Market Overview

Second Quarter 2025

A VOLATILE START AND AN EPIC REBOUND

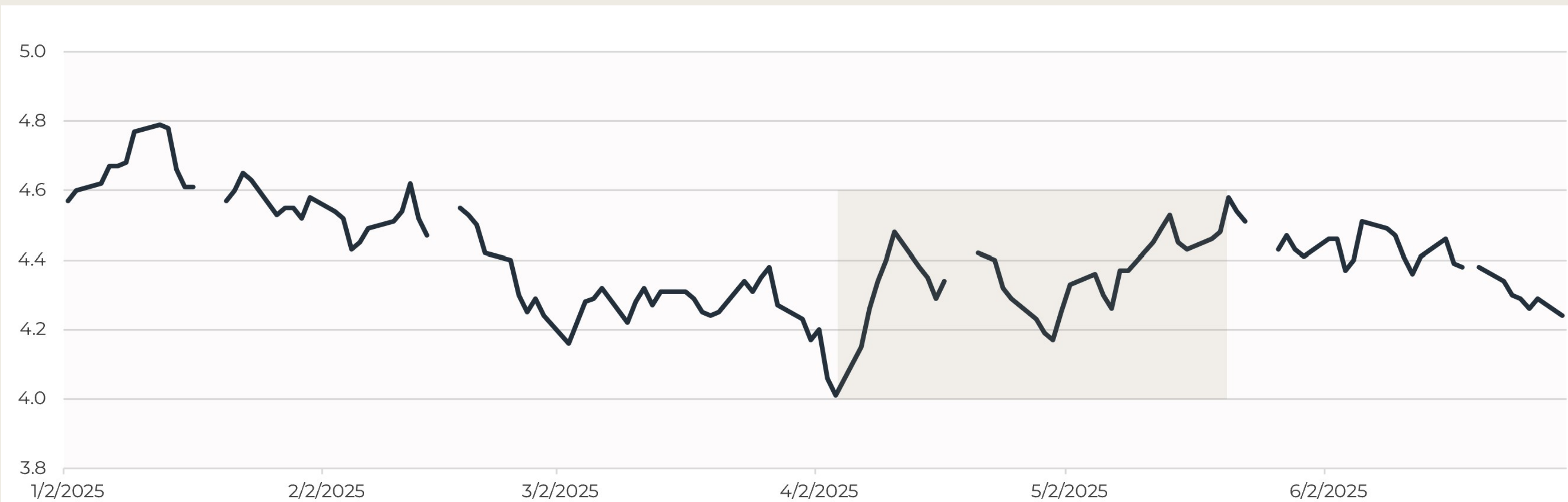
When Rocky Balboa stepped into the ring in 1985's cinematic classic, few expected him to withstand the raw force of Ivan Drago. The odds were against him, the blows relentless and yet somehow, through sheer resilience, he stayed on his feet. The early days of the 2nd quarter reminded us of that fight. Equity markets, much like Rocky, found themselves pummeled by policy shocks and investor anxiety, sparked largely by a wave of tariff announcements from the administration. By early April, the S&P 500 had fallen nearly 19% from its peak; an echo of past selloffs that shook investor confidence.

Much like watching Rocky in the first round, an investor entering the second quarter with a crystal ball on global events might conclude it was time to throw in the towel. Market blows included 1) Tariff announcements on April 2 2) A final credit agency downgrade of the U.S. 3) A hot war between Iran and Israel leading to the United States intervening with an attack on Iran's nuclear facilities 4) A budget bill with increased government spending and little regard to fiscal hawks.

But in true underdog fashion, markets found a turning point. Unlike typical downturns where investors seek refuge in bonds, this time Treasuries were sold off aggressively early in the quarter, causing yields to spike. The 10-year yield surged from 3.99% to 4.49% in just a few days, a rare sign of stress in what is usually considered the world's safest asset class. Rumors that bond vigilantes[1] had finally gotten it right echoed through proverbial market halls (Figure 1).

The sharp equity market decline paired with a spike in yields served as a wake-up call. In response, the administration pivoted, softening its trade rhetoric and opening new channels for dialogue and this paired with moderating economic data was enough for investors to respond in kind,

U.S. 10-YEAR TREASURY YIELD (FIGURE 1)



Source: *Federal Reserve Economic Data, Federal Reserve Bank of St. Louis, data as of June 30, 2025*

[1]*A bond vigilante is a term used in financial markets to describe investors who sell bonds aggressively in response to government fiscal or monetary policies they perceive as inflationary or irresponsible. Their actions can drive bond yields higher, effectively pushing borrowing costs up for governments and influencing public policy.*

reigniting risk appetite and driving a nearly 25%[2] rebound in the S&P 500 by quarter-end and once again reaching new all-time highs (Figure 2).

RESILIENCE IN ECONOMIC FUNDAMENTALS

Despite the headline uncertainty, the U.S. economy continues to show signs of resilience. After a modest contraction in Q1, largely due to inventory build-ups ahead of tariff hikes, GDP growth is tracking at 2.6%[3] for Q2. Consumers have played a vital role in this rebound. Spending remains strong, bolstered by moderating inflation and rising real wages. The Consumer Price Index declined to 2.4%[4] in May, and inflation expectations for the longer-term outlook are stable around these levels, despite possible one time increases as tariffs are still in flux.

Labor market data paints a similarly constructive picture. Unemployment was little changed at 4.1%[5], and while the 4-week average for jobless claims ticked up slightly, wage growth continued to outpace inflation.

These are two of the main data points we continue to evaluate closely in the ever-changing landscape. The relationship between elevated levels of unemployment and a slowdown in the US consumer are highly correlated to economic weakness which portends to more dramatic declines in equity levels. Quite simply, this is not the environment we find ourselves in at the moment… further evidenced by the fact that earnings revisions have started to turn higher following the second quarter.

INDEX RETURNS (FIGURE 2)

INDEX	QTD	1-YEAR	3-YEAR	5-YEAR	10-YEAR
S&P 500 Index	10.9	15.1	19.7	16.6	13.6
Dow Index	5.5	14.7	15.0	13.5	12.0
NASDAQ Index (Price Change)	18.0	15.7	23.7	16.1	16.2
Russell 2000 Index	8.5	7.7	10.0	10.0	7.1
Russell 3000 Value Index	3.8	13.3	12.4	13.8	9.0
Russell 3000 Growth Index	17.6	16.9	25.0	17.5	16.4
MSCI EAFE Index	11.8	17.7	16.0	11.2	6.5
MSCI Emerging Markets Index	12.0	15.3	9.7	6.8	4.8
Barclays U.S. Aggregate Index	1.2	6.1	2.5	-0.7	1.8
U.S. Corporate High Yield	3.5	10.3	9.9	6.0	5.4
BBG/Barclays Muni Index	-0.1	1.1	2.5	0.5	2.2

Source: *Bloomberg, data as of June 30, 2025, annualized if longer than 1 year*

POLICY, RATES, AND MARKET RISKS

This isn't to say that this is the all clear! Bond markets remain unsettled. Long-term yields have stayed elevated even as equity markets recovered, pointing to a persistent rise in the term premium, which is the additional return fixed income investors demand for holding longer dated bonds instead of shorter term bonds.

The spread between 30-year and 2-year Treasuries remains near 1.0% - levels not seen since before the Fed's tightening cycle began in 2022. A variety of forces are contributing to this dynamic: the Fed's ongoing quantitative tightening, reduced foreign demand for U.S. debt, growing fiscal burdens, and inflation concerns, which are tied to the uncertain impact of policy changes.

The Federal Reserve recently held the Fed Funds rate steady at 4.25%–4.50% for a fourth consecutive meeting. While Chair Jerome Powell urged patience, voices within the FOMC are diverging. Some members advocate for rate cuts as soon as July, pointing to signs of economic fragility. Market expectations agree, pricing in 125 basis points of cuts by the end of 2026, 50 basis points more than the Fed's own projection. One thing history has taught us well is that market expectations for interest rates are often incorrect, however we believe the direction of expectations to be correct.

While the Fed is politically independent, and rightfully so in our opinion, political dynamics may soon come into play as well, with speculation that a new Fed Chair could shift policy more dovishly and possibly be announced well prior to the end of Chair Powell's term comes to an end. This will likely cause market volatility but should be looked at as short-term noise as the state of the economy will be the policy driver.

In a world of uncertainty, one thing has become clear. Bond investors are demanding a premium to compensate for the unknown path. Even with an

[2] *S&P 500 total return April 8, 2025 through June 30, 2025 was 24.53%.*
[3] *GDPNow, July 3, 2025 - https://www.atlantafed.org/cqer/research/gdpnow*
[4] *https://www.bls.gov/cpi/*
[5] *https://www.bls.gov/ces/*

eventual cut to the Fed Funds we expect bond yields to remain elevated until the path of fiscal spend to growth or recession is determined.

POSITIONING FOR GROWTH AHEAD

Throughout the uncertain environment we have continued to rely on the investment process as our calm in the storm. This means keeping a long-term perspective. During the brief market pullback we remained fully invested as the data did not suggest a sharp economic contraction was on the horizon.

In many ways, markets find themselves in a similar position starting the second half of 2025 as they ended 2024. This includes elevated valuations, currently 22.0 times next twelve months earnings, with momentum carrying index levels to new highs on the back of growing AI adoption.

The traditional characteristics of a bull market, widening credit spreads, surge of IPO activity, extreme levels of inflows to equities, are absent from the current environment. With industrials and financials leading the way year to date it is hard to ascertain that the market is concerned about an economic slowdown or the higher level of yields (Figure 3).

With that as the backdrop, the core of our asset allocation remains relatively unchanged, which is an investment decision in itself.

Our exposure to domestic stocks remains heavily tilted towards large cap companies, an inherent bias to quality over lower market capitalizations. Within our large cap holdings we continue to tilt towards value being mindful of stretched valuations. This sleeve of the portfolio is likely going to lag behind if US markets are once again driven by a handful of growth names, but will continue to provide exposure in a rising market environment. We continue to evaluate this from a risk adjusted perspective and feel it a prudent choice in allocations as we have seen a broadening out of performance. We also know that trees don't grow to the sky.

Through the course of the quarter we have maintained our international allocations, which has continued to be a bright spot within portfolios for 2025. It is fair to point out that roughly 50% of international returns have been driven by the decline of the US dollar compared to other currencies. On a currency adjusted basis, international allocations aren't outperforming domestic markets as dramatically as the headline numbers show. What is important here is that the global growth story remains intact. If the US dollar continues to decline, relative to other currencies, this will be an added boost to international holdings. Even without that "boost", international markets continue to be a diversifying mechanism in portfolios which are holding their own to provide growth.

Within fixed income we continue to utilize rather boring allocations. At this point in the cycle we are maintaining our focus toward high quality (and predominantly tax exempt) bonds. Our positioning is to be duration neutral, which means we are not taking extra risk based on the direction of interest rates. As discussed prior, even with the Fed Funds rate anticipated to come down – yields are likely to remain elevated. For this reason, we do not think

SECTOR PERFORMANCE (FIGURE 3)

SECTOR	INDEX WEIGHT	2Q RETURN	YTD RETURN	FORWARD P/E	20-YEAR AV. P/E
Energy	3.0%	-8.6%	0.8%	15.2x	13.6x
Materials	1.9%	3.1%	6.0%	20.3x	15.4x
Financials	14.0%	5.5%	9.2%	16.9x	12.8x
Industrials	8.6%	12.9%	12.7%	24.2x	16.6x
Consumer Discretionary	10.4%	11.5%	-3.9%	28.5x	20.2x
Technology	33.1%	23.7%	8.1%	28.9x	18.4x
Communication Services	9.8%	18.5%	11.1%	20.1x	18.9x
Real Estate	2.0%	-0.4%	3.1%	17.1x	17.3x
Health Care	9.3%	-7.2%	-1.1%	16.1x	15.1x
Consumer Staples	5.5%	1.1%	6.4%	22.0x	17.7x
Utilities	2.4%	4.3%	9.4%	17.9x	15.9x
S&P 500	100.0%	10.9%	6.2%	22.0x	16.0x

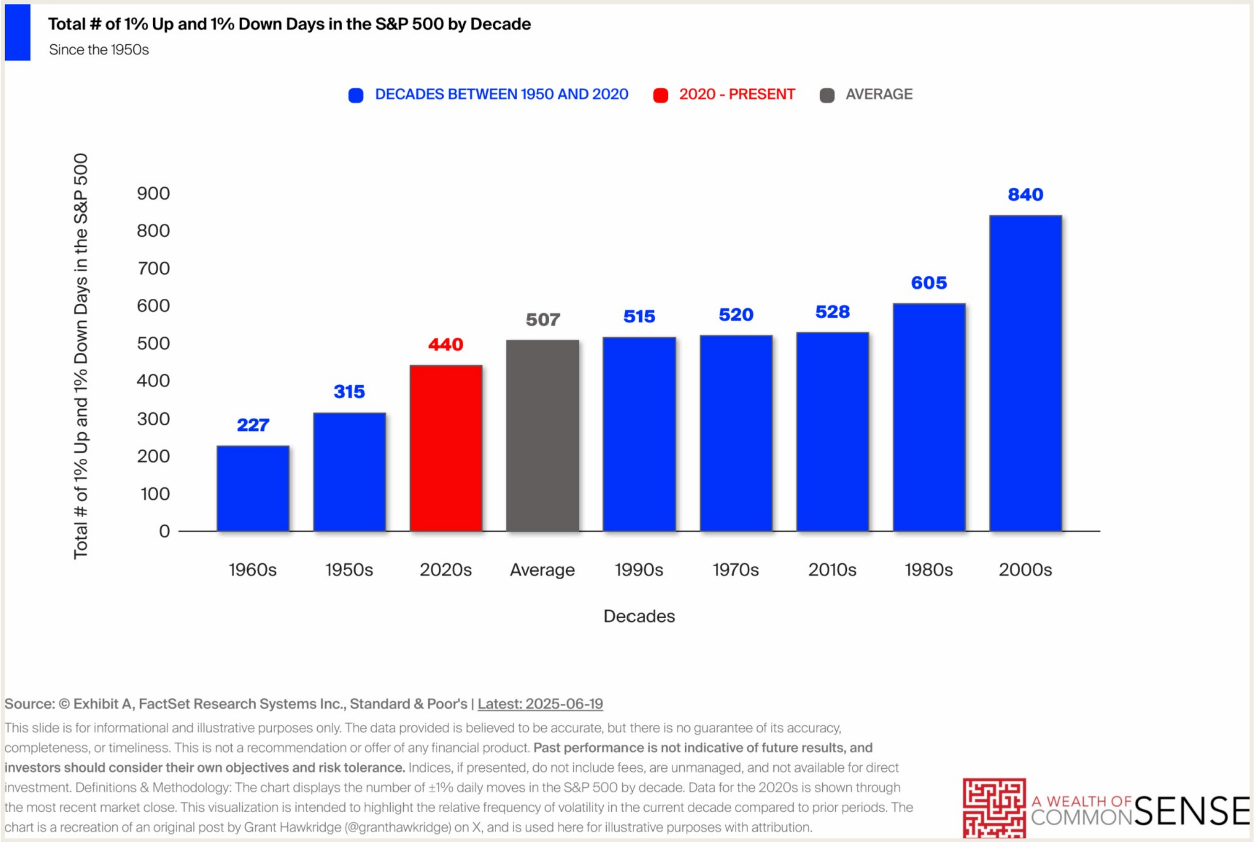
Source: *JPMorgan "Guide to the Markets", data as of June 30, 2025* there is a lot of value to add by taking on additional interest rate risk within portfolios. We would rather the value add comes from credit quality and yield enhancement, which, despite the volatility of yields, has added value across fixed income allocations.

This investment cycle could prove to be a significant driver of productivity and economic growth in the years ahead. Paired with a dovish shift in monetary policy and selective deregulation, it lays the groundwork for a more robust expansion.

Q2 2025 reminded us that markets, like boxers, can take a hit and keep moving forward. Policy noise and volatility will likely persist (Figure 4), but underlying economic resilience, technological momentum, and adjustments by policy makers give us a tempered optimism. As always, we remain focused on the investment process - identifying opportunities where risk is appropriately priced and long-term value can be realized.

We appreciate the trust and confidence you share with the investment team, please reach out with any questions.

A DECADE WORTH OF VOLATILITY IN THE 2020s (FIGURE 4)



https://awealthofcommonsense.com/2025/06/the-most-volatile-decade/

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