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SECOND QUARTER 2025 REVIEW

It is challenging to write about tariffs as new pronouncements occur so frequently; however, markets seem increasingly optimistic that a resolution may soon emerge. Although tangible progress remains limited, with few significant agreements finalized and ongoing ambiguity surrounding tariff outcomes, the continuation of trade negotiations leaves room for incremental deals or deadline extensions, supporting hopes for a gradual de-escalation.

We believe that tariffs are unlikely to lead to prolonged inflation. Consequently, the Federal Reserve should retain the flexibility to cut interest rates if economic conditions deteriorate. Given the approximately one-year lag before interest rates fully impact the economy, the 1.00% reduction in the Federal Funds rate delivered in the latter half of last year will lend some support to the economy in the second half of this year.

On July 4th, President Trump signed the One Big Beautiful Bill Act into law, making permanent many provisions of the 2017 Tax Cuts and Jobs Act, including certainty for household tax brackets. We were pleased to see the expensing of investment in short-lived assets and domestic research and development. Expensing capital projects lowers the cost of capital, encouraging investment in projects that were previously uneconomic under prior depreciation rules. This tax provision is expected to materially benefit cash flows at research and development-intensive companies, such as software vendors.

Following President Trump's "Liberation Day" tariffs announcement on April 2nd, the Standard & Poor's 500 Index fell by over 21% from its February peak to its April intraday low. Subsequently, it rebounded to new heights at an unprecedented pace. The index gained 10.9% in the second quarter, with the technology sector – the first quarter's biggest laggard – leading the market higher once again.

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ECONOMY

We would not be surprised to see inflation readings tick higher during the summer. We learned from tariffs in Trump's first term in office that it took a quarter for the effects to fully show up in prices. Based on import data and management conversations, companies clearly anticipated tariffs this spring and filled available warehouse space with stock. This inventory buffer has likely enabled companies to maintain pricing as they await the final outcome of tariffs.

We believe there is a cogent case to be made that while tariffs may cause a temporary price increase, they are unlikely to spark persistent inflation based on four key observations. First, unlike the recent bout of inflation from 2021 to 2023, current weakening labor market conditions limit workers' bargaining power for wage increases, thus reducing the potential for a wage-price spiral. Second, tariffs primarily apply to goods, which represent only 32% of consumer spending, while services, accounting for 68%, remain predominantly insulated from tariff impacts. Third, declining housing costs, a significant component of inflation that accounts for 40% of the Consumer Price Index (CPI), should dampen the impact of tariffs on overall inflation. Lastly, tariffs essentially function as a consumption tax, and such taxes typically do not contribute to persistent inflationary effects.

Examining the other half of the Federal Reserve's dual mandate, full employment is less encouraging to us than the inflation picture. In the absence of concerns about inflation, the Federal Reserve might soon preemptively cut interest rates based on labor market indicators. Initial weekly jobless claims are up about 30,000 from levels at the beginning of the year. Continuing jobless claims have also recently begun to rise, indicating that it is taking longer for unemployed workers to land new positions, signaling labor market slack is starting to build. Notably, the growth rate of workers on payrolls has slowed to 1% annually. Since 1960, every time payroll growth has fallen below its current level, payrolls have swiftly contracted. If inflation readings are higher, but relatively tame, and the labor market deteriorates, we anticipate the Federal Reserve may begin cutting rates by year-end.

The passage of the One Big Beautiful Bill will provide a tailwind to the economy by introducing a range of tax incentives that offer meaningful benefits for businesses, potentially boosting Gross Domestic Product (GDP) by as much as 0.5% in 2026 and 2027, according to some estimates. As mentioned, the bill restores full expensing for capital investments, allowing companies to deduct the entire cost of qualifying property and equipment in the year of purchase, improving cash flow and encouraging reinvestment. Businesses engaged in research-based innovation can now immediately deduct qualified R&D expenses, while also claiming valuable tax credits, thereby enhancing liquidity and supporting growth. Energy-efficient construction and upgrades are eligible for significant tax savings in both commercial and residential projects, although these incentives are only available through 2026, making early action critical.

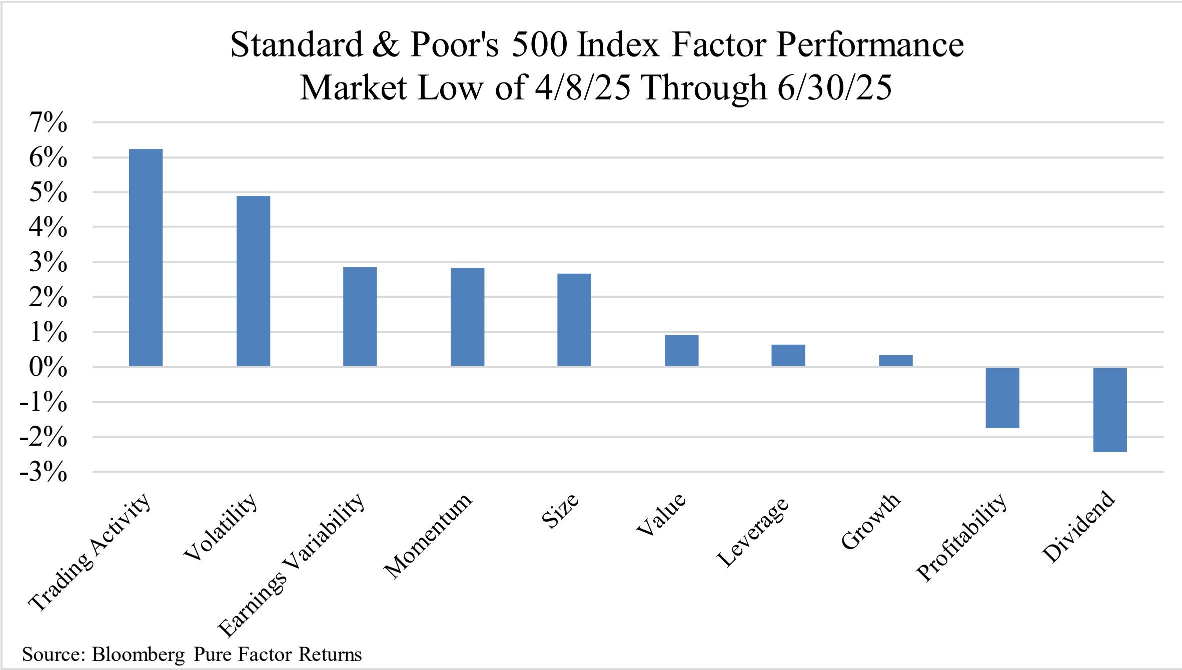
CAPITAL MARKETS

During the second quarter, investors faced numerous headwinds, including escalating trade tensions, the deployment of American bombers over Iran, and uncertainty surrounding the federal budget bill. Despite these challenges, Treasury yields declined, the dollar weakened, and oil prices dropped. Both the NASDAQ Index and Standard & Poor's 500 Index briefly entered bear market territory, yet ultimately ended the quarter at record highs.

The quarter began turbulently with the administration's announcement of reciprocal tariffs on nearly all U.S. trading partners on April 2nd, termed "Liberation Day." In reaction, the Standard & Poor's 500 Index fell by 12.1% over four trading sessions. However, sentiment shifted swiftly on April 9th, when the administration announced a 90-day moratorium on reciprocal tariffs (excluding China). This announcement triggered a sharp market rally of 9.5%, marking the third-largest single-day gain since 1950. From the April low, the market reached a new high in just 55 trading days, the fastest recovery period following a decline of 15% or more in history.

Although investors are right to cheer new market highs, the composition of the recent rebound from the April low does not inspire great confidence. Only three of the eleven sectors on the Standard & Poor's 500 Index outperformed the index from the April 8th market low through quarter end: Technology, Communications, and Industrials. This contributed to the market narrowing again in the second quarter, with the Standard & Poor's 500 Index advancing 10.9% compared to a 5.5% return for the average stock in the index.

The characteristics of the stocks that have performed the best since the recent market low focus on factors such as high trading volume, high share price volatility, and high earnings variability. In contrast, stocks offering good value, growth opportunities, or solid dividends have lagged behind.



Notably, corporate earnings growth, a crucial driver of stock market performance over the medium to long term, is again improving. Initial consensus expectations for 2025 anticipated an ambitious earnings growth rate of 14%, a target we viewed as overly optimistic in the presence of trade uncertainties and a slowing economic backdrop. Although expectations moderated through the year's first half, recent forecasts have begun rising again, propelled by strong earnings performances from major firms such as Nvidia, Microsoft, and Alphabet.

Small-cap stocks have underperformed their large-cap counterparts in recent years, and this trend has continued in 2025. In recent years, small-cap earnings growth has notably lagged behind that of large-cap companies, contributing to the underperformance of small-cap stocks compared to their larger counterparts. While large-cap companies, particularly in the Technology and Consumer Discretionary sectors, benefited from global reach, robust pricing power, and margin stability, small-cap firms struggled with higher input costs, tighter credit conditions, and elevated interest rates. Valuation multiples for small-cap indices remain at historically low levels relative to their large-cap peers. Nevertheless, small-cap stocks may soon see improved conditions driven by anticipated increases in market liquidity.

The Treasury's preference for short-term Treasury bill issuance, characterized by maturities of one year or less, enhances market liquidity compared to longer-term notes and bonds. Additionally, expectations for lower interest rates over the coming year offer another positive catalyst. Rate cuts may result from economic necessity due to weakening labor market conditions or through a potentially more accommodative monetary policy stance under a new Federal Reserve chair appointed by President Trump next May.

CONCLUSION

A primary challenge facing economic forecasts is uncertainty regarding the trajectory of U.S. tariff policy. Early 2025 witnessed aggressive trade rhetoric, although the most severe outcomes have frequently been dialed back. However, assuming the existence of a dependable "Trump Put" beneath market levels, or that the administration will consistently pivot to market-friendly positions as it did in April, may be a risky assumption.

Assessing the economic impact of tariffs that do become effective remains inherently complex. The absence of a modern historical precedent makes it particularly challenging to predict their real economic consequences accurately. Consequently, the Federal Reserve has been explicit about its desire to assess the effects of tariffs before adjusting monetary policy.

The current bull market, approaching its third anniversary in October, is unusual in that it has grown despite restrictive monetary policy, sustained high bond yields, weak money supply growth, a robust U.S. dollar, and declining consumer confidence. Many of these factors are currently reversing or are expected to reverse in the coming year. Additionally, continued significant issuance of short-term Treasury debt will likely inject substantial liquidity into financial markets. While this enhanced liquidity supports asset valuations, it also raises concerns about potentially inflating asset prices, particularly given that equity valuations already stand at historically elevated levels.

*FINANCIAL MARKET TOTAL RETURN**

	Second Quarter 2025	Six Months Ending 06/30/25	One Year Ending 06/30/25	Annualized Return Two Years Ending 06/30/25	Annualized Return Three Years Ending 06/30/25	Annualized Return Five Years Ending 06/30/25
Standard & Poor's 500 Index	10.94%	6.20%	15.16%	19.77%	19.71%	16.64%
Standard & Poor's 500 Equal Weight Index	5.46%	4.82%	12.73%	12.24%	12.76%	14.38%
Russell 2000 Index	8.50%	(1.79%)	7.68%	8.86%	10.00%	10.04%
Russell 3000 Index	10.99%	5.75%	15.30%	19.15%	19.08%	15.96%
Value Line Composite Index	6.36%	(0.54%)	5.02%	4.58%	6.78%	8.47%
Dow Jones Industrial Average	5.46%	4.55%	14.72%	15.37%	14.99%	13.52%
Nasdaq (OTC) Composite	17.97%	5.86%	15.70%	22.45%	23.68%	16.06%
Bloomberg Gov't/Credit Intermediate Bond Index	1.67%	4.13%	6.74%	5.46%	3.57%	0.64%

* *Total Return Includes Income*

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July 5, 2025

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