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Capital Markets Commentary ~ July 2025

We don't know about you, but it seems to us that virtually every single June day dealt us an entire month's worth of news. It would be impossible to unpack it all, and in any event, despite all the drama, the news seems to have had minimal impact on markets, with oil markets being the exception. Oil spiked around the Israel-Iran conflict only to dive again when Iran's response to the bombing of their Fordo nuclear facility was much more restrained than previously feared. Rather than attempt to predict whether or not a fragile cease-fire will hold (which is above our paygrade) or attempt to predict the long-term ramifications of the One Big Beautiful Bill, this month we'll stick to our knitting for a discussion of the Fed and earnings. Before we get to that, though, let's review the numbers for June.

Despite the chaotic environment, June was a very good month. For that matter, it was a very good quarter and has been a very good year thus far, too. Of course, that great performance means that valuations might be less than compelling, but this is a not a bad problem to have. For the month, the NASDAQ returned 6.6%, followed by the S&P which gained 5.1% and the Dow which closed the month 4.5% to the good. In fact, all major global bourses were positive. Even bonds, as measured by the US ten-year Treasury gained ground for the month. The ten-year ended May at a yield of 4.41% but drifted consistently lower all month long to close June at a yield of 4.23%.[i] So, were markets up because of good news, the relative absence of bad news, or are investors simply choosing to ignore bad news (as happens from time to time)? Let's talk.

As widely expected, the Fed left the overnight lending rate unchanged following their June meeting. At his press conference following the announcement, Powell presented the rationale as follows:

"Changes to trade, immigration, fiscal and regulatory policies continue to evolve, and their effects on the economy remain uncertain. The effects of tariffs will depend, among other things, on their ultimate level. Expectations of that level, and thus of the related economic effects, reached a peak in April and have since declined. Even so, increases in tariffs this year are likely to push up prices and weigh on economic activity.

We may find ourselves in a challenging scenario in which our dual mandate goals (stable prices and maximum employment) are in tension. If that were to occur, we would consider how far the economy is from each goal, and the potentially different time horizons over which those respective gaps would be anticipated to close. For the time being, we are well positioned to wait to learn more about the likely course of the economy before considering any adjustments to our policy."

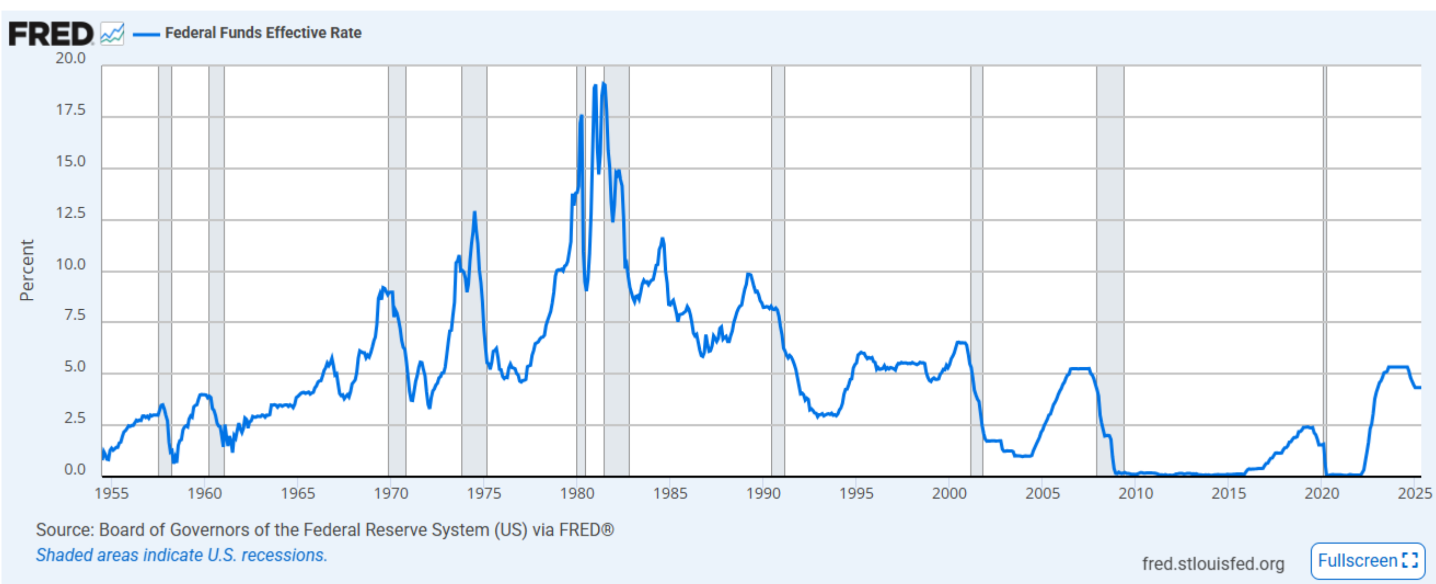
What Powell is saying here is that if (and that's an enormous ***IF***) tariffs prove sticky, they could simultaneously send inflation higher and employment lower. In this case, inflation wouldn't be the result of a massive injection of stimulus, as was the case during COVID. Consumers would be faced with higher prices without the benefit of free government cash spilling out of their pockets. During COVID, prices rose but folks had plenty of government cash to spend. Under a tariff scenario, prices rise, but without all that stimulus money floating around, consumption drops. When consumption drops, employment can suffer, and this could put the Fed's dual mandate – stable prices and maximum employment – at odds.

In fact, in a panel discussion during a European Central Bank forum on July 1st, Powell was asked if the Fed would have cut already if not for tariffs. He answered, "I think that's right," adding, "In effect, we went on hold when we saw the size of the tariffs and essentially all inflation forecasts for the United States went up materially as a consequence of the tariffs."

In any case, the Fed's reluctance was not well received in some quarters. It's important to remember, though, what the Fed can and cannot accomplish by cutting rates. Recall that the Fed can cut only the overnight lending rate charged to banks. While their action can influence markets by signaling that they're either wary of recession (cutting) or fearful of letting the economy overheat (hiking), the Fed funds rate is not the rate consumers pay on loans for houses and cars, or that businesses pay to borrow for expansion. Those lending rates are set by banks, which raise and lower them based upon their assessment of both the borrower and the economic environment.

Inflation is also a supply-demand thing, and the Fed can't create supply. Take housing for instance. Pundits and politicians might argue that lowering rates could help folks who have been priced out of the housing market by making loans more affordable, but that isn't necessarily true. As we'll discuss in a moment, a lower Fed fund rate may not translate into lower mortgage rates and even if it did, a lower mortgage rate may not serve to make housing stock cheaper. Why? Cheaper mortgages can drive competition for houses thus driving up housing prices to the extent that many buyers are priced out of the market, no matter how cheap the mortgage. We saw this during the pandemic, a problem which persists to this day. The only sure way to drive down housing prices is to increase the supply of houses, and this the Fed is powerless to do.

But even though a Fed rate cut lowers the cost of money for banks, banks don't have to pass those savings along. You can't force a bank to lend money no matter how hard you try. We saw this in 2010, in the wake of the Great Recession. Back then, the Fed cut the overnight rate from 4.75% down to 0%. Banks did not lend. The Fed tried injecting banks with piles of cash. Banks responded with a collective "Nope, not gonna." So, we need to set aside this notion that Fed rate cuts alone will prompt consumers and businesses to spend like drunken sailors on shore leave. That's just not how it works. Plus, historically, the Fed funds rate isn't particularly high. Here's the rate for the past 70 years. Over that time span, it averaged 4.62%. Today, the effective Fed funds rate is 4.33%.



Markets have been a bit too manic to the upside for our comfort level (certainly preferable to manic on the downside), but other than the unresolved issue of trade tariffs, we see no obvious catalyst for correction. The tariff issue, thankfully, is a can that continues to be kicked down the road. The Liberation Day pause was supposed to end July 9th but has now been extended to August 1st. Employment (private employers) showed some softening to the downside in June, but the unemployment rate actually ticked down by 10 bps to 4.1%.[ii] Retail sales, while also a tad softer in May versus April[iii] remain robust. Earnings? We don't think we'll be able to get a firm grip on earnings until the second or third quarter when we better understand the impact of tariffs. Even if that impact is minimal, it's hard to see how multiples expand from current levels. Historically, the median PE for the S&P 500 is 17.96X. Today that PE is running 22.4X[iv] which means that on average, stocks aren't cheap. When valuations are high, and uncertainty is high, it stands to reason that we should continue to exercise caution when putting money to work.

The thing about corrections, is that they rarely announce themselves, and just because we don't see an obvious catalyst, doesn't mean one can't be lurking. That's why we absolutely must pay close attention to valuations and resist the lure of momentum.

As always, should you have any specific questions or concerns, we hope you'll never hesitate to call. We look forward to hearing from you.

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[i] Source: Morgan Stanley Wealth Management GIO, Bloomberg, FactSet

[ii] Source: Bureau of Labor Statistics, The Employment Situation – June 2025. https://www.bls.gov/news.release/pdf/empsit.pdf

[iii] Source: Federal Reserve Bank of St. Louis (FRED), https://fred.stlouisfed.org/series/RSXFS

[iv] Source: Yardeni Research through 07/03/2025

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