Market Commentary and Outlook

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Capital Markets Performance

U.S. equity markets ended the quarter at record highs, despite a significant market selloff early in the quarter following President Trump's April 2 tariff announcement. Markets rebounded following the administration delaying the implementation of reciprocal tariffs. The S&P 500 ended the second quarter up 10.9%, and 6.2%, for the first half of the year. In a reversal of first quarter performance, growth stocks outperformed value stocks across market caps. Eight of the eleven S&P500 sectors were positive for the quarter, led by the Technology and Communication Services sectors. The Energy and Health Care sectors were the lagging sectors for the quarter.

International stocks outperformed their U.S. counterparts once again in the second quarter, benefitting from a weaker U.S. dollar and monetary and fiscal stimulus. The U.S. dollar (DXY) weakened by 7.0% in the second quarter. This led to the weakest first half for the U.S. dollar since 1973. A weaker dollar is a tailwind for international equity returns. The MSCI ACWI ex USA Index gained 12.0% in the second quarter, while the MSCI Emerging Markets Index was also up 12.0% in the quarter, registering its best quarterly performance since 2020. The MSCI Pacific region was the best relative performer for the quarter.

Interest rate volatility continued during the second quarter as the market digested U.S. policy uncertainty. The yield curve steepened as long-end Treasury yields rose primarily on growing fiscal concerns, including a U.S. credit downgrade by Moody's and the anticipated passage of a bill to extend President Trump's tax cuts. Credit spreads tightened as investors grew more comfortable owning corporate debt. The U.S. Aggregate Index was up 1.2% in the second quarter, with all six sectors recording gains led by Collateralized Mortgage Back Securities and Corporate Bonds. Lower rated bonds and intermediate duration bonds were the relative outperformers for the quarter.

U.S. Economy and the Federal Reserve

The U.S. economy contracted by 0.5% in the first quarter. The decrease in Real U.S. GDP primarily reflected an increase in imports as businesses boosted imports ahead of potential tariffs. This drag on economic growth should reverse as imports declined following the early April tariff announcement. While we still expect slower economic growth this year, the economy should be able to grow and avoid a recession this year, in our view. Importantly, recently announced tax cuts should be a tailwind for consumer spending and economic growth in the first half of 2026.

The U.S. job market remains solid as the economy added 449k non-farm payrolls in the second quarter with the June unemployment rate at 4.1% and wages up 3.7% year-over-year. The unemployment rate has remained in a narrow range of 4.0% to 4.2% since May 2024. We continue to watch weekly jobless claims for signs of any potential weakness in the U.S. job market.

Inflation reaccelerated in the second quarter and remains above the Fed's 2.0% annual target. Tariffs represent a one-time step up in prices and would boost inflation in the short term, pushing inflation back up above 3.0% and further away from the Fed's desired rate. We anticipate the tariff rate on U.S. imports may approach at least 15.0% as compared with a 2.4% rate last year. In early April, the markets were digesting the potential for a tariff rate on U.S. imports at or above 30.0%.

The U.S. Federal Reserve maintained its target federal funds rate at both its May and June meetings at a range of 4.25% to 4.50%, citing solid labor market conditions and inflation uncertainty due to tariff policy. The Fed maintained its forecast for two 25 basis point cuts this year while reducing its economic growth forecast and increasing its inflation expectations. The Fed is in a wait-and-see mode, remaining focused on the "hard" economic data associated with their dual mandates of maximum employment and price stability. Current market expectations are consistent with the Fed's forecast of two 25 basis point rate cuts by the end of the year.

Outlook and Portfolio Positioning

We expect continued capital market volatility until greater clarity emerges regarding the trajectory of tariff implementation and economic growth. Tariffs are likely to elevate inflation in the near term, but potential positive catalysts for the markets include a reduction or elimination of tariffs or governments' reacting to slowing economic growth with significant monetary and fiscal stimulus. The U.S. Federal Reserve is still restrictive with its monetary policy and has flexibility to move rates lower if needed, while the potential for additional fiscal policy support and deregulation legislation could help corporate earnings and the U.S. economy.

The second quarter market performance illustrated the importance of being diversified across asset classes and geographies. We remain well diversified and balanced in our equity positioning between growth and value, market capitalization and global market region. Market rotation has been significant year to date, with international markets outperforming the U.S. markets by over 10%. A continued weaker U.S. dollar, fiscal and monetary stimulus and still attractive relative valuations remain catalysts for international equities. In the U.S., value and small-cap stocks remain relatively attractive versus growth and larger capitalization stocks.

Our fixed income portfolio remains positioned toward intermediate duration and a tilt toward quality, consistent with our expectations for economic data to soften in the second half of the year. Interest rates have moved lower over the past year, which has boosted fixed income returns and provided ballast for our portfolios. Higher coupon rates also help insulate fixed income holdings from any potential rate increases.

Despite market uncertainty, it remains critical to stay diversified and committed to long-term investing. Second quarter performance, along with market history, shows that time in the markets produces better outcomes than attempting to time the markets.

As always, we thank you for your continued support and trust in Newport Capital Group.

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