WESTEND Advisors

A VICTORY CAPITAL® INVESTMENT FRANCHISE

Economic and Market Commentary

Q2 2025

A Path Forward in an Uncertain World

While uncertainty surged and then partially subsided in Q2, markets rebounded despite slowing economic trends. We see potential for continuation of late-cycle growth that brings opportunities and challenges. We are selectively positioning portfolios to capture potential excess returns and manage risks in this macro environment.

SUMMARY

- The second quarter of 2025 saw wide swings in sentiment and markets, driven in part by trade policy uncertainty, but ended on a high note for equities as worst-case fears faded.
- While global economic trends continue to slow, we anticipate an extension of late-cycle growth that brings opportunities and risks.
- In U.S. allocations across strategies, we are pairing economically sensitive sector exposures where we see secular tailwinds with defensive sector exposures.
- In global portfolios, we are underweight international stocks broadly, but overweight Asia, given recent signs of improvement.
- In balanced and multi-asset portfolios, asset class diversification includes select fixed income exposures with avoidance of long-term corporates where credit spreads are historically low.

Q2 2025 REVIEW

The second quarter of 2025 (Q2) began with a sharp escalation in already-elevated global uncertainty as the Trump administration announced its "Liberation Day" tariff proposals. Global equity markets that had declined more than 5% in U.S. dollar terms in the second half of Q1, fell by more than 11% in the week following the April 2 tariff announcement, only to begin a recovery on April 9, when most of the extreme tariffs (except on China) were paused for 90 days. Despite escalated U.S. involvement in the Middle East with its bombing of nuclear facilities in Iran near quarter-end, markets largely looked past geopolitical tensions and the related oil price volatility in Q2. By quarter-end in the U.S., the S&P 500 Index had recovered from the tariff pullback, returning 10.9% in Q2 to reach a new all-time high.

U.S. economic data remained noisy in Q2. Volatility in various measures of trade was suggestive of tariff front-running, while other measures like employment and consumption-related high-frequency data remained more stable. Overall, U.S. data in Q2 remained indicative of late-cycle economic conditions, which strengthened our view that we are entering a late-cycle period of slower growth.

Late-Cycle Opportunity
Amid uncertainty and noisy economic data, U.S. stocks hit new highs in Q2.

Amid easing uncertainty and sentiment following the initial tariff shock, a rebound in tech and AI-related Information Technology and Communication Services sectors led U.S. equity performance in Q2, along with Industrials and Consumer Discretionary. Other more economically sensitive sectors like Financials and Materials underperformed, as did late-phase defensive sectors like Health Care and Consumer Staples. Energy was the worst-performing sector, as oil prices declined, despite a temporary spike as Middle East tensions flared late in the quarter.

Expectations for Fed rate cuts in 2025 fluctuated throughout Q2. The number of expected cuts increased as concerns over tariffs escalated, then declined as some tariffs were paused or reduced. Corporate bonds, especially high yield, outperformed Treasury securities in Q2 as long-term Treasury yields rose, the yield curve steepened, and credit spreads narrowed.

Internationally, broad indices of developed and emerging market stocks modestly outperformed the U.S. for Q2 in U.S. dollar terms, partly due to a continued decline in the dollar against most major currencies. China was a notable exception, underperforming in both local and dollar terms despite apparent progress in trade negotiations and stabilization in the credit and property market backdrops.

OUTLOOK

Overview: In many ways, 2025 is playing out as we expected, with moderate overall returns (e.g., the S&P 500 has returned 6.2% YTD), but with significant late-cycle volatility. This stage of the cycle creates both opportunities and risks. We are being opportunistic in seeking return, both through where we allocate and what we choose to avoid. While markets seemed to have shifted over the course of Q2 toward the view that the worst-case scenarios on trade policy and near-term

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economic risks were largely off the table, the global economy continues to exhibit signs of being at an advanced stage of the cycle, particularly within developed economies, and we have positioned portfolios accordingly.

In the U.S. we continue to see a balance of near-term risks and potential intermediate-term positives that could extend late-cycle economic growth. The combination of protectionist trade policy, government spending and job cuts, diminished private sector hiring, and slower household wealth gains leading to a higher savings rate all have the potential to weigh on economic growth this year. However, while the administrative policy agenda remains fluid, the largest headwinds from extreme tariffs appear to have eased, and attention is beginning to shift to policies that could have more stimulative implications, such as deregulation, extension of prior tax cuts, and other measures. Meanwhile, a potential for steadily improving earnings and sentiment could support continued equity market gains. Interest rates remain an area of uncertainty, with the Fed still in "wait-and-see" mode at quarter-end, but speculation for an increased number of rate cuts this year has started to regain acceptance among investors.

Internationally, the picture is mixed, though our outlook for most regions is less favorable than for the U.S. Developed international markets face similar late-cycle headwinds as the U.S., in addition to risks from U.S. trade policy, but are generally less well positioned to sustain growth, in our view. Emerging markets, which tend to have high economic sensitivity, also face late-cycle headwinds globally, but we have seen notable signs of improvement in EM Asia, following a prolonged period of sluggishness.

U.S.: Our broad outlook for the U.S. is little changed, with late-cycle economic conditions and a balance of risks and opportunities for extending the cycle. A combination of uncertainty around trade policy, reduced private-sector hiring, and slower household wealth gains—which could lead to a higher savings rate—has the potential to weigh on economic growth this year. We believe we likely have already entered a slowdown phase of the cycle, which typically last 9-12 months, but various factors could help avert recession and support a resumption of late-cycle growth toward year-end or in 2026.

Near-term, while trade policy risks appear to have narrowed somewhat, the situation remains fluid. The Trump administration paused most of its extreme tariffs, but new trade deals remain elusive as we approach the initial pause set to end on July 7. News of a framework for a deal with China and Treasury Secretary Bessent's target for wrapping up Trump's trade agenda by Labor Day are encouraging, but potential negotiation breakdowns or disruptions continue to loom with Canada's negotiations serving as an example at the end of the quarter.

Managing Macro Risks Remains Key

Late-cycle environments can bring both opportunities and risks. Recent policy uncertainty comes as economic growth is slowing and consumers may have limited ability to accelerate spending.

We believe headwinds from on-again-off-again tariff uncertainty and actual tariffs have yet to fully work through the economic data. The economic impact of other policies is also unclear at this point, like increasing deportation of undocumented immigrants who make up a significant part of the workforce in key industries like construction, agriculture, and low-wage service roles. These policies could have inflationary impacts, but we have yet to see those materialize broadly. Given the time it takes for inflationary pressures to work through the economy, we are more likely to see impacts in the second half of the year, though the longevity of those impacts remains a key question. Further, impacts to broad inflation may prove limited since tariffs are primarily focused on goods, while services disinflation has continued to help provide an offset. We expect to gain more clarity on trade policy and inflation as the year progresses. Meanwhile, Congress appears poised to pass a version of the so-called "One Big Beautiful Bill Act" that is shifting some investor focus onto potential longer-term positives for the economy, such as tax cuts.

The U.S. consumer remains on stable footing, in our view, partly due to continued income growth and gains in household wealth. A pullback in personal consumption and retail sales in May likely had more to do with a temporary dip in sentiment (that has since reversed along with the market) than with a sustained shift in fundamentals, even as we have seen some weakening in hiring. Corporate profit margins remain high, however, which so far appears to be limiting the risk of a big spike in layoffs. Still, given slowing labor demand and that the personal savings rate remains low, consumers may have limited capacity to accelerate spending from here.

Elevated profit margins may also help support continued capital investment. We expect business equipment investment could be supported by "filling the factories" as factory construction spurred by prior IRA and CHIPS Act stimulus is completed and tax changes like restoration of accelerated depreciation favor equipment investment.

Another factor that could help extend the cycle is the potential for rate cuts. We believe the current level of interest rates provides the Fed room to ease, if necessary, and while macro fundamentals currently have the Fed on hold, a continued near-term slowdown could be sufficient to move the Fed in that direction if inflation remains contained.

Meanwhile, U.S. equity valuations have rebounded to elevated levels as fears of a worst-case trade environment subsided. Given these valuations, and assuming the near-term economic slowdown proves limited, we believe earnings growth is likely to be the key for positive equity returns over the next year as the economic cycle extends.

Overall, we see a near-term slowdown in economic growth with the potential for a subsequent extension of late-cycle growth rather than a reacceleration to robust early-cycle growth as the most likely path for the economy at this point. Given near-term risks, our positioning across portfolios includes avoiding the economically cyclical U.S. Industrials, Materials, and Energy sectors, which tend to benefit from strong growth. We also recently reduced our allocation to U.S. Financials, though we still see the sector benefitting from a steeper yield curve and potential deregulatory actions. We continue to emphasize a mix of sectors with moderate economic sensitivity and secular or cycle-specific tailwinds, like Information Technology (especially Software) and Communication Services along with late-phase, defensive sectors such as Health Care in U.S. equity allocations.

International: As global economic growth slows in the near-term, we see a mixed picture abroad. We see Asia (developed and EM) as experiencing more favorable economic conditions. In contrast, we believe Europe continues to face headwinds from elevated interest rates, and we also expect slowing growth to present headwinds for economically cyclical emerging markets outside of Asia.

Seeing EM Asia Improvement
We have added an overweight to EM Asia, where we see stabilization in China, increased monetary stimulus, and renewed growth in high-tech manufacturing.

We recently added an overweight of Emerging Market (EM) Asia in global portfolios, as we have seen signs of improvement for Asia's major emerging economies. These include a stabilizing credit and property market backdrop in China following a prolonged downturn, a pivot to more stimulative monetary policy among the region's central banks, and renewed growth in high-tech manufacturing on the back of healthy secular trends in technology investment across the region.

We funded the EM Asia overweight with a reduction in our overweight of Developed Asia. Given slowing nominal GDP growth and global trade headwinds, we expect Japanese and broader Developed Asia EPS growth to decelerate to a below-average pace for several quarters before re-accelerating in 2026. With Japanese stock valuations in-line with long-term averages and other Developed Asia valuations above average, we see a reduced Developed Asia overweight as appropriate given a slowing growth outlook.

We maintain an underweight of Europe in global portfolios. Economic growth in the major European economies has continued to grow at a slower pace compared to the U.S. and Asia, and late-cycle risks have not abated, in our view, as the region continues to face headwinds from high interest rates and evolving U.S. tariffs and trade policy.

Developed European equities currently trade at a valuation premium to international markets, as optimism around a higher fiscal spending trajectory has driven multiples higher in 2025, even as earnings growth has remained subdued. Given the fundamental challenges facing Europe's manufacturing sector and the region's sector composition, which features higher allocations to early-phase sectors relative to other developed regions, we see limited upside to European equity valuations in the intermediate term.

We maintain an underweight of emerging markets outside of Asia, which tend to be very economically sensitive and are likely to underperform, in our view, amid slower global economic growth. Many of these EM economies and markets are heavily reliant on commodities, with significant exposure to the Energy and Materials sectors, which we expect to underperform as the global economy and inflationary pressures continue to slow.

Fixed Income and Real Assets: Given recent economic and policy uncertainty, we believe the Fed is on a path toward recalibration. The yield curve has steepened, and we see two potential paths for this to continue. Longer-term rates could rise if inflationary pressures or inflation expectations increase due to tariffs or fiscal policy, which would likely limit near-term Fed easing. Alternately, near-term economic weakness could help offset inflationary pressures and spur a resumption of Fed rate cuts.

Given these potential scenarios and currently healthy coupon yields, we maintain a neutral allocation to fixed income along with duration exposure that is only modestly longer than our benchmarks' in traditional balanced portfolios. However, we simultaneously maintain significant bifurcation of credit exposure across maturities. At the longer end of the curve, we see Treasury bonds as relatively attractive going forward given the current level of rates. Meanwhile, we have concentrated corporate bond allocations in the shorter durations, which helps limit risk to returns from widening credit spreads in the event of economic weakness.

Within broader multi-asset portfolios, we maintain similar positioning within fixed income and have reduced real asset exposure by trimming our allocation to gold. Gold has benefited this year from a weaker dollar and rising uncertainty around trade policy, geopolitics, and the sustainability of U.S. "exceptionalism." We believe gold markets have largely discounted the uncertainty associated with many of these issues, which presented a chance to take advantage of other opportunities in the portfolio, in our view. However, we retain a moderate exposure to gold in multi-asset portfolios, given a mix of factors including central bank demand and lower real interest rates

CONCLUSION

Late-cycle economic environments have traditionally presented opportunities for macro investors, even as these conditions increase the need to navigate risks. While we are currently seeing some economic weakness play out, we continue to see a realistic path for extension of late-cycle U.S. economic growth in the intermediate term. The international outlook remains mixed, in our view, and we see a relatively balanced risk/return profile for other assets like fixed income and gold. Given this macroeconomic backdrop, we have positioned portfolios to balance opportunities we see for capturing excess return and managing risk control. As always, we will continue to adjust portfolios as warranted as our outlook evolves.

WestEnd Advisors Investment Team | July 1, 2025

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