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Market Commentary – 2025 Mid-Year Outlook

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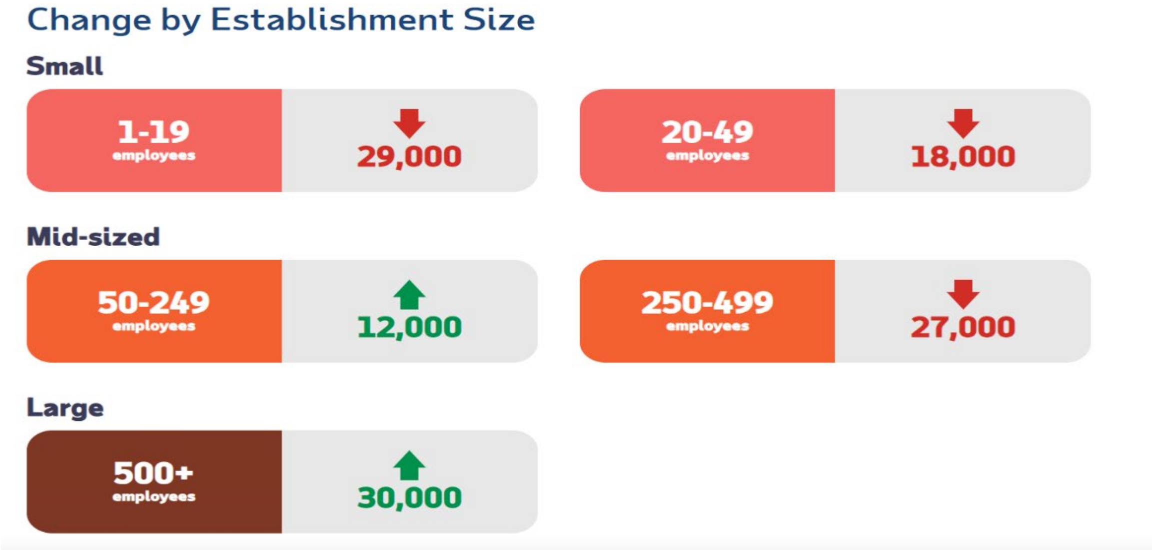
It's sometimes hard to find the words to describe the resiliency of the US economy and large cap stocks. After barely avoiding a bear market in April, the S&P 500 is now setting new all-time highs. I remain optimistic that this rally still has legs to it based upon strong corporate earnings, pending tax cuts, and probable deregulation in the 2nd half of the year. I also believe we will see two rate cuts from the Fed in the 2nd half of the year. Of course, there remain risks of trade negotiations falling apart with major US trading partners and/or geopolitical conflicts escalating again. There's also the risk that the Fed will hold rates at restrictive levels for too long.

We need to get past this cloud of trade policy uncertainty as it's holding back businesses from capital expenditures and hiring plans, and may also dampen consumer spending. As an example, in the latest JOLTS report, new hires dipped 2% in May and the hiring rate ticked down 0.1% to 3.4%. The current hiring rate remains relatively low and would normally be associated by a higher unemployment rate, but a low pace of layoffs has limited the rise in unemployment. I believe we are on our way to clarity, but we need to see more trade agreements finalized. Some economic uncertainty was cleared on July 4th, when President Trump signed the One Big Beautiful Bill. The bill includes a swath of business investment incentives which raise the after-tax return on qualifying capital expenditures, thereby boosting the supply side of the economy.

Labor Markets and Consumer Spending

Overall, the labor market remains healthy, but it continues to slowly moderate. While the nonfarm payroll surprised to the upside rising by an above-consensus 147,000 in June, there were some elements of softness beneath the better-than-expected headlines. Job gains were narrowly based as a spike in state and local government employment likely driven by seasonal factors explained more than half of the increase in payrolls while private-sector job growth slowed significantly. Additionally, the ADP Private payroll report highlighted the struggles of smaller companies under restrictive rates. Large companies (with over 500 employees) added 30,000 jobs in June, but smaller companies (less than 49 employees) shed 47,000 jobs in June.

Change in US Private Employment – June 2025



Source: ADP Research, ADP National Employment Report

Consumer spending is slowing, but not slumping. The wealth effect (from rising home equity and the stock market) should keep consumer spending healthy moving forward as well as the fact that wage growth is exceeding inflation. Back-to-back years of the S&P 500 posting returns of over 20% boasted consumers' net worth. Additionally, US mortgage holders had a record $17.6 trillion in home equity entering Q2 2025, with the average homeowner sitting on $212,000 in tappable equity. While the May retail sales report was below expectations, we also know there are some distortions with several economic reports, including GDP, due to the excessive front-loading of purchases before the tariff rates were implemented.

Inflation and the Fed

Inflation continues its slow downward trend, and we have not yet seen any major inflationary consequences because of tariffs. Of course, many companies loaded up on their inventories ahead of Liberation Day, so as those inventories are depleted, we may see some small inflationary bumps. However, I believe all the reinflationary fears are a bit overblown. Inflation spiked after COVID due to massive fiscal stimulus and high money supply growth, which do not apply to today's macro environment. According to regional Fed Business surveys, only 50% of tariffs are expected to be passed onto the consumer while US businesses are expected to absorb 40% of those costs and foreign exports are expected to eat 10% of those costs.

There were no major surprises from the most recent Fed meeting. While the updated Dot Plot still projected two rate cuts, it seems like there are some very different views. 7 Fed officials are now projecting no rate cuts this year, which is up from 4 in March. On the other hand, Christopher Waller and Michelle Bowman commented that a rate cut in July is still on the table. The Fed has always described itself as data dependent, so

I believe their credibility will suffer if they do not cut rates soon as the data over the past several months have proven the disinflationary trend is in place. While I agree with Waller and Bowman that a rate cut should happen at the July Fed meeting, I do not think it will happen. However, I strongly believe that we need to reinitiate rate cuts by the September Fed meeting at the latest. Otherwise, the Fed risks unnecessarily increasing the probabilities of a recession. As noted above, June's ADP Private Payroll displayed the struggles of smaller companies under restrictive rates.

Investment Thoughts

Since the beginning of the year, we have been shortening the duration of our fixed income portfolios in anticipation of interest rate volatility. While interest rate volatility was high in the first months of 2025, rates have been tamer recently. Within our public equity holdings, we have increased our exposure to the Quality factor by focusing on companies with strong balance sheets and a track record of strong cash flows and earnings. While a recession is not my base case, I believe the odds of a recession are slightly higher than normal and we want to put more focus on companies that could withstand a possible economic downturn, especially with tighter financial conditions.

I always advocate for some international equity exposure, which has obviously helped our portfolios this year. The fiscal stimulus should continue to help defense stocks, infrastructure companies and industrial companies exposed to German projects. However, I believe US stocks will outperform their international peers in the 2nd half of the year. Eurozone equities are vulnerable to a decline in the global manufacturing cycle as tariff front-running fades. Additionally, US consumer spending remains at healthier levels than international consumer spending. US exceptionalism is not dead, and the AI revolution will help companies across all sectors cut expenses and improve profit margins. US large cap profit margins are currently at 13.4%, which are significantly better than Euro STOXX's profit margin of approximately 9% and MSCI Japan's margin of nearly 8%. Here are specific areas of the US market I like the most right now.

- Within fixed income, I like High Yield. High Yield outperformed other fixed income sectors over the past several years. The credit quality has improved with over 51% of the high-yield universe rated BB and more than 85% are B or higher. Pre-GFC, barely 40% of the high yield universe was rated BB or higher.
- MegaTechs have reassumed their leadership role in the markets as the AI revolution is still in the early innings. While their valuations are frothy, their continued earnings growth justifies those prices. The Mag 7's earnings growth rate is expected to outperform the other 493's earnings growth rate in 2025, 16% to 7%, respectively.
- I believe Financials will benefit with potentially more M&A activity later this year as well as deregulation polices from the White House. Financials' profit margins are near their 15-year highs currently. Additionally, Financials have outperformed Ex-Financials in 10 out of the last 14 years.
- I'm more optimistic on Communication Services recently. Valuations have improved and this sector has a high-Quality factor due to its high and stable profitability and strong balance sheets. Communication Services had the 2nd highest earnings growth rate in the 1st quarter, profit margins are improving, and EPS revisions are bucking the broader downward trend. During the 1st Quarter earnings season, Communication Services was the only sector that increased its EPS estimates for 2025.

- Utilities reported the 4th highest sector earnings growth rate in the first quarter. Utilities typically is one of the most highly leveraged sectors, so that sector should benefit from interest rates dropping. After a decade of anemic growth in power demand of roughly 1% to 2% annually, the AI revolution is propelling power demand growth estimates for utilities up to 6% to 8% annually over the next 10 years. This growth in power demand has the potential for improved earnings growth and durable multiple expansion for utilities. Over the next few years, investors' view of Utilities may change from a defensive strategy to an offensive strategy out of the AI playbook.
- Finally, I like Mid-Caps. While large caps valuations are roughly 30% above their 30-year average, mid-caps valuations are slightly below their 30-year average. Mid cap revenues are typically more domestic-based, so they will be more insulated from any trade war and are positioned to benefit from the reshoring efforts by the White House. Finally, mid-caps generally face the highest regulatory cost, 47% greater than small caps and 18% greater than large caps. A more deregulated business environment could benefit mid-caps the most.