Economic Commentary

After a steep sell-off and volatility resulting from Liberation Day, the majority of Q2 2025 was marked by a strong recovery rally driven by easing trade tensions, stronger-than-expected corporate earnings, and modest inflation readings. Additionally, a geopolitical flare-up between Israel and Iran temporarily increased oil price volatility, but markets quickly stabilized. However, concerns resurfaced regarding fiscal deficits and the long-term sustainability of U.S. debt, amplified by Moody's downgrade of U.S. sovereign credit ratings. Despite negative headlines throughout the quarter, including a U.S. attack on Iran's nuclear facilities, equity markets marched toward all-time highs in conjunction with increasing fixed income yields on the longer end of the curve.

Domestic Fixed Income Markets

The most notable activity within fixed income came from longer-term yields, with 20- and 30-year Treasury yields rising above the psychologically critical 5% threshold following Moody's downgrade of U.S. sovereign debt due to escalating fiscal deficits, hitting their highest levels since 2007. The increase on long-term yields reflected heightened investor sensitivity toward rising U.S. budget deficits and fiscal policy concerns. Concerns were also fueled by the "One Big Beautiful Bill" which is likely to extend tax cuts and lower near-term tax revenue without a reduction in legislative spending, leading to further growth of the national debt. While the 20- and 30-year Treasuries increased 18 and 20 basis points, yields inside 10-years fell, with the 3-year Treasury falling 19 basis points, contributing to a steepening of the yield curve. Spreads, the additional yield earned on 10-year A-rated corporate securities specifically, widened to 109 basis points during the peak of the Liberation Day volatility before returning to 80 basis points by quarter end, indicating investor confidence in corporate creditworthiness.

Domestic Equity Market

After reaching all-time highs in mid-February, the broad equity markets were trending lower heading into the second quarter amid trade tensions and overall economic uncertainty. Tariff concerns dominated headlines in early April when Liberation Day led to more than a 12% correction in the S&P 500 across 4 trading days, marking a 19% decline from the recent peak. Those who "bought the dip" were rewarded this quarter, as the sharp sell-off was met with a huge recovery rally after Trump announced a pause in tariffs. As a result, U.S. equities staged a significant rebound with the S&P 500 gaining +10.9% in the quarter, bringing year-to-date gains to 6.2%. As was the case with previous quarters, the real winners were mega-cap growth and technology stocks, with the Nasdaq returning nearly 18% during the quarter, compared to small and mid-cap indices with 8.5% and 6.7% returns, respectively. Valuations remain rich, with the S&P 500's forward 12-month P/E (price/earnings) ratio finishing the quarter at 22.2, above the 5-year average of 19.9 and the 10-year average of 18.4.

Federal Reserve

At the June FOMC meeting, the Federal Reserve held the Fed Funds rate steady at 4.25%-4.50%, adopting a cautious "wait-and-see" approach amid inflationary risks associated with ongoing tariff concerns. The FOMC's most recent projections indicated a median expectation from Fed Members of only 2 cuts the second half of this year, for a Fed Funds rate of approximately 3.9% at year-end. The Fed's dual mandate, with the goal of both price stability and economic support, has continued to draw criticism from President Trump and his calls for lower interest rates. While employment numbers remain robust along with moderate inflation, jobless claims have been trending higher, signaling some potential economic softening. Futures markets are in line with the Fed’s expectations, also pricing in just 2 cuts through the rest of the year. However, similar to previous quarters, the markets are expecting additional cuts in 2026, pricing in a Fed Funds rate of 3.15% at year-end 2026, compared to Fed Members’ expectations of 3.625%.

Summary

Despite the ongoing negative geopolitical headlines worldwide, uncertainty around tariffs, elevated yields and rich valuations, the second quarter provided meaningful returns in both equity markets and fixed income. While the Fed is likely to cut rates, due to longer-term concerns over deficits and the national debt, it will likely lead to additional steeping of the curve, where shorter term rates fall while long term yields remain flat or potentially continue to trend higher. Given headline risk around wars and tariffs, coupled with elevated valuations, we fully anticipate ongoing volatility in equity markets, especially after such a strong rebound rally of nearly 25% on the S&P 500 since early April.