Financial Markets Perspective

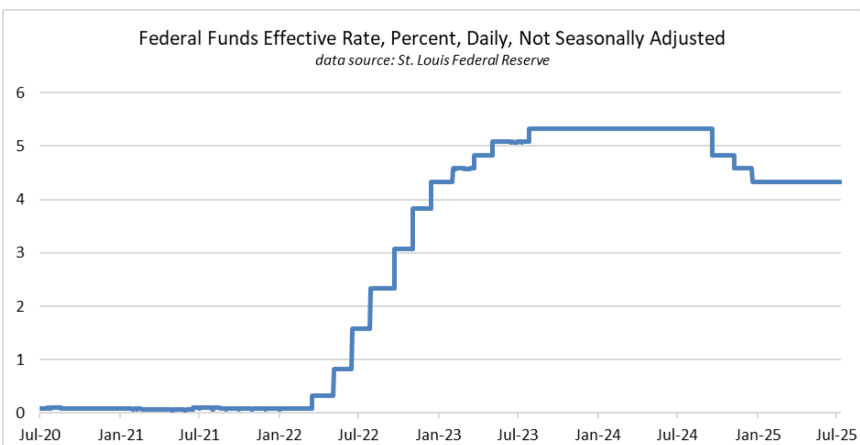
July 2025

Returning to Stability

We concluded last quarter's Perspective with the cliché, "April showers bring May flowers." Following a significant decline in equity markets, exceeding 10%, in response to President Trump's tariffs early in April, the President adjusted the timing of tariff implementation and initiated negotiations with individual countries, offering them the opportunity to reach a reasonable settlement. As a result, this change in direction relieved stress on financial markets, and a recovery rally ultimately took equity markets to record highs by the end of June. The moral of the story is that unexpected events, in this case political, led to both a dramatic decline in stocks and then a sudden reversal to new highs, giving greater credence to staying the course when the underlying fundamentals remain intact. What are those fundamentals that have provided support for both the stock and bond markets? Let's briefly identify the factors that can keep the market rising for the balance of 2025.

Interest Rates

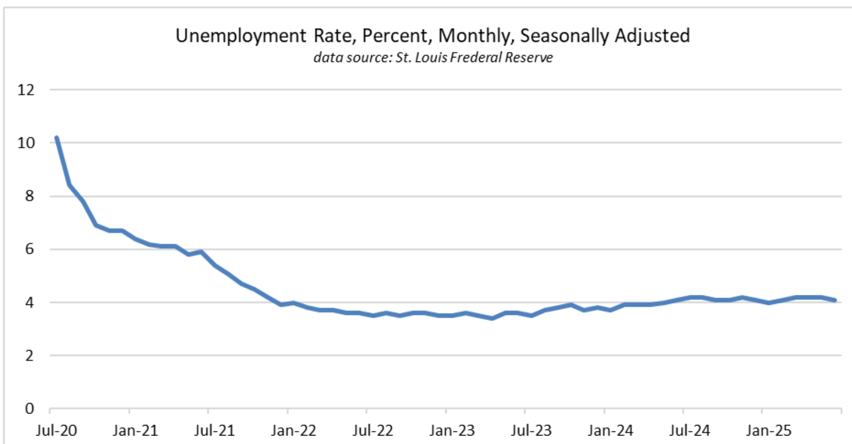
For the past year, market participants have been forecasting significant reductions in the fed funds rate, the rate that the Federal Reserve sets to impact the economy. While some forecasters expected up to six cuts through 2025, those expectations have dwindled to two or less because the Fed has kept interest rates steady (rates were lowered to a target of 4.25-4.5% at the December meeting as you can see in the chart below). Two major concerns when conducting monetary policy are inflation and the unemployment rate. The reason the Fed has not reduced the rate this year is a combination of reasonably good inflation data, although not to the level the Fed has targeted. Additionally, the expected rise in unemployment has not materialized, with the latest report indicating a decline in the unemployment rate to 4.1%, down from 4.2%. The related underlying strength in the economy has kept the Fed from lowering rates further. Only a few forecasters expect the Fed to keep rates steady, given that most economists expect the Fed's next move to be to lower rates.



There is a good possibility that the stabilization of interest rates has benefited the economy. When the Fed lowers or raises interest rates, mainly when those decisions occur quickly, it undermines the ability for businesses and consumers to plan. When the Federal Reserve raises interest rates to slow down the economy, it increases the income of lenders, who may, in turn, increase their spending to some extent, thereby offsetting the Fed's objectives. When the Fed lowers rates to stimulate the economy, it also reduces the income of savers, who may then curtail spending and limit the effects of Fed easing. By keeping rates steady, both borrowers and savers understand the environment that they are in and can plan accordingly. This stability could be good for the economy. So far, stability has been beneficial to financial markets.

Employment

Ever since the Fed began to tighten monetary policy (raise the fed funds rate), there was concern that such a policy would slow the economy and increase unemployment. Surprisingly, that has not happened in this business cycle, as you can see in the chart below. Unemployment has remained low during this period of restrictive monetary policy, leading to reluctance on the part of the Fed to lower interest rates, a step typically taken when unemployment rises. There are still broad concerns that the economic policies emanating from the Trump Administration, i.e., dramatic tariff increases and mass deportations of illegal immigrants, will cause unemployment to skyrocket. So far, we have not seen any evidence of this expected rise in unemployment. Many job openings should keep the unemployment rate at bay, although there has been a pickup in the number of layoffs announced by major corporations.

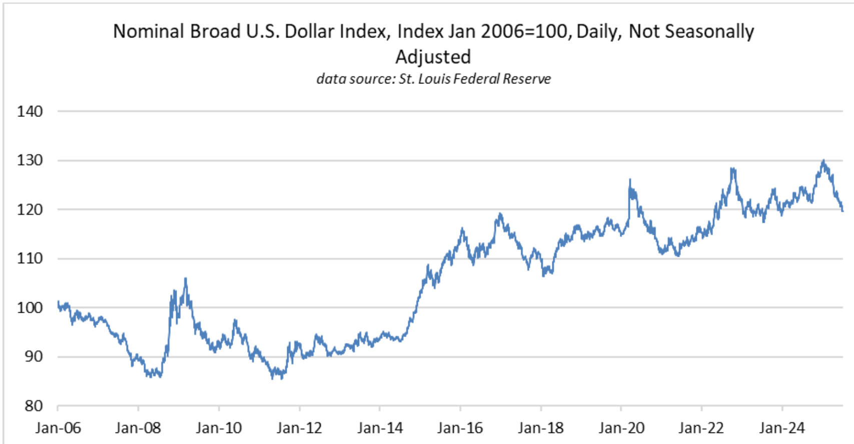


In the long term, the challenge will be evaluating the benefits of artificial intelligence and how it will impact unemployment, while also considering the prospect of new jobs created by the advances generated by AI. The commitment of billions of dollars by major corporations to build data centers will expand the knowledge capabilities of AI, create jobs, as well as generating output from these data centers. President Trump's aggressive tariff program is encouraging many companies to relocate their operations to the U.S., thereby increasing demand for workers. The expulsion of many illegal immigrants will also lessen the pressure to include such illegals in the unemployment rate calculations. Additionally, from a demographic perspective, approximately 10,000 people retire in the U.S. every day. They are not counted as unemployed. However, the replacement of these retirees should be reflected in increased employment. Taken together, these factors should provide stability in employment.

The U.S. Dollar

An essential component of the trade equation is the value of the U.S. dollar. As with the value of stable interest rates, a stable dollar value is a crucial component of world trade due to its dominance as the world's primary reserve and transaction currency. Most central banks hold U.S. dollars as their primary reserve asset, as it provides liquidity and is considered a safe-haven currency, especially during times of global uncertainty. Countries also use dollar reserves to stabilize their currencies and meet international obligations.

Recently, the trade debate has hurt the value of the dollar, although the long-term trend has been positive, as shown in the chart below. In the future and given the uncertainty of the overall trade war's outcome, the dollar should serve as a good indicator of the U.S.'s standing in this conflict. A continued decline in the value of the dollar relative to other currencies suggests that tariffs are eroding our global competitive position.



Corporate Profits

Even in the face of tariff uncertainties, corporate profits have continued to trend upward. Pressured by the impact of across-the-board tariffs, companies are moving quickly to insulate their income statements from the effects of tariffs. In the face of this challenge, companies have responded quickly to maintain their profitability. Another important factor affecting profitability is the implementation of artificial intelligence. The technology of AI is moving faster than we realize, and the impact on corporations will depend on how quickly companies recognize the opportunities in AI implementation. The impact of tariffs on individual companies and their stocks remains, but the day-to-day shifts in levy levels and tariff targets keep us guessing about what the implementation of these duties will mean for specific industries and companies.

Global Instability

The economic consequences of trade wars cannot be estimated, but any tariff can undermine economic growth. However, the rise in global tensions, both economic and defense-related, is having a long-term beneficial effect on the economy and financial markets. The strong equity markets in Europe this year could be due to the pressure from the U.S. to increase military spending, which stimulates the manufacturing sector. The threat of tariffs is also forcing governments to rethink their ability to improve domestic productivity. For example, European governments are waking up to the risks of conflict and the need to focus on self-defense. Such efforts will contribute not only to individual companies' bottom line but to overall economic growth in those countries.

On the other hand, the Israeli/Hamas war appears to be winding down, and the bombing of the nuclear facilities in Iran substantially reduces the threat of a "nuclear Iran." The Russia/Ukraine conflict continues with no end in sight, and the upgrading of Ukraine's defensive capabilities with contributions from both the U.S. and NATO suggests that the conflict will continue given the intransigence of both participants.

Conclusions

April was a key month for equity markets, as surprise announcements about global tariffs pushed broad market indices into bear market territory. When President Trump backed off many of his tariff threats, markets rallied sharply. The strong underlying economy provided a foundation for a continued rally into late June, as broad market indices rallied to new highs, surprising nearly all professionals who had been forecasting a recession-related market downturn. Many of these forecasters still expect a recession, based on the impact of tariffs. As we examine various indicators, we do not see a recession on the horizon, and the stability of many key market indicators suggests that a recession is unlikely. Unfortunately, the threat of larger tariffs or retaliation from our two largest trading partners, Canada and Mexico, could undermine the chances for continued growth for the rest of the year.

In such an environment, equity markets are likely to react quickly to any essential economic news relating to the implementation of tariffs. For most of this year, interest rates have remained stable as the Federal Reserve continues to adopt a wait-and-see approach to lowering interest rates. If corporate profits continue to rise—as they have been- equity markets should perform reasonably well for the balance of the year.