



Back to Fundamentals

What a quarter that was! The “Liberation Day” tariff announcements came on just the second day of the quarter, causing the S&P 500 to fall nearly 11% over the next three trading days. US stocks were already in a correction prior to the tariff announcement, and they ultimately bottomed on April 8th down almost 19% from their high. The pause in tariff implementation provided the catalyst for the market to turn around, and the S&P 500 ultimately ended the quarter up 10.5%.

The performance we were seeing across US assets early in the quarter was concerning. US stocks, bonds, and the dollar were all selling off simultaneously. During normal stock market corrections, we would expect to see more solid performance in bonds as investors seek a safe haven. Likewise, when bonds sell off (and their yields rise), we would expect to see support for the dollar as foreign investors are incentivized to purchase US bonds. To the contrary, the dollar lost -5.7% in value during the first three weeks of the quarter. The simultaneous decline in value of all these US assets was alarming, and we erred on the side of caution in light of this.

To a greater extent than usual, policy proposals in Washington have influenced stock and bond market performance during the first half of the year. Several policies have been publicly proposed only to be delayed, changed, or abandoned shortly thereafter- often after sharp market reactions. This is driving investors to largely ignore the bluster until policies are finalized and there is a growing belief that any economically damaging proposals won't actually be pursued.

It therefore appears that we are heading back to an environment where corporate earnings, interest rates, and economic growth are driving market performance rather than rhetoric from Washington. Let's take a look at the economy and interest rates the way the Fed does, through the lens of inflation and employment.

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Index	Q2 Total Return	YTD Total Return	1 Year Total Return
S&P 500	10.5%	6.2%	14.9%
DJIA	5.5%	4.6%	14.6%
Nasdaq Comp	16.9%	5.9%	14.7%
MSCI EAFE	12.0%	20.9%	18.7%
Russell 2000	8.5%	-1.9%	8.5%
US Aggregate Bond	0.9%	4.1%	6.7%



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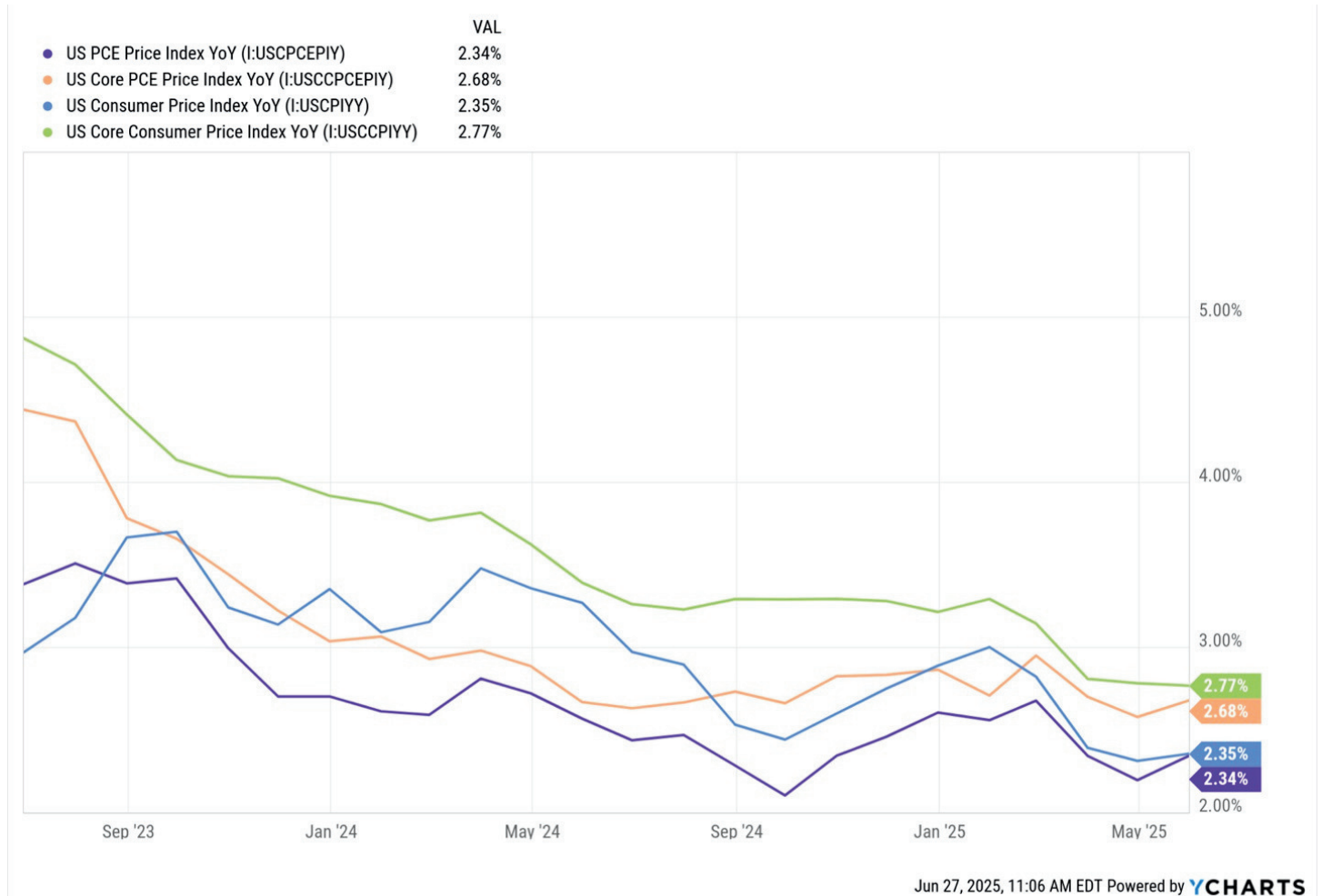
SPECIAL POINTS OF INTEREST

- If you would like to schedule a meeting for planning or portfolio questions, don't hesitate to contact us!
- Q3 Market & Office Closures:
 - Independence Day - July 4th, 2025
 - Labor Day- September 1st, 2025

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Inflation

While there has been substantial fear amongst economists and in the markets that tariff policies could cause inflation to reaccelerate, we haven't yet observed it in the data.



As you can see in the chart above, all four of the most followed inflation indices are slowly moving lower. While that is welcome news, we still see some risks here.

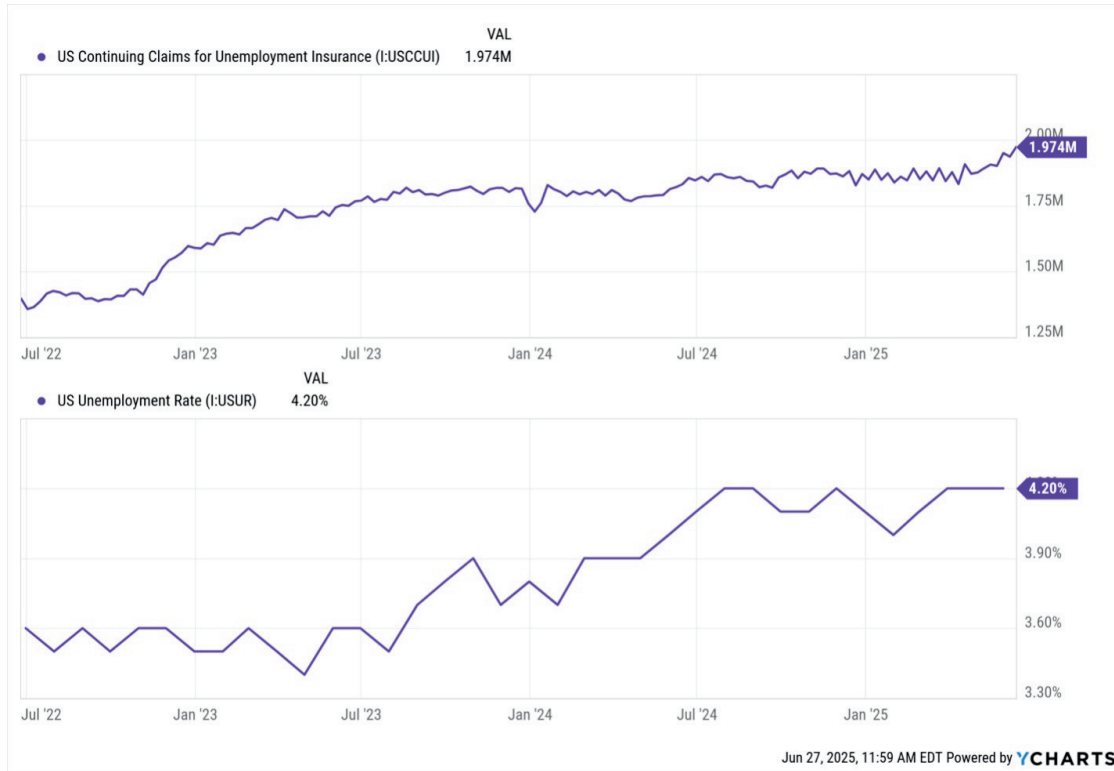
- All four measures remain above the Fed's 2% target, and core inflation (which excludes the volatile food and energy categories) is higher than the overall numbers for both CPI and PCE. This means that the overall numbers are being dragged down by food and energy- the two categories with the highest potential to reaccelerate.
- There will be upcoming "base effect" issues for both CPI and PCE. For example, CPI showed month-over-month inflation of 0.0%, 0.0% and 0.1% in May, June, and July of 2024, respectively. As these numbers roll off, the headline year-over-year numbers will likely rise.
- It's possible that it's still too early to observe the price effects of tariffs.

If the last several years taught the Fed anything, it's that people detest inflation. In fact, most would rather experience a recession than a bout of inflation. Furthermore, we haven't seen year-over-year inflation below the Fed's target since February 2021. For these reasons, barring a rapid deterioration in the labor market, we believe the Fed is unlikely to lower interest rates significantly. We may still see one or two interest rate cuts before the end of the year, but we believe rates are within about 0.5% of where they should be.

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Employment

The labor market still appears to be healthy, but it has weakened over the past 18 months. The following charts show continuing claims for unemployment insurance and the unemployment rate, both of which are rising.



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It's unclear precisely what is driving this. The increase in the unemployment rate is not being driven higher by new entrants to the labor market (the best cause of a rise in unemployment). Businesses hoarded labor after COVID, so they may be trying to right-size their payrolls now. It's also possible that some companies are downsizing their staff to maintain profit margins in a higher tariff environment. Finally, many businesses (especially the more technology-focused ones) have drastically restricted new hiring as they integrate AI. Managers in these businesses are being asked to prove why the job can't be done by AI before they can hire an employee.

Neither of these numbers is currently at a concerning level- continuing claims is almost exactly at the 5-year pre-pandemic average, and most economists consider unemployment around 4% to be healthy. However, the trend is higher in both, and we don't want to see further deterioration here.

Looking Forward

Tariffs are clearly still on the minds of corporations and economists. American importers currently face an average tariff rate of around 15% - about 5 times the level at the beginning of the year. This is substantially higher than most investors and economists predicted, but the market is telling us that it's not so onerous that businesses and the economy can't handle it. Furthermore, there appears to be room for negotiation and flexibility on tariffs, which may lead to lower import tax rates in the future.

As we wrote about in the first quarter newsletter, foreign stocks have performed very well year-to-date, though US stocks started staging a comeback over the last two weeks. We added to client positions in international developed market stocks (IDEV and CB) throughout the quarter. Still, we are hesitant to build much larger positions in foreign stocks given the growth prospects for US companies versus those of their foreign peers. Nevertheless, the year-to-date outperformance of foreign stocks has caused us to lag some of our benchmarks over the shorter term. We continue to be pleased with our strategy on the bond side of portfolios.

Overall, it seems that the economy and corporations are still on relatively solid footing. First quarter earnings looked fine, and we aren't seeing anything in the economic data that indicates an imminent problem. We're attuned to the risks we discussed, but we feel it's prudent to be fully invested until something changes.

Twin Deficit Dilemma

We wrote about the twin deficits hypothesis on our blog in 2018- the last time tariffs and the trade deficit were in the headlines. We got some questions about this again recently during meetings with clients so we thought it would be helpful to share an updated version of this blog.

While we try to avoid commenting on politics, we thought it might be useful to discuss the economics behind some of the policies currently being debated in Washington. Populist views on both sides of the aisle consider the trade deficit (the United States importing more goods than we export) a bad thing for American workers and something in need of correction. At the same time, Congress has continued to avoid addressing our federal budget deficit which is at a high level historically (outside of wars or severe recessions). The twin deficits theory tells us that it will be difficult to address the trade deficit without also addressing the budget deficit.



When US companies import goods, they are in effect exporting US dollars to foreigners. Here's another way to look at the trade deficit: the US is a net exporter of dollars. Since foreign US dollar holders buy fewer American made goods than the dollars they hold, foreigners use the surplus cash to buy US stocks and bonds (many of which are treasuries that finance the federal government). To simplify- our trade deficit helps enable our budget deficit. Likewise, the trade deficit benefits American investors by allowing more foreign purchases of US stocks or other assets.

Let's imagine we eliminated the trade deficit overnight. It's possible that as foreign buying of US treasuries dried up, the price of bonds would fall causing the yields to rise, which would attract more domestic buyers and enable future budget deficits. The problem with this scenario is that this could dramatically increase the cost of government borrowing. The interest cost on our debt is already near an all-time-high as a percentage of the federal budget, so this is probably not a desirable outcome. Furthermore, this would require Americans to save more and consume less- again probably not a desirable outcome.

Neither trade deficits nor budget deficits are inherently bad on their own. In many ways they are two sides of the same coin; but policies that ignore this relationship altogether are likely to be either fruitless or costly.



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