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Quarterly Investment Commentary

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2Q market action

After the worst quarter in nearly three years, stocks rocketed higher in the second quarter (S&P 500 10.57%, NASDAQ 17.57%, DJIA 4.98%, and Russell 2000 8.11%). Treasurys were mixed, with the curve steepening; the dollar fell 7%; gold was up 5%; and WTI crude fell 9%. The Magnificent Seven raced higher, with more than half of them up more than 20%, as technology was the best-performing sector. Headlines included trade policy off-ramps, better-than-expected earnings, a renewal in AI growth, and modestly better inflation.

Trade, tariffs, and the labor market

Investors are on the lookout for evidence that the trade war is taking a toll on the U.S. economy. Historically, investors would have garnered this insight from cyclical economic indicators such as the PMI surveys, housing, durable goods orders and spending on household durables. However, these cyclical indicators are distorted, and less useful than usual at present.

Although the state of the labor market is usually a lagging economic indicator, it could provide the cleanest read on the trade war's impact on the U.S. in the current distorted macro environment. As the effects of the tariffs become more pervasive, net job creation will cool over the balance of this year. There is no doubt that there will likely be some layoffs in the goods-producing sectors directly affected by restrictive trade policy, as well as in the government sector. Firms may turn more cautious about hiring, given the fact that the endpoint of the Trump Administration's trade war is still highly uncertain. Importantly, initial jobless claims have not spiked yet, which means that firms are not in a hurry to lay off workers.

The trade war is unlikely to accomplish many of the promised long-term objectives. The U.S. is not running a massive trade and current account deficit purely because the world is engaging in "unfair" trade practices, as asserted by the Trump Administration. Rather, it is the result of the uncompetitive U.S. manufacturing sector against its Asian and Mexican counterparts.

Investors are not likely to get clarity on trade policy anytime soon, as a durable "deal" (in contrast with a "framework") is time-consuming to craft and agree on. Thus far, we have a few "frameworks" and no fully agreed-upon "deals." In addition, the legality of Trump's tariffs is likely to remain unresolved for weeks or months. Most of our trading partners have been reluctant to agree to deals for a host of reasons. For example, the bid-ask spread between what Trump wants is worlds apart from what most major trading partners are prepared to accept.

Job creation will cool over the balance of this year as the effects of higher tariffs become pervasive, but the unemployment rate will remain historically low amid a significant drop in immigration inflows.

Inflation

Before the pandemic, monetary authorities were confronted with an unusual problem: Inflation was too low. From 2009 to 2019, U.S. core PCE inflation averaged just 1.6% annually. However, the sharp acceleration in global inflation that occurred following the pandemic profoundly altered policymakers' and investors' views about the risk of structurally elevated inflation.

Central banks have mostly succeeded in bringing inflation back toward target levels, but in the U.S., 2% core PCE inflation remains a forecast rather than a reality. In the meantime, expectations that tariffs will cause prices to surge have shown up in some measures of inflation expectations, raising further alarm. Our base case remains that U.S. inflation will remain above 2% over the longer term.

Among the common arguments made to support the idea that inflation will be structurally elevated, three of them are risks, and one is uncertainty. U.S. trade policy, unanchored inflation expectations, and future large-scale supply shocks are the three risks to structurally higher inflation, whereas the demographic effects are near certain to exert some upward pressure on inflation.

The fiscal problem

Fiscal tailwinds have played key roles in driving solid economic growth and rising stock prices in the post-pandemic environment. However, the huge, obvious problem is that the U.S. federal debt is now on a completely unsustainable long-term trajectory. More specifically, the CBO currently projects that publicly held federal debt will reach an all-time high in 2032 – surpassing the level reached following World War II!

While U.S. federal debt levels are expected to rise past all-time highs (as a percent of GDP), there is significant uncertainty around the level and outlook for long-term interest rates. We believe policymakers and the market are likely underestimating the impacts of this dynamic and future projected net interest costs.

Our sense is bond vigilantes are starting to push back on the unsustainable long-term outlook encapsulated in the tax bill working its way through Congress by sending long-term yields higher. We believe that interest payments on the U.S. federal debt are beginning to squeeze out other spending faster than previously expected as interest rates stay higher for longer.

As the "Sell America" theme continues in the background of significant trade policy volatility, we are closely watching how foreign holders of U.S. Treasurys respond. A further reduction of foreign holdings is likely to put additional downward pressure on the U.S. dollar.

Earnings

First-quarter 2025 U.S. earnings and corporate guidance were better than feared. Investors were worried that companies would withdraw earnings guidance due to the uncertainty around tariffs. While some firms pulled their profit projections for the year, the majority of companies either indicated that tariffs would have a limited impact on their businesses or discussed various mitigation strategies that reassured investors that the headwinds would be manageable.

While first-quarter earnings demonstrated the continued resiliency of the U.S. corporate sector, the results were helped by a pull-forward in demand as consumers and businesses accelerated their purchases ahead of anticipated tariff- induced price increases and supply shortages. The year-over-year earnings growth of the S&P 500 Index is poised to slow in the coming quarters as the actual effects of the trade policies enacted by the Trump Administration have a larger impact on the economic activity and the demand strength that occurred ahead of tariffs is paid back. According to I/B/E/S, S&P 500 earnings growth is expected to average 5% year-over-year in the remaining three quarters of 2025, a marked slowdown from the growth of 13% in the first quarter. Risks to consensus earnings forecasts remain tilted to the downside.

The ability of the equity market to absorb further downgrades to earnings will depend on whether investors can look through the messy economic data in the next few quarters to better growth prospects next year, driven by tax cuts and deregulation. Doing so requires a continuing de-escalation of trade tensions and the ongoing resiliency of the hard economic data, especially employment metrics. However, with the equity market trading at over 22 times forward earnings and upward pressure on bond yields constraining the upside for valuations, the near-term risk-reward is unappealing.

Stocks

Equities have rallied smartly as investors have gained confidence that the administration's tariff bark is far worse than its bite. However, the apparent best-case scenario of 10% universal tariffs is hardly rosy. It heralds narrower profit margins, lower volumes, and less net income, which point to headcount reductions and slowing consumption.

We have argued that dismal soft data will eventually show up in slowing hard data; a lasting turnaround in household and business sentiment would reduce the probability of a significant economic slowdown. Consumer-facing companies continue to miss earnings expectations and/or lower guidance. The evolution of the labor market is the most important variable for the consumer outlook.

The bull case

We continue to believe that the business cycle is nearing an inflection point, as the pandemic stimulus measures that helped power the expansion through the most aggressive monetary tightening cycle of the last four decades recede further into the past.

On the other hand, the essence of the bullish view is:
1. We have passed the point of “peak tariffs.”
2. 2022’s manufacturing recession didn’t spread to the broader economy, and businesses already have a tariff mitigation playbook from 2019 they can follow again.
3. Hard data remain solid and surveys indicate that the détente between China and the U.S. has relieved fears among households and businesses.
4. 10% tariffs are manageable and nowhere near what the fixed income and equity markets were discounting in the wake of so-called Liberation Day.

In conclusion

The U.S. stock market appreciated 20% in less than six weeks, moving from a bear market to a year-to-date gain. The primary reasons for the rally were a relaxation in the administration’s tariff policies from the announcements of April 2 and by strong first-quarter earnings, resilient hard economic data, and the fiscal stimulus embedded in the reconciliation bill that is taking shape in Congress.

However, there are important reasons for investors to remain cautious. Even with recent concessions, tariffs are much higher than at the start of the year. This, along with sharply falling immigration and government spending cuts, will likely drag on both supply and demand, dampening economic growth. Also, while hard economic data look acceptable for now, some of this may just reflect lagged effects, maintaining the prospect of slower growth and higher inflation in the months to come. Finally, as the reconciliation bill takes shape, it is becoming more obvious that it cannot provide fiscal stimulus to a soggy economy without further worsening an already alarming deficit trajectory.

We expect to see real GDP rise by only 1% annualized over the first three quarters of the year, representing very slow growth but not quite recession. Monthly payroll job gains could well fall to 100,000 or lower for the rest of the year causing the unemployment rate to rise to 4.5%. Inflation will likely pick up, and we expect the year-over-year gain in the consumption deflator to be over 3% by the end of the year boosted by higher tariffs and fiscal stimulus. Corporate profit growth should continue to slow but remain positive.

Elevated valuation could limit market upside, but it is rarely a sell catalyst on its own, especially if the U.S. continues to deliver strong growth and the AI story remains intact. Rich equity valuation will remain a psychological hurdle for some investors, in particular, foreign investors who tend to have a greater value bias.

The uncertainty of the global macroeconomic landscape will likely persist in the second half of the year. Macro dynamics, monetary policy, U.S. fiscal and trade policies, and geopolitics will drive the outlook for markets in 2H25. We are not out of the woods yet on U.S. trade policies, though there is broad “tariff fatigue” among investors. The global macro narrative drifted sharply from the U.S. exceptionalism theme earlier this year to a gloomy outlook with self-inflicted U.S. policy damage expected to take U.S. close to a recession, while bottom-up guidance from corporates still points to solid earnings projections. Of late, the “pain trade” has remained to the upside. Perhaps the risk-reward profile is turning negative. Valuations have rebounded to near all-time highs, while profit growth is slowing, margins are weakening, and tariffs are higher than they were at the start of the year.

10 Predictions for 2025: Review and update (3Q 2025)

Introduction (written December 2024)

Investors continue to enjoy the bull market, but remain somewhat nervous about valuation. Policy uncertainty is higher than usual, in part because there are so many policy changes at the same time. Donald Trump campaigned on a mix of policies that are both economy-supportive (tax cuts and deregulation) and economy-disruptive or negative (tariffs and deportation). As a result, the election outcome has created fatter tails for the U.S. economy. It is possible that a mix of pro-growth and disruption policies will occur simultaneously and/or the administration will toggle back and forth, thereby heightening uncertainty as well as economic and financial market volatility. The main policy downside risks are related to trade and immigration policies. This could be negative for growth and push up inflation. That could lead to the Fed ceasing the cutting cycle and potentially even restarting rate increases, putting upward pressure on bond yields and negative pressure on stock valuation. Trump 2.0 may drive higher uncertainty around inflation and deficit risks. Immigration and tariffs may be inflationary, but corporate tax cuts are disinflationary as benefits get passed onto the consumer. Lower oil prices from increased energy production could also help. Lighter regulations will be positive for financials (especially banks), which now have relatively strong balance sheets and are focused on cash returns and potential loan growth. A pickup in merger-and-acquisition activity may occur with lessened regulatory scrutiny.

Key: ✓ Heading in the right direction ✗ Heading in the wrong direction ? Too soon or too close to call

1 ?	**Economic growth slows as the unemployment rate rises past 4.5%.** As goes the labor market, so goes consumer spending. And as goes consumer spending, so goes the economy. 1Q real GDP came in at a disappointing 2.1%. Consumer spending is holding up due to the wealth effect (both stocks and housing), the absence of labor market weakness (although we expect weakening in Q3), respectable wage growth, tolerable inflation (tariffs have not yet impacted prices), and the promise of a stimulative tax bill. Obviously, the jury is still out on a potential economic slowdown, but we expect such a slowdown has begun in June, and that we will see it in July economic releases. We still expect the unemployment rate to inch up to 4.5% before year-end.
2 ?	**Inflation remains sticky, fails to reach the Fed's 2% target, and causes Fed funds rate to fall less than expected again.** As noted above, the inflation rate has been reasonably well-behaved. But we still think tariff impacts will hit in Q3 or Q4, causing inflation to rise modestly. Even before that, a 2.0% inflation rate (Fed target) is/was very unlikely absent a recession (the probability of which has declined over the last couple of months). The consensus still anticipates two Fed cuts before year-end. While economic weakness could make that possible, cutting rates while inflation remains sticky (or rises) is unlikely. Certainly, the administration will continue to put pressure on Chairman Powell and the Fed to lower rates.
3 ?	**10-year Treasury yields trade primarily between 4% and 5% as credit spreads widen.** As we write, the 10-year Treasury yield is close to the middle of our suggested trading range, where it has been for much of the first half of the year. Our best guess is that trading range continues. The quality spread part of the prediction remains uncertain. Credit spreads rose a bit during the tariff concern days, but have narrowed again as those concerns have lessened. An economic slowdown (which is our assumption) is probably a necessary condition for that half of the prediction to be realized.
4 ✓	**Earnings fail to achieve consensus a) 14% growth and b) every sector has up earnings.** Earnings estimates continue to fall. After growing 13% in Q1, consensus estimates are that earnings growth will fall to 5% for the final three quarters of 2025. In our view, the risk to those new forecasts is still to the downside. Profit margins can generally expand if top-line growth is double digit. But the revenue growth slowdown could even put negative pressure on margins. In terms of the second half of the prediction, earnings estimates for energy and several other sectors have turned from positive to negative for the full year.
5 ✓	**Equity volatility rises (VIX average approaches 20 for only the third year in 14).** The VIX averaged 18.5 in Q1 and accelerated to 24.4 in Q2 (both a significant increase from the 15.5 average for 2024). While volatility has calmed noticeably toward the end of Q2, confusion and uncertainty have wreaked havoc from time-to-time on investors. Hopefully, the Israel-Iran conflict and the impact on the price of oil will not lengthen the period of uncertainty. However, in general, a period where growth estimates are receding and inflation projections are increasing is unlikely to result in much stability. Tariffs, and the fireworks around the debt ceiling and the Big Beautiful Bill, are fodder for potential additional volatility.

6 ✓	**Stocks experience a 10% correction as stocks fail to keep up with earnings (i.e., P/Es contract).** As we know, the market corrected nearly 20% rather abruptly around the tariff noise. The rebound to near all-time highs was almost as furious. Unless stocks move noticeably higher, and/or earnings estimates are cut significantly, a lower P/E ratio is likely to stick. Nevertheless, relative to history, multiples still remain high. As we note in our essay, the risk-reward from current levels does not appear favorable. Having said that, it is possible here at the end of the second quarter that we have already seen both the high and the low for the stock market for 2025.
7 ?	**Equal-weighted portfolios beat cap-weighted portfolios (average manager beats index), and value beats growth.** While both assertions in this prediction are true at the moment, the cushion for both has shrunk noticeably in Q2, largely due to the significant rebound in the Magnificent Seven in the quarter. Investors, uncertain about the outlook, have returned to the strong earnings growth and cash flow stories of the Magnificent Seven and other similar stocks.
8 ?	**Financials, energy, and consumer staples outperform healthcare, technology, and industrials.** Like prediction #7, if the year ended on June 30, we would have made an accurate prediction, but the margin of outperformance has shrunk during Q2, such that the final year-end outcome has turned uncertain. In particular, financial stocks have struggled somewhat especially during the second half of the quarter, while technology and industrial stocks have recovered nicely.
9 ?	**Congress passes the Trump tax cut extension, reduces regulation, but tariffs and deportation are less than expected.** The mention of tariffs being less than expected has put this prediction in the questionable category since "Liberation Day." We expect the second half of the year to be more Big Beautiful Bill-focused and less tariff focused. A dark horse for improvement on many fronts is the ongoing efforts at deregulation.
10 ✓	**DOGE efforts make progress but fall woefully short of $2 trillion per year of savings.** The retreat of Elon Musk and the sheer magnitude of the hoped-for cuts make this prediction a likely "correct" even here at mid-year. Ring-fencing so many parts of the budget (e.g., entitlement programs) made even a trillion dollars of savings nearly impossible. As we continue to state, the ONLY way to begin to solve the increasingly acute debt and deficit problem is to tackle the entitlement programs – that, at the moment, comes with political suicide!

Final Tally: ✓ 4 ✗ 0 ? 6

In summary (written December 2024)

U.S. equities should remain supported by continued economic expansion and earnings growth, ongoing easing by global central banks and a likely 1Q wind down of the Fed's quantitative tightening. Consumers are largely flush with cash and record wealth, although there is evidence of fraying at the low end and some mid-level consumers. The Fed is in easing mode, but will likely dial its dovish intent down in 2025 due to sticky inflation, with potential upside risks due to continued economic growth and trade/tariff issues. The stock market is already pricing in an optimistic backdrop and carries high valuations creating risks as we enter 2025. An early-in-the-new-year 5-10% pullback is possible (if not probable) given the sharp gains, froth in sentiment, and stretched valuations, leaving the market vulnerable to bad news or simply in need of consolidation. Note that stocks tend to be strong in November/December, but weaker in January/February.