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Playing Monday Morning Quarterback with the Fed

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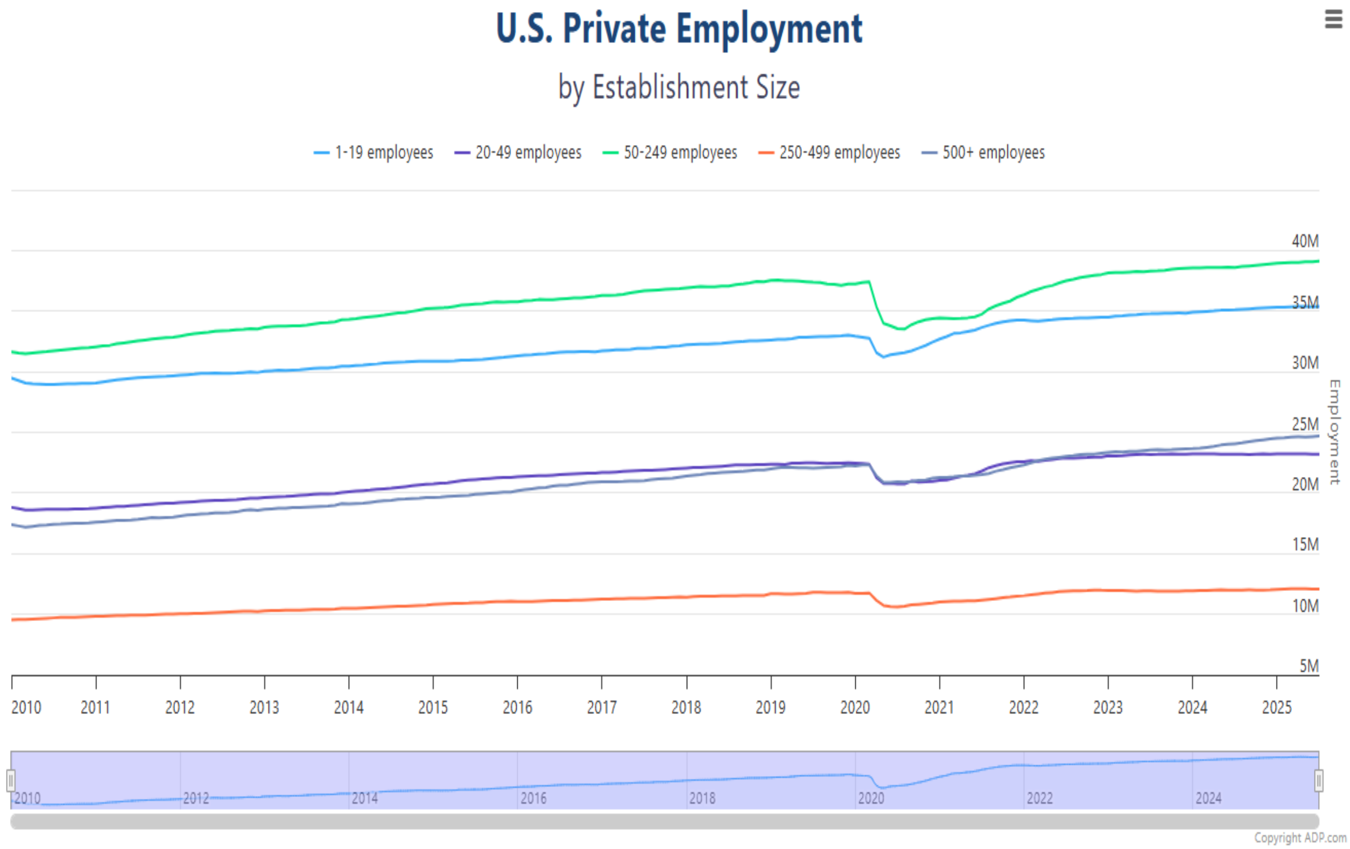
Playing Monday Morning Quarterback is an expression well known to many as commentators and fans reflect on Sunday football games the next day. For non-football fans, the expression's meaning is to judge or criticize someone from a position of hindsight. With the July nonfarm jobs report in hand, we have many investors playing Monday Morning Quarterback on the Fed's decision to keep rates unchanged. The labor report was weaker than expected with payrolls rising only 73,000 vs consensus expectations of a rise of 102,000. The real story with the payroll data, however, were the whopping downward revisions to job growth for May and June. Job gains for May were slashed by 125,000 to 19,000 and by 133,000 for June to 14,000. The sluggish gain in jobs for July along with the revisions pushed the three-month moving average of job gains to 35,000, the weakest since the pandemic. The Fed's job is to balance their dual mandate of maximum employment and price stability. I have been vocal recently that the majority of Fed officials were not putting enough focus on the moderating labor market.

Labor Markets

There has been mounting evidence that the labor market's health was deteriorating. While the initial release of the June nonfarm payroll report surprised to the upside rising by an above-consensus 147,000 in June, there were 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. Obviously, the revisions to June's report painted even more gloom to it. Additionally, the two recent ADP Private payroll reports highlighted the struggles of smaller companies under restrictive rates. Large companies (with over 500 employees) added 78,000 jobs in June and July, but smaller companies (less than 49 employees) shed 29,000 jobs in those two months. Continued jobless claims have also been elevated for months highlighting how unemployed workers are finding it difficult to find new jobs.



Source – ADP Research

Inflation and the Fed

Inflation, on the other hand, has continued its slow downward trend, and we have not yet seen any major inflationary consequences because of tariffs. It was interesting to note that import prices rose only 0.1% in June and there was a downward revision of 0.4% in May. Along with the weakening US dollar, there are signs that foreign exporters are eating some of the cost of tariffs, leading to lower import prices. 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 many of the reinflationary fears may be 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.

I'm in agreement with Christopher Waller and Michelle Bowman that a rate cut should have happened at this latest meeting. The Fed has always described itself as data dependent, so I believe their credibility may suffer if they do not cut rates soon as the data over the past several months have indicated the disinflationary trend is in place. In my view we need to reinitiate rate cuts by the September Fed meeting at the latest. While the unemployment rate is somewhat holding steady, much of that is due to a decrease in labor supply with limited immigration and recent deportations. The labor market is traditionally the last economic indicator to fall before a recession. Historically, as the unemployment rate has moved up, it can quickly increase its velocity leading to an economic downturn. While a recession is not my base case, if the Fed does not initiate rate cuts soon, in my view, it may unnecessarily increase the odds of a recession.

I do remain very concerned about the possibility that President Trump attempts to fire Jerome Powell. It's critical to the long-term health of our economy that the Fed remains independent. If the President does act to remove Powell, it is possible we could see a strong sell-off in the US dollar, stocks, and bonds and see long-term rates spike very quickly. I do not expect this scenario to happen, but we can't entirely rule it out.

Uncertainty Slowing Fading

One of the other big concerns earlier this year was the cloud of uncertainty caused by the tariff negotiations, which held back many companies from capital expenditures and hiring plans. However, that cloud is slowly dissipating thanks to the recent trade agreements with Japan, South Korea and the EU. We still need to finalize agreements with other major trading partners, but we are moving in the right direction. It also helps that the One Big Beautiful bill was signed into law and is no longer another source of uncertainty. I expect the OBBA to help spur economic growth with its pro-business stance including increasing the bonus depreciation rate for qualified property and providing immediate ability to deduct R&D expenses

Portfolio Positioning

I remain bullish, but due to these concerns I still recommend clients to tilt their portfolios towards the Quality factor and focus on companies with strong balance sheets, cash flows and earnings track records. The market is getting a bit frothy lately as we've seen low-quality and other speculative investments shoot higher. In June, the S&P 500 High Beta index (more risky stocks) was up 5.46%, and I anticipate some pullback within that segment. Investors should stay clear of unprofitable companies and other "meme" stocks given these risks and consumer spending moderating.

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. 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 and a strengthening Euro will serve as a headwind to European exporters. 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. The AI revolution is still in the early innings, and despite their lofty valuations, I expect the Big Tech companies to remain the leaders of the US rally due to their impressive earnings.

Within fixed income, the short-to-intermediate part of the curve remains the sweet spot. I believe we will continue to see more interest rate volatility moving forward due to budget debt concerns. Other areas of the market I like right now include,

- High Yield Fixed Income. The credit quality in this sector 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.
- Financials is one of 3 sectors which are reporting a year-over-year increase in their profit margins in Q22025 compared to Q22024. This sector should also 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.
- Communications Services is another sector reporting net profit margin growth on a year-over-year basis. This sector has a high-Quality factor due to its high and stable profitability and strong balance sheets.
- 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. Mid caps valuations are much more attractive compared to Large cap stocks. 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 along with the pro-business OBBA.