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Second Quarter 2025 Market Commentary

An Oxford Harriman & Company Market Commentary

After a volatile start to the year, equities staged a strong rebound over the last three months. In the first quarter, market sentiment was cautious due to rising policy and tariff uncertainty, concerns about slower economic growth, and questions about the longer-term outlook in the artificial intelligence industry. In the second quarter, caution gave way to renewed optimism as tensions eased, tariffs had a limited economic impact, and companies posted stronger-than-expected first-quarter earnings. The dramatic shift in sentiment across the quarters created two distinctly different market environments.

The first half of 2025 was busy and eventful, but for all that happened, markets ended the first half not far from where they started the year. The S&P 500 returned 6.1% through the end of June after being down by over 15% at one point in April. Long-term interest rates, as measured by the 30-year U.S. Treasury bond yield, ranged from 4.40% to 5.10% but ended the first half of the year right where it started, near 4.80%. If one did not follow the markets closely, it might seem as though little had changed.

In this commentary, we recap the second quarter, discuss how market conditions changed from the start of the year, and look ahead to the second half of 2025.

Markets Were Volatile Due to Waves of Policy Uncertainty

This year has been defined by large, frequent shifts in U.S. trade policy. There were periods of increasing tariffs and targeted actions against trading partners, followed by exemptions and temporary agreements. While the first quarter was marked by trade escalation, the second quarter saw a significant shift toward de-escalation.

The escalation started in February and March with targeted tariffs on imports from China, Canada, and Mexico, along with broader duties on global steel, aluminum, and auto imports. Tensions peaked in early April with the

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announcement of sweeping tariffs on most imports. However, the tone quickly shifted a week later toward de-escalation, when the Trump administration paused reciprocal tariffs for all trading partners except China. By early May, the White House announced a trade agreement with China, signaling a further move toward easing tensions.

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While the second quarter's de-escalation efforts lowered tariffs from the initial extreme levels, uncertainty remains. In late May, a U.S. trade court ruled the tariffs unconstitutional, and by early June, the administration was weighing new tariff actions. As July and August deadlines on tariff exemptions approach, the policy environment remains fluid, with several key details still unresolved.

Reviewing Tariffs' Early Economic Impacts

Trade policy uncertainty impacted economic data and temporarily boosted activity early this year, as businesses and consumers rushed to buy goods ahead of anticipated tariffs. The front-running behavior was evident in the first quarter, with monthly imports of consumer goods and industrial supplies rising. Separately, auto-related tariffs led to a surge in vehicle sales in March and April. The spikes don't appear to be seasonal but rather a response to anticipated tariff changes, suggesting businesses and consumers pulled forward purchases to avoid potential cost increases.

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Early inflation readings have been encouraging, but concerns remain about the potential inflationary impact of tariffs. Economists caution that May's inflation report may not fully capture the tariffs' impact, as it takes time for supply chains to adjust. This has sparked a debate about the path forward: one group believes companies will raise prices and pass through tariffs, while the other thinks firms will absorb the higher costs to remain competitive. The upcoming corporate earnings season will provide an early look at how companies are navigating tariffs and policy uncertainty, including updates to their pricing strategy and earnings guidance for coming quarters.

Federal Reserve Urges Patience Due to Uncertainty

Tariffs and trade policy uncertainty have influenced Fed policy. The central bank faces a difficult policy tradeoff: tariffs could lead to higher inflation, but they could also slow economic growth if higher prices reduce demand for goods and services. Given this uncertainty, the Fed held interest rates steady at its May and June meetings, reiterating that it wants more data before deciding on interest rate cuts.

The market has adopted the Fed's wait-and-see approach. Based on current fed funds futures pricing, the rate cut forecast through the end of 2026 points to a target range of 3.0% – 3.25%. The market expects a gradual near-term decline in rates, with the first anticipated cut occurring in September. The pace of rate cuts is then forecast to increase in the fourth quarter and continue throughout 2026. Looking ahead to December 2026, the market expects the Fed to lower interest rates by approximately 1.25% over the next 18 months.

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Based on this current market pricing, investors expect the Fed to lower interest rates at a modest pace. This likely reflects the inflationary risk from tariffs, but also their limited economic impact thus far. It's important to emphasize that the market's forecast will likely change as more data becomes available, with the timing and size of rate cuts depending on inflation, trade policy developments, and the economy's trajectory over the next several quarters.

Also, it is important to remember that if the economy keeps growing and unemployment remains low, the Fed may elect not to cut as much, as quickly, or possibly decide to keep rates where they are.

Stock Market Rebounds as Valuations Expand

While the Fed paused its rate-cutting cycle due to policy uncertainty, the stock market has taken the view that tariffs will have a modest and temporary impact. The first quarter stock market selloff and subsequent second quarter rebound were primarily driven by changes in the S&P 500's valuation.

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At the end of 2024, the S&P 500 traded at approximately 22 times its forward earnings estimate. Investor optimism around the new administration's pro-growth policies and the future of artificial intelligence meant investors were willing to pay such a valuation. However, the P/E multiple fell to approximately 18 times in early April after the administration unveiled new global tariffs, with investors worried about economic and earnings growth.

As trade tensions eased in the second quarter and investor sentiment improved, valuations recovered. By the end of June, the S&P 500 once again traded at approximately 22 times, near where it started in 2025.

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Stock market valuations can be sensitive to sentiment shifts, and this year's reversal underscores how conditions can change dramatically from quarter to quarter. The next section discusses how the transition from P/E multiple contraction to expansion impacted second-quarter returns, leading the first quarter's underperformers to outperformance in the second quarter.

Equity Market Recap – S&P 500 Ends the Second Quarter at Record High

The tariff escalation in the first quarter and de-escalation in the second quarter created two distinct market environments. Looking at year-to-date returns for the low volatility and high beta factors shows two contrasting environments. Low volatility consists of stable and defensive stocks such as Utilities, Consumer Staples, and Healthcare, which tend to outperform when market volatility increases.

Conversely, high beta includes stocks that are more cyclical and sensitive to market movements, such as the Industrials, Financials, Energy, and Materials sectors. High beta thrives in periods of strong economic growth and lower uncertainty. In short, the two factors generally work best in different market conditions.

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In the first quarter, low volatility outperformed high beta by nearly 20%, reflecting the market's cautious tone. However, there was a trend reversal in the second quarter. The high beta factor outperformed low volatility by over 25% in the second quarter, erasing all its first quarter underperformance. This performance diversion during the first half of 2025 illustrates the broader theme of rapid escalation and de-escalation discussed throughout this commentary.

Stock market returns reveal a dramatic change in market leadership. For example, the S&P 500 rose approximately 10.8% in the second quarter after falling approximately 4.3% in the first quarter. Over the same periods, small-cap stocks (as measured by the Russell 2000 Index) gained approximately 8.5% after a 9.5% decline.

Growth and tech stocks led the market reversal in the second quarter. The Russell 1000 Growth Index increased approximately 18% after a nearly 10%

decline in the first quarter. The Nasdaq 100 gained 17.8% after an 8.1% loss, and the "Magnificent 7," a group of large-cap technology stocks, gained 21.0% after falling 15.7% in the first quarter.

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Despite the reversal from the first quarter to the second quarter, one trend remained intact. International stocks outperformed U.S. stocks for a second straight quarter, with developed and emerging market stock indices both returning more than 11% in the quarter. Year-to-date, developed and emerging market stocks have returned 20.2% and 16.4%, respectively, outperforming the S&P 500 by over 10%.

We believe most of the outperformance can be attributed to a weaker U.S. dollar, which is being impacted by tariffs, policy uncertainty, and a rotation out of U.S. stocks into international stocks.

Credit Market Recap – Bonds Search for Direction

Like the stock market, the bond market experienced a significant shift in sentiment from the first quarter to the second quarter.

The 30-year U.S. Treasury bond yield declined in the first quarter amid rising policy uncertainty and concerns about slower economic growth. This combination prompted investors to move into longer-maturity Treasury bonds, driving the 30-year yield down from 4.80% at the end of 2024 to 4.40% in early April.

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However, the trend reversed in the second quarter, as market attention shifted from slower growth and policy uncertainty to worries about higher inflation and widening fiscal deficits. The 30-year yield peaked around 5.10% in late May before falling back to 4.79% by the end of June. Despite the volatility and changing narratives, the 30-year yield is mostly unchanged year-to-date.

Corporate bonds outperformed Treasury bonds in the second quarter, with lower-quality corporate bonds outperforming. Corporate bonds, particularly high yield, benefited as tensions eased and investor sentiment improved, which caused corporate credit spreads to tighten after they widened in the first quarter. High yield produced a total return of 3.7%, outperforming investment grade's 2% return after underperforming in the first quarter.

2025 Mid-Year Outlook – Staying Disciplined and Focusing on What You Can Control

At the start of the year, few could have anticipated the events and market volatility that would unfold over the first six months. The market's early-year optimism was disrupted by policy-driven volatility, a dynamic that could persist in the second half of the year.

However, despite the policy uncertainty and market volatility, financial markets have proven resilient. In the second quarter, the S&P 500 posted its strongest quarterly return since Q4 2023 and fully reversed the first quarter declines.

The rebound suggests the market believes the economic impact of tariffs will be modest and temporary. However, the economy is highly complex, and introducing trade policy volatility could have a range of impacts. Tariffs could be short-lived, causing only minor disruptions as businesses and consumers adjust. In contrast, the cumulative effects of trade policy uncertainty could start to weigh on the broader economy in the second half of the year, leading to slower economic growth, weaker labor demand, and higher inflation.

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The coming months will provide important context, with economic data and earnings reports capturing a period marked by both trade escalation and de-escalation. Corporate earnings commentary will shed light on how trade developments have affected business conditions, and companies will provide earnings guidance for the coming quarters.

Second-quarter GDP growth will be released in late July, offering insight into how shifting trade policy and tariffs have impacted the U.S. economy. Along the way, there will be more trade policy developments, along with monthly economic data releases to track inflation, tariffs' impact on consumer spending, manufacturing activity, and the labor market.

Market volatility can be unsettling, but it's a normal part of investing. Periods of enthusiasm often lead to recalibration. It's natural to feel uncertain, but history shows that staying invested through volatility and maintaining a longer-term

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view is a prudent approach. By maintaining a diversified portfolio aligned with your long-term goals, you can be positioned to help weather the market's swings.

With uncertainty on the horizon, the theme for the second half of 2025 is simple: focus on what you can control. It's impossible to know what impact the tariffs will have on the global economy or whether the administration will change its mind on tariffs again. However, history shows the economy and market usually adapt to changing environments.

Rather than reacting to headlines and market volatility, the best course of action is to stay focused on your investment plan, maintain a diversified portfolio, and make decisions in line with your long-term goals.

We pledge to continue to guide you on this process and keep you updated on market developments.

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