial Unemployment Claims are also up 8% year over year, so the unemployment rate should move higher over the course of the year and have a dampening impact on consumer spending. The Federal Reserve now expects the unemployment rate to be 4.5% by year end, and we wouldn't be surprised if this number moved higher. Inflation seems to be "stuck" for now in the upper 2% range as the May Core PCE came in at 2.7% year over year. The Fed will remain on the sidelines waiting to see the impacts of tariffs on inflation, and we should start to see those in the next few months. The inflationary pulses are currently in the services sector and within the housing components. With 20% more homes on the market, and existing home sales now running at the lowest rate since 2009, we would expect some ease in housing inflation. With import prices already rising slightly, and mega retailers like Walmart indicating they will pass on price increases, we also expect inflation to rise somewhat in the next few months, consistent with the Fed raising their forecast for Core PCE up from 2.8% to 3.1%. The University of Michigan Consumer Confidence index surged 16% in June to 60.7 and registered its first increase in 6 months. However, it is still well below the December post-election bounce (18 points lower) and is consistent with an economic slowdown and rising inflation. While we would still classify the consumer as being in solid shape, we are seeing slowing in spending as retail sales in May fell 0.9% and were worse than expected, following April when they were up just 0.1%. The Personal Savings Rate is indicative of a small consumer retrenchment as well as the rate has moved up from 3.5% in December of 2024 to 4.5% in May. With companies likely to pass along the cost increases, we expect consumers to balk at higher prices, resulting in substitution of cheaper goods, or reduced demand, which would support our thesis of GDP slowing. The "One Big Beautiful Bill" has passed, but is unlikely to lower the debt as a percentage of GDP ratio, and we suspect this will keep pressure on interest rates for longer maturity securities. The weakness of the US dollar (down over 10% and its worst first half of a year since 1973) is hurting international holders of US securities, and that coupled with policy uncertainty is likely to lead to less foreign buying of US debt in the near term.

Market Review **Second Quarter Market Recap:**

The markets ended the quarter on a high note with new highs for the S&P and the Nasdaq 100. The “risk on” sentiment returned with cyclical stocks performing well and defensives lagging. Bitcoin, which has become a risk on indicator, bounced from a low of \$75,000 on April 9th and ended the quarter at \$107,158, up 31%. The S&P return of 10.9% was surprising given where the quarter began. In fact, from the closing low on April 8th it took just 55 days for the S&P to reach a new high, which was the fastest turnaround to a new high when the market experienced at least a 15% pullback in the last 75 years! The top performing sector in the quarter was Technology (+23%), recovering from the Deep Seek news of Q1 as capital spending on AI chips and infrastructure continues unabated. Capex from the major AI hyperscalers is projected at \$278 billion this year and forecasted to reach \$331 billion in 2027. Broadcom posted impressive gains in the quarter, up 65%, while Nvidia advanced another 46% and Microsoft added 33%. With the big Tech recovery there is some concern that performance might again be concentrated in the mega tech names, but YTD that is not the case with the S&P ex-Mag 7 up 5%, and the Mag 7 itself up 3%, with Tesla and Apple lagging. Industrials were strong, adding 12.9% as recession risk faded with the lifting of the worst-case tariff scenario. The Communications sector posted a gain of 18.5% with Meta accounting for the bulk of the sector return (+28.1%), and Google, the other large component of the Communications sector, gained roughly 14%, but is trailing the market for the year at -6.6% as concerns of potential market share loss in search persist as well as antitrust challenges in the US and internationally. Consumer Discretionary has started to perform better, adding 11.5% for the quarter, and is outpacing Consumer Staples, which gives us some confidence about consumer strength. Energy (-8.6%) was the poorest performing sector as OPEC announced larger than anticipated output increases which could lead to surplus barrels if the global economy slows. The price of crude declined 9.5% in Q2. The Healthcare sector continued to be a laggard in Q2, falling 8.2%, impacted by Medicare and Medicaid projected spending cuts for reimbursements. The fundamentals for healthcare still screen well for 2025 with eps growth at +14.3%, behind only Technology at +18% and Communication Services at +15.1%.

Stock Market Indexes

Market/Index	2024 Close	06/30 Close	Quarter Change Total Return	YTD Change Total Return
DJIA	42544.22	44094.77	5.46%	4.55%
Nasdaq	19310.79	20369.73	17.97%	5.86%
S&P 500	5881.63	6204.95	10.94%	6.20%
Russell 2000	2230.16	2175.04	8.50%	-1.79%
IEFA	70.28	83.48	12.33%	20.91%

What to Expect Going Forward:

Given the breadth and magnitude of events that occurred in Q2, trying to make sense of what happened or what to anticipate in the second half of the year is a humbling exercise. Uncertainty reigned, and ironically, market returns in the 12 months following spikes in uncertainty are almost +20%, proving the point that fear can create buying opportunities, even though it is contrary to our psyche. So, what is “certain” that we can identify in the economy and in US companies to give us a degree of confidence in the direction of markets in the second half? First, profit margins remain near historic highs with the estimated next 12-month operating margin at 17.7%. Yes, it’s possible that tariff price increases could result in companies having to “eat” some of that increase resulting in lower margins, but in general companies are in good fiscal condition. Earnings are projected to grow at solid rates of 7.3% in Q3 and 6.4% in Q4, with the full year 2025 now forecasted to be +9.1%. The earnings growth continues into 2026 with current expectations for another up year at +13.8%. Market valuations are stretched on almost every metric, whether it be price/earnings, price/cash flow, etc.. However, when looking closer under the hood, the biggest technology stocks have again been the major drivers of the market’s overall valuation levels. The top 5 stocks are now selling at 32.2X earnings, raising the S&P multiple to 22.1X, while the median stock sells for 18.5X, which is not excessive given the level of earnings growth. Another positive is the likelihood of the Fed cutting rates. Fed Funds’ futures indicate two rate cuts by year end, and this could be supportive of equity valuations. The unexpected June drop of 33,000 private sector jobs as reported by ADP on July 2 when expectations were for a 100,000 increase, should get the Fed’s attention. While the stronger than expected June Non-Farm Payrolls report offset some of that concern, we suspect they will be watching this closely. July is historically the second-best month of the year for returns over the past decade, returning on average 3.4%. However, Q3 is also the lowest return quarter of the year averaging +1.3%. The strength in Industrials and Financials makes it hard to believe that the market is worried about either the economy, inflation, or interest rates. We would conclude that recession risk is low with fiscal spending likely to ramp, business tax cuts coming, more R&D and capex expensing, and the Fed becoming less restrictive. We view inflation as the biggest risk, as only time will tell who bears the brunt of the tariffs. Upcoming fiscal stimulus in 2026 will be enough to effectively “neutralize” the negative impacts of tariffs. Nevertheless, we need to see this play out. If any tariff inflation is viewed as a one-time bump in the price level, we wouldn’t expect it to have a major impact on equity prices. It’s normal at this time of year for the market to look into the next year and start to price in the outlook. For now, that outlook is positive given the strong anticipated earnings growth, and this is likely part of the reason for the strong market recovery. As we know, things can change quickly, but at current valuations we would expect muted gains in the back half of the year. The debt remains a top concern, and some forecasts now have interest payments consuming up to 18% of federal revenues by the end of this year. This is not sustainable, so while our political class doesn’t seem to seriously address the issue, the bond market will at some point force the government to get serious.

Fixed Income Recap and Outlook

The second quarter of the year started with quite a bout of volatility. Liberation day sent shockwaves across markets causing a sharp bond rally (yields lower) due to tariff fears as Trump unveiled a larger and more broad-based tariff than expected. This pullback in yields was swiftly reversed the following week as a 90-day suspension was implemented to allow for period of negotiation – easing recession fears. After widening sharply in reaction to Liberation Day, both Investment Grade and High Yield credit spreads have retraced back below levels see pre-Liberation Day and remain at historically tight levels.

As tariff fears subsided the market began to shift its narrative from concerns on the US debt sustainability towards a greater focus on the potential downside risk to the economy. Consumer spending, which accounts for ~68.5% of GDP, also showed signs of slowing. On a real basis, consumer spending fell -0.3% in May after posting just a slight 0.1% rise in April. For the first half of the year consumer spending is averaging 1.00%, a weaker trajectory versus 1H 2024 pace and well below the 3.1% average pace for 2024. The labor market continues to show resilience, supportive of the consumer for now, but job growth is slowing despite the unexpectedly strong June employment report. Thus far we have only seen one month in 2025 with job growth exceeding 150k, thanks to the recent upward revision for April to 158k. The backdrop for overall job growth remains disappointing and reflects a lack of labor force growth stemming from a decline of immigrants and slowing domestic working age population.

The yield curve continued a steepening trend over the quarter with the belly of the curve, i.e. more intermediate durations outperforming, alongside higher credit quality bonds. This outperformance was driven by falling treasury yields and rising risks to the US economy. The US Agg index locked in 2Q and 1H cumulative gains of 1.21% and 4.02%, respectively. IG Credit posted 1.82% returns for 2Q and 4.17% for the year and the Intermediate Government/Credit index saw 2Q returns of 1.67% and 4.13% YTD.

The FOMC (Federal Open Market Committee) left rates unchanged and revealed a gloomy forecast on the updated Summary of Economic Projections (SEP).

- The Fed left interest rates unchanged in a range of 4.25%-4.50% for a fourth straight meeting. Both the committee's statement and Powell himself reiterated that policymakers want to wait and see how economic data evolve going forward. Still, the median estimate of participants is for two rate cuts this year, unchanged from the outlook in March.
- There was no change in the long-run fed funds median projection this time. That number, a proxy for the so-called neutral rate, remains at 3%.
- The FOMC sees higher inflation this year and inflation remains a little higher through 2027. Core inflation is currently 2.7% year-on-year, but the median forecast for 2025 is now 3.1%. The forecast implies a remarkable pickup in inflation in the second half.
- The FOMC sees a further slowdown in the second half, cutting forecast for GDP for 2025 to 1.4% (vs previous 1.7%) and only a very small acceleration next year, with 2026 GDP at 1.6%.
- The FOMC sees slightly higher unemployment, raising forecast by 10bps to 4.5% for 2025 and upward estimates for 2026 at 4.5% and 2027 at 4.4%.

While 2Q25 proved to be volatile at the start with a temporary panic in April, the last two months were constructive towards stabilizing. As attention swayed from scrutiny over Treasury supply to risks to economic growth stalling, Fed rate cut expectations began to take root with Fed speak leading markets to price in a full 25bp cut as soon as the September meeting. Near-term economic trends remain muddled as the market begins to focus on potential weakness from the survey-based economic data to leak into hard economic data. The Fed remains data-dependent, signaling caution to act prematurely ahead of potential tariff impacts but remaining agile to pivot as conditions evolve.

As always are here to assist you in any way and to answer your questions. We appreciate the opportunity to serve you and value the trust and confidence that you have placed in us.