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July 2025 Perspectives

We hope you all are enjoying the summer. As we reach out to share our latest *Perspectives*, our thoughts are with those who were impacted by the catastrophic flooding in the Texas Hill Country earlier this month. We are grateful for the first responders, volunteers, and leaders who rushed to the aid of those in need, and we are praying for comfort and healing for those grieving lost loved ones and/or displaced from their homes.

A Rollercoaster First Half

The U.S. stock market experienced significant volatility in the first half of 2025. The S&P 500 surged to an all-time high on February 19th, driven by earnings growth, AI optimism, and anticipated pro-growth policies from the incoming Trump administration. However, this momentum reversed in March, with the index dropping 10%+ from its February peak by mid-March, largely due to uncertainty surrounding President Trump's trade policies as well as increased AI competition. The decline intensified in early April, triggered by the announcement of sweeping tariffs on April 2nd, dubbed "Liberation Day," which targeted nearly all U.S. trading partners, including Canada, Mexico, and China. This led to a sharp sell-off, with the S&P 500 plunging 4.8% on April 3rd—its worst single-day loss since the Pandemic period—and falling 11%+ below its February high, entering correction territory. By intraday April 7th, the index briefly fell into bear market territory, marking a 20% correction from the all-time high.

A turning point came on April 9th, when President Trump announced a 90-day pause on some tariff increases, sparking a 9.5% surge in the S&P 500—the largest single-day gain since October 2008. This pause, coupled with trade negotiations and partial tariff exemptions (e.g., $102 billion of Chinese imports and $40 billion of U.S. goods exempted by China), fueled a robust recovery. By May 13th, the S&P 500 turned positive for the year, and on June 27th, it closed at 6,173.07, surpassing its February high to set a new all-time high.

Uncertainty Remains in Tariffs, Inflation, and Interest Rates

Tariffs have raised concerns about stagflation—a combination of slowing economic growth and rising inflation. By some estimates, the April tariff measures could boost prices by 1.5% in 2025[1], with inflationary effects most pronounced in the middle quarters. Despite these forecasts, recent data suggests tariffs have had a modest impact on inflation, with the consumer price inflation index rising 2.67% year-over-year in June, down significantly from 2022 peaks, but still above the Federal Reserve's 2% target. Morgan Stanley's global economics team notes that historically there has been a lag of 3-4 months from tariffs to CPI impact, although front-loading of imports in the first quarter could muddy the waters, and rates are still not settled.[2]

Federal Reserve Chairman Jerome Powell has emphasized a cautious policy approach to these dual risks. The Fed maintained its federal funds rate at 4.25–4.5% in June, with Powell indicating that rates may remain elevated longer than anticipated due to persistent inflation. However, recent remarks from Federal Reserve Governors have indicated some divergence in views amongst Fed officials, signaling cuts could come sooner to support a deteriorating labor market if inflation remains subdued in the near term[3]. Lower rates could support equities by reducing borrowing costs, but the Fed's data-dependent stance means policy will hinge on economic indicators like employment, inflation indexes, and consumer spending. Futures markets are pricing two rate cuts in the second half of 2025, while Michael Gapen, Morgan Stanley's Chief US Economist projects the Fed will not resume cuts until 2026, but a Fed that cuts late, will cut more.[4]

One Big Beautiful Bill (And Even Bigger Debts and Deficits)

On July 4th, President Trump signed the One Big Beautiful Bill Act into law. The act aims to stimulate economic growth through permanent extensions of the 2017 Tax Cuts and Jobs Act, new deductions for tips and overtime, increased defense and boarder spending, and incentives for R&D and cap-ex spending. Proponents have claimed the bill will reduce deficits by $1.4 - $2T over a decade owing to spending cuts and economic growth. But the bill increases the US Debt limit by $5T, to $40T, and Morgan Stanley estimates a $3.3T net increase in the federal budget deficit over 10 years. Debt and deficit expansion is projected to push the deficit-to-GDP ratio north of 6% by 2026, double the historical average of 3% before the Global Financial Crisis. We expect growing deficits to place upward pressure on US Treasury term premiums and lead to higher rates on the long end of the yield curve[5].

For more on the One Big Beautiful Bill Act, we are attaching a link to "A Big Beautiful Guide to the Big Beautiful Bill" from our Public Policy team.

The Stock Market is not the Economy

Although we are anticipating a pickup in inflation and slower growth in the second half, our longer-term stock market outlook remains constructive. Morgan Stanley sees Corporate Earnings Growth at 7-8% for 2025 and 13-14% in 2026, with gains coming from margin expansion and tax benefits. Mike Wilson, Morgan Stanley's Chief Investment Officer sets his mid-year 2026 base case forecast for the S&P 500 at 6,500[6].

Tariff-related concerns led to downward corporate earnings revisions in March and April, with markets anticipating a drag on earnings due to tariffs and retaliatory measures. Sectors reliant on international supply chains, such as technology and retail, faced significant pressure. But as tariff fears eased in May and June, analysts revised forecasts upward. Second-quarter S&P 500 earnings are now expected to grow by 9.3% year-over-year, reflecting optimism about resilient consumer spending and lower-than-feared tariff rates. However, high valuations—near cycle highs with a forward P/E ratio of 21 compared to a long-term average of 15.8[7]—suggest limited room for multiple expansion at the index level, making earnings growth critical for sustained market gains.

Positioning

The U.S. stock market's recovery to new highs reflects resilience amid significant challenges. While tariff policies have driven volatility, tax cuts, deregulation, and strong corporate earnings provide reasons for cautious optimism. However, risks remain, including ongoing trade negotiations, inflationary pressures, high valuations and geopolitics. While our portfolio advice is always bespoke and fact specific, we see opportunities for investors to diversify and complement US Large Cap exposure with international equities, investment grade fixed income, private credit, commodities, infrastructure, and private equity.

As always, we invite you to reach out to discuss how best to align your portfolio with your financial goals. We will be monitoring conditions carefully and wish you and your families the best for the Summer season!

Sources:

[1] Thomson One

[2] State of US Tariffs: June 17th, 2025, Yale Budget Lab, 6/17/2025

[3] Global Economic Briefing, The Weekly Worldview: The Economy and the Market, Morgan Stanley, 7/13/2025

[4] It's not political': Waller again calls for rate cut in July, reinforcing Fed divide, Yahoo Finance, 7/11/2025

[5] Why the Fed Will Cut Late, But Cut More, Morgan Stanley, 6/26/2025

[6] Macro Update from Ellen Zentner, Chief Economic Strategist & Global Head of Thematic Investing for MSWM, 6/8/2025

[7] GIC Monthly Perspectives, 7/9/2025

[8] FactSet