



2Q25 Market Review: Suddenly It's a Folk Song

Though the early-April “Liberation Day” tariffs announcement struck a discordant note, a delay in the most punitive levies proved to be sweet music to investors even as trade noise continued to reverberate throughout the quarter.

The “sell America” stock trade that emerged in mid-February reached a crescendo with Trump’s April 2 announcement of (not actually) “reciprocal” tariffs on trading partners the world over. Major equity indexes globally turned sharply lower, with the S&P 500 Index losing more than 15% in only a few days. Though trade issues remain unresolved, easing tensions were enough to draw investors back to the markets, and growth names helped drive the S&P 500 to a 10.9% quarterly return and a new record high.¹

While not immune from the April selloff, non-US markets continued their surge amid the relative calm that followed, and the MSCI EAFE Index delivered an 11.8% gain in the second quarter. Year to date, the MSCI EAFE has outperformed the S&P 500 by more than 1,300 basis points as the US dollar weakened sharply.²

KEY TAKEAWAYS

- While there are signs of equipoise in the economy, we believe the potential for resurgent inflation—likely emanating from the labor market—remains significant and underappreciated by investors.
- The combination of shrinking labor-force growth and ongoing fiscal largesse threatens to reignite wage pressures in still-tight labor markets.
- The tariff drama and other Trump administration contributions to global dis-ease have prompted a broader rethinking of fiscal policy among economies worldwide.
- Historically, US dollar weakness has coincided with periods of relative outperformance by non-US stocks. This trend has been evident year-to-date 2025.

1. Source: FactSet; data as of June 30, 2025.

2. Source: FactSet; data as of June 30, 2025.

Are US Markets Equipoised for Success?

With valuations and spreads having returned to pre-Liberation Day levels, risk perception in the equity and bond markets appears to reflect an economy in equilibrium—or what John Williams, president of the New York Fed, has described as “equipoise.”³ For a central banker, this state suggests a balanced labor market and target-level inflation. And while there is evidence of equipoise in the current environment—job vacancies are in line with unemployment levels, for example, and inflation metrics have fallen markedly—investing by this narrative disregards the high levels of risk that we believe persist, especially the risk of renewed inflation pressures.

In our view, the labor market is the epicenter of this risk due to a supply shock we see looming in the not-too-distant future. The natural increase in the US population—that is, the difference between births and deaths—has been in decline for much of the twenty-first century as Baby Boomers age and Americans have fewer children, though this has been more than partially offset by net immigration. Assuming the Trump administration maintains its aggressive approach to immigration—monthly Immigration and Customs Enforcement (ICE) detentions are running around 300% higher than pre-Trump levels, and a sharp decline in arrests at the border suggest fewer crossing attempts—this labor source is likely to shrink dramatically.⁴ With the recently signed tax and spending bill allocating \$100 billion to ICE through 2029—its budget for fiscal 2025 was \$10 billion—this seems like a fairly safe assumption.⁵

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And while the labor market may be in balance today, its equilibrium was achieved at levels tighter than have been typical of past cycles. Labor utilization is near historical highs, wage growth is above its long-term average, and the unemployment rate is well below average. Job openings receded sharply over the past three years but have since plateaued well above the pre-pandemic trend and have inflected upward in recent months.⁶

We’ve noted in previous commentaries that we believe the resilience of the labor market throughout the Fed’s rate-hike cycle was due at least in part to the massive fiscal stimulus of the Covid-19 era. The nominal rebasing of the economy that resulted from the government’s debt spree helped bolster corporate profits in the face of monetary tightening, supporting a moderation in payrolls growth rather than an outright contraction. With financial conditions again accommodative and the accumulation of public debt unrelenting, corporate profits and profit margins have been biased higher, and historical data suggest that job openings are likely to follow suit. Introducing more jobs into a stagnant labor pool is a potential spark for wage inflation.⁷

Fiscal Tap Opens Globally

You would expect an economy in equipoise to have a primary balance of zero and a total deficit equal to the interest expense on debt, which for the US is currently around 3% of GDP. As a result of loose fiscal settings, however, the US federal deficit stands around 6.5% of GDP, or 3.5% more than would seem necessary. With a baseline cost of \$3.0 trillion over the next 10 years, Trump’s tax and spending bill is forecast to widen the deficit still further, to 6.9% of GDP by 2034; were the temporary tax cuts in the bill to be extended or made permanent, as they often are, the cost increases to \$3.7 trillion and the deficit to 7.3%.⁸ In recognition of the increased inflation risk this represents, interest rates have broken out to the upside, with the 30-year Treasury around 5%—a level it hasn’t seen consistently since before the financial crisis.⁹

3. Source: Federal Reserve Bank of New York; data as of February 11, 2025.

4. Source: Haver, US Customs and Border Protection; data as of May 30, 2025.

5. Source: Bloomberg; data as of July 6, 2025.

6. Source: Federal Reserve Bank of St. Louis; data as of July 1, 2025.

7. Source: Bloomberg; data as of June 30, 2025.

8. Source: Yale Budget Lab; data as of July 1, 2025. This also assumes the backloaded spending cuts—largely to Medicaid—are enacted by a future Congress and president; if not, the deficit would be even larger.

9. Source: Federal Reserve Bank of St. Louis; data as of June 30, 2025.

The dismal fiscal situation presents the US with a double bind. Doing nothing to address the trajectory of debt will likely increase the risk of inflation and push interest rates still higher. Taking action to curb it, such as generating additional revenue through tariffs, will likely increase the risk of a recession and wider credit spreads. In other words, both inaction and action increase the risk of tighter financial conditions, to the likely detriment of risk assets.

Notably, all of the US tariff drama and its associated rhetoric has prompted a broader rethinking of fiscal spending among policymakers globally. Germany's new governing coalition spearheaded legislation to permanently exempt defense spending above 1% of GDP from its restrictive constitutional debt brake and created a €500 billion infrastructure fund, allowing the European country with the most fiscal space the flexibility to deploy it.¹⁰ NATO countries agreed to raise annual defense spending to 5% of GDP by 2035.¹¹ China has emphasized the need to boost consumption in the face of external threats like the escalating trade war with the US; indeed, Chinese spending growth during the first quarter was sharply higher at both the federal and provincial levels, leading some analysts to increase their expectations for 2025 economic growth.¹²

Easy fiscal policy as a global phenomenon may help dislodge the notion of US exceptionalism, but it also presents its own set of risks to monetary stability. That said, equity market valuations suggest risk compensation is better in non-US markets than in US markets, including far higher earnings yields.¹³ Year-to-date relative performance suggests that investors may have begun to take notice.

Shifts in the value of the US dollar compared to other major currencies has been a key factor influencing relative equity performance across cycles, with US equities tending to outperform during periods of dollar strength and non-US stocks leading during periods of dollar weakness.¹⁴ The latter dynamic has been intact thus far in 2025 as real interest rate differentials favoring US investment have begun to ease.¹⁵ While the duration of the dollar's current pullback can be measured only in months, there are reasons to believe further weakening is possible. At levels not seen since the mid-1980s, the dollar remains exceptionally strong relative to its trading partners, even after recent weakening in our view, and decisions by foreign investors to trim oversized US exposures in favor of home-grown assets could further weigh on the dollar while boosting their domestic markets.

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Resilience Remains in Focus

With Trump's July 9 deadline for trade deals extended to August 1 and a steady flow of ad hoc sector and country tariffs—copper and Brazil, Canada and the European Union, most recently—trade policy very much remains a moving target. Meanwhile, the combination of diminishing growth in the US labor force and ongoing fiscal largesse threatens to reintroduce wage inflation to markets seemingly detached from risk. And we didn't even mention the escalations of military conflict in the Middle East and Ukraine or any of the many other sources of geopolitical strife.

With clarity in short supply, we highlight the importance of exposure to assets that have the potential to demonstrate resilience across multiple states of the world.

10. Source: Reuters; data as of March 21, 2025.

11. Source: NATO; data as of June 27, 2025.

12. Source: Bloomberg; data as of May 20, 2025.

13. Source: Bloomberg; data as of June 30, 2025.

14. Source: Bloomberg; data as of June 30, 2025.

15. Source: Haver Analytics, national central banks, US Bureau of Industry and Security, US Bureau of Economic Analysis; data as of May 31, 2025.

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