



2025 SUMMER INVESTMENT OUTLOOK

Two hallmarks that defined the capital markets in the opening months of 2025, uncertainty and volatility, have continued in the year's second quarter. As summer gets underway, investors are still grappling with several competing forces that will shape the market in the coming months.

On the positive side of the ledger, economic growth remains strong enough to sustain a solid job market which, in turn, underpins consumer spending. That has given Wall Street confidence that corporate profit growth can be achieved this year to help justify the elevated valuation metrics of the broad stock market indices. Furthermore, while the specifics of the tax and spending package that is working its way through Congress continue to be debated, investors remain hopeful that a bill will be signed into law that will extend the majority of expiring tax cuts while implementing some new measures that will benefit the average American. Regulatory relief and an emerging belief that the U.S. will sign bilateral trade deals before the worst-case tariff scenarios are imposed have also buoyed investors' spirits.

At the same time, market participants must contemplate a number of potential offsets to these tailwinds. Despite several notable pauses in the numerous tariffs that have been proposed, it is reasonable to assume that the eventual policy will result in a tariff regime that is far higher than what is in place today. Most economists agree that, on the margin, this will lead to slower economic growth and higher inflation relative to current policy. This is occurring against the backdrop of ongoing uncertainty that is making it difficult for business leaders to set their spending and hiring plans for the upcoming year and beyond. This, in turn, has implications for the job market. Notwithstanding satisfactory payroll growth numbers and a low and stable unemployment rate, some underlying trends in the job market suggest that employees no longer have the upper hand in workplace negotiations.

Inflation remains above the Federal Reserve's target, so the five interest rate cuts the market assumed as the year began have now been pared to less than two. At the Fed meeting last week, the committee decided to leave its benchmark lending rate unchanged and Chair Powell reiterated that monetary policy will be data dependent. Of the two mandates that drive Fed decisions, full employment and price stability, it is the inflation side of the equation that has policymakers more concerned, particularly with new tariffs looming.

These concerns weighed on the stock market in the spring as the S&P 500 declined by nearly 19% in early April from its mid-February peak. Since that time, however, sentiment has turned more positive as President Trump has paused tariffs on numerous occasions in an effort to give negotiations more time to work. Since its recent trough on April 8th, the S&P 500 is up nearly 20%. Concerns over the ongoing military action in Gaza and the war in Ukraine, rising U.S. federal debt levels, and the failure of interest rates to fall as expected have done little to spoil investors appetite for stocks. Even the new conflict between Israel and Iran and the subsequent escalation by the U.S. in removing Iran's nuclear threat has

not been sufficient to keep the stock market from inching to within 3% of its record high. Year-to-date returns for some of the popular market indices are noted below.

Equity Markets – 6/20/2025

	<u>Index Price Level</u>	<u>2025 YTD Total Return</u>
Dow 30 Industrials	42,207	+0.1%
S&P 500	5,968	+2.1%
NASDAQ Composite	19,447	+1.1%
MSCI All Country World Index ex-USA	367	+14.9%

Outlook

Growth in the domestic economy continues, albeit at a pace that is well below the long term trend. Bloomberg consensus estimates call for economic activity to advance only 1.4% this year and 1.6% in 2026. This is notably lower than the 3.2% average in the post-WWII period.

These tepid expectations are occurring despite robust federal spending levels that are additive to growth. The federal government is projected to run annual deficits that average approximately 6% of gross domestic product (GDP) over the coming decade according to the non-partisan Congressional Budget Office. The budget bill being debated in the House and Senate may change these estimates with most economists believing it will meaningfully increase deficits over the baseline assumption. The much-hyped Department of Government Efficiency, which was launched with a goal to cut government spending by \$2 trillion annually, will likely achieve only a small fraction of those savings and will do little to alter the deficit math in the coming years.

Ongoing uncertainty regarding trade and tariff policies is also expected to curtail near term growth as business leaders on the margin wait for more clarity before committing capital to increase capacity. Based on the peak tariff announcements, which have since been scaled back, Goldman Sachs estimated that U.S. GDP would be negatively impacted by two percentage points leaving growth barely positive. The firm also predicted that Americans' inflation adjusted incomes would be reduced by 1.5% due to the ongoing tariff impact of higher prices and lower growth. World Bank economists agree that economic activity will be negatively impacted by trade uncertainty. In its latest report, it decreased 2025 growth estimates for 70% of the global economies covered including the U.S. which it now believes will grow at a 1.4% rate this year, down from its previous 2.3% estimate.

Weaker growth and higher spending will add to federal deficits. For years, politicians and market participants downplayed concerns about levels of deficits and debts as low interest rates meant the cost to service the debt load was manageable. That may begin to change as debt levels are approaching 100% of GDP, up from approximately 40% only 15 years ago. Net interest payments on U.S. debt as a share of federal revenue are now over 17%, the highest since the late 1990s, and up from approximately 9% a few years ago as debt levels have climbed at the same time interest rates have risen over that period. Despite this, interest rates across most of the yield curve have fallen year-to-date, though they have drifted higher in recent weeks on concerns over the lack of fiscal discipline in Washington.

Consumers remain in a relatively healthy position though early signs of stress may be emerging. The primary drivers of Americans' ongoing ability to spend is the state of the job market and growth in real incomes. On that front, the news is positive. Through the first five months of the year, the economy has created an average of 124,000 new jobs per month. While this figure is down from 167,000 and 216,000 in 2024 and 2023, respectively, it has remained sufficient to keep the unemployment rate from rising above 4.2%, in line with its 12-month average. The low unemployment rate has been a contributing factor that has allowed incomes to continue to grow on an inflation-adjusted basis, an important

consideration in our consumer driven economy. At the same time, the number of jobs available relative to the number of unemployed people is roughly at a 1:1 ratio currently. This is down from 2:1 just over three years ago, an indication that jobs are not as easy to find. Other signs tell a similar story, including voluntary quits being down and the unemployed are taking significantly longer to secure a new job in today's economy. Layoffs have been rising, though they are not yet at worrisome levels.

These and other factors have weighed on consumer and small business confidence and behavior. Small businesses, which are an important contributor to the economy and new job creation, are reporting declining optimism about their near-term prospects due to rising expenses and higher financing costs. On the consumer side, retail sales fell in May for the second consecutive month as anxiety about tariffs and personal finances held back spending. It is also possible that, after front loading purchases to get ahead of pending tariffs, buyers are pausing to assess where policy ultimately settles. Credit card and automobile loan delinquency rates have been trending upward for the past couple of years and are at their highest level since just after the Great Financial Crisis. University of Michigan consumer sentiment surveys recently reported a 45-year low in consumer confidence in part because inflation expectations reached a 40-year high. If these trends persist, economic activity will likely be negatively impacted later in the year.

On the inflation front, recent news has been positive as consumer prices continue to rise but have been doing so at a decreasing rate since peaking in 2022. Despite this, at their meeting last week, Federal Reserve officials modestly raised their estimates for inflation this year and next to 3.0% and 2.8%, respectively. They cited the delayed impact of tariff policy and noted that many companies have discussed passing along higher costs to the end consumer. The Fed's projections for inflation remain well above its 2.0% target, suggesting that the economic outlook will have to weaken for the Fed to cut its key lending rate as expected. Market interest rates across much of the Treasury yield curve have declined slightly this year. For this trend to hold, inflation readings will have to moderate versus current expectations in the coming months. To put today's 10-year U.S. Treasury yield of 4.37% into perspective, Bank of America estimates that the long-term average for this benchmark lending rate is 4.75%. Therefore, a normalization would imply that rates may drift higher from here. This seems more likely than not given the seemingly unending fiscal deficits, ongoing trade frictions, and rising military conflicts around the globe, all of which can put upward pressure on inflation.

Stock market investors remain optimistic and have been quick to push shares higher on any positive news. When President Trump announced a 90-day pause for the most draconian tariffs on April 9th, the S&P 500 increased 9.5% on the day. This was its third largest daily gain in the post-WWII era. The rally has continued since then as stocks have advanced an additional 9.4%. Increasingly, Wall Street has been focused on the so-called TACO trade. This acronym stands for Trump Always Chickens Out and implies that investors believe that the president will back down from imposing any trade and tariff measures that will ultimately be unfavorable to the stock market. Additionally, investors remain focused on their belief, according to FactSet consensus estimates, that S&P 500 earnings growth this year and next will be 8.9% and 13.5%, respectively. Meanwhile, corporate profits as a percentage of GDP currently are at almost 12%, just off a record-high level. As noted, this positive sentiment has pushed the stock market back to a near record high.

From today's elevated levels, firms such as Goldman Sachs, Bank of America, and Vanguard are predicting only low-to-mid single digit returns from common stocks over the coming decade. This is consistent with what the Case-Shiller cyclically adjusted price-earnings ratio suggests. This valuation metric has a poor track record of predicting near term results. However, over longer time spans, its accuracy in predicting stock market returns improves dramatically. Its current level is consistent with returns under 5% in the coming years. This squares with data on the equity risk premium, or the extra

return investors should expect to earn by investing in common stocks relative to risk-free U.S. Treasury notes, which tells a similar story.

Despite high valuations and tough talk on trade and tariffs, overseas interest in buying into corporate America remains strong. Foreign flows into U.S. equity funds are on pace to make 2025 the second largest year on record, trailing only last year. On the other hand, the ratio of insider sellers to buyers is near its lowest level in many years, indicating that the leaders of corporate America may not share this enthusiasm.

The geopolitical climate remains complex and it is too soon to know exactly how things will play out across multiple theaters across the globe. The war between Russia and Ukraine wages on in its fourth year with no clear sign of an endgame. Similarly, Israel's response in Gaza and, more importantly, the new conflict between Israel and U.S. forces on one side and Iran's nuclear capabilities on the other introduce potential for a black swan event which could surprise investors.

Investment Conclusions

Despite living in unsettled times, it is worth remembering that the U.S. remains the preeminent global leader in technological innovation, economic diversity, and military power while the U.S. dollar remains the dominant currency for international trade and foreign currency reserves. Our financial markets are the envy of other countries, boasting the deepest and most liquid exchanges and featuring the most prominent businesses in the world. Market participants would be wise to keep the majority of their long-term capital invested in leading U.S. companies. That being said, there are many notable uncertainties in the current investment landscape at a time when valuations are high, so investors are advised to maintain some dry powder to take advantage of opportunities that may develop in the coming months. Importantly, since the Federal Reserve has yet to cut interest rates, short-term bond and cash reserves currently offer attractive risk-free returns.

As always, we will maintain a long-term investment philosophy as we seek to sustain and build our clients' portfolios. We will endeavor to select a diversified mix of high quality equity and fixed income securities which will help build wealth slowly and allow the power of compounding to do its job. In doing so, we embrace the sentiment embodied in the quote by famous American investor Warren Buffet who is credited with saying "Someone is sitting in the shade today because someone planted a tree a long time ago." Nothing is more important to us than fulfilling our duty to be capable stewards of your capital as we partner with you as you navigate your financial lives.

June 23, 2025