

# Economic & Market Update

## Third Quarter 2025 Outlook



### WORLD ECONOMY

- » After contracting slightly in the first quarter due primarily to a sharp increase in imports as consumers and businesses accelerated purchases in anticipation of punitive tariffs, the U.S. economy is on track to show positive growth when second quarter gross domestic product (GDP) is announced at the end of July. A decline in imports will be an obvious contributor to this growth, but continued increases in jobs and incomes should allow the consumer to be the primary driver of growth in the quarter. However, there has been a notable slowdown in consumer spending as the quarter proceeded, and this slower growth rate ought to carry into the second half of the year, as still-restrictive monetary policy and the uncertain implication of tariffs will likely have a dampening effect on both consumer and business spending. Relatively healthy balance sheets of both consumers and corporations should mitigate the contractionary policy impact. Growth for the overall U.S. economy may be below trend over the second half of the year but is strong enough to avoid a recession both this year and next. The housing market continues to disappoint as high mortgage rates and high prices throw off a strong affordability headwind. The sector is showing nascent signs of bottoming, but a catalyst for a true upturn remains elusive.

- » The impact of trade friction remains highly uncertain as market participants still attempt to handicap the motivation of the U.S. administration in placing new and enhanced tariffs on imported goods. Most of the bilateral negotiations conducted in the second quarter appear to have the primary goal of extracting concessions from these countries to help and encourage American production of certain goods. The one exception is China where the administration is looking for retribution from decades of unfair trade practices that have benefited an economy that has become a formidable competitor. There also appears to be a need for some element of consistent tariff revenue earned by the United States to offset the extension and initiation of tax cuts being proposed in the ongoing congressional budget negotiations. Tariffs on China will be negotiated down from the unbelievably high levels initially announced early in the second quarter, but they should be meaningful revenue generators through the rest of the decade.
- » European economic growth estimates for this year and next are anemic but still positive in the slightly above or below 1.0% range. With inflation basically under control save for the contractionary impact of tariffs, policy responses can be relatively aggressive in keeping the continent out of recession. Fiscal policy expansion is perhaps the biggest surprise as the collective group of countries seems to be finally more accepting of the need to bolster defense spending as the United States decreases its contribution to NATO. This unexpected surge in

government spending should be enough to offset the impact of tariffs on the sales of goods exporters.

- » As trade tensions with the United States have subsided somewhat entering the third quarter, the Chinese government's goal of 5.0% GDP growth for 2025 is more feasible. Overcapacity in certain goods-producing sectors, a stubborn property recession, and the impact of incrementally higher tariffs is likely to restrain growth to around 4.5% unless the government introduces more aggressive fiscal and monetary support. Increased tariffs are expected to hurt Japan's export-dominated economy unless the government can achieve a relatively favorable trade agreement with the United States. Reliance on domestic spending will likely generate a growth rate below 1.0% in 2025.



## **MONETARY POLICY**

- » The U.S. Federal Reserve (Fed) sees itself in a position to wait and learn more about the effects of tariffs before considering monetary policy adjustments. However, differences in opinion are beginning to develop within the Federal Open Market Committee (FOMC). Some members believe that if inflation remains near current levels or moves closer to the 2% target, it would be appropriate to revive the federal funds rate-cutting program, which has been dormant since the last rate cut in December 2024. Observers of the Fed are also closely monitoring any signs of a weakening labor market as an additional catalyst for Fed ease. Continued criticism from President Donald Trump has increased the probability of a rate cut at the July FOMC meeting, but September remains the most likely timing as the Fed will then have a better sense of the inflationary and economic impact of tariffs. Another cut at the December meeting is likely, as the forecasted economic slowdown should be more evident to the committee.
- » The European Central Bank (ECB) has cut its key deposit rate by 200 basis points to 2.0% over the past year. As inflation on

the continent appears to be settling around the 2.0% target, the ECB is near the end of its tightening cycle. After a likely pause in any further cuts at its July meeting, the ECB should be in a better position to assess the effects of tariffs on an already slow-growing economy. The Bank of England left its key rate unchanged at its most recent meeting but reiterated that rates remain on a gradual downward path. Two 25-basis-point cuts should be announced by year-end to offset the contractionary impact of tariffs and a restrictive monetary policy at current rate levels.

- » Heightened global uncertainty and concerns around the impact of tariffs on exports have kept the Bank of Japan (BOJ) on hold since initiating a rate-increase cycle in January. This approach has surprised markets somewhat as the achievement of its higher inflation target has been accomplished and the timing appears right for the BOJ to finally remove the excessive ease that has been in place for decades. The People's Bank of China continues to provide support to the Chinese economy but in a very measured approach as it attempts to avoid capital flight out of the country. We expect this approach, which utilizes small 10-basis-point cuts to its key rate and reductions in the reserve requirement ratio, to continue into year-end.



## **BOND MARKETS**

- » Attempting to match demand with supply in the Treasury market has seldom been a fruitful rate-forecasting technique. But impending Treasury supply in an ever-growing fiscal deficit environment is attracting the attention of the so-called bond vigilantes who would like to see greater fiscal discipline when the overall economy is expanding. Some less-than-stellar bond auctions at the end of the second quarter may be providing an initial indication that bond demand is waning due to the lack of discipline.

- » As expected, the 10-year U.S. Treasury note traded in a narrow range of 4.00%–4.50% for most of the first half of the year. The slower-growth economy expected in the second half should drive this yield to the bottom of the range and perhaps pierce below 4.00%. Shorter maturity bonds will likely perform even better as the Fed resumes its rate-cutting cycle. These dynamics should result in a steeper yield curve and a full return to the more usual upward-sloping shape across the curve.
- » Interest rate spreads on below-investment-grade bonds compared to Treasuries spiked higher at the beginning of the second quarter after the initial tariff announcements that put a chill in most risk assets. As the rhetoric subsequently subsided, spreads have returned almost fully to the expensive levels seen at the beginning of the year.



## EQUITY MARKETS

- » Although it is never a comfortable experience for market participants, the peak-to-trough declines in U.S. markets, which straddled both the first and second quarters of the year, turned out to be a classic correction that is now fully recovered entering the third quarter. With 2025 earnings for the S&P 500 expected to grow by roughly 9.0% year over year, it appears to be an earnings-driven market as valuations are again somewhat dear. Breadth of participation in equity market gains has improved somewhat, but the market recovery was still led by the top names in the information technology, communication services, and consumer discretionary sectors. Geopolitical events are always a wild card, but the apparent achievement of bilateral trade deals and imminent passage of the budget package in Congress should provide additional tailwinds over the summer months before investors must assess the implication of tariffs to earnings growth.
- » The benefits of global diversification this year have finally accrued in the portfolios of equity investors who have had the

courage to adhere to a global allocation, which includes relatively inexpensive developed international markets. Stimulative monetary and fiscal policy in continental Europe has helped deliver notable outperformance over U.S. equities in both local markets and through currency translation. Investors will now need to grapple with the effect of tariffs on certain industries in these slow-growth economies.

- » The weak performance of mainland Chinese equities has masked the year-to-date outperformance of emerging markets. Weak domestic demand and the uncertain impact of increased tariffs on earnings growth will continue to restrain the mainland markets. As fiscal and monetary support of the Chinese economy has been rather timid, some caution is advised in allocating to emerging market equities.



## COMMODITIES & CURRENCIES

- » After heightened volatility as Israel and then the United States both attacked Iran to destroy its nuclear weapon capability, crude oil prices resumed a downward trend as Saudi Arabia appears to have tired in its frustrating role of global swing producer. Increased Saudi production to gain back market share should put further pressure on oil prices through the summer.
- » Easier monetary policy being conducted by developed and some emerging market central banks will further increase the relative attractiveness of gold as a portfolio diversifier. Continued central bank allocation away from U.S. dollar-based assets will also serve as a tailwind for the yellow metal, but these drivers of price movements may already be in the price at current levels.
- » After trading in a relatively tight trading range for the last few years, the U.S. dollar may be about to break out of the lower end of the range and begin a true bear market. As bull/bear markets in the dollar tend to last many years, this current dynamic could be another compelling argument for unhedged international diversification in dollar-based portfolios.



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