

Q2 Market Update

Market Commentary

The second quarter of 2025 saw a sharp reversal in the stock market drawdown that resulted from U.S. tariff threats in April. The S&P 500 increased 10.9%, notching a new all-time high at the end of the quarter.

International stocks held up much better than U.S. stocks during the tariff drawdown and remain ahead on a year-to-date basis. MSCI EAFE returned 11.8% for the quarter and is up 19.5% year to date. While certainly not the only reason, one contributor to this year's performance is the decline in the value of the dollar relative to other global currencies. Removing the effect of the dollar, the index is up 10.7% in local currency terms for the year.

The price of bonds, as measured by the Bloomberg Aggregate Bond Index, finished positive for the quarter, up 1.2%. This result came with notable volatility as the index saw four different periods where prices moved greater than 1.5% during the quarter. Ultimately, credit spreads tightened from their early April peak, short-term interest rates fell, and the 10-year U.S. Treasury note rate rose by 7 basis points. Much of the treasury rate volatility came as investors tried to incorporate the impact of tariffs and a new budget bill moving through Congress on inflation as the Fed plots a course for monetary policy.

The uncertainty regarding tariff policies manifested perhaps most vividly in commodity markets. News of tariffs on metals like steel and aluminium, production increases from OPEC+, and weaker industrial demand led to a 4% decline in the Bloomberg Commodity index despite gold returning more than 5% for the quarter.

Economic Outlook

While news persists of framework trade deals between the U.S. and key trading partners, significant uncertainty remains as individual sectors and countries receive disparate treatment. As the index closed the quarter at an all-time high, it seems the market is celebrating a lack of escalation in the trade war, rather than a resolution or softening of tariffs. Much of the short-term economic data remains distorted as a result of the potential changes to trade relationships. We did see some 'front running' of potential tariffs in the first half of the year, which pulled forward demand.

For the past year, the unemployment rate has oscillated between 4% and 4.2%, while Core PCE (the Fed's preferred measure of inflation) has increased by 3% or less on a year-over-year basis. While the Fed's mandate of 'full employment' does not have an

explicitly stated unemployment rate target, minutes from their meetings suggest that they are comfortable with the current level for now. On the inflation side of things, they would like to see inflation come down from between 2.5% and 3% to 2%. This suggests that monetary policy shouldn't become much more accommodative in the near term. However, markets are pricing in a greater than 50% probability of a rate cut in September. Ultimately, the economy has remained stronger than many expected just a few months ago, while inflation has remained stubbornly above the Fed's target. President Trump has continued to suggest that the Fed should significantly cut interest rates. However, unless the labour market weakens or inflation declines, the Fed may conclude that the case for meaningfully easing policy remains unconvincing.

S&P 500 valuations remain at very elevated levels, ending the quarter with a price-to-earnings ("P/E") ratio of 22 times the next 12 months' expected earnings. Comparisons to the tech wreck are almost becoming cliché, but it's worth noting that of the two prior periods we saw with greater than 21x multiples, the interest rate environment we're in now is most similar to the dot com bubble. While valuations can potentially remain elevated for a period of time, it's worth noting that the dot com bubble around 2000 was the only time we've ever seen P/E ratios for the market cross 23x, suggesting that any upside from valuations is probably quite limited from here. Long-term return data from periods with comparable starting valuations is limited but telling—forward 5-year returns have typically ranged from below average to negative, suggesting elevated valuations may pose a significant headwind to future performance.

Stock valuations outside of the S&P 500 are also generally elevated but do look more reasonable relative to historical levels. Small and mid-cap U.S. stocks are closer to their historical average valuation levels, but there are caveats – relative to the larger companies in the S&P 500, small and mid-cap stocks have a much higher number of unprofitable companies and lower profits relative to the interest payable on their debt. Valuations for foreign companies generally can be categorized as normal to slightly elevated relative to their historical levels, though they continue to look inexpensive relative to their US counterparts despite meaningful outperformance so far in 2025. The theme of risky assets looking expensive carries over into the bond market where spreads (the excess yield compared to a risk-free U.S. Treasury Bond) hover near historically low levels across both high-quality investment grade and lower quality high-yield corporate bonds.

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