



TRIDENT  
STRATEGIC PARTNERS

# Quarterly Market Narrative

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THIRD QUARTER 2025 OUTLOOK

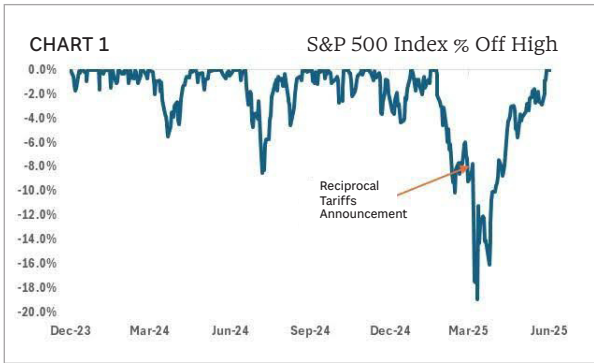
# MARKET RECAP

Several shocks occurred in the second quarter, including President Trump’s April 2nd reciprocal tariff announcements, which disrupted markets, and tensions in the Middle East as Israel launched its military operation against Iran’s nuclear facilities. However, markets continued to rise as the tariff threat eased throughout the quarter, and a ceasefire agreement was reached between Israel and Iran after the U.S. became involved by targeting Iran’s nuclear facilities with its Massive Ordnance Penetrator (MOP) bombs. The ceasefire prevented a prolonged rise in oil prices, unlike what happened when the Russia-Ukraine conflict began.

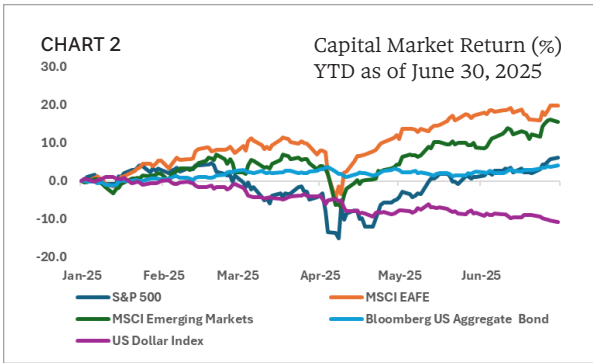
Despite these macroeconomic and geopolitical shocks, which, following the reciprocal tariff announcement, caused equities to approach bear-market territory with a 19% drop (Chart 1), U.S. equities reached new all-time highs by the end of the quarter, as measured by the S&P 500 Index. It’s a cliché to say, but remaining disciplined and invested throughout the volatility would have been the best course of action.

For the first half of the year, major asset classes delivered positive returns; however, the standout was the exceptional performance of international equities, both developed (+19.9%) and emerging (+15.6%), compared to the U.S. (+6.2%) (Chart 2). Rising tensions among global leaders over tariffs and U.S. fiscal policies caused a sharp decline of over 10% in the U.S. dollar in the first half of the year, which boosted returns for international equities for U.S.-based investors. Nevertheless, it is worth noting that international equities outperformed even after removing currency effects. Meanwhile, the modest decline in yields contributed to a positive return of 4.0% for core fixed income.

“It’s a cliché to say, but remaining disciplined and invested throughout the volatility would have been the best course of action.”



Source: YCharts



## MVP PROCESS

Markets are becoming increasingly reactive to evolving market narratives. Therefore, it is crucial to have a process that can look past the noise and distill informed perspectives. We describe our approach as our comprehensive ‘MVP’ process, which encompasses a macroeconomic perspective, market valuations, and gauging the market’s pulse. Essentially, we aim to understand how financial markets are positioned in terms of valuation and sentiment relative to our assessment of the current macro environment and perspective on the outlook for the business cycle; this, in turn, shapes our perception of risk in the current climate.

# MACROECONOMIC PERSPECTIVES

## NARRATIVE SUMMARY

### MACRO

Elevated tariffs and related uncertainty continue to impact inflation, keeping the Fed cautious. Yet, healthy consumer balance sheets help lower recession risks. However, slowing growth and labor market trends suggest the Fed will resume cutting rates, possibly at its September policy meeting.

### EQUITIES

U.S. stock valuations are high, making international diversification more attractive as global fiscal support boosts sentiment.

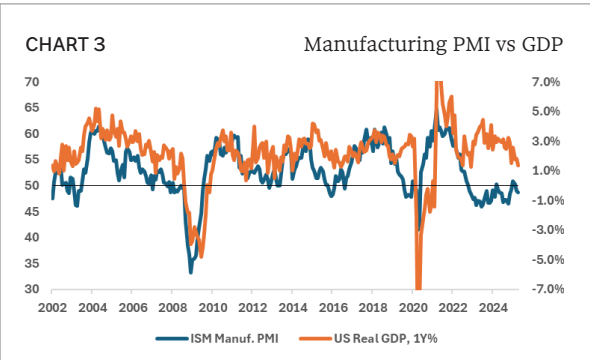
### FIXED INCOME

Bonds offer attractive yields, especially in a slower-growth environment; however, ongoing fiscal concerns and their effects on inflation and the term premium remain a key watchpoint.

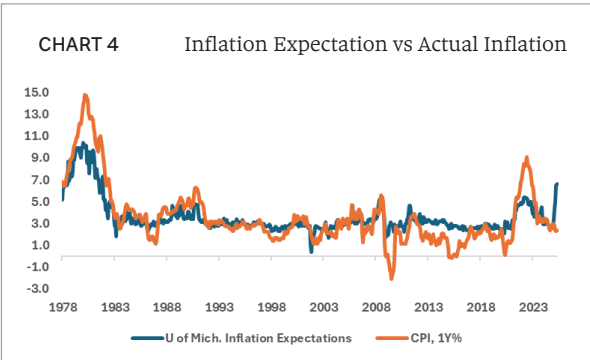
## UNCERTAINTY AND THE FED

There has been a divide between hard data and soft data, with surveys (soft data) offering a more sobering view of the outlook than what actual or hard data have shown. For example, ISM Manufacturing PMI, a business survey that measures manufacturers' outlook for their businesses relative to actual GDP growth, as shown in Chart 3. The chart displays a close historical relationship but a clear break in the pattern. The PMI data has been tracking below 50 and in contraction territory for some time; however, GDP growth, while slowing, remains positive.

Similarly, inflation, a decisive factor during last year's election, is nearing the U.S. Federal Reserve's (Fed) 2% target. Yet, perceptions about future inflation remain near the inflationary levels of the 1970s and early 1980s (Chart 4). Admittedly, we chose the University of Michigan survey of consumers to illustrate the point, as it is an outlier in measuring inflation relative to other surveys; however, it effectively drives home the fact that the economic data have fared better than perceived.



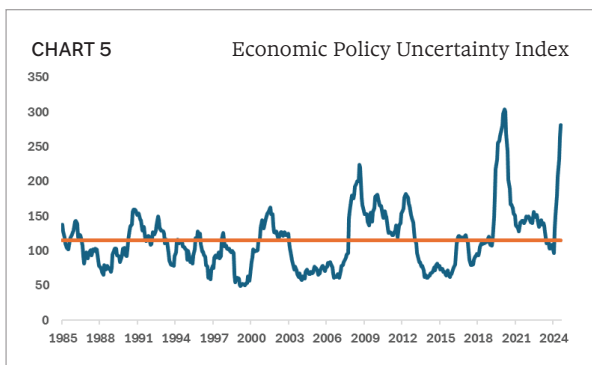
Source: YCharts (L) and TradingView (R)



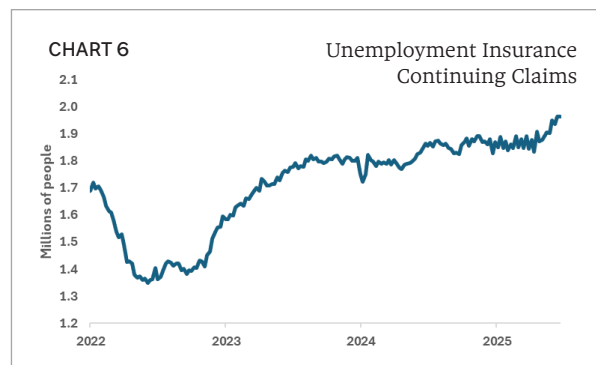
**The challenging part is identifying the cause of the disconnect, and one possible explanation is uncertainty. Human behavior naturally shows that confidence and uncertainty are inversely related. This means that as uncertainty increases, confidence decreases. So, when households or businesses are asked to respond to surveys, their reactions tend to reflect their perceived level of certainty.** While it's difficult to measure precisely because perceptions of certainty are more of a feeling than a hard fact, the economic policy uncertainty index, shown in Chart 5, is one way to measure it. It's a volatile series, which we have smoothed, but it's near levels last seen in 2020/2021. Back then, it was the pandemic; today, the uncertainty is linked to tariffs and trade policies.

Unfortunately, the uncertainty might persist for some time as the Trump administration works to establish frameworks for trade agreements before reciprocal tariffs take effect by the postponed August 1st deadline. While some key trade partners, such as the European Union, South Korea, and Japan, are the main ones to watch, many smaller nations are likely to miss the deadline. Still, the effective tariff rate is expected to be around 15% even after agreements are finalized, which is significantly higher than last year. The effect of higher tariffs is likely to be higher inflation, as businesses pass along some of the burden of the levies onto consumers.

**The main reason the Fed is holding back is due to tariff uncertainty and its effect on inflation.** As Chairman Powell mentioned in a Bloomberg interview, the Fed would probably have cut rates this year if not for concerns about inflation related to tariffs. The other part of the Fed's dual mandate is employment. Although the unemployment rate is low at 4.1%, the number of people with ongoing claims who are unemployed and seeking work has risen to over 1.9 million, suggesting reemployment is challenging. However, the labor market story becomes more complex when immigration trends are taken into account. Trends in deportation combined with a significant slowdown in legal immigration are shrinking the labor force and have also helped lower the unemployment rate in June. Interestingly, the American Enterprise Institute estimates that, due to a shrinking labor force, the monthly job gains needed to maintain the current unemployment rate could be as low as 40,000 to 70,000, a sharp decline from the average gains of nearly 170,000 in 2024. **In simple terms, a rate cut might be justified, but concerns about inflation, as well as the complexity of immigration on the labor force, may prevent the Fed from acting as fast as the President has desired.**



Source: YCharts (L) and St. Louis Fed FRED database (R)



## HOUSEHOLDS AND HOUSING

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**When examining the outlook for inflation and employment, there are signs of stagflation, with tariffs potentially increasing inflation while a cooling labor market and declining immigration slow down growth. However, a slowdown in growth should not be confused with a recession, and a recession is not our baseline expectation over the next twelve months.**

There are many ways to assess recession probabilities. Still, a helpful data point comes from Polymarket, a betting site where people wager on the likelihood of various events, serving as a good gauge for the “wisdom of the crowds.” Polymarket’s recession probability reached 66% shortly after the “liberation day” reciprocal tariff announcement, but has since fallen to around 20%. Compared to that, a market-based measure using the yield curve, developed by the New York Fed, estimates recession risks at about 28%, which is nearly double the long-term average of 15%. 15%, not coincidentally, aligns with the unconditional probability of a recession at any given time, based on the frequency of recessions. Our baseline leans towards Polymarket; recession risks are slightly higher than the long-term average, but not as alarming as a market-based measure, such as the yield curve, suggests.

Also underpinning our view of no recession is the strength of consumer balance sheets. What precipitated the Great Recession of 2008/09 was the sheer magnitude of household debt, which peaked at 87% of GDP in March 2009. As of the first quarter of 2025, it stands at 61%. Since consumption contributes to roughly 70% of the U.S. economy, the health of consumers is crucial. Still, healthy balance sheets are not uniform across the wealth distribution, and we know that lower-income cohorts are experiencing challenges. **However, in the aggregate, healthy consumer finances mean there is less risk that a growth slowdown could morph into a severe recession.**

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## INTERNATIONAL

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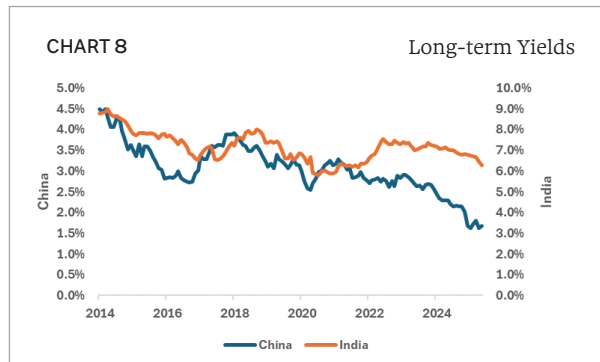
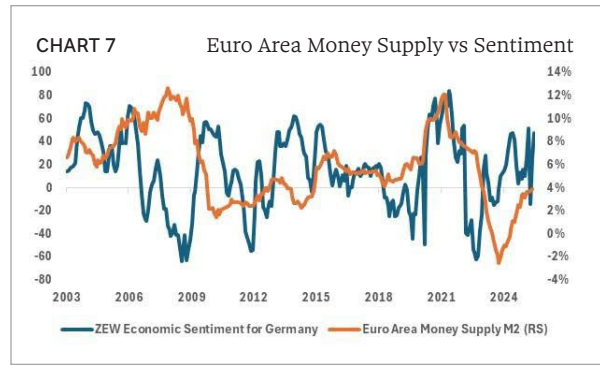
International markets have performed exceptionally this year, as shown in the returns chart. The uncertainty about tariffs, a weaker U.S. dollar, the fiscal effects of U.S. government spending, and increased defense budgets have all contributed to this trend. Still, with U.S. equity market capitalization making up around 65% of global equities, the law of large numbers, combined with these factors, has boosted international shares. **The key difference, however, is that after years of focusing on austerity and budgetary constraints, European nations are now looking to spend.** For example, Germany has passed a spending package worth €500 billion with a focus on infrastructure and defense, which has

improved economic sentiment in the Euro Area’s largest economy. Additionally, liquidity trends are improving, with yearly growth of the money supply approaching 4%, shown in Chart 7. Of course, six months of outperformance does not establish a new trend, but the factors that contributed to its underperformance, such as the lack of fiscal spending, are shifting and will serve as support.

The key issue in emerging markets is whether Chinese policymakers will become more focused on supporting consumption, which is showing some signs of improvement. However, the ongoing decline in Chinese long-term interest rates reflects weak demand, leading to falling producer prices

and stagnant consumer inflation. In contrast, Indian long-term rates have eased from their 2022 peaks but remain much higher compared to the sharp decline in Chinese yields, reflecting the growth gap between the two largest developing economies, Chart 8. Nevertheless, we believe that Chinese policymakers will eventually increase their support for consumers, which would be a positive development for broader emerging economies and Europe, which is more heavily leveraged to China through trade linkages.

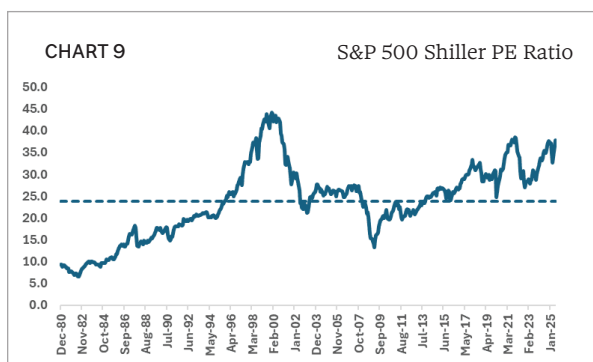
That said, the most immediate concern is the U.S. trade negotiations with both of these essential trading blocs. An extended impasse will challenge the growth outlook, not only for Europe and China, but also for the U.S.



Source: YCharts

## VALUATIONS

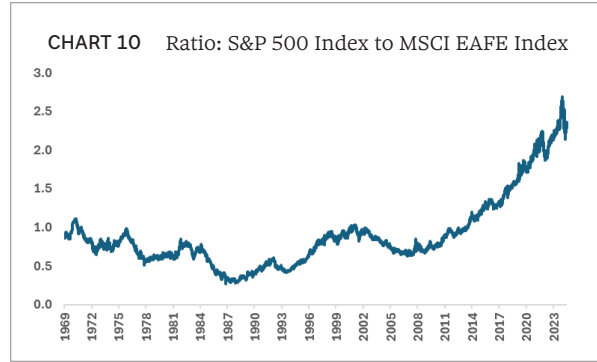
It is not a stretch or a secret to say that U.S. equities are expensive, in an absolute sense and relative to other regions. Chart 9 shows the cyclically adjusted P/E ratio for the S&P 500, also known as the Shiller PE, has rarely been as expensive in its history as it is today, at roughly 38 times, compared to the long-term average of about 24 times. So, sustaining current levels and, importantly for investors, pushing higher requires earnings to continue growing steadily. Encouraging, Q1 EPS growth of 13.7% based on LSEG data was better than expected. However, analysts have halved their Q2 EPS growth estimates since the start of the year, from 12% to 5.8% as tariffs are expected to encroach on profitability. Once again, the good news is that with the backsliding of the most punitive retaliatory tariffs and with hopeful signs of trade deals with key partners, Q2 estimates are no longer in decline. Moreover, as noted above, the macroeconomic cycle is slowing, but not recessionary. Therefore, a growth slowdown may lead to some bumps over the coming months, but we do not expect a severe drawdown that typically accompanies recessions.



Source: YCharts

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Still, for asset allocators, international equities deserve consideration. Given the strong outperformance of U.S. equities compared to international equities over the past fifteen years, shown in Chart 10, it's reasonable to assume most allocations favor U.S. equities. Even just following the benchmark weight results in a striking 65% allocation to U.S. equities within a global equities portfolio. **The combination of improved fiscal spending, a more accommodative monetary stance, better valuations, and dividend yields enhances the appeal of international markets.**

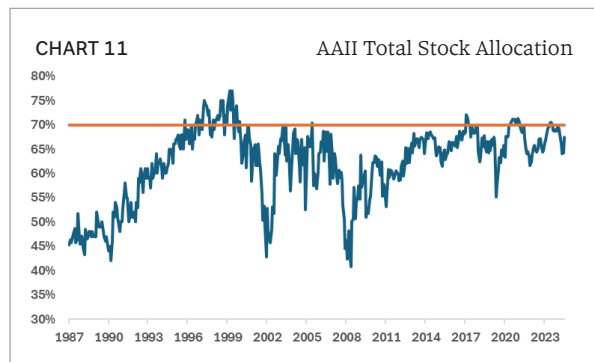


Source: YCharts

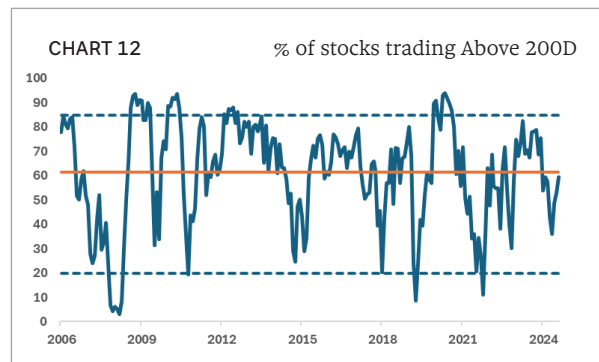
## MARKET PULSE

Equities are hot, but the market pulse isn't overreactive, at least not yet. For example, Chart 11 shows that the individual investors' equity allocation remains high at around 68%, but it's far from the extreme levels that often exceed 70%. Additionally, Chart 12 shows that the strength of the rally hasn't been enough to lift more stocks above their 200-day moving average (200-D). As of the start of July, roughly 60% of equities traded above the 200-D, just near the long-term average and far from the 85% level that accompanies overbought conditions.

**Market sentiment can shift quickly, but since several technical indicators suggest an interim extreme hasn't been breached, markets might continue to rise, supported by modest yet slowing growth. The earnings outlook from companies during their Q2 conference calls will be a key focus, along with macroeconomic indicators such as initial and continuing claims, and, notably, trade discussions.**

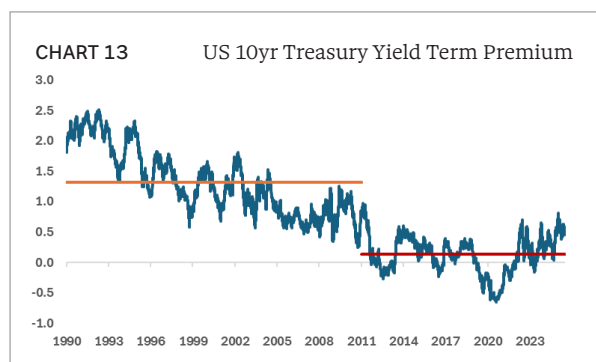


Source: YCharts (L) and TradingView (R)



# BOND BRIEF

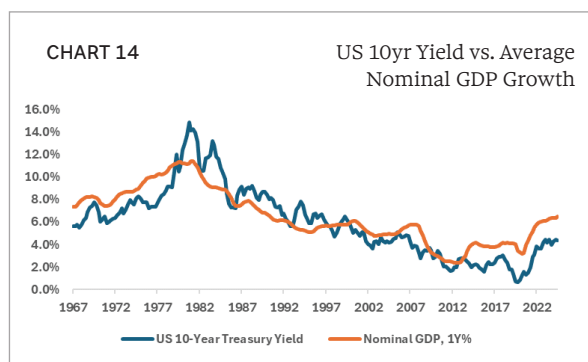
Bond markets have performed reasonably well despite concerns about the 10-year yield in an environment characterized by high stagflation and fiscal worries. While the short end of the curve is greatly affected by Fed policy, the long end, along with the Fed, is influenced by growth, inflation, and structural issues such as deficits and the term premium, which are now in focus due to the ongoing fiscal deficits. Chart 13 shows the term premium is trending higher and above the average since 2011, but remains well below the averages from 1990 to 2010. **Given the U.S. fiscal trajectory, it is possible that the term premium could gravitate back towards its previous long-term average over time, implying higher yields. In the meantime, however, if a growth scare occurs, expectations for a Fed rate cut would likely rise, leading to lower yields across the curve, including the 10-year yield.**



Source: YCharts (L) and TradingView (R)

Chart 14 shows that historically, the average annual nominal GDP growth has been a decent proxy for the fair-value level of the 10-year treasury yield. Average annual GDP growth over the past five years has been 6.5%, significantly higher than the current level of the 10-year yield. We don't expect yields to rise that much. Still, if nominal GDP slows to around 4% to 5%, and the term premium remains near the current level of 50 basis points, a fair-value range for the 10-year yield of 4.5% to 5.5% seems reasonable. The risk, however, is that if the U.S. fiscal situation does not improve and the term premium rises, yields could increase due to a higher term premium.

**Over the next twelve months, however, bonds offer a compelling yield, and slower growth should help support their appeal.**



## NARRATIVE SUMMARY

Despite a macro backdrop marked by mixed signals, resilient hard data versus more cautious sentiment indicators, the U.S. economy seems to be slowing but not slipping into recession. Tariff-related uncertainty is weighing on Fed policy, delaying rate cuts despite a cooling labor market. While inflation risks persist, especially with elevated tariffs, strong consumer balance sheets are an underlying support for the U.S. economy.

For asset allocators, diversification remains crucial. Stretched U.S. equity valuations and tariff-related uncertainty support a more diversified approach. International equities are benefiting from better relative value and prospects for more fiscal spending in Europe. At the same time, China's more forceful support for domestic consumption would improve its outlook and strengthen the broader emerging markets as well as Europe. In fixed income, higher yields reflect inflation and fiscal concerns and rising term premiums, but bonds remain attractive in a slower-growth environment.

Disclosure:

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