Caron's Corner Transcript – 7.7.2025

Break on Through to the Other Side? Looking Past the Soft Patch

- "Uncertainty gives way to clarity" is our theme for 2H 2025.
- In other words, once "known unknowns" become "known knowns," risk premiums may be reduced.
- U.S. jobs data released last week surprised to the upside and President Trump's budget was signed into law on July 4th.
- Deregulation is an important component of that legislation, as it could offset tariffs and help operating leverage and valuations.
- But there are still risks to consider, namely weaker GDP growth data, rising unemployment and higher inflation.
- The Fed may "wait and see," but the markets look ahead, where the ultimate budget test is whether it spurs nominal GDP faster than the growth of U.S. debt in order to reduce the deficit.
- This may provide support to assets through the expected soft patch in 2H25, where investors may start to price 2026 upside as soon as 4Q25.
- In the end, it's all about breaking through to the other side!

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Welcome to another edition of Caron's Corner powered by The BEAT, our asset allocation framework across Bonds, Equities, Alternatives and short-term Transitional (cash) investing.

The title of this week's Caron's Corner is "Break on Through to the Other Side? Looking Past the Soft Patch." Our theme for the second half of 2025 is uncertainty gives way to clarity. This refers to markets having a better understanding of tax and budget policies and realizing there is a pathway to achieve agreements on tariffs. The European Union seems willing to accept Trump's 10% universal tariff, but wants lower rates on key sectors, with the July 9th deadline looming. In other words, once known unknowns become known knowns, it can go a long way to increasing visibility and reduce risk premiums. The feared U.S. jobs data released last week surprised to the upside on the headline, and the unemployment rate fell to 4.1% when it was widely expected to rise to 4.3%. For many, a weak data point here would have put the Fed in play to cut rates as soon as at their July meeting. Now on Friday, July 4th, the One Big Beautiful Bill Act was signed by President Trump, which has many pro-business and investment features. Perhaps the most important is deregulation, which in my view is an underappreciated cost offset to tariffs that should help operating leverage and valuations. That said, there are still risks to consider on what may lie ahead: weaker GDP growth, rising unemployment and higher inflation, all of which are in the Fed's forecasts - and I tend to agree with them. But will the weak turn in data matter to asset prices? That's the question. And I really don't think it will matter much because it is a well expected soft patch that the market is willing to look through. The Fed may wait and see, but markets look ahead. What may matter most is how the U.S. budget, taxes and stimulus and business enhancing deregulation may run through markets in 2026. Yes, we're talking about 2026 already. The ultimate test of the budget's veracity is if it actually spurs a growth rate in nominal GDP faster than the rate of growth of the U.S. debt in order to reduce the deficit. This may provide a support to assets through the soft patch of the second half of 2025, and investors may start to price upside in 2026 as soon as sometime later this year, like in the fourth quarter of 2025. It's all about breaking through to the other side. Let's get into it.

So there are 5 points that I want to talk about in the look through that the market seems to be anchoring on. The first one is AI and a tech-led optimism. The S&P 500 is increasingly driven by a few mega-cap stocks, many of which are riding the AI boom. Investors are betting that AI-driven productivity will boost earnings and offset macro concerns.

The second is strong earnings momentum. Corporate earnings have been surprising to the upside. Even if macro risks loom, companies have kept margins solid and guiding higher, reassuring investors that fundamentals remain intact.

The third is about the Fed and rate cut expectations. Markets are pricing in Fed rate cuts starting later this year, which supports equity valuations. Lower rates reduce discount rates on future cash flows, making stocks, especially growth stocks, look more attractive.

The fourth is that the market is shrugging off fiscal risks, at least for now. Investors tend to discount long-term fiscal risks like the U.S. budget deficit if they don't see immediate consequences, as long as Treasury markets remain orderly and the Fed, seen as a backstop, equities are likely to stay resilient.

The fifth is about global liquidity and the demand for U.S. assets. Global capital continues to flow into U.S. equities, maybe not as fast as it had in the past, but still flowing in. More recently, the U.S. has been outperforming Europe and China. That's driving demand for the relative safety and upside of U.S. stocks, even with budget and tariff clouds.

So the bottom line is that as we walk through these doors, just as day divides the night and night divides the day, markets are forward looking, breaking on through to the other side of the anticipated soft patch.

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