August was another good month for both equity markets and fixed income markets. Generally speaking, performance reverted to the trends established in the first half of the year where dollar weakening favored international and emerging market stock indices over domestic. That said, domestic equities broadly rallied again, and not just the large cap growth stocks as had been the case in the prior couple months. What caused the rally and reversion to early 2025 trends? As Morgan Stanley put it in the GIC Weekly from August 27th , "since nonfarm payrolls disappointed in early August, the market has discounted higher odds of a September rate cut, currently at more than 80%." Markets at one point had even priced the odds of a September cut at 99 percent.

For the month, the S&P 500 and Dow Jones Industrial Average gained 2.0 percent and 3.4 percent respectively. Midcap stocks increased by 2.5 percent and small caps by 7.1 percent, as measured by the Russell Midcap and Russell 2000 indices. Internationally, the MSCI EAFE rose 4.3 percent and the MSCI Emerging Markets rose 1.5 percent. The Bloomberg US Aggregate Bond Index also gained 1.2 percent during August.

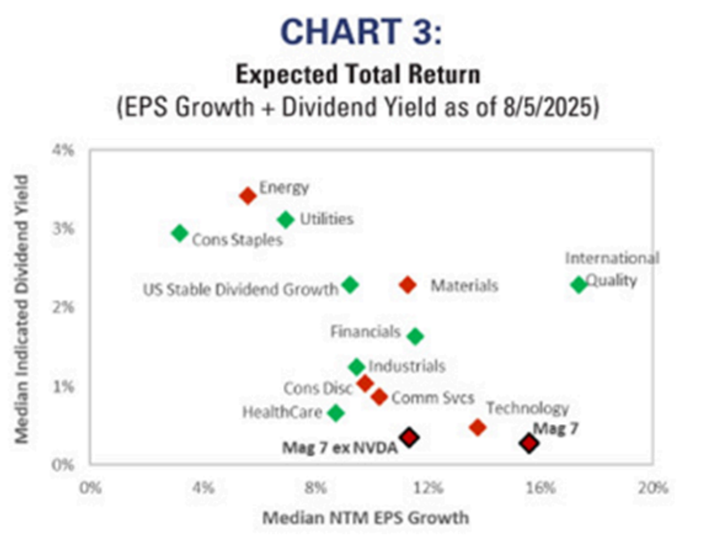
While our team has been predicting a rate cut at the tail end of 2025 since January and still does, we do think there's a chance the Fed disappoints the markets on the 17th of September – or the markets suss out the likely disappointment a week earlier when August CPI is released. Keep in mind a couple things: First, as we pointed out last month in our note, August CPI is likely to come in pretty hot and we think September will too. The Cleveland Fed's Inflation Nowcast measure is showing 0.30 percent for August and 0.31 percent for September – that would annualize at 3.6 percent per year. Second, the Fed still has two meetings this year, in October and December. Ultimately, an 80 percent chance sounds too high to us and too high to Morgan Stanley's Global Investment Committee who framed it this way, "the GIC sees the data as less compelling, with the Fed's commitment to independence and its policy framework rendering the probability closer to 50%. In our view, and especially with easing likely to be shallow, it comes down to, "What problem are we trying to solve?" Real economic growth remains positive, unemployment is modest, financial conditions are loose and corporate credit is flowing. Furthermore, inflation is well above the Fed's 2% target."

Source

In short, there's still plenty to be optimistic about, but that actually lessens the likelihood of a September rate cut. Real wage growth seems to be not only increasing but accelerating. Nominal and real GDP numbers have been better than expected and very much in line with a soft-landing narrative. Financial conditions have been loosening the last several months, not tightening, despite the Fed's position on rates. Overall, the economy seems to be on firm footing despite the headlines and weakening jobs numbers. But we do worry about market concentration amplifying any risk off moment. It's not the level of good that determines the change in the markets. It's the difference between expectation and reality – and the emotional reaction that ensues as a consequence—that drives short term market volatility. In that regard, we are nervous heading into September. In our view, market participants have likely overestimated the odds and/or magnitude of a fed cut; furthermore, they have become historically myopic with regard to security selection and risk appetite – choosing the highest beta and most expensive stocks for the bulk of their portfolios when opportunities for equal or better growth, with better dividend yields and more security abound – especially internationally. Richard Bernstein had a great couple charts that demonstrated this point in his "Charts for the Beach" this past month.

Source: Richard Bernstein Advisors LLC, Bloomberg Finance L.P.

This investor tunnel vision is happening while the dollar is actively weakening – which favors international performance. And it's not just theoretical: international markets have outperformed significantly so far in 2025. A fact that has hardly been noticed by the mainstream financial press which has been more focused on tariffs, inflation, and the magnificent 7 stocks.



Source: Richard Bernstein Advisors LLC, MSCI, S&P Global, Bloomberg Finance L.P. Green shading denotes an OW position and Red denotes an UW position in our strategies. NTM = Next Twelve Months. Sectors are the S&P 500® GICS Sectors. For Index descriptors, see "Index Descriptions" at end of document.

Has our longer-term outlook changed much? No; we are just nervous in the short term about a September disappointment. Our convictions and recommendations remain especially biased toward a weakening dollar, the notion that the Fed's two percent inflation target will remain a perennial unattainable floor for inflation, that growth while decelerating will remain positive for the rest of 2025 and into early 2026, and that tariffs like any other type of tax increase will do more to slow economic growth than cause inflation as economists define that word in an economics textbook.

This month's On the Markets framed it this way: "In sum, we see mostly positive returns across fixed income and equities into year-end. For instance, in US Treasuries, based on a forecast of a slowing economy and falling policy rates, our Morgan Stanley & Co. Research colleagues still see yields falling. And they still expect curve steepening, especially with the Fed's increased comfort in cutting rates despite inflationary pressures. We continue to expect a weaker US dollar because we see more policy-rate easing from the Fed than from other central banks, among other factors. While the Fed lowered the bar for rate cuts, the ECB seems to have raised it." But they also note that, "free-cash-flow growth from the "Magnificent Seven" market leaders is now negative, and pressure to demonstrate returns on massive data center investments will intensify as the implementation speed of generative AI applications is tested. Historically, shrinking free-cash-flow growth has been a headwind for high-flying growth stocks."

How does all this translate into portfolio allocation tilts? For our team that it means we prefer international and high quality over domestic and low quality. Within fixed income markets: we prefer government and high-quality municipal over credit. We remain neutral with regard to duration as there are some signs, especially in the labor market, of slowing growth. We also agree with the Morgan Stanley GIC's advice to overweight "real assets—like gold, REITs, energy infrastructure and industrial and agricultural commodities—to complement benchmark weighting in passive US equities, while favoring stock selection in large-cap, quality US names. Intermediate-duration IG fixed income, including municipals; international equities, including emerging markets; private secondaries and hedge funds; and asset-backed lending and distressed investments in private credit."

As always, if you have any questions or concerns, please don't hesitate to reach out to any member of our team.