A Bank Built on a Strong Foundation

June 2025 Capital Markets Commentary

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"The stock market is filled with individuals who know the price of everything, but the value of nothing"

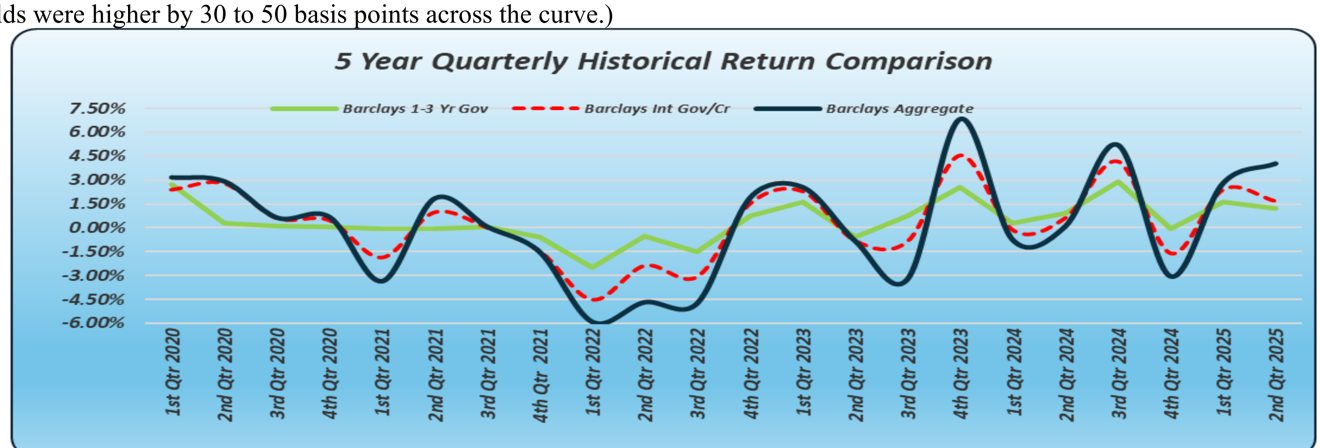
Phillip Fisher

Fixed Income

The 2nd quarter of 2025 brought increased volatility within the fixed income markets. The quarter was characterized by a rise in geopolitical tensions – due to US tariffs, developments in the Middle East, and the ongoing turmoil between Russia and the Ukraine. Fears of recession peaked around the so-called "Liberation Day" tariff announcements in the US. These fears faded when the current administration back peddled on the high tariff percentages. There was a shift in emphasis away from monetary policy, as global central banks neared the end of their rate cutting cycles, and towards fiscal policy and what this would mean for debt sustainability.

Volatility was high during the quarter. The yield on the benchmark US 10-year Treasury was as low as 4.01% and as high as 4.58% during the 2nd quarter. However, the 10 Treasury note closed the quarter at 4.23%, almost exactly where it ended March 31st.

As yields stayed relatively low, returns were positive across all parts of the curve during the quarter. The Barclays U.S. Aggregate posted a +1.21% return for the quarter, and the Barclays Intermediate Index was at +1.67%. The short end of the yield curve also saw positive returns, with the 1-3 Year Government Index at +1.19%. On the truly short end of the yield curve, you also saw positive returns. The 1-Year T-Bill returned +0.94% for the quarter. As for yields, the 10-year Treasury yield ended the quarter at 4.23%, the 5-year Treasury yield ended at 3.79%, and the 2-year Treasury yield ended at 3.72%. (As of the end of December, yields were higher by 30 to 50 basis points across the curve.)



Fixed Income Markets - Looking Ahead

At the most recent FOMC meetings, there was still no change in policy and the FOMC stayed on course. At the Fed's June meeting, officials opined that the Fed was still looking for two rate cuts by year-end despite raising their inflation forecasts. Although tariffs may cause price increases, inflation's persistence will influence monetary policy as the Fed balances its three mandates: maximum employment, price stability and moderate long-term interest rates.

As the 2nd quarter ended, US Treasury yields were volatile and corporate bond spreads broadly narrowed. Ironically, the ongoing backdrop of ongoing nonstop policy headlines fueling uncertainty, could be a positive for credit investors. This could inhibit excitement among debtors that, in optimistic times, usually leads to a steep rise in downside credit risks. Going into the 3rd quarter, lower net issuance of debt and reinvestment of coupons can possibly lead to positive conditions for fixed income markets. Although high quality corporate bond and US Treasuries can benefit from this situation, ultra-short and short duration municipal bond strategies are expected to have positive total returns driven by the imbalance between supply and demand.

The Fed's top priority of inflation reduction and containment remains. Inflation is the main headline. Many forecasters expect inflation to accelerate in the second half of the year as the current Administration's tariffs work their way through the supply chain and into stores. If that does happen don't expect the Fed to cut rates in 2025. <u>In fact, don't rule out a rise in rates, however implausible.</u>

Equity

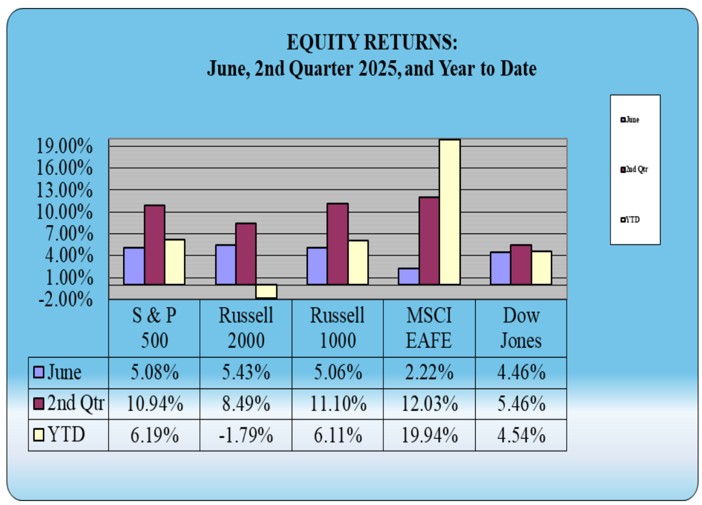
The equity market, as measured by the S&P 500 Index, rose +10.94% in the 2nd quarter.

Stocks were up across all major US market segments, non-US stocks continued to deliver positive results, and bonds added value. The familiar refrain of big cap growth and technology stocks resounded with investors who showed renewed confidence in the US equity markets after a painful end to the 1st quarter of 2025 and the huge losses that occurred in the 1st weeks of April as the markets reacting negatively to Liberation Day on April 2nd only to reverse a week later when the first tariff "pause" was announced.

Since April, the market has surged more than 24%, bolstered by progress in trade negotiations that eased fears of worst-case scenarios. However, new uncertainties are on the horizon, including the tariff deadline in July, the approval process for the proposed budget bill **(it has since passed)**, rising geopolitical tensions in the Middle East, and the Ukraine/ Russia war continuing. Volatility has risen and is likely to persist as investors try to manage these evolving challenges in the second half of 2025.

It was a good quarter for value, large cap, and high profitability stocks. Large Cap stocks, or those with higher market capitalizations, outperformed growth stocks for the quarter through June. Over the same period, the stocks of small cap companies lagged large caps, although all returns were positive.

All indexes were positive for the quarter, even on the international side. On the US side, the Russell 1000 Index ended with positive +11.10% return for the quarter, and the S & P 500 Index returned +10.94%. The other indices also had positive returns. The Russell 2000 index returned +8.49%, and the Dow returned +5.46%. The international markets posted not only a positive return, but a strong +12.03% on the EAFE for the quarter.



	S & P 500	Russell 2000	Russell 1000	MSCI EAFE	Dow Jones
June	5.08%	5.43%	5.06%	2.22%	4.46%
2nd Qtr	10.94%	8.49%	11.10%	12.03%	5.46%
YTD	6.19%	-1.79%	6.11%	19.94%	4.54%

Equity Markets - Looking Ahead

Second half 2025. The question remains. Do we continue the roller coaster year in stocks?

As we move into the second half of 2025, conditions still remain good for US equities. The US equity markets have shown remarkable resilience in 2025 despite the ongoing turbulence. After a first quarter decline of 4% in the S&P 500 Index, the second quarter delivered a robust **10.6% rebound**, reaching a new all-time high. However, the Fed could very well be the key player that will alter the outcome of the markets either positively or negatively.

As we move into the second half of 2025, recession concerns have eased a little as severe trade policy scenarios appear unlikely. Nevertheless, economic data may remain volatile as the inventory build-up triggered by early-year tariff anticipation continues to cycle through the system.

A robust labor market and steady wage growth have continued to reinforce consumer spending and overall economic expansion. However, momentum has slowed as consumers have used greater caution amid ongoing tariff-related uncertainty. While a normal rise in tariffs typically represent a one-time price adjustment rather than persistent inflation, they come at a particularly challenging time—layered on top of several years of elevated price pressures that have already strained household budgets, especially for families with lower incomes. This can have severe impacts on the bottom line of corporations and in turn stock prices.

For the stock market to maintain its positive momentum, the economy, inflation, and earnings data need to continue exceeding the current lofty expectations. So far, economic data has been fine. However, the biggest risks to the market will be a reacceleration in inflation or anything that challenges earnings growth.

The Economy

The Economy. Where is it going?

In the 2nd quarter 2025, the US economy continued to demonstrate resilience amid aggressive trade policies and geopolitical tensions, with GDP growth numbers projected to exceed 2.5% annualized despite ongoing worries.

During the quarter, the FOMC again held the current target Fed Funds to the range of 4.25% to 4.50%. Inflation was and still is higher than the Fed's target and moved slightly higher during the quarter. Although most Fed governors held rates steady, many are still leaning towards lowering rates in 2025.

In spite of the lingering tariff effects and heightened uncertainty, economic data has proven relatively strong during the quarter. Employment and wage growth remained steady with no major layoffs materializing, and even though there has been negative consumer sentiment, Americans are still spending. And, while inflation numbers have been softer due to oil prices softening, the tariff impact has not shown up in the data yet. Also, a favorite labor market indicator, continuing jobless claims, has actually been trending upwards in recent releases.

Tariffs and the US trade policy continued to be the focus during the quarter, with the US administration's "liberation day" unveiling the highest levies on trading partners since at least the 1930s. Policy uncertainty peaked when tariffs between China and the US reached more than 100% on both sides, resulting in a de facto trade embargo. Tensions and tariff levels leveled off but still remain higher than previous levels. Although reciprocal tariffs have been lowered to a broad 10% baseline, the relief is a temporary pause that will expire in 90 days.

As June ended, the FOMC had no changes in policy.

The Economy - Looking Ahead

Inflation? Economic Growth? Tariffs? Recession? Stagflation? Global problems? – *We changed the order from last quarter. Inflation is more important.*

As we begin the 3rd quarter of 2025, it is with a constructive but less optimistic economic outlook for the US. While indicators for the US economy point to continued growth (albeit slower), the outlook is increasingly shadowed by high levels of uncertainty around economic policy and geopolitics.

The current economic forecast for 2025 continues to show growth but at a slower pace. Inflation will probably remain above the Federal Reserve's target, with the current administration's policies limiting production while stimulating spending. A big risk moving forward, is that we could still be heading towards Stagflation.

As I mentioned last quarter, stagflation is relatively rare because inflation and economic stagnation don't typically occur at the same time. During periods of stagflation, slowing economic growth and rising consumer prices occur simultaneously. This typically results from supply-side shocks, restrictive trade policies, or poor government decisions that drive prices higher while hurting economic activity. (**That seems to be what is currently happening**)

Based on current market pricing, the markets expect the Fed to lower interest rates at a modest pace, and more than likely, at the end of the year. This probably reflects the inflationary risk from tariffs but also the limited economic impact so far this year. It's important to point out that the market's forecast will likely change as more data becomes available, with the timing and size of rate cuts depending on inflation, trade policy developments, and economic data over the rest of the year and into 2026. That said, there is always the possibilty that the Federal Reserve could raise rates. Current markets are 'complacent' about the risk of more US rate hikes. With the current administration's new wave of tariffs, the government's expanding fiscal deficit, and restrictive immigration policies, inflationary forces could put pressure on the Fed to raise rates.

Despite early declines in inflation at the beginning of the year, inflation has ticked slightly upwards due to new tariff policies and their effects. At the present time, Fed officials want to see more sustained progress in the inflation data before making additional rate cuts, but they don't want to curtail economic growth if they cut rates too soon. Currently, the markets are pricing in just 5% odds of a Fed rate cut at the July 30 meeting, down from about 25% ahead of the jobs report. While hiring was higher than forecasts, the drop in the unemployment rate will probably keep the Fed on hold because it signals less slack in the labor market.
