Leading or Just Misleading?

Quick Look

- U.S. stocks gained 11% on the quarter, rallying from from a 19% drawdown to new all-time highs in just over 50 days despite the overhang of tariff uncertainty, budget concerns, and geopolitical events.
- Economic data has been deteriorating since the Inauguration, but it is only apparent in leading indicators, which are broadly considered softer data that is used to project turning points in a business cycle.
- The reemergence of diverging leading and coincident/lagging indicators stems from fiscal policy uncertainty.
- First quarter earnings were excellent, as companies saw 13% growth, well above expectations. The Mag-7 companies continue to be the primary driver of earnings growth.
- Both the ISM manufacturing and services surveys portray challenging conditions, with respondents noting uncertainty contributing to softening demand, supply chain disruptions, and higher costs as suppliers pass through tariff costs.
- The coming quarter should bring more clarity to policy uncertainty and ultimately narrow the gap between lead and lag indicators.
- Risks are certainly present, but things are looking much better than two months ago. In the near-term, odds are favorable that inflation will pick up, though not to the extent of 2022 levels.

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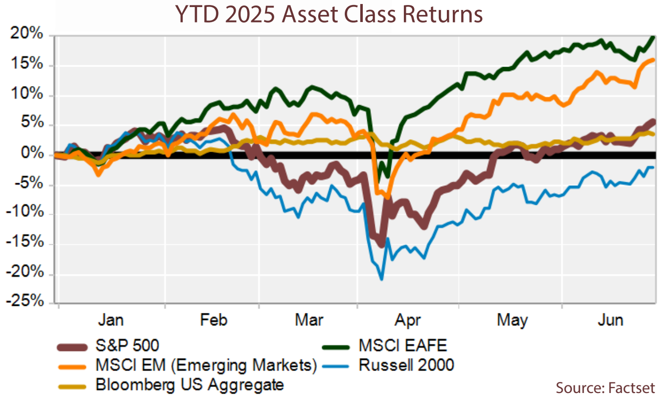
Quarterly Investment Letter, Q2 2025

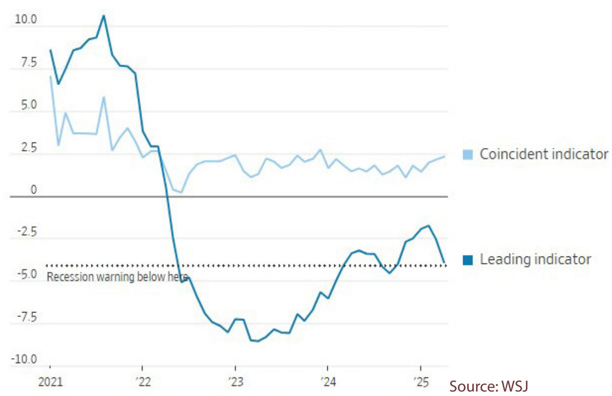
The headline will read a 11% gain for U.S. stocks this quarter, but that does no justice in recounting the remarkable twists and turns of the past three months. Stock market weakness that began in late February rapidly escalated in response to President Trump's April 2nd "Liberation Day" announcement of higher tariff rates, culminating in a 19% drawdown for the S&P 500 Index. The stock market bottom coincided with the President's decision to walk back peak tariff rates, triggering a V-shape "wall of worry rally" that saw stocks surge 28% in just over 50 days despite the overhang of tariff uncertainty, budget concerns, and geopolitical events. In football terms, this past quarter was like a snap that sailed over the head of the quarterback, who then managed to recover the fumble, break some tackles, and surprisingly scramble for a first down.

YTD 2025 Asset Class Returns



This dizzying theme carries over to the broader economy as well; headline data looks solid, but the data under the surface is a bit messier. As seen in the chart in the next column, leading economic data has been deteriorating since the Inauguration; this softer data is used to project turning points in a business cycle. The current environment is giving off similar vibes to three years ago, where previous tried-and-true leading indicators were flashing warnings of a pending recession which ultimately never materialized, thanks to pandemic-era factors that distorted economic data. This year's reemergence of diverging leading and coincident/lagging indicators stems from fiscal policy uncertainty. Let's dive into this divergence, starting with the coincident/lagging indicators that reflect the present state of the economy.

Leading vs Coincident Indicators Are Diverging Again



GDP: Admittedly, growth contracted -0.5% in the first quarter, but that was driven by the abrupt change in U.S. trade policy. Net exports subtracted nearly five percentage points from headline GDP, the largest quarterly trade drag on record. Second quarter GDP currently projects to rebound 3.5% thanks to a reversal in net exports, as companies front-ran imports ahead of Liberation Day. Adding the two quarters together brings the projected first-half total to 1.5% growth, roughly in line with the Fed's growth forecasts. Headline GDP suggests the economy continues to grow, but at a slower pace than in 2024 amid signs of weakening consumer spending.

Employment: The monthly payroll reports continues to show steady job gains, even if those gains continue to be mostly concentrated within the health care, hospitality, and local government sectors. Layoffs have not noticeably accelerated, as the four-week moving average of initial jobless claims of 245,000 is roughly the same level as a year ago. While the recent rise in continuing claims and the struggles of recent college graduates in finding employment suggests companies are more reluctant to hire, they are at least retaining their current employees as they await more clarity from Washington.

U.S. EQUITY RETURNS (%)

As of 6/30/2025	Q2 2025	YTD 2025	1-Year	3-Year	5-Year	10-Year
S&P 500	10.9	6.2	15.2	19.7	16.6	13.6
Russell 1000 (Large Cap) Growth	17.8	6.1	17.2	25.8	18.2	17.0
Russell 1000 (Large Cap) Value	3.8	6.0	13.7	12.8	13.9	9.2
Russell 2000	8.5	-1.8	7.7	10.0	10.0	7.1
Russell 2000 (Small Cap) Growth	12.0	-0.5	9.7	12.4	7.4	7.1
Russell 2000 (Small Cap) Value	5.0	-3.2	5.5	7.5	12.5	6.7

Source: Morningstar

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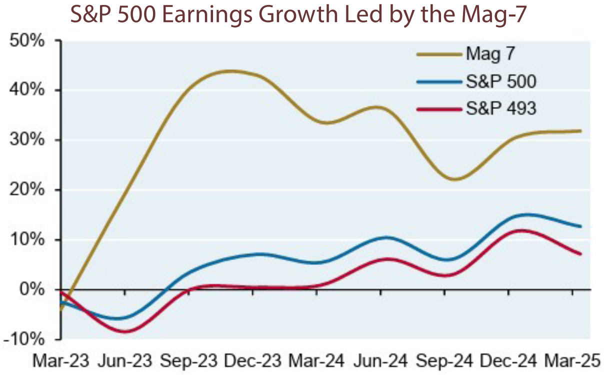
Inflation: Consumer prices have been subdued over the last four monthly reports, with the last report showing prices rose just 0.1%, less than was expected. Headline inflation has fallen to 2.4% over the last year, while core inflation has dropped to 2.8%. Both the Federal Reserve and most economists expect inflation numbers to begin to rise in the coming months in response to tariffs, but thus far, there is no hard evidence of increasing price pressures.

Corporate profits: First quarter earnings were excellent, as companies saw 13% growth, well above expectations. As seen in the chart below, the Mag-7 companies continue to be the primary driver of earnings growth, collectively growing 28% last quarter, while the other 493 companies in the S&P 500 Index grew 7%. The gap between Mag-7 earnings growth and the rest of the Index is expected to narrow as the year progresses in part due to cost headwinds from tariffs, but to this point, the Mag-7 growth machine keeps steamrolling, and their collective earnings surprise helped to propel the recovery in U.S. stocks this quarter.

S&P 500 Earnings Growth Led by the Mag-7

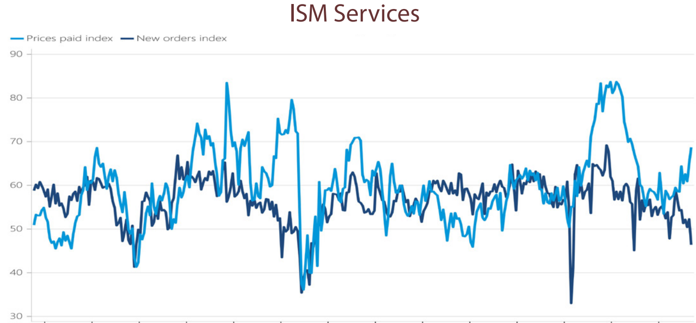


Source: JP Morgan

Now on to the softer-data leading indicators, which are used to signal where the economy is headed.

Business Surveys: Both the ISM manufacturing and services surveys portray challenging conditions, with respondents noting uncertainty contributing to softening demand, supply chain disruptions, and higher costs as suppliers pass through tariff costs. The chart below graphs both new orders and prices paid from the services survey. The dark blue line has fallen below 50, which means new orders are contracting. Meanwhile, the prices paid component (the light blue line) has risen to nearly 70, signaling that price pressures are mounting.

ISM Services



Source: WSJ

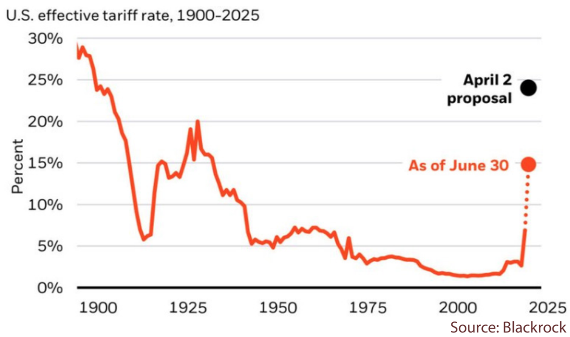
Consumer Surveys: Though it improved in June, consumer sentiment remains 20% below its December 2024 post-election bump, as concerns namely with inflation expectations have sentiment at levels associated with recessionary periods. That said, it is fair to wonder if surveys have become so partisan that they have lost their usefulness, as there is a clear delineation between Republican and Democrat respondents. While a political gap has always existed in sentiment surveys, it has noticeably widened over the last ten years as our nation has become more divided.

Building permits: Used as a sign of future residential construction activity, building permits have declined 8% over the past six months, while housing starts are down 5% on the year. Home-builder sentiment has sunk to three-year lows as long approval delays, rising lumber and material prices from tariffs, and 7% mortgage rates are keeping builders on the sidelines, particularly small-company home builders.

Stock Prices: Perhaps the most leading of all lead indicators, the S&P 500 Index reflects the current sentiment of investor expectations on future corporate cash flows. While profits drive long-term stock market returns, sentiment steers short-term market fluctuations. This quarter's abrupt market recovery included a rotation back into the high-volatility, high-momentum, growthier, and somewhat lower-quality stocks that worked so well in the period post-election to pre-Inauguration. This shift in investment sentiment dovetails with the notion that the President's on-again, off-again tariff policies are more bark than bite, so much so that the recent rally became known as the TACO trade (feel free to look up that acronym).

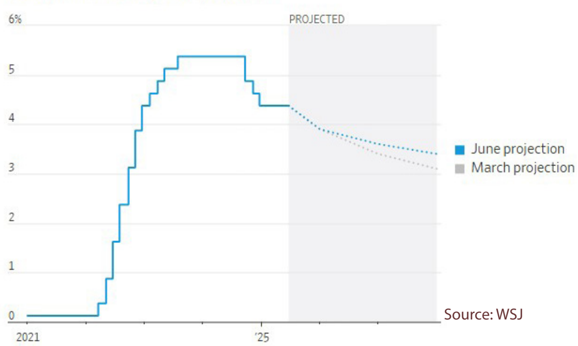
Speaking of tariff policy, reciprocal tariffs are scheduled to go back into effect on July 9, while the reduction for tariffs on China rolls off August 12, though markets are betting that these dates are subject to change. In late May, the U.S. Court of International Trade ruled to block Trump's tariffs, but then the U.S. Court of Appeals quickly countered to keep tariffs in place. If the President's tariff policy is ultimately ruled an overreach, there are still workarounds the Administration can use to reinstate tariff rates, but they would be temporary and would need to be implemented with each country. For now, the baseline seems to be a 10% universal tariff and 30%+ on China, bringing the effective tariff rate to approximately 15%. This is well above last year's 2% effective rate and would be the U.S.'s largest since 1939. Tariff uncertainty remains an overhang, though the 15% seems at least more palatable than the peak rates being threatened on Liberation Day.

Tariff Rates Have Surged, but are Down From Liberation Day



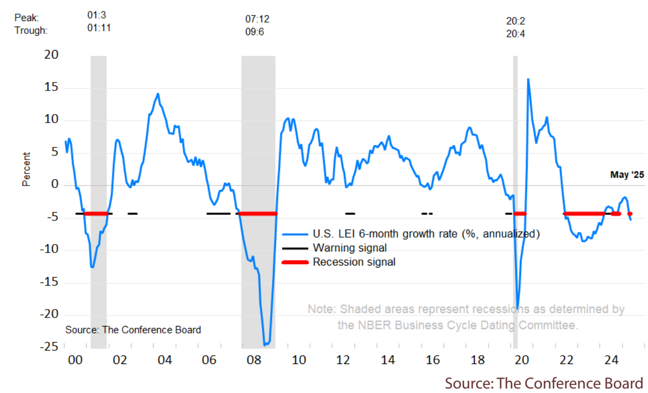
Since cutting rates one full percentage point last fall, the Federal Reserve has held rates steady this year as it awaits more clarity regarding the economic impact of tariff policy. Fed Chair Jay Powell has admitted that the Fed's current rate policy is probably too tight if judged strictly on the hard data, but the soft data has kept them cautiously on the sidelines while waiting to see what manifests. Powell has stated that the next couple of months should begin to reflect the tariff impact on prices and labor markets. At the June meeting, the Fed lowered its near-term growth outlook and increased its inflation expectations. The Fed's dot plot still points to two rate cuts by the end of the year, though nearly as many Board members thought zero cuts were just as likely.

Fed Funds Rate Target: Further Cuts Expected



The coming quarter should bring more clarity to policy uncertainty and ultimately narrow the gap between lead and lag indicators. The glass-half-empty view would be that the lagging data is out of date and propped up by inventories companies stocked up pre-Liberation Day, and that tariffs will soon push prices higher and weaken demand, trimming corporate profits and increasing job losses, particularly for small businesses. The glass-half-full view is that the sentiment-driven soft data was debunked as useful three years ago and just a continuation of our 2020's-era Vibecession, where gloom persists contrary to solid economic growth.

Leading Indicators Are Signaling Recession



In our view, the truth will likely be somewhere in the middle as this data begins to converge in the coming quarters. Risks are certainly present, but things are looking much better than two months ago. In the near-term, odds are favorable that inflation will pick up, though not to the extent of 2022 levels. The economy most likely muddles through as tariffs weigh on growth, but recession odds have come down from the 50/50 scenario of mid-April.

Given the commotion and volatility that has unfolded year-to-date, investors might be pleasantly surprised with portfolio returns halfway through 2025. U.S. large stocks are up 6% while U.S. small stocks are down 2% on the year. U.S. bonds have gained between 3% to 4% depending on index. International stocks, boosted by a 10% decline in the U.S. dollar, have performed best, as Developed International stocks are up nearly 20%, while Emerging Markets have gained 15%. All told, most investors should find themselves with positive mid-single digit gains as they enter the second half of the year.

INTERNATIONAL RETURNS (%)

As of 6/30/2025	Q2 2025	1-Year	3-Year	5-Year	10-Year
Int'l Developed ex US	11.8	17.7	16.0	11.2	6.5
Emerging Markets	12.0	15.3	9.7	6.8	4.8

Source: Morningstar

FIXED INCOME RETURNS (%)

As of 6/30/2025	Q2 2025	1-Year	3-Year	5-Year	10-Year
Aggregate Bond	1.2	6.1	2.6	-0.7	1.8
Muni	0.3	1.6	2.6	0.7	1.9
Int'l Bonds	4.9	9.2	4.2	0.4	1.3
High-Yield	3.3	9.1	9.1	5.6	4.5
Short-Term	1.6	6.5	4.6	2.2	2.2
90-Day T-Bill	1.1	4.7	4.9	3.0	2.1

Source: Morningstar

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