AVITY Investment Management Inc.®

# PERSPECTIVE

**July 2025**

U.S. stock indices staged a forceful recovery in the second quarter following a sharp, but brief, correction in April triggered by trade policy developments. Fixed income investments recorded positive returns in a somewhat volatile period for interest rates as investors weighed the risks of higher inflation against those of softer economic data. Middle East tensions flared in June but have not broadened. The outlook appears constructive but will be shaped by economic policies, as trade negotiations continue and new fiscal policy is implemented.

## ECONOMIC BACKDROP

U.S. GDP growth rebounded in the second quarter, signaling more stable trends after an idiosyncratic decline at the start of the year driven by a sharp rise in imports as businesses accelerated orders ahead of tariffs. The trade backdrop remains fluid, but the high degree of uncertainty experienced in April has eased. Some level of tariffs are likely to persist, but at rates far lower than initially proposed. Consumers remain resilient but cautious. Confidence among households rebounded some, driven by easing trade war fears and a stronger stock market, but remains well below levels at the start of the year. The unemployment rate held steady at 4.1% as businesses appear reluctant to make significant staffing changes. Initial jobless claims remain relatively low, indicating limited layoffs, but the data suggest companies are hesitant to hire. In the housing market, activity is sluggish with home affordability challenged by elevated mortgage rates and prices. Inflation trends are favorable as the Consumer Price Index increased a benign 2.4% in May. Wage growth continued to moderate but still exceeds the rate of inflation, providing consumers with purchasing power. Tariffs have yet to significantly impact goods prices, but the sharp rise in import costs suggests some inflation pressures may emerge later this year depending on how much of the burden is passed through to consumers. Oil prices remain subdued after a brief period of volatility caused by escalating Middle East conflict, which appears contained for now. For the second consecutive quarter, the U.S. dollar weakened against most major currencies driven by a confluence of factors including tariffs and U.S. fiscal policy. Economic conditions overseas are mixed as China's growth has stabilized while major European economies take steps to boost lackluster activity.

## THE DEBT DILEMMA

The One Big Beautiful Bill Act rekindled longstanding concerns over the federal debt and budget deficit. The U.S. has not achieved a budget surplus in over two decades. Military conflicts, recessions and the pandemic partly explain the nation's deteriorated fiscal condition. However, the significant budget deficit that persists today, equal to 7% of gross domestic product, is inconsistent with an otherwise healthy economy and suggests there is a structural imbalance between government revenues and outlays. Entitlement programs, including Social Security, Medicare and Medicaid, consume more than half the federal budget and aging demographics will further strain retirement programs. Defense spending is unlikely to be curbed due to ongoing geopolitical tensions and the need for military modernization. Exacerbating these budget pressures have been higher interest rates. In 2024, the nation's debt service costs reached $882 billion, surpassing the entire defense budget. The government is likely to fund ongoing shortfalls through additional borrowing, which may increase interest rates further and undermine confidence in the U.S. Treasury market. Elevated financing costs driven by fiscal expansion can crowd out investment in more productive areas such as infrastructure, education, research and business formation. Budget deficits indirectly contribute to the trade imbalance by absorbing domestic savings and increasing the need for foreign capital. The U.S. dollar, long buttressed by its status as the world's primary reserve currency, still enjoys the "exorbitant privilege" of relatively cheap funding, yet that advantage rests in part on global confidence in Wash-

**U.S. Federal Debt as a % of GDP—1970 to 2025**

Source: Bloomberg

ington's fiscal stewardship. A reduction in the deficit, an early objective of the new administration, appears unrealistic given recent legislation.

The U.S. fiscal path, while unsustainable in the long run, is unlikely to be an imminent economic threat. The size and strength of the U.S. economy, its deep and liquid Treasury markets, and robust economic and political institutions, including a Federal Reserve committed to low inflation, underpin the durable supremacy of the U.S. financial system, of which there are few credible alternatives. There is no precise debt level that triggers an economic reckoning, as evidenced by Japan, whose relative liabilities greatly exceed that of the U.S. without commensurately high inflation or interest rates. After a short-lived tremor in April, Treasury yields ended the quarter in a complacent manner despite growing deficit rhetoric. While the political appetite for meaningful fiscal reform appears limited for now, rejuvenated economic growth provides a plausible path to mitigating the country's fiscal challenges. Growth stimulating legislation and the diffusion of artificial intelligence offer a source of optimism. Goldman Sachs estimates that AI has the potential to add 1.5% per year to productivity growth, which would dramatically improve the nation's fiscal condition by lifting wages, corporate profits and tax revenues without corresponding inflationary pressure. Nonetheless, excessive government spending warrants careful scrutiny and we remain attuned to its impact on global financial markets.

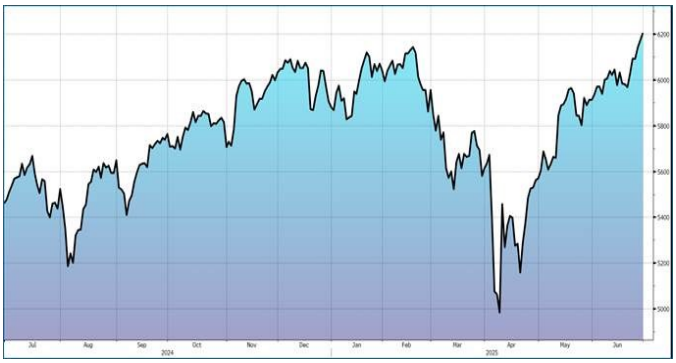
## FIXED INCOME

Fixed income investments registered gains for the quarter and solid returns for the year-to-date. The yield on ten-year U.S. Treasury Notes finished the period at 4.2%, nearly unchanged from the start of the period, but not without volatility. Long-term rates fell sharply in early April, as tariff announcements introduced uncertainty to the outlook, before surging as investor focus shifted to the potential for higher prices and growing deficits. The turbulence of the bond market may have influenced President Trump's decision, on April 9, to announce a pause on tariff implementation. As we expected, the reconciliation bill did not propose any changes to the tax-exempt status of municipal bonds. Under present conditions, which include muted inflation and a slower pace of hiring, Federal Funds Rate cuts would be expected. However, further monetary easing has been deferred until the Fed gains more visibility into the full impact of tariffs. Long-term rates are likely to remain rangebound as investors balance the risks of higher deficits and inflation with those of a potentially slowing economy. After extending the average maturity of client bond portfolios over the last two years, we are comfortable maintaining an intermediate duration as we monitor developments in trade, the labor market, and monetary and fiscal policy.

## EQUITIES

The S&P 500 Index recorded a 10.9% return for the quarter and finished the period at an all-time high, having mounted a historically sharp rebound after an approximately 20% decline from its February peak. Equity market volatility reflected trade war escalation and subsequent pause, within a backdrop of strong corporate profit growth that analysts expect

**S&P 500 Index—Past 12 Months**



Source: Bloomberg

to continue into next year. While tariffs pose a risk to some company earnings, management teams are taking action to preserve margins by re-engineering their supply chains and will selectively pass price increases through to customers. The U.S. reconciliation bill, despite its deficit implications, has stoked optimism around tax and regulatory relief. Artificial intelligence capital expenditures and consumption remain robust, which has positive implications for broad swaths of the economy that are enabling and adopting the technology. U.S. equity valuations returned to record highs, driven in the quarter by Technology, Communication Services, Industrials and Consumer Discretionary. Client portfolios have benefited from exposure to these sectors with investments in enterprise software, semiconductors, cybersecurity, digital media, electrical infrastructure and e-commerce. Stock prices are currently underpinned by solid fundamentals, but amidst a backdrop of high price-to-earnings ratios, policy ambiguity, and the reshaping of globalization trends, we remain committed to our valuation discipline and emphasis on businesses with above average growth and profitability.