A review of recent economic and financial market developments, and what our team expects going forward.

"Our outlook on risk assets has become more positive following the April volatility and subsequent recovery. We believe the economy is stable and unexpected surprises are possible. However, we are cautious about stock market valuations, as a healthy dose of good news seems priced in."

Key Takeaways:

- Still strong economic data and delays in implementing tariff policy allowed for a quick rebound in global stock markets.
- Each selloff and recovery are driven by different factors, with market expectations constantly changing. Stock prices reflect forward-looking expectations of companies' future fundamentals.
- Bond investors can benefit from near 5% yields on diversified intermediate-term portfolios, presenting opportunities for robust, equity-like returns with lower volatility.

As professional investors, our main objective is to evaluate economic scenarios and their impact on financial markets. Daily data can be mundane, and exogenous shocks are rare. Most often, we remain seated at our desks, calmly analyzing data, but there are rare moments that make us leap to our feet. We experienced one of these events in the first few weeks of the second quarter, marked by historic volatility due to unexpected tariff announcements and modifications.

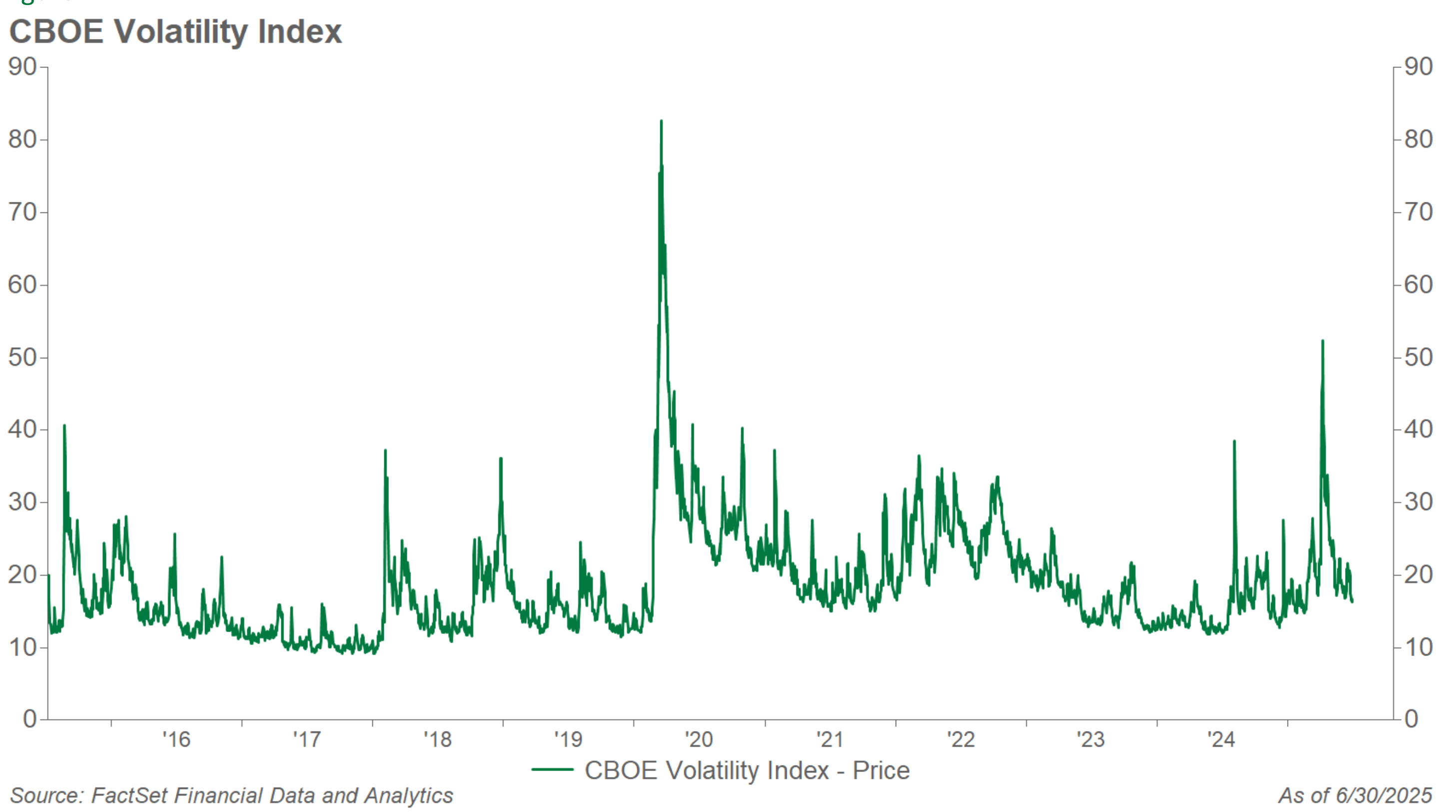
Our strategy emphasizes consistent asset allocation, yet we remain vigilant for moments when market volatility presents actionable opportunities. As Warren Buffett wisely noted, "The stock market is a device for transferring money from the impatient to the patient." We believe there are times to be less patient, especially when asset prices appear cheaply priced relative to history. By utilizing strategies such as allocation shifts or rebalancing, value can be gained while other investors rush to decide their next move.

Our outlook has improved after April's volatility and recovery. We believe the economy is stable with potential for positive surprises. The recent rally in stocks, has returned valuations to pre-sell off highs, which in our view makes the prospects for future returns more uncertain. Bonds are attractive, but rising interest rates may limit near-term returns. We currently prefer stocks over bonds in multi-asset portfolios due to potential benefits from trade negotiations, advances in AI, and a business-friendly U.S. climate.

On again, off again

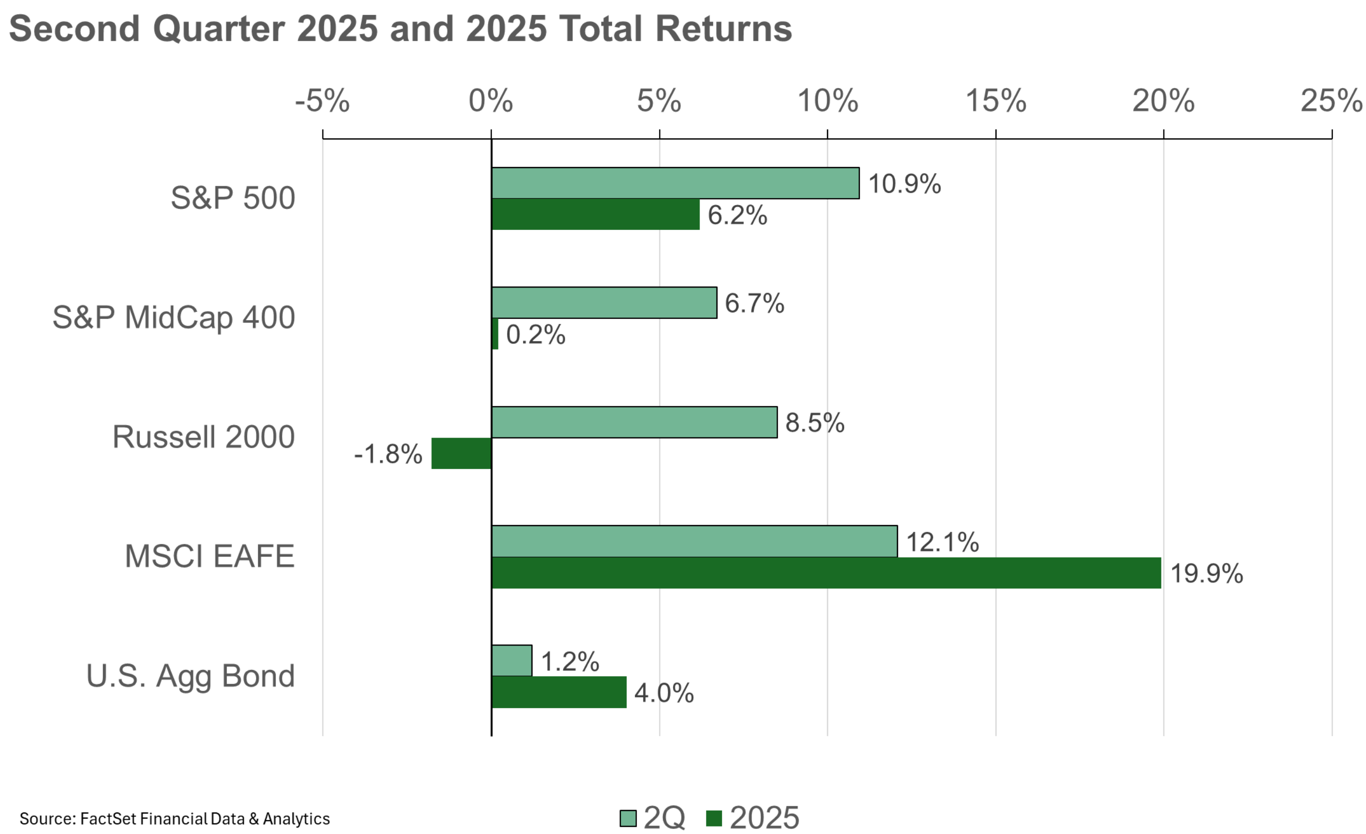
The second quarter of 2025 is one that will not soon be forgotten. The day after tariffs were announced (April 2, 2025, and coined "Liberation Day" by President Trump), volatility spiked, the S&P 500 Index fell 4.8% and then another 6% on April 4 (Figure 1). Shortly thereafter on April 9, it was announced that the tariffs would be delayed 90 days and the S&P 500 climbed 9.5% that day. With that went the rest of the quarter with announcements and subsequent delays in implementation causing continued uncertainty in the macroeconomic outlook for the U.S. and abroad.

Figure 1



Despite all the uncertainty, markets eventually settled down and finished the quarter very strong with the S&P 500 returning 8.9% and developed international stocks increasing 9.8%. Emerging markets provided a further boost to returns, climbing nearly 12% in the quarter. A continued fall in the U.S. dollar back to levels last seen in early 2022 helped boost international returns. International returns increase when the U.S. dollar falls due to converting international currencies back to U.S. dollars at a lower price. While small and mid-cap U.S. stocks were up in the quarter, they remain the laggards year-to-date. Bonds were up just shy of 1% in the quarter and provided a much-needed ballast during early April stock market volatility.

Figure 2



And the survey says

The hard economic data and the soft economic data continue to paint two slightly different pictures. The labor market continues in a positive direction with payrolls climbing by an average of 135,000 over the last three months (March through May) though have been below the average number of jobs gained over the last year. Initial jobless claims remain at the lower end with the 4-week moving average standing at 245,000.

We saw our first quarterly contraction in gross domestic product (GDP) in three years with the first quarter declining 0.5%, but it is important to understand the driver of the contraction. Imports surged in the first quarter as companies decided to get ahead of any impacts tariffs might have with the import of goods surging by a seasonally adjusted 51.6% in the first quarter. In the calculation of GDP, imports are a subtraction. Consumer spending continued to push higher, though at a slower pace, which is typically the primary driver of GDP in a given year. The Federal Reserve Bank of Atlanta's GDPNow estimates second quarter GDP bouncing back to a positive 3.4% with the reversal in imports and still strong consumer spending supported by incomes rising above the level of inflation.

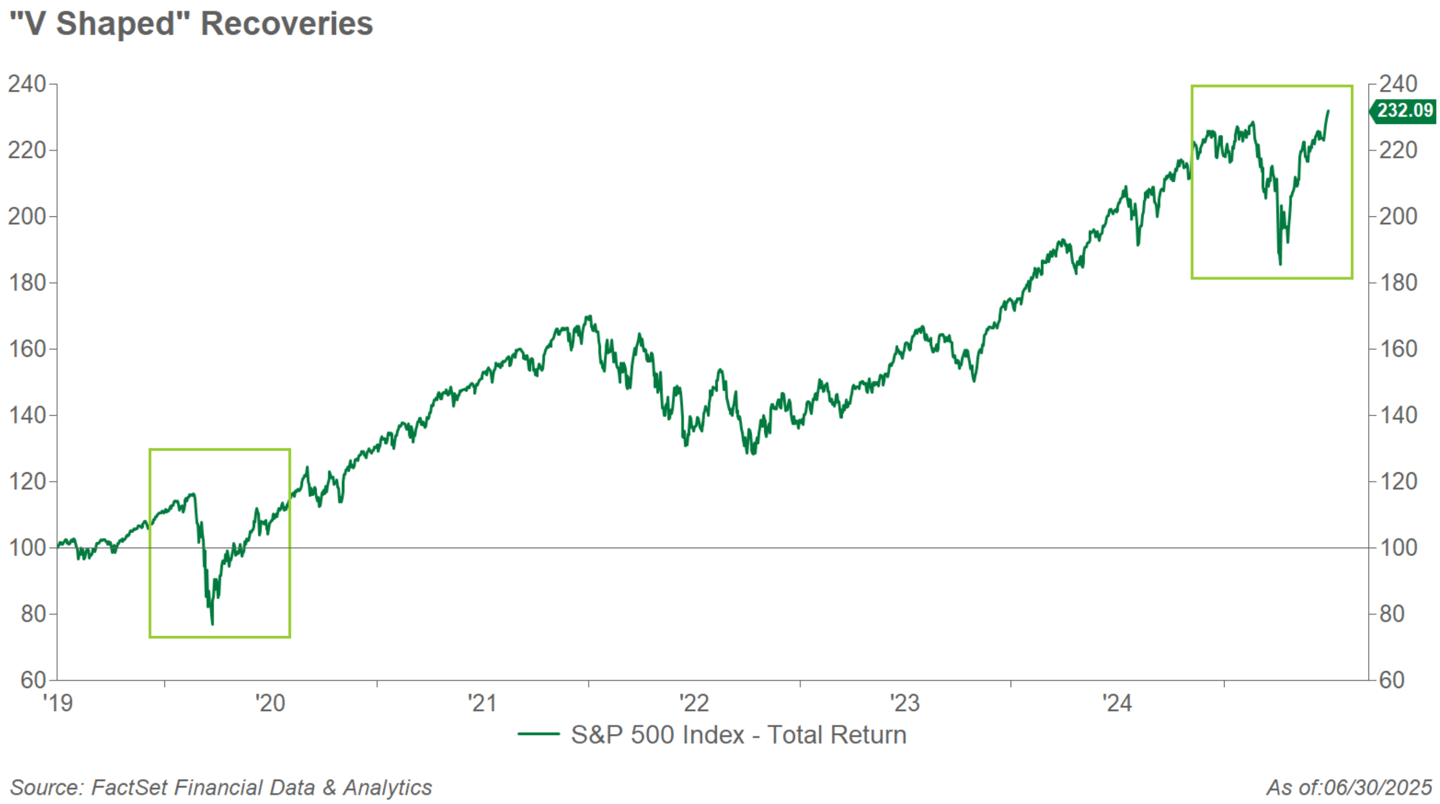
The soft data continues to be soft. The Consumer Confidence Survey dropped to 93.0 at the end of the quarter from 109.5 at the start of the year and the Expectations Index fell to 69.0 where readings below 80 are consistent with an increased risk of recession ahead. Though off the April lows due to the rollback of tariffs, both measures show consumers are still concerned about impacts from potential tariffs particularly on inflation.

Federal Reserve officials also have a watchful eye on trade policy and the uncertain impact tariffs could have on inflation moving forward. At both their May and June meetings, the Federal Open Market Committee (FOMC) elected to hold rates steady in a range of 4.25% to 4.5% as they gather more data before making any shifts to interest rate policy. In their Summary of Economic Projections (SEP), Federal Reserve Board members increased their expected inflation rate at the end of the year to 3%. The Personal Consumption Expenditures (PCE) price index sits at 2.3% at the end of June. There is also uncertainty amongst the members about where the fed funds rate will go over the course of the year with many expecting no rate cuts while the others expect two. Our team believes there will be at least one rate cut prior to the end of the year.

Volatility meets opportunity

The first week of April was volatile for stocks. On April 9, the most significant tariff policies were paused, leading to the S&P 500 rallying over 28% from its lows to finish the quarter up almost 11% and surpassing February's record highs. Experienced investors have often faced volatility and large downswings. Two recent examples of these downswings have shown relatively quick, V-shaped recoveries (Figure 3).

Figure 3



The S&P 500 experienced a sharp decline from March to early April this year, similar to the onset of COVID-19 in 2020. Both periods saw quick and powerful rallies, leading to new highs within a few months. This pattern has led many investors to consider "buying the dip" in anticipation of similar turnarounds.

We have observed since 1980 that there have been 11 instances where the S&P 500 declined by at least 15% from its all-time highs before reaching new highs. On average, it took about 15 months to recover, with the average sell-off being 29%, indicating more pain before recovery. From market lows this year, we saw new highs after only 89 trading days, the fastest recovery since 1980.

Given that it typically takes longer than a few months to reach new highs and often involves more volatility, we caution against assuming recent patterns will always repeat. We recommend a measured approach to navigating volatility, guided by careful planning rather than gut feelings.

When the market realized the ultimate tariff policies were not as severe as initially projected, stocks rallied due to improved fundamental expectations. Similarly, during the COVID-19 shutdowns, government and Federal Reserve interventions mitigated the worst-case economic scenarios, leading to another stock market rally.

It is important to remember stock markets are always forward-looking, basing current prices on expectations of companies' future cash flows. Each selloff and recovery are driven by different factors, with market expectations constantly changing. While there may be opportunities to take advantage of volatility, there are no guarantees of the timing of rallies and the drivers of each situation are unique. Recently, our team discussed opportunities extensively as markets moved quickly. While we took advantage of the opportunity to purchase what we viewed as oversold positions, we also took a calculated approach ensuring moves aligned with portfolio investment objectives and opted not to overreact.

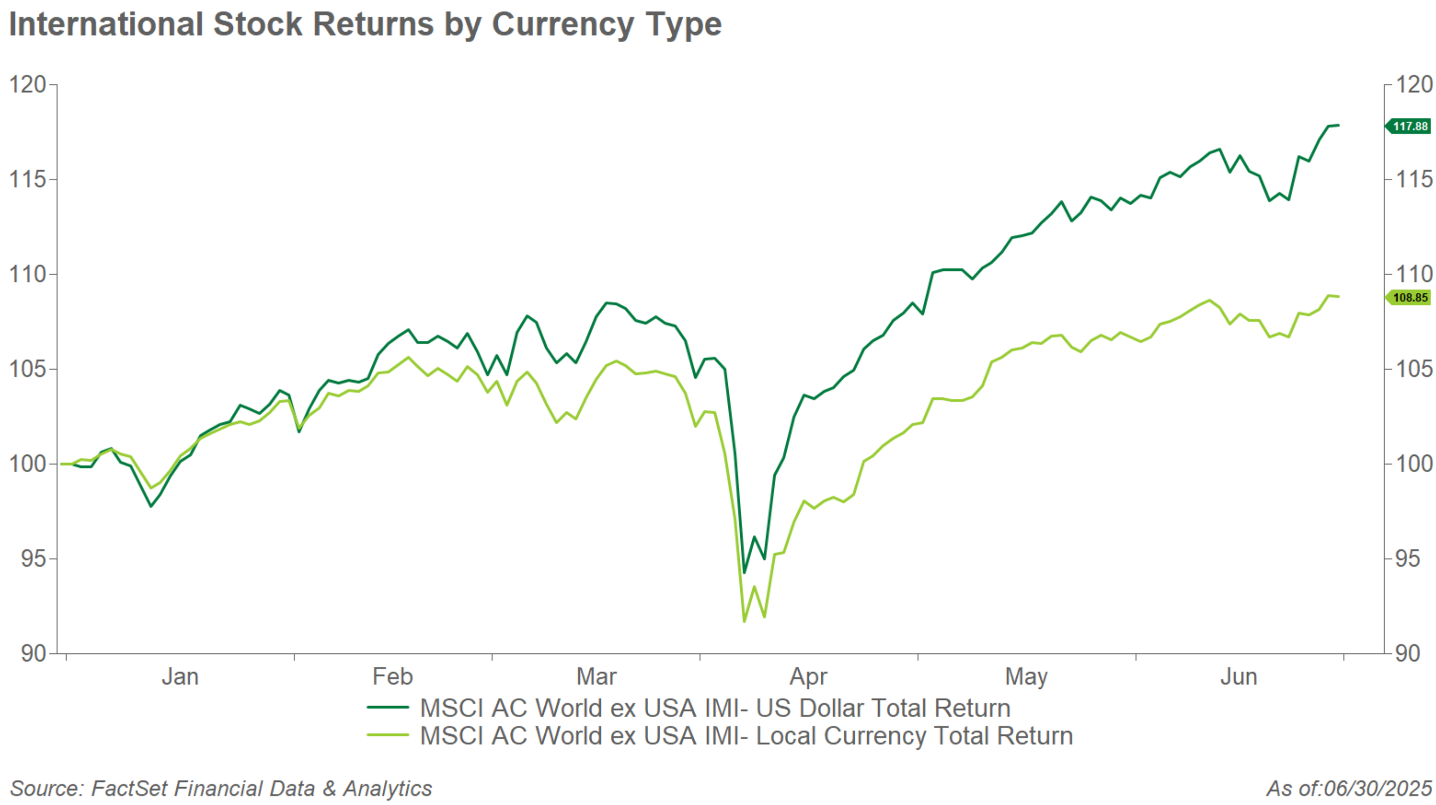
Trading tariffs for geopolitical risk

International stocks have outperformed U.S. large-cap stocks at the start of the year, despite increased geopolitical headlines related to tariffs. While the market seems to have taken events in stride thus far, we continue to monitor these events for eventual market implications.

We continue to have a neutral view between international stocks and domestic stocks. Given the recent outperformance of developed market stocks relative to emerging markets, and our current outlook on emerging markets becoming more balanced, we moved to a neutral view between developed and emerging market stocks.

It is interesting to note, over half of the international stock outperformance was driven by a depreciating U.S. dollar (USD). When U.S. investors own foreign companies, they benefit from a weaker dollar as returns are translated back into USD. Although currency impacts tend to balance out over time, this depreciation has boosted returns for diversified portfolios during a volatile year for U.S. stocks. (Figure 4)

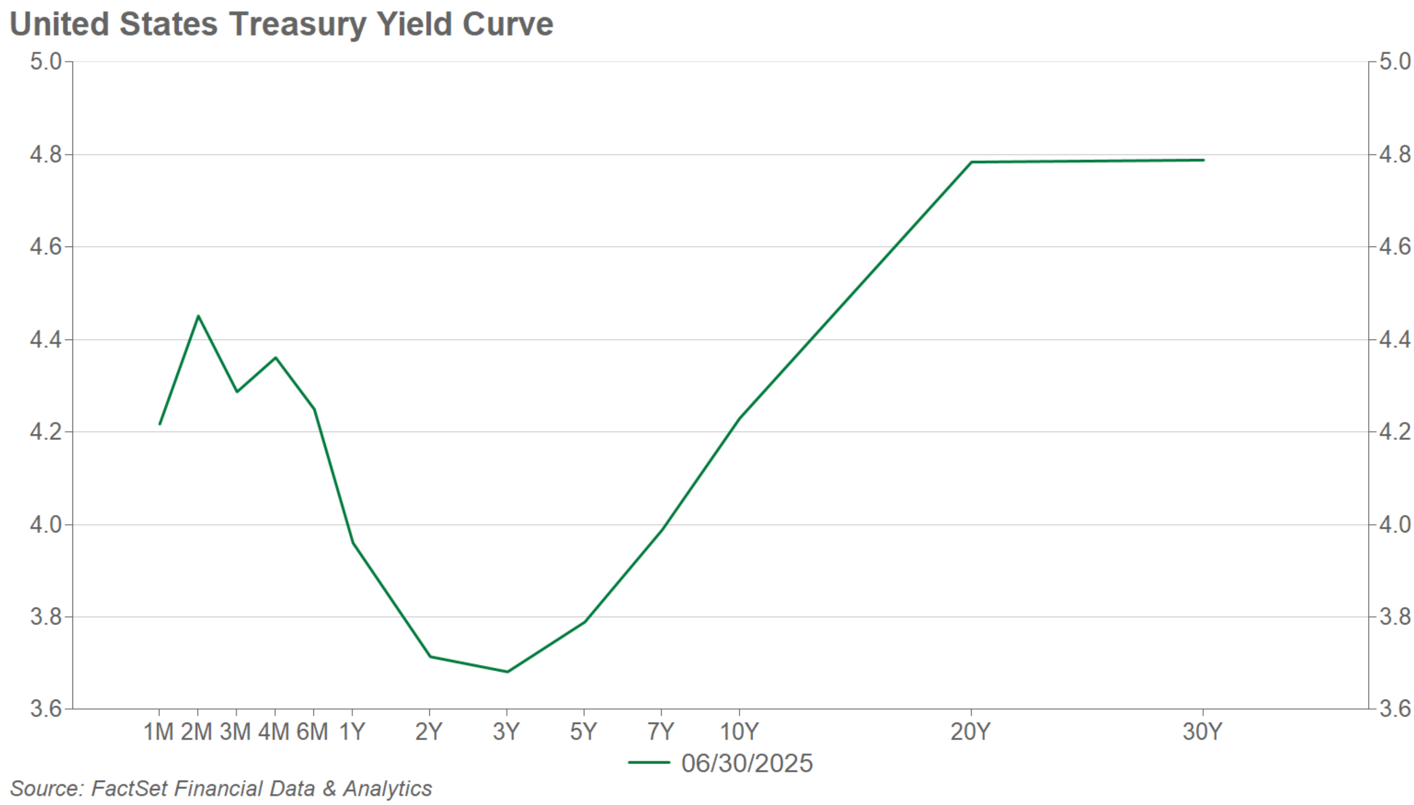
Figure 4



Rates roller coaster

Short and intermediate-term Treasury rates rose during the first half of the quarter but fell in late June as investors sought the haven of U.S. bonds. The 30-year U.S. Treasury yield has remained elevated, with a higher term premium compensating for long-term risks. This trend is also being seen globally, with long-term bond yields rising in Japan, the U.K., Canada, and Germany. Investors are assessing the impacts of tariffs and higher government deficits. The Federal Reserve is in a wait-and-see mode, expecting 1-2 interest rate cuts in the second half of the year. With inflation stabilizing, there's less pressure on the Fed to maintain high rates, contributing to the decline in short and intermediate term yields year-to-date (Figure 5).

Figure 5



Moody's recent downgrade of the U.S. credit rating indicates increased perceived risk in lending to the U.S. government. Successive U.S. administrations and Congress have struggled to reach consensus on effective measures to address large annual fiscal deficits and escalating interest costs. Current proposals are unlikely to lead to significant multi-year reductions in mandatory spending and deficits. Larger deficits could undermine investor confidence and devalue the U.S. dollar in future years. The U.S. is projected to spend nearly $1 trillion on interest payments this year alone. We continue to monitor these trends and their impact on interest rates and fixed income markets.

Throughout history bond investors have impacted the bond market by selling off government bonds in response to fiscal policies they perceive as inflationary or irresponsible. Coined in the 1990s, the term "bond vigilantes" describes how bond traders can influence interest rates, driving up yields and borrowing costs for the government. Selling pressure could force policymakers to reconsider higher government spending and may pursue more disciplined fiscal policies to regain investor confidence. The long-term impact of bond investor concerns about deficits and inflation on U.S. Treasury yields remains to be seen.

Time to clip the coupon

Low yields persisted from the 2008 financial crisis until after the COVID-19 pandemic, with bond investors enduring a painful bear market in 2022 as the Federal Reserve tightened monetary policy to combat inflation. Today, bond investors are in a better position. A diversified intermediate-term bond portfolio yields near 5%, offering a much different landscape for fixed income compared to five years ago. This presents opportunities for bond investors to lock in robust yields, with investment-grade bonds offering potential equity-like returns with lower volatility. Focusing on income rather than making duration bets based on interest rate moves is prudent in our view. We feel leaning on the "income" part of fixed income—the coupon element of a bond portfolio—makes sense rather than trying to predict a significant decline in interest rates.

The bottom line

As we move into the second half of the year, it is essential to focus on patience and diversification to achieve long-term goals. The economic outlook has stabilized, and the S&P 500 seems fairly valued after recovering from the April low. High-quality bonds present attractive return potential and the ability to reduce portfolio risk. Despite ongoing uncertainties, we recommend clients make informed decisions when opportunities arise, while always keeping their long-term goals in mind. This approach remains important even in the face of concerns about tariffs, inflation, or other unexpected events that may grab our attention.

Figure 6

Asset Class	Next 5 to 10 years*	Long-term Average
Stocks	5%-8%	10.4%
Bonds	4%-6%	4.9%
Cash Equivalents	2%-4%	3.3%
Balanced Portfolio (50% Stocks/ 50% Bonds)	4%-7%	8.1%

*Forecasted average annual returns of COUNTRY Trust Bank Wealth Management

Source: Morningstar and COUNTRY Trust Bank® - See Definitions and Important Information below

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Definitions and Important Information

Figures 1,2,3,4,5: Data sourced from FactSet Research Systems Inc, a global provider of integrated financial information, analytical applications and services for the investment and corporate communities.

Figure 6: The long-term average return data comes from Morningstar and is based upon compound average annual returns for the period from 1926 through December 31, 2024. Stocks are represented by the Ibbotson® Large Company Stock Index, which is comprised of the S&P 500® Composite Index from 1957 to present, and the S&P 90® Index from 1926 to 1956. Bonds are represented by the Ibbotson® U.S. Intermediate-Term Government Bond Index. Cash Equivalents are represented by the 30-day U.S. Treasury bill. The “Balanced Portfolio” is representative of an investment of 50% stocks and 50% bonds rebalanced annually. Forecasted stock returns include small capitalization and international equities. Forecasted bond returns include investment grade corporate bonds. These returns are for illustrative purposes and not indicative of actual portfolio performance. It is not possible to invest directly in an index.

Stocks of small-capitalization companies involve substantial risk. These stocks historically have experienced greater price volatility than stocks of larger companies, and they may be expected to do so in the future.

International investing involves risks not typically associated with domestic investing, including risks of adverse currency fluctuations, potential political and economic instability, different accounting standards, limited liquidity, and volatile prices.

Fixed income securities are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors. Debt securities typically decrease in value when interest rates rise. The risk is usually greater for longer-term debt securities. Investments in lower-rated and nonrated securities present a greater risk of loss.

The S&P 500® Index is an unmanaged index consisting of 500 large-cap U.S. stocks. The index does not reflect investment management fees, brokerage commission and other expenses associated with investing in equity securities.

The S&P Midcap 400 is a stock market index published by Standard & Poor’s (S&P). It measures the performance of 400 mid-sized companies in the United States, providing a benchmark for this segment of the market. These companies typically have market capitalizations ranging from about $2 billion to $10 billion.

The MSCI EAFE Index measures international equity performance. It comprises the MSCI country indexes capturing large and mid-cap equities across developed markets in Europe, Australasia, and the Far East, excluding the U.S. and Canada.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

The Bloomberg Aggregate Bond Index, often referred to as “the Agg,” is a broad-based benchmark that measures the performance of the U.S. investment-grade bond market. It includes a wide range of fixed-income securities.

Non-farm payrolls are collected by the U.S. Bureau of Labor Statistics (BLS) monthly through the establishment survey which provides information on employment, hours, and earnings of employees on non-farm payrolls.

The CBOE Volatility Index (VIX), often referred to as the “fear index,” is a real-time market index that represents the market’s expectations for volatility over the coming 30 days.

GDP or Gross Domestic Product is the monetary value of all goods and services produced during a specified period. The figure is used as a barometer of an economy’s health including its size and growth rate. In the U.S., quarterly GDP figures are typically “annualized” meaning the quarterly growth is compounded for four quarters.

The Fed Summary of Economic Projections (SEP) is a quarterly report published by the Federal Reserve. It compiles the economic forecasts of the members of the Federal Open Market Committee (FOMC), which is responsible for setting U.S. monetary policy.

The Personal Consumption Expenditures (PCE) Price Index is a measure of the average change over time in the prices paid by consumers for goods and services. It is compiled by the U.S. Bureau of Economic Analysis (BEA) and is used to track inflation.

The price-to-earnings ratio is a valuation ratio which compares a company's current share price with its earnings per share (EPS). EPS is usually from the last four quarters (trailing P/E), but sometimes it can be derived from the estimates of earnings expected in the next four quarters (projected or forward P/E). The ratio is also sometimes known as "price multiple" or "earnings multiple."

The yield curve plots the interest rates of similar-quality bonds against their maturities. The most common yield curve plots the yields of U.S. Treasury securities for various maturities. An inverted yield curve occurs when short-term rates are higher than long-term rates.

The federal funds rate is the interest rate at which depository institutions (like banks and credit unions) lend reserve balances to other depository institutions overnight on an uncollateralized basis. This rate is a key tool of U.S. monetary policy, set by the Federal Open Market Committee (FOMC) of the Federal Reserve. Changes in the federal funds rate can influence various economic factors, including inflation, employment, and the rates on consumer loans and mortgages.

Yield to Maturity (YTM) represents the total rate of return an investor can expect from a bond if they hold it until maturity and reinvest all interest payments at the same rate. It’s expressed as an annual percentage.

Credit spreads measure the difference in yields between bonds with the same maturity but different credit quality.

The term premium refers to the additional return that investors require for holding a longer-term bond compared to a series of shorter-term bonds. This premium compensates investors for the risks associated with long-term investments, such as interest rate risk and inflation risk.

The Consumer Confidence Index measures consumer attitudes, buying intentions, vacation plans, and consumer expectations for inflation, stock prices, and interest rates. The Present Situations Index is a sub-index that measures consumers’ assessments of current business and labor market conditions. The Expectations Index is a sub-index that measures consumers’ short-term outlook for income, business, and labor market conditions.

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