Market Strategy
by STRATEGAS A BAIRD COMPANY

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Quarterly Market Update
Second Quarter, 2025

ON A SURPRISINGLY STRONG SECOND QUARTER

Unexpected rally. The performance of markets in Q2 stands as a testament to the old, wry observation that with $1 million dollars and unlimited insider information, the average investor would go broke within a year. Indeed, if one were to tell you that, in just 3 months, there would be fears of all-out global trade war, there would be endless wrangling over a budget bill that, if not passed, would result in an additional $400 billion tab to taxpayers, the final credit agency to have a AAA rating on U.S. debt would downgrade it, a hot war between Israel and Iran would start, and that the U.S. would take out three of Iran's nuclear enrichment sites, who would guess that the S&P 500 would hit a new all-time high, Treasury yields would decline, the dollar would fall 10%, and that oil prices would be in the red.

V-shaped. President Trump's initial attempt at trade "negotiations" resulted in a nasty drawdown in stock prices to start the quarter. New lows for the S&P 500 were set on April 8, marking a -19% decline from the index's February high. Yet, the 55 trading days from the April 8 low to the new high on June 27 also mark the fastest roundtrip for the market after a 15% correction in history.

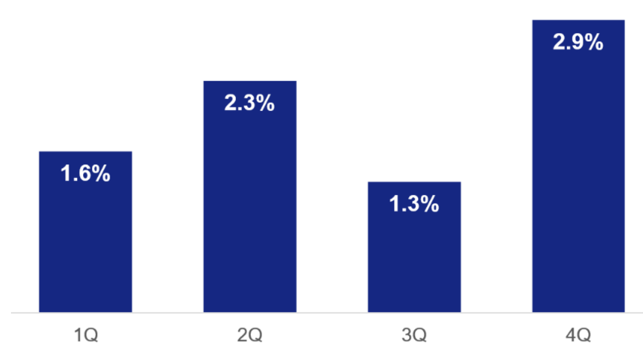
On markets. It seems as if investors have concluded that in a Trump world, where everything is a negotiation and there are no loyalties to convention, some uneasy peace will be reached on trade and that his Big, Beautiful bill will pass, providing a boost to the U.S. economy in the form of fiscal stimulus. With Industrials the best performing sector in the S&P 500 so far and the Financials recently rallying, it is difficult to say that Mr. Market is worried about either a significant slowdown in economic activity or higher inflation and interest rates.

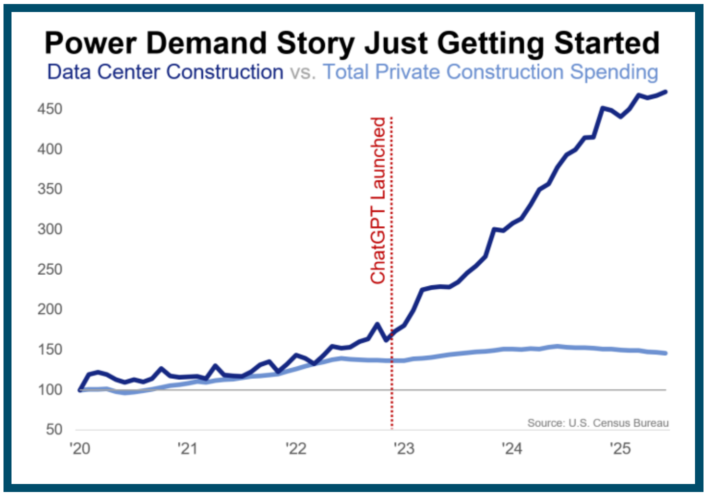
Rates, earnings, valuations. While it is difficult to plant one's feet in this environment, one presumes that some resolution of questions regarding trade and the budget will be positive for sentiment. As for the Fed, we think it's important to note that the tension between the President and the central bank extends well beyond just Chairman Powell. Seven of the 19 FOMC members see no need for a rate cut in 2025, while the futures market is implying more than an 80% probability of two and a half cuts by the end of the year. In essence, investors are betting on an easing of monetary, fiscal, and regulatory conditions that justifies the S&P's 23x forward P/E multiple. To the extent that stock prices are a function of both interest rates and earnings, expectations are somewhat lackluster. Consensus sees earnings growth for the second quarter at only 6%, down from the 10% expectation at the start of the quarter. Still, consensus estimates are pegging full year earnings growth at 9%, and with animal spirits percolating, further multiple expansion cannot be ruled out.

Asset Class	Representative Benchmark	Q2 '25	YTD '25
US Large Cap	S&P 500	10.9%	6.2%
US Small Cap	Russell 2000	8.5%	-1.8%
International	MSCI AC World ex-USA (USD)	12.3%	18.3%
Commodities	Bloomberg Commodity	-3.1%	5.5%
Gold	LBMA Gold PM ($/oz)	5.2%	24.4%
Municipal Bonds	Bloomberg Municipal Bond	-0.1%	-0.3%
Taxable Bonds	Bloomberg US Aggregate	1.2%	4.0%
Cash	Bloomberg 3-Month T-Bill	1.1%	2.1%

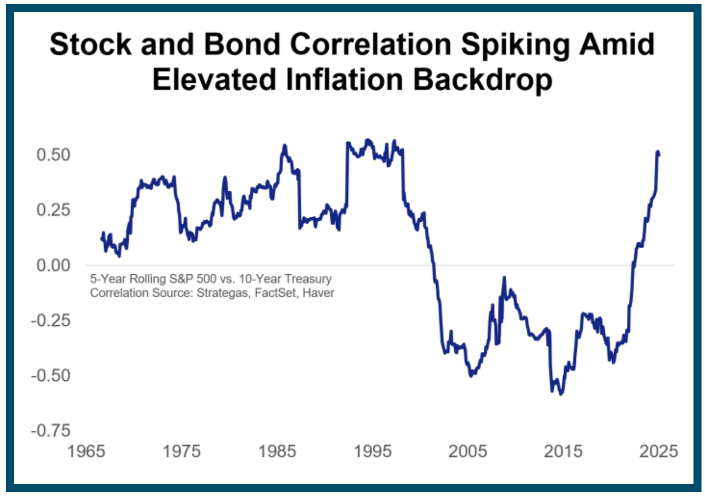
S&P 500 Average Quarterly Return (since 1928)

All data is from FactSet



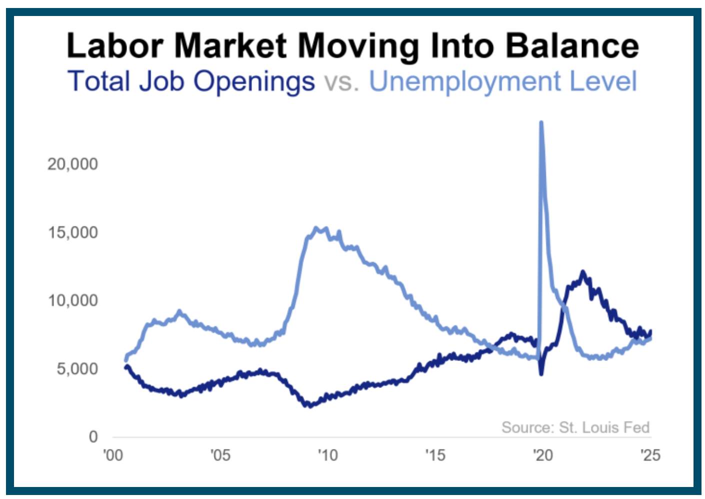


The increase in demand for power started with electric vehicles and got a further boost with the advent of Artificial Intelligence. The rapid adoption of A.I. has led to the need to build more data centers, which, in turn, have their own energy needs. It has been estimated that training large A.I. models like GPT-3 can consume the same amount of electricity as 130 homes in the U.S. per annum. And while the use of A.I. is widespread among companies in one or two functions, there is vast untapped potential for companies to adopt a more widespread use of A.I. among their operations. Industrial power generation remains one of Strategas' major long-term themes.

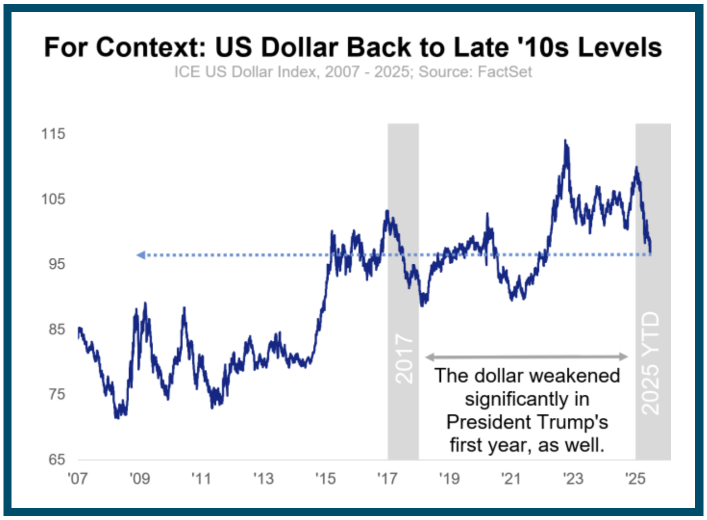


While the S&P 500 closed the quarter at a new all-time high, the rising stock/bond correlation is something to keep an eye on (a correlation closer to 1.00 indicates that two assets are moving more closely in sync with one another). A 60/40 stock and bond portfolio flourished throughout the 2000s and 2010s from the negative correlation that allowed bonds to act as a productive hedge against stock market drawdowns, but that may be in the rear-view mirror should inflation remain elevated (rising interest rates are typically bad for stocks and bonds). Over the past two decades the right hedge for stocks was bonds, but are investors properly allocated if that's not the case in the decade ahead?

The U.S. housing market attempted a thaw last year as the Federal Reserve began to cut rates. But mortgage rates have proved sticky, and the Fed has now put monetary policy on an extended hold – in what appears to be restrictive territory – in large part due to the uncertainty around tariff policy's impact on inflation. Residential investment is unlikely to drive U.S. economic growth until this changes. However, depressed sales activity (see chart) has also had the effect of suppressing home price growth, which could fuel lower core inflation readings down the road – and open the door for the Fed to come back into play.



Fed Chair Powell recently emphasized that U.S. labor demand and labor supply appear equal. As such, there's no meaningful inflationary pressure coming from the labor market (more demand than supply → inflationary wage growth). The flip side is that the U.S. will likely be able to add only enough jobs to keep up with population growth (i.e., there's also no slack). The U.S. population seems unlikely to grow much in 2025 given the recent changes in immigration policy. Therefore, monthly job gains of "just" 50,000-100,000 shouldn't be all that alarming – that's the new speed limit on the supply side for now.



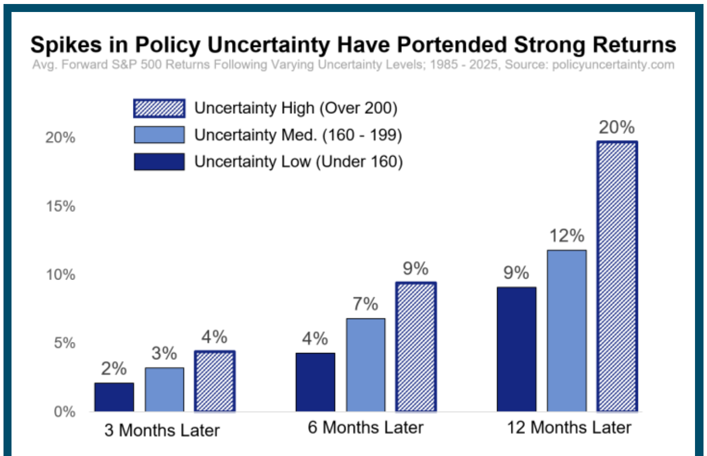
The U.S. dollar has had its worst start to a year in decades, though admittedly off of nearly 20-year highs (and not tracking too differently from President Trump's first term, either). The dollar had been trading in a higher range as the American exceptionalism theme took hold, though some of that tailwind is coming out of the system today. The Administration probably isn't too upset that the dollar is now back to its 2015-2020 historical range given their view that too strong a dollar impedes domestic manufacturing. Still, it would be significant if it dropped below its 2015-20 range. We'll be watching closely.

Section 232 Investigations Will Continue

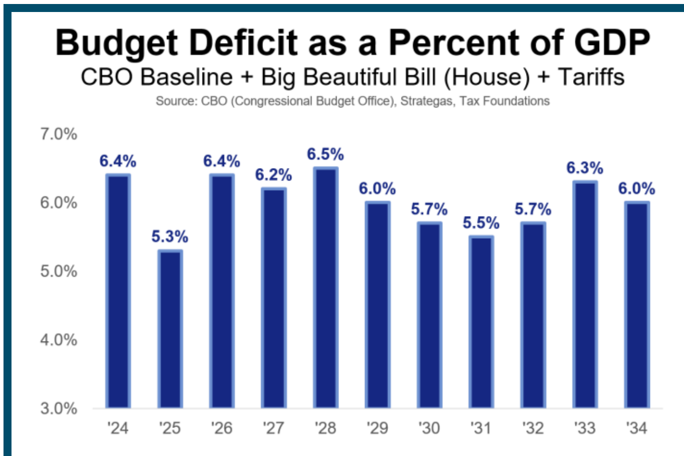
Area	Duty Rate	Commerce Deadline
Steel	50% (up from 25%)	-
Autos	25%	-
Critical Minerals	-	19-Oct-2025
Copper	-	22-Nov-2025
Lumber	-	26-Nov-2025
Pharmaceuticals	-	27-Dec-2025
Semiconductors	-	27-Dec-2025
Trucks	-	17-Jan-2026
Aircraft	-	26-Jan-2026

Source: Strategas, U.S. Dept. of Commerce

Though the Court of International Trade earlier this year ruled against President Trump's tariffs imposed through the International Emergency Economic Powers Act, sectoral tariffs for autos, steel, and other commodities, as well as the forthcoming pharmaceutical and semiconductor tariffs, are not impacted by this ruling as they were justified by Section 232 of the Trade Expansion Act of 1962 (which allows the President to levy tariffs if the Dept. of Commerce determines a U.S. national security threat). These are likely to complicate trade negotiations given the uncertainty around future tariff rates.



The second quarter featured levels of policy uncertainty unseen across recent history – in fact, April 2025 saw the highest monthly reading in the 40-year history of the economic policy uncertainty index (above Covid-19, the 2008 Financial Crisis, etc.). As we noted last quarter, this tends to be a counterintuitively bullish indicator for forward returns – particularly when paired with deeply negative investor sentiment, as was the case in April – though these times are admittedly uncomfortable moments to put money to work. All said, from the April 8 lows (i.e., peak uncertainty) through quarter-end, the S&P 500 rallied 25%, one of the best bear market bounce-back rallies in the last century.



While the Big, Beautiful tax and spending bill that extends the 2017 TCJA tax cuts is likely to add to the federal budget deficit over the next decade (i.e., it reduces revenue more than it reduces spending), we believe that incoming tariff revenue will offset most of the projected deficit increase. Nevertheless, the U.S. fiscal picture remains negative as entitlement spending continues to climb and as the U.S. debt servicing cost remains elevated at 18% of tax revenues. Long term, that is unsustainable.

S&P 500 Index (Large Cap / U.S. Stocks): A representative sample of 500 leading companies in leading industries of the U.S. economy. These are equity securities of large capitalization (generally $7 billion plus market cap) companies having growth and value characteristics. ● **Russell 2000® Index (Small Cap / Small Core):** Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. These are equities of small capitalization. ● **MSCI EAFE Index Net (International / Developed Markets):** A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US and Canada. As of December 2024, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. ● **BBgBarc Aggregate Bond Index (Taxable Bonds / Bonds):** Composed of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years. ● **BBgBarc Muni Bond Index (Municipal Bonds):** Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, part of a transaction of at least $50 million, issued after December 31, 1990, and have a year or longer remaining maturity ● **FTSE 3-month T-bill Index (Cash):** This index measures monthly return equivalents of yield averages that are not marked to market. It consists of the last one-month and three-month Treasury bill issues, respectively. ● **Bloomberg Commodity Index (Commodities):** Composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Subindices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs.

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