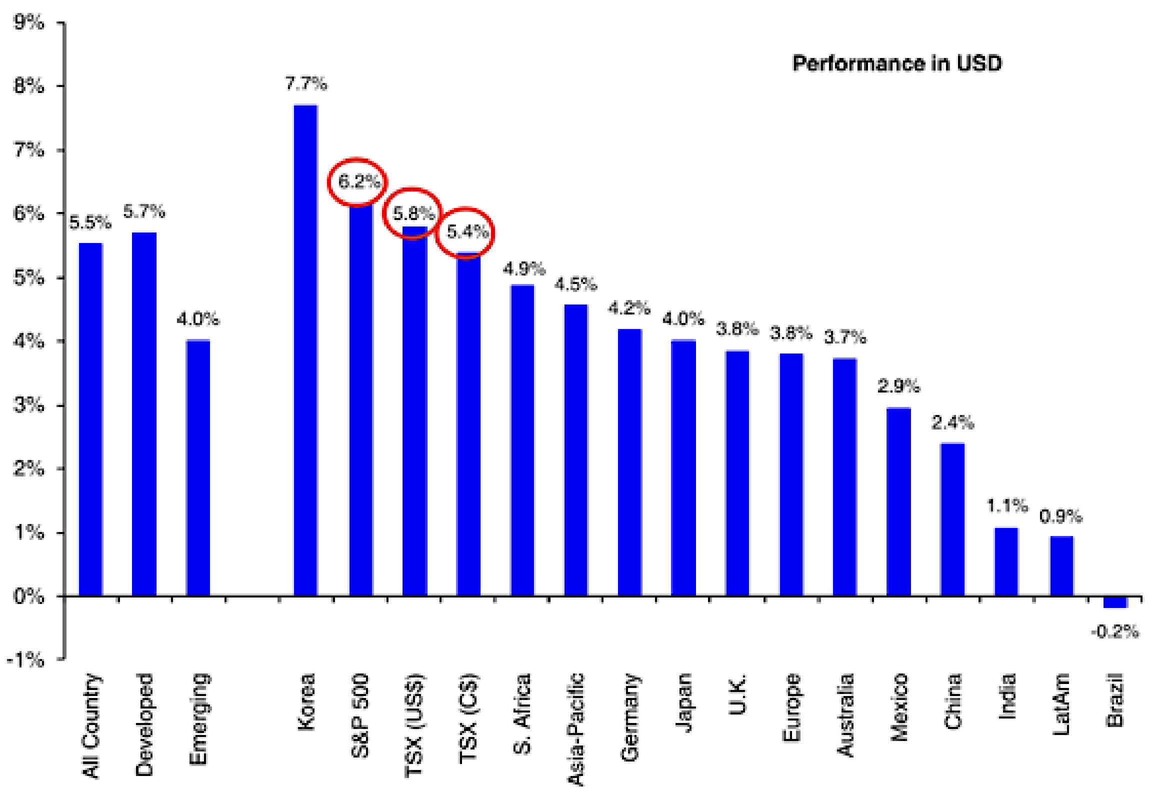
May Market Commentary | Markets Rise, But Questions Multiply

By Rob Edel, Chief Economist

May marked an impressive rebound in equity markets. The S&P 500 returned +6.3% (total return in U.S. dollars), marking its best May in 35 years. Global equity indices were also strong, with Brazil being the lone outlier in negative territory. Canadian equities also performed well, with a return of 5.6%. Gains were broad-based, although U.S. large-cap stocks led, with Korea being one of the few global peers to keep pace. Year to date, however, the S&P 500 has underperformed global markets, trailing the MSCI All Country World Index excluding the U.S. by the widest margin since 1993.

Exhibit 1 - Global Large Cap Equities: MTD Performance (As at May 30, 2025)



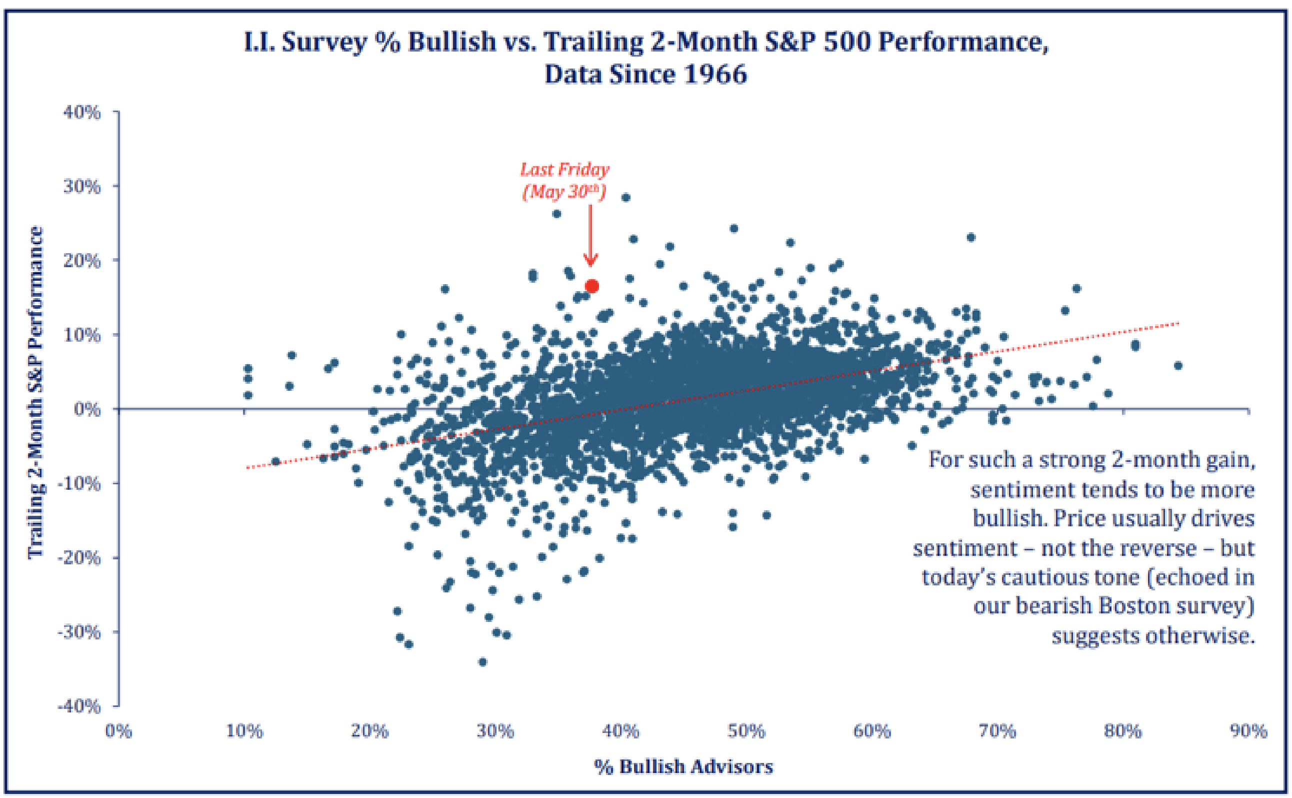
Based on MSCI indices unless otherwise indicated

Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

Rally Meets Skepticism

Investors may welcome May's returns, but many remain unconvinced about the rally's durability. As of May 30, the S&P 500 was up nearly 19% from the April 8 "Liberation Day" lows. According to Strategas, advisor bullishness remains low, suggesting institutional investors aren't buying into the rally, at least not yet. The real story last month may have been in the bond and currency markets. As the Financial Times noted, the usual positive correlation between the U.S. dollar and 10-year Treasury yields has broken down. Since early April, yields have trended higher, but the dollar has weakened, a rare divergence that likely contributes to investor unease.

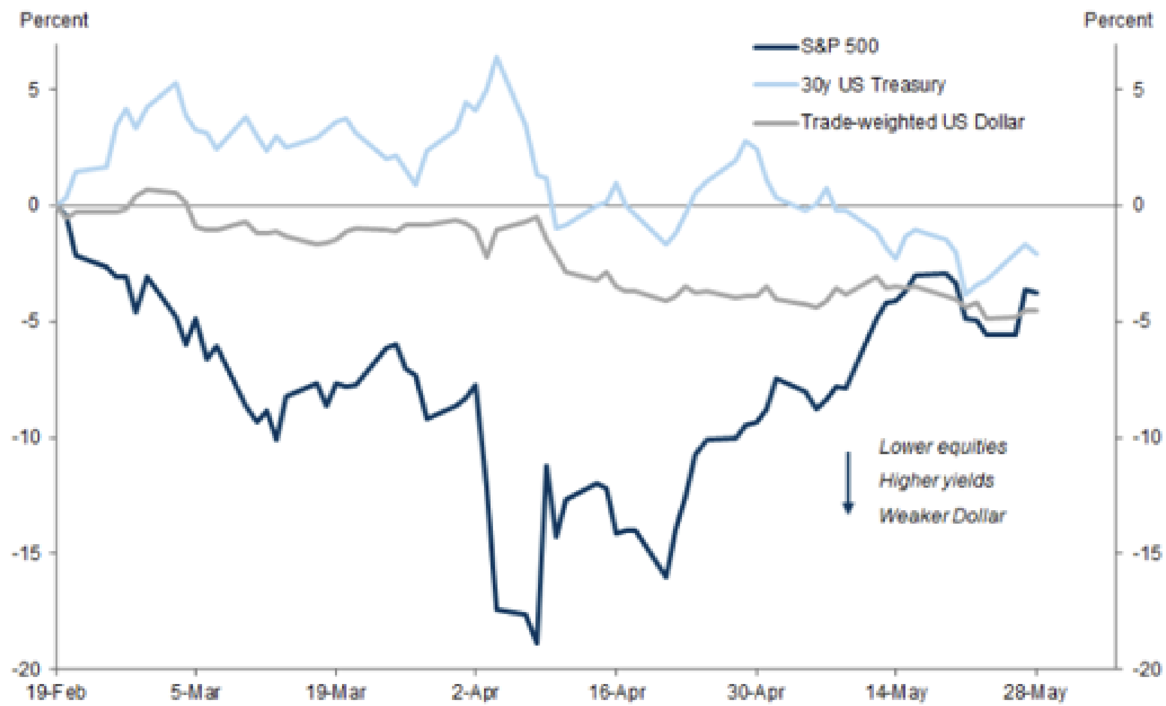
GIVEN THE LAST TWO MONTHS, THERE SHOULD BE MORE BULLS…



Goldman Sachs recently observed that stocks, bond prices, and the dollar have all declined in tandem during previous periods of market stress. Typically, bonds and the dollar serve as safe-haven assets when equities falter. This time, they may be part of the problem. Rising government debt and the growing difficulty developed economies face in attracting capital are drawing increased attention. We explore the implications of higher yields and a weakening dollar below. While our focus is on the U.S., the trends are global in nature.

Exhibit 1: US equities, bonds, and the Dollar have declined simultaneously in recent episodes, which is unusual

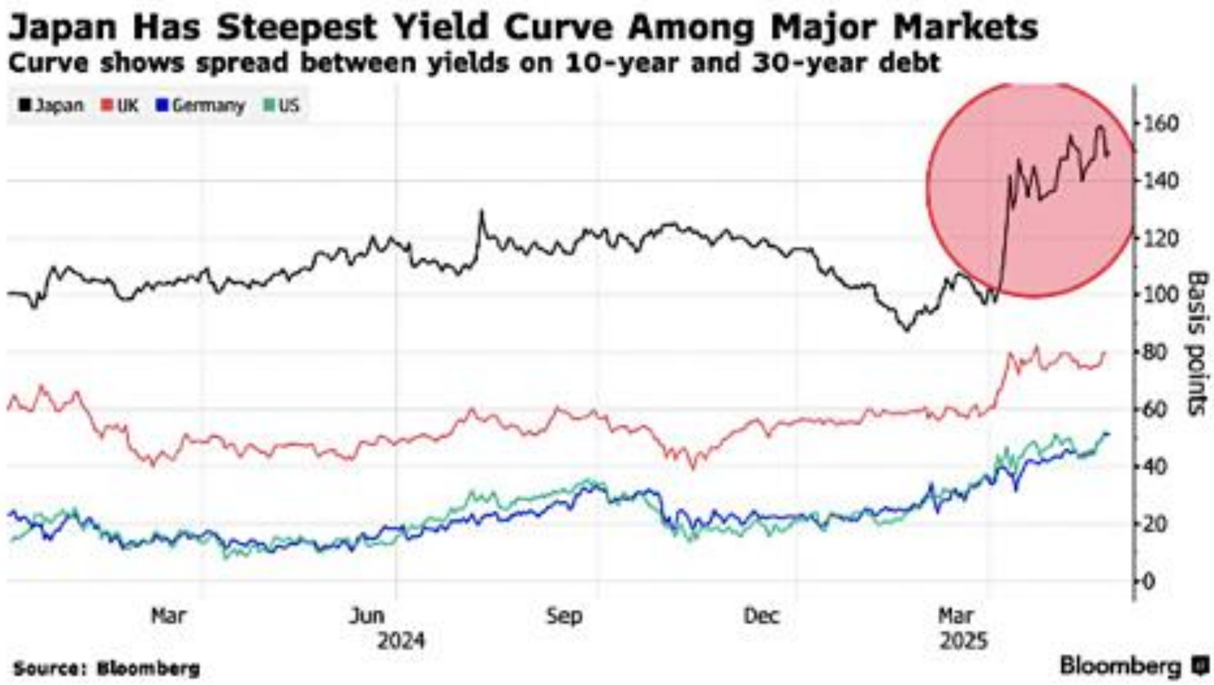
Performance since February 19



Source: Haver Analytics, Bloomberg, Goldman Sachs Global Investment Research

Bond Yields Climb Worldwide

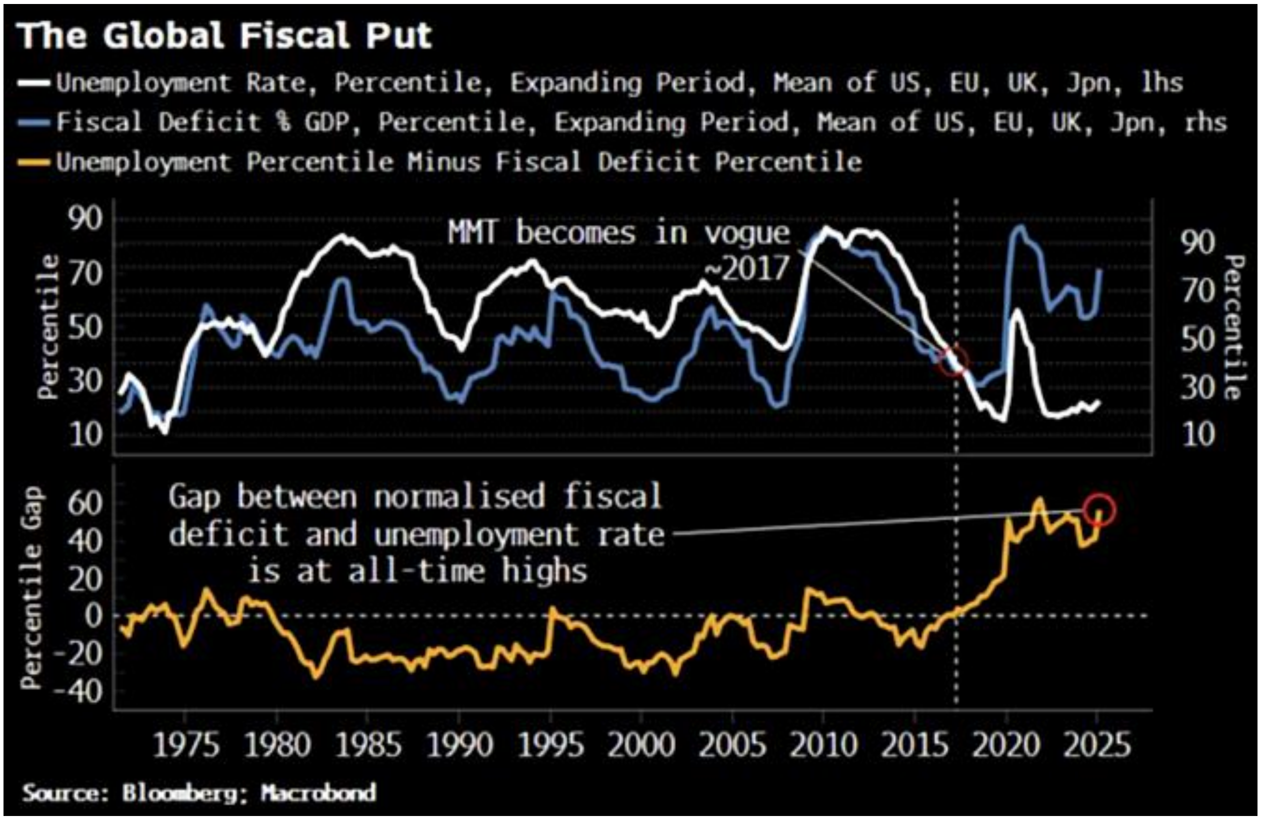
Despite concerns about tariffs and their potential drag on economic growth, bond yields moved higher in May, not just in the U.S., but across most developed markets. Japan stood out. Long known for issuing large volumes of government debt while maintaining ultra-low yields, Japan is seeing its yield curve steepen. As Bloomberg reports, the Bank of Japan may be losing control over long-term rates as it contends with inflationary pressures stemming from years of bond buying.



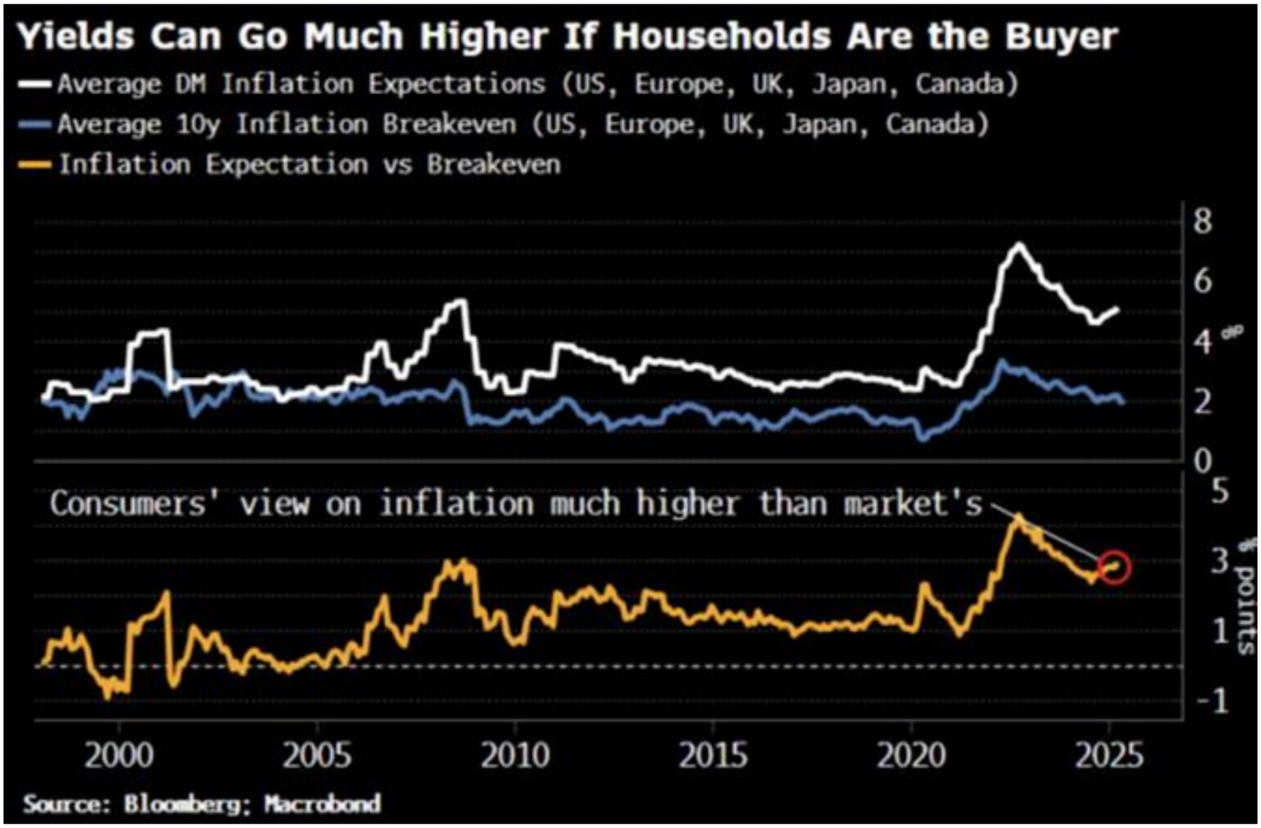
According to Bloomberg's Simon White, inflation expectations in Japan are becoming unanchored, prompting the Bank of Japan to taper its bond purchases. As a result, investors must absorb more of the supply, and long-term yields have risen. While absolute yields in Japan remain low (around 1.48% for 10-year JGBs), hedged into U.S. dollars, they offer higher returns than equivalent U.S. Treasuries. Strategas recently calculated a currency-hedged yield of 5.61% for JGBs, 1.18% higher than 10-year Treasuries.

Rising Yields Reflect Fiscal Pressures

The phenomenon isn't isolated to Japan; Japan is just further along in the process. According to White, the global surge in long-term yields stems in part from a structural shift in fiscal policy. Traditionally, government debt rose during recessions and declined during recoveries. That changed around 2017, when Modern Monetary Theory gained traction. Deficits have remained elevated even amid low unemployment, creating inflationary pressures.

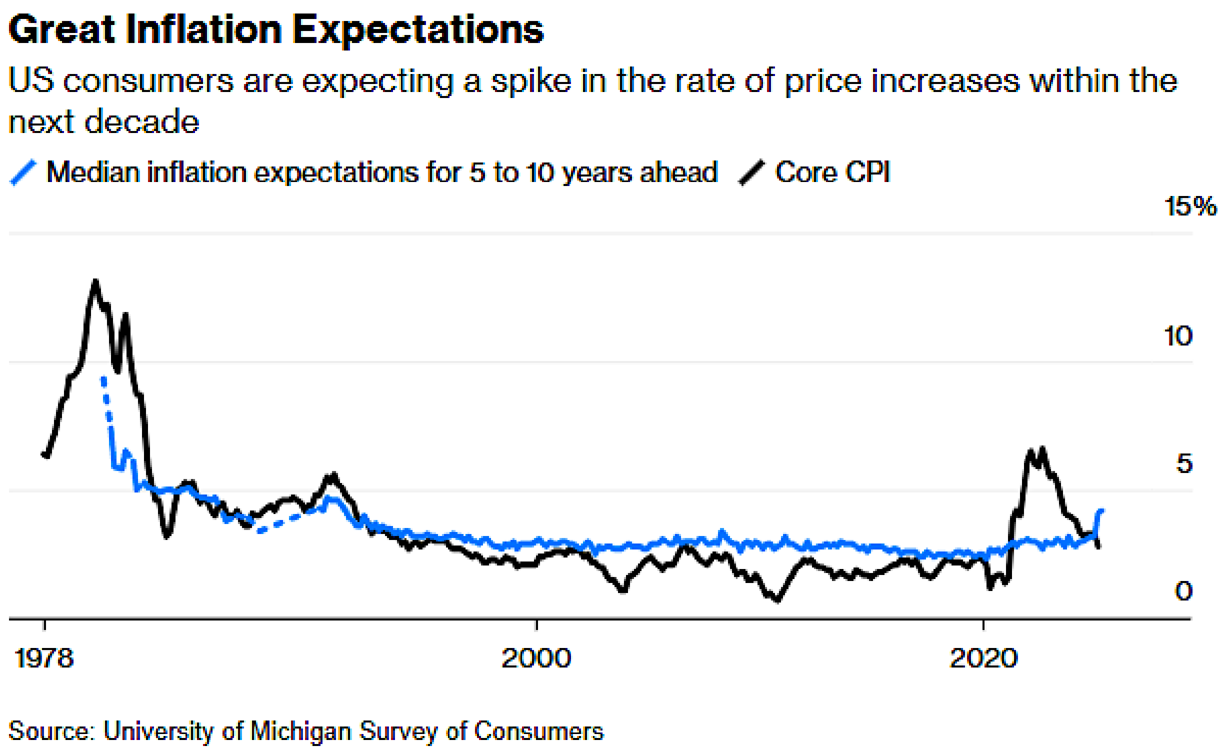


As inflation takes hold, central banks tend to scale back their support, leaving households to shoulder more of the burden, pushing yields higher. White points out that Japan may be furthest along, but no developed market, including the U.S. and Canada, appears immune to the pressure.



Inflation Expectations on the Rise

If higher inflation is a sign that fiscal policy may be hitting its limits, then the market may be right in driving long-term yields higher. A record percentage of Americans now expect inflation to hit 15% or higher within the next 10 years. As striking as that is, some context is required.

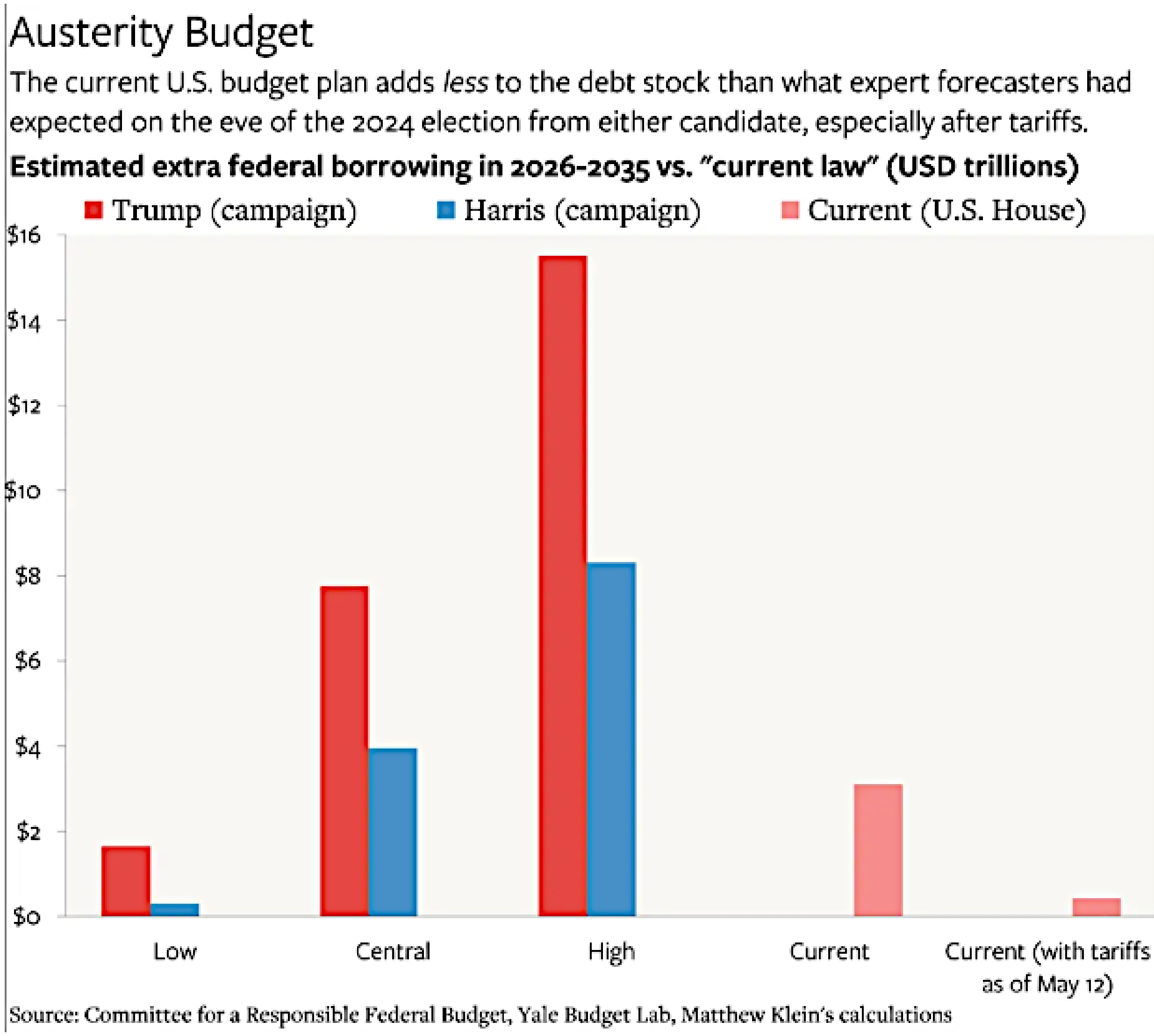


First, as Bloomberg notes, consumers often overestimate short-term inflation. Second, expectations are heavily influenced by politics. Since President Trump's 2024 election win and the Republican takeover of Congress, inflation expectations have soared among Democrats. Republicans are less concerned. Interestingly, independents have also sharply raised their expectations, likely driven by concerns over tariffs.

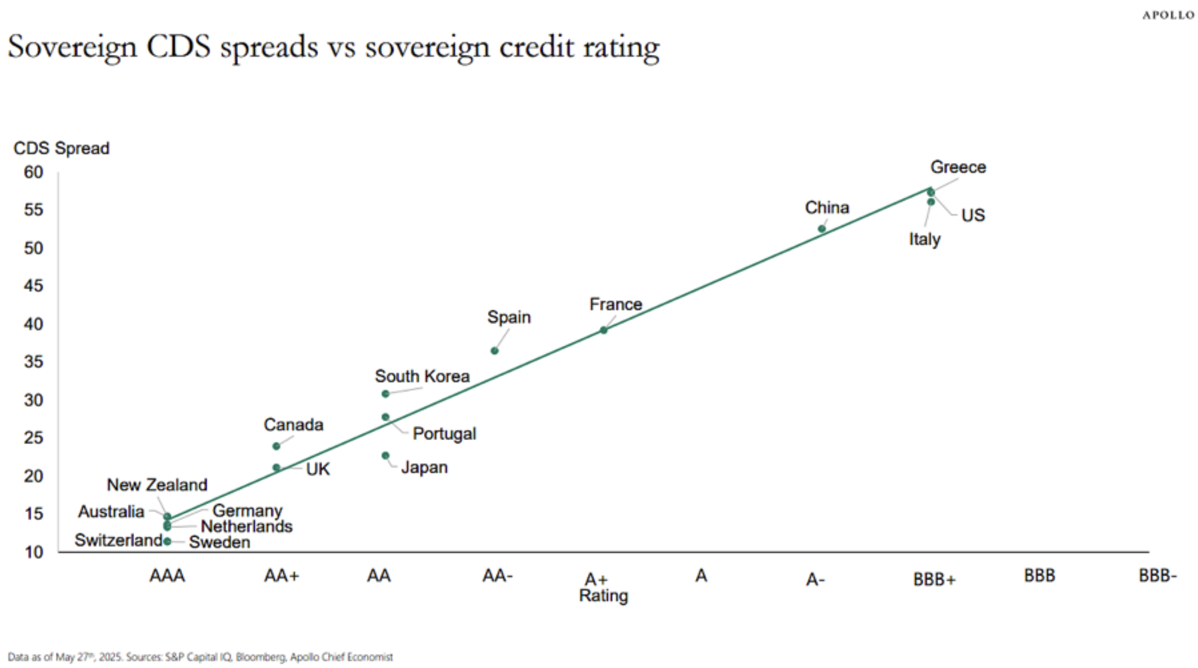
One Big Beautiful Bill Act and a Credit Warning

It's difficult to predict what impact Trump's tariffs will have on inflation. We still don't know what the administration is ultimately trying to achieve. That said, the rise in bond yields last month likely had more to do with fiscal policy and the proposed "One Big Beautiful Bill Act" (OBBBA).

While we won't delve into the bill's details, the takeaway is clear: it's likely to add significantly to U.S. debt. The Committee for a Responsible Federal Budget estimates it could add $3-5 trillion to the deficit over 10 years. The Congressional Budget Office estimates it could add $1.8 trillion in interest costs alone, even if rates remain around 4.4%.



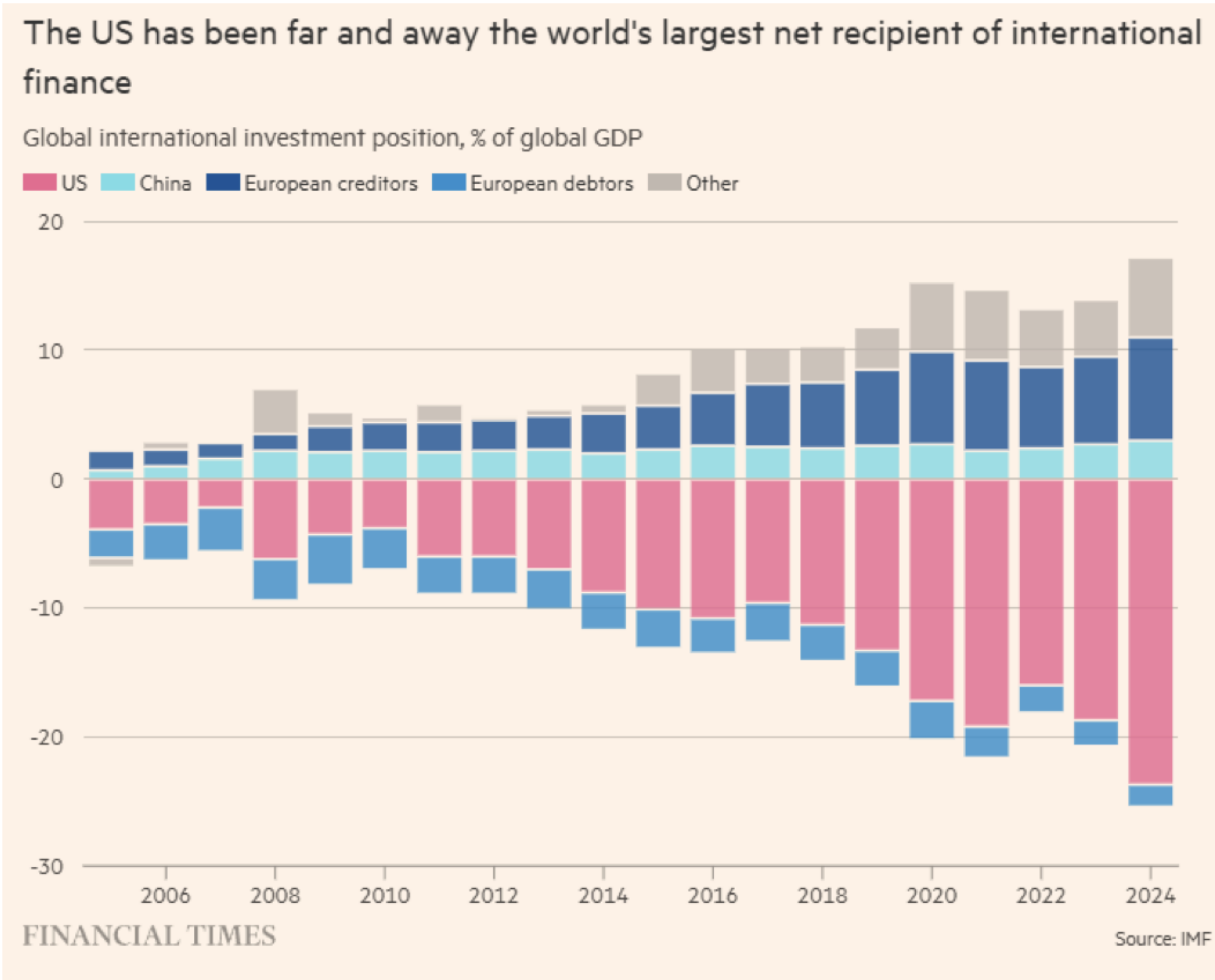
Moody's reacted by downgrading U.S. debt one notch below its top rating, following similar moves by S&P in 2011 and Fitch in 2023. Credit default swaps on U.S. debt spiked, with Apollo noting that U.S. CDS spreads now resemble those of BBB-rated countries like Italy and Greece. As Gillian Tett pointed out, some in the Trump administration call the OBBBA the "Triple B" plan, which may now be more accurate than intended.



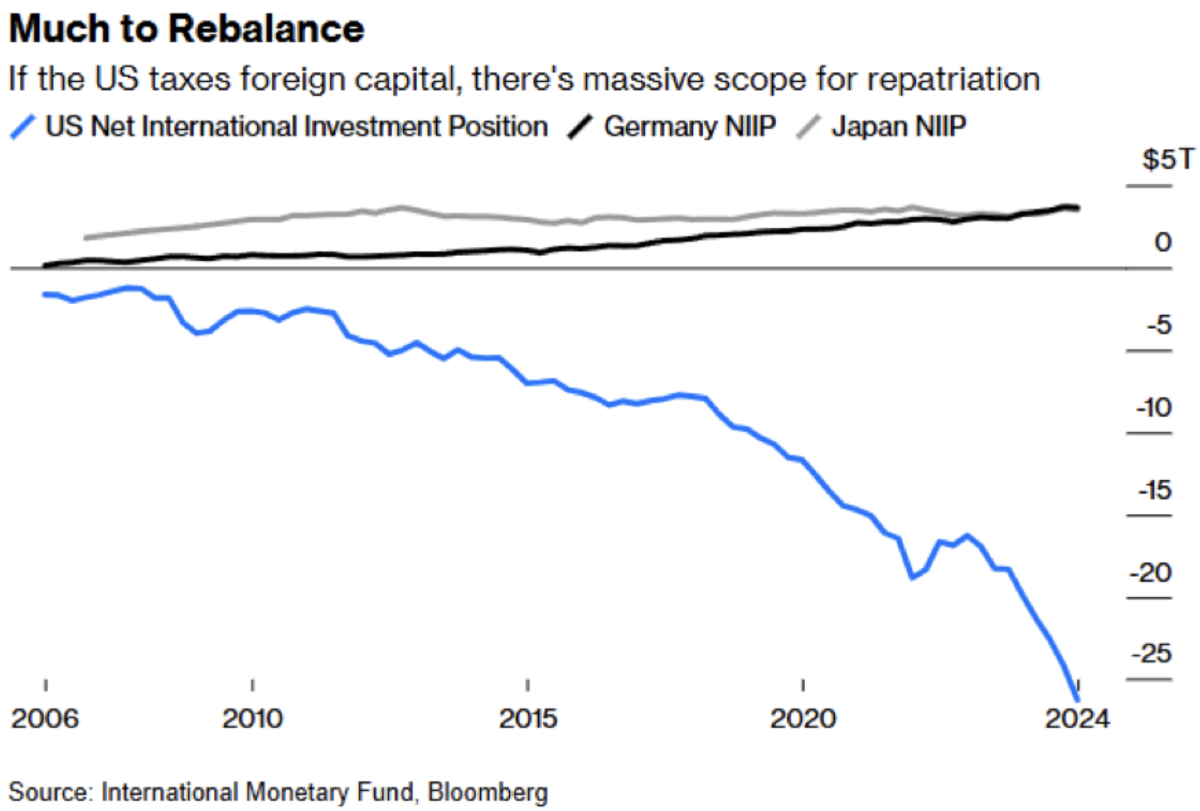
The timing of the downgrade is curious. The current House budget is expected to add less debt than projected prior to the 2024 election, regardless of who won. Trump may not be cutting the deficit, but no one was expecting him, or anyone else, to do so either.

A More Difficult Capital Environment

Still, if the U.S. deficit remains elevated, the funding must come from somewhere. The U.S. has long attracted the largest share of global capital flows, helping finance its fiscal deficits. But that may be changing.



The International Monetary Fund also reports that the U.S. has built up a negative international investment position of $26 trillion, meaning foreign investments in the U.S. exceed American investments abroad by that amount. Retaining that capital will be a challenge, let alone attracting more.



This is why it's so perplexing that the Trump administration appears to be making it harder by proposing a tax on foreign capital. Section 899 of the OBBBA would allow the U.S. Treasury to tax interest, dividends, and rent income flowing to foreign investors from countries with "unfair" tax systems, including Canada. Rather than attracting capital, Section 899 may deter it. The Senate may still revise the proposal, but for a country needing steady buyers for its debt, the U.S. is not looking especially welcoming, especially when investors like the Japanese have better alternatives.

The Dollar's Weakness

The OBBBA's impact is visible in the bond market, with long-term yields trading higher. But its influence is also being felt in the U.S. dollar, which has come under pressure since April's Liberation Day announcement. The dollar has lost ground against all G10 currencies. Trader positioning suggests more weakness ahead.

Absolute Strategy Research's recent quarterly survey of global allocators shows a record share of respondents expect the dollar to weaken over the next year. Bloomberg and the Commodity Futures Trading Commission data show short positions near their highest levels since 2023. Despite the recent decline, the dollar remains expensive. According to Deutsche Bank, it has traded more than 20% above purchasing power parity for three straight years, an unprecedented stretch.

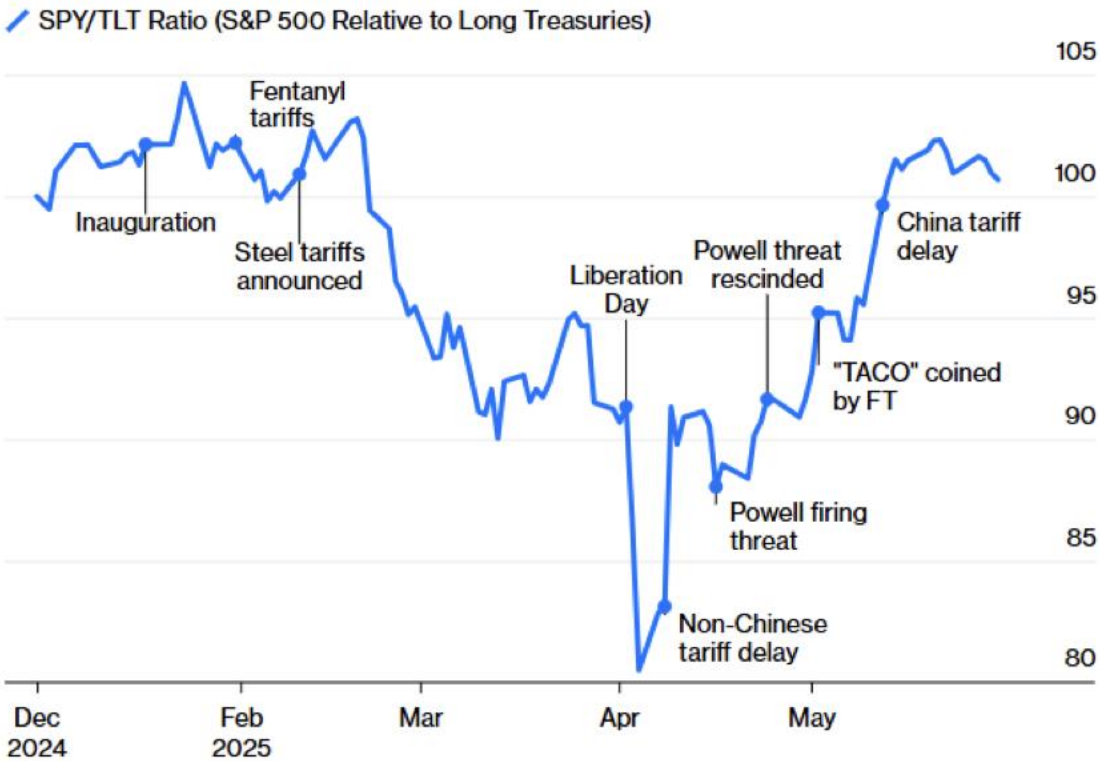
Why Were Stocks Higher?

Concerns over government debt and foreign capital outflows may help explain higher yields and a weaker dollar. But why did stocks rise?

One reason may be optimism that Trump's more extreme tariff threats won't materialize. The Financial Times' Robert Armstrong coined the term TACO: Trump Always Chickens Out. Markets seem comfortable with that. A 145% average tariff on Chinese goods would've halted trade and likely triggered a global recession. But the belief that final tariffs will land closer to 10%, a level markets can live with, has probably helped settle nerves.

Five Months in TACO Territory

In markets, 2025 is the story of threats made and then rescinded



Source: Bloomberg
Data is normalized with factor 100 as of December 31, 2024.

Citigroup says four groups influence Trump: China Hawks, Wall Street "Walas", Academics, and Tech Giants. According to Citi, if two of the group agree on a policy, it gets the green light by Trump. Wall Street's pick, Treasury Secretary Scott Bessent, is seen as one of the "adults in the room." TS Lombard recently noted that the S&P 500 performs better when Bessent is in the spotlight than when Commerce Secretary Howard Lutnick or economist Peter Navarro are driving the narrative.

Who Has Trump's Ear?

Decisions seem to be made when two camps agree

Event	Academics	China hawks	Wall Street walas	Tech giants	Outcome
April trade war	1	1	-1	0	1
Tariff backdown	-1	-1	1	1	1
China bifurcation	0	1	-1	-1	-1
Section 899	0	0	1	1	1

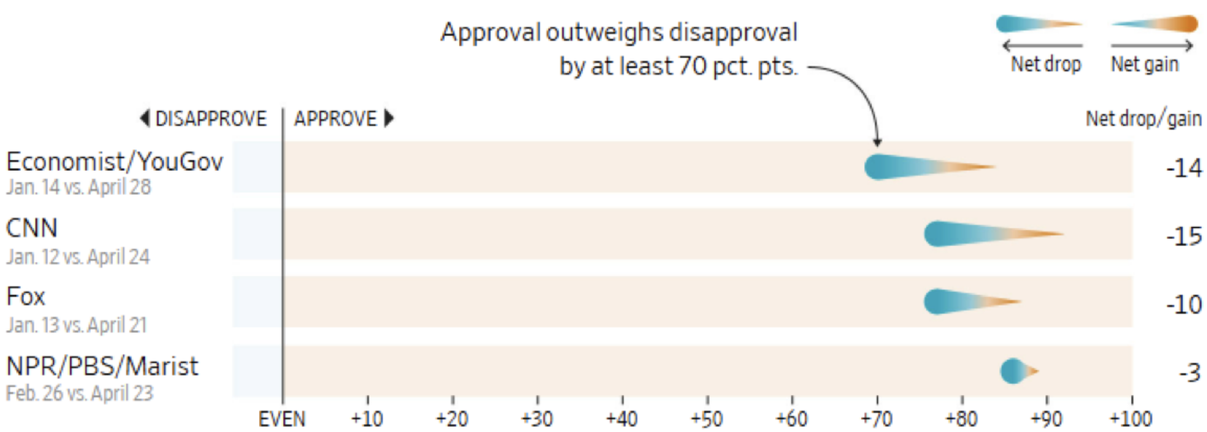
Source: Citi Trading Strategies
Note: Deep blue is yes, white is no, and pale blue is neutral.

Popular Support: A Key Guardrail

Beyond Bessent, public opinion remains an important check on the administration. Despite a conservative-leaning Supreme Court, decisions have so far been split. But Congress is more reactive to the polls. According to the Wall Street Journal, Trump's net approval among his 2024 supporters has fallen by 3% to 14%, depending on the poll. A CNBC poll in April found his economic approval rating, traditionally a strong point, has slipped below his overall job rating for the first time.

Trump's net job-approval rating among respondents who voted for Trump in 2024

By pollster over time, in pct. pts.

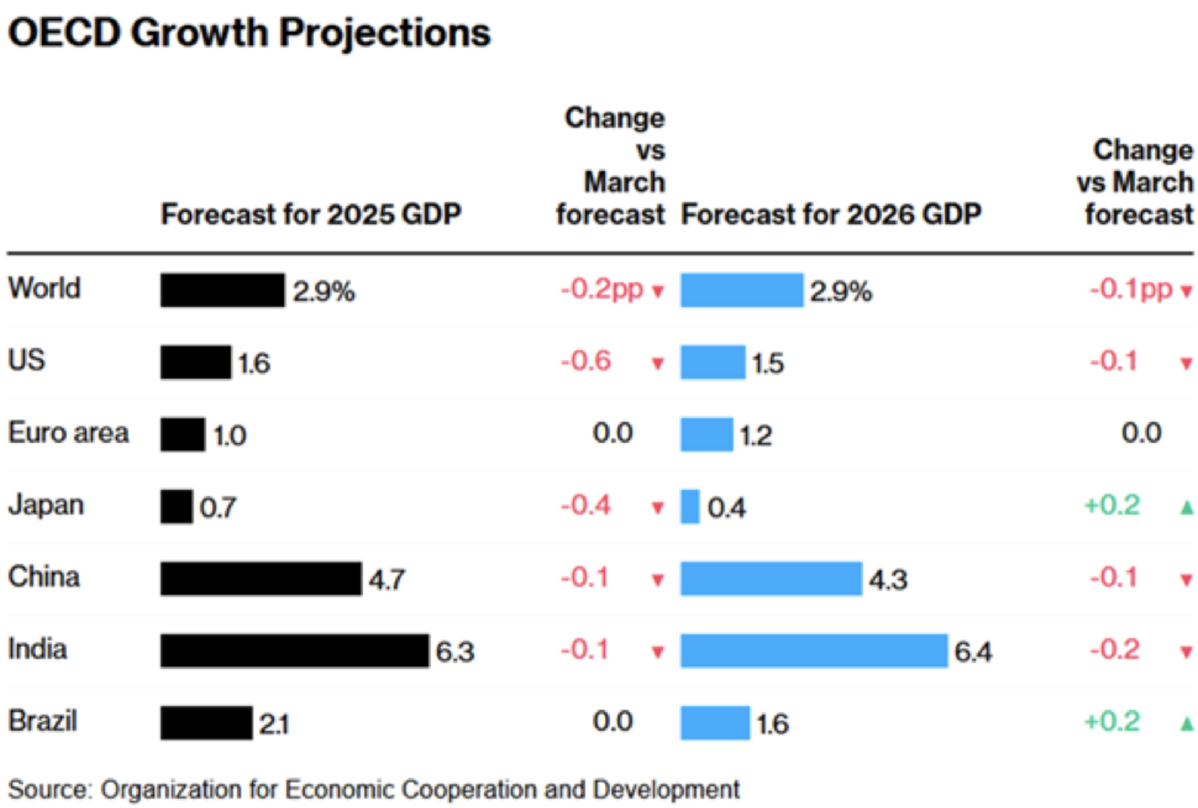


Note: Sorted by days passed between polls
Source: the polls

Trump is keenly aware of the importance of public support and has a long history of shaping media narratives. Markets seem to be betting that he may take negotiations to the brink but will ultimately back off if approval begins to erode.

The Economy is Sending Mixed Signals

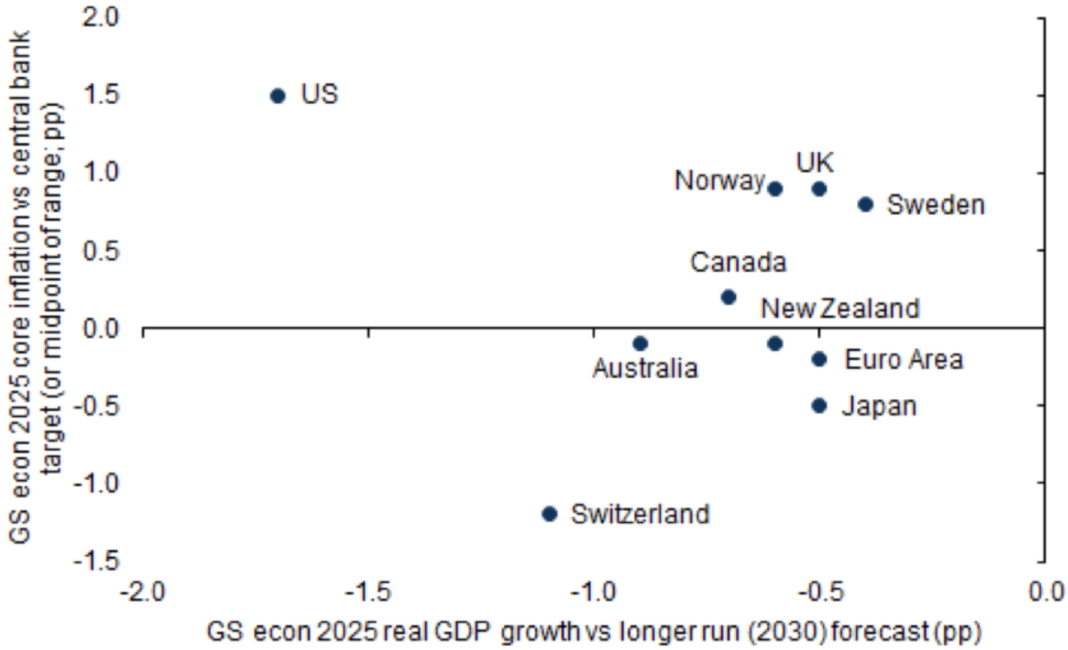
The state of the U.S. economy may be key to Trump's future popularity. According to the OECD, U.S. GDP is expected to grow 1.6% in 2025, down 0.6% from its March forecast. The 2026 forecast was also revised slightly lower to 1.5%.



Goldman Sachs sees the risk of stagflation, slower growth and higher inflation, as more pronounced in the U.S. than in other G10 nations. Liberation Day has made forecasting difficult, as tariff uncertainty is distorting consumer and corporate behaviour.

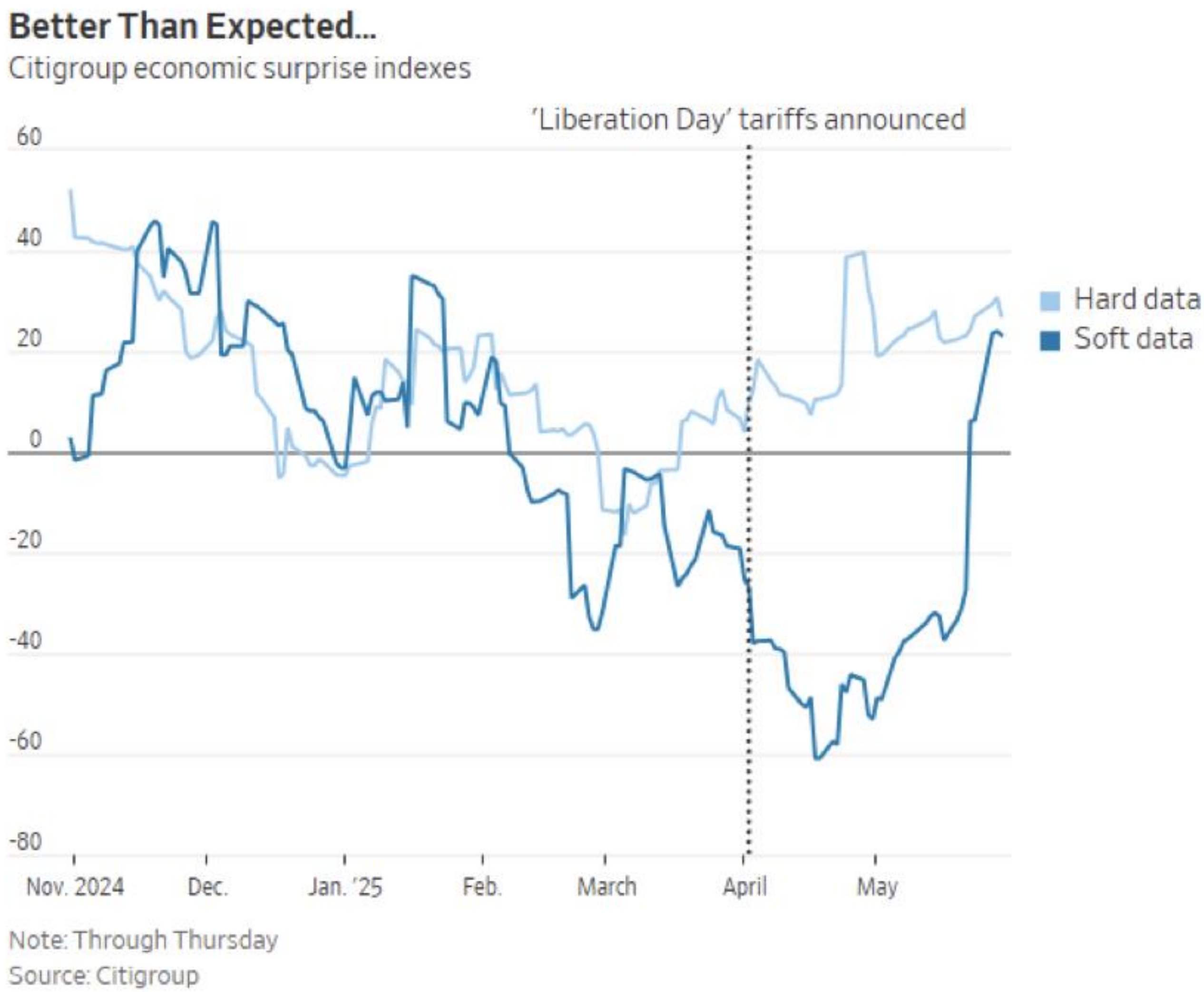
Exhibit 5: The tension between near-term growth and inflation risks in the US is pronounced compared to the rest of G10

GS econ 2025 core inflation forecast vs central bank target versus GS econ 2025 q4/q4 growth vs longer run forecast



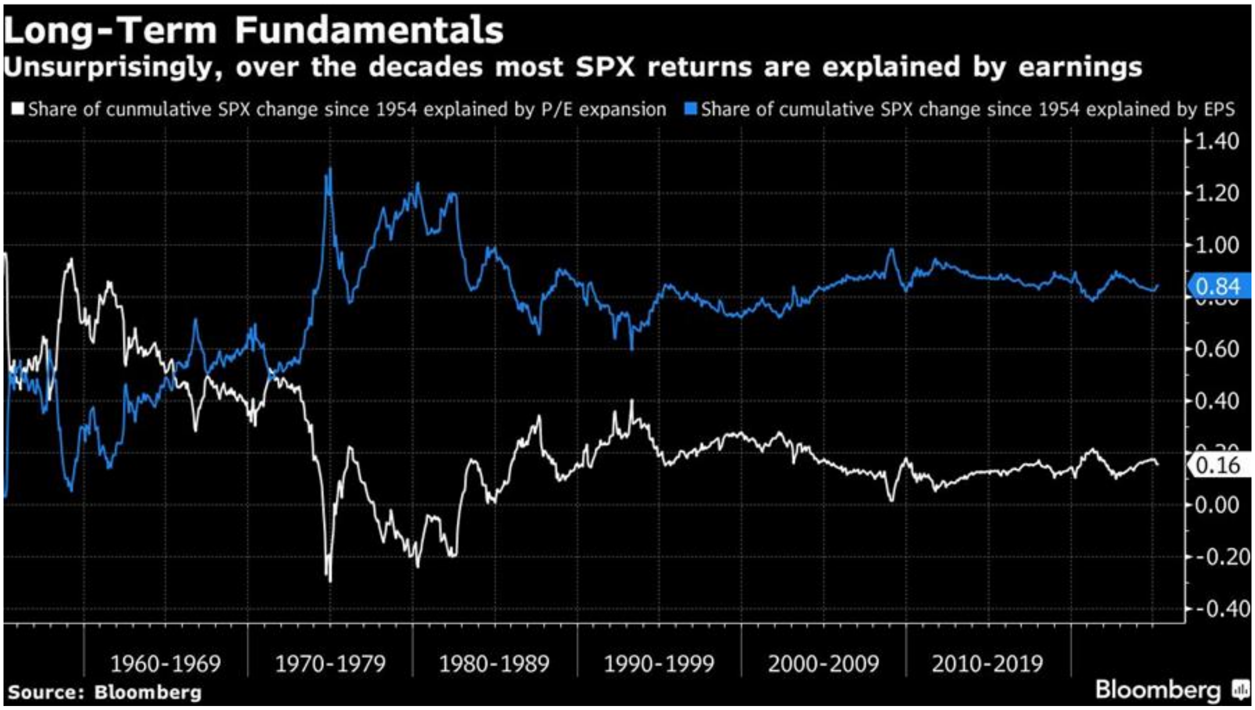
Source: Goldman Sachs Global Investment Research

The Atlanta Fed's GDPNow tracker shows Q2 2025 growth at 3.8%. That would be a headline-grabbing number, but the strength likely reflects a sharp drop in imports and may overstate any real momentum. As Citigroup notes, recent soft data has improved only because it's been less bad than expected.

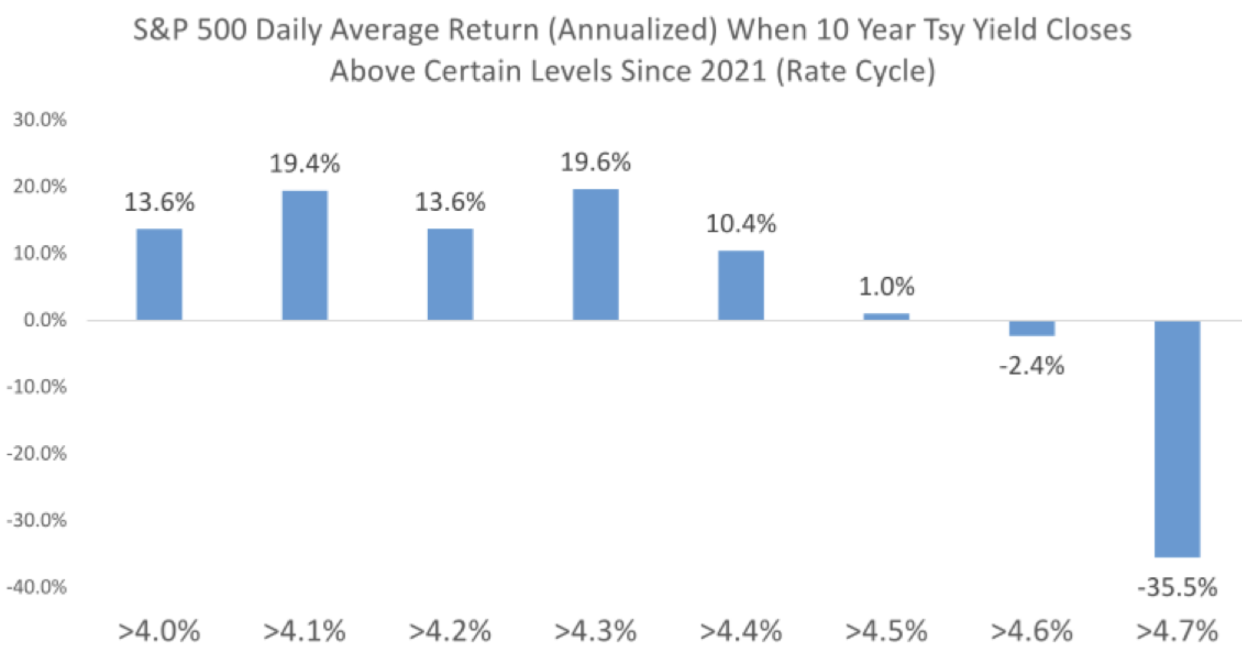


Earnings Matter to Stock Prices

Ultimately, earnings matter most to equity markets. Over the long run, S&P 500 returns are driven more by earnings than valuation multiples. That's encouraging, as Citigroup's U.S. Earnings Revision Index turned positive in May after six months of negative readings.

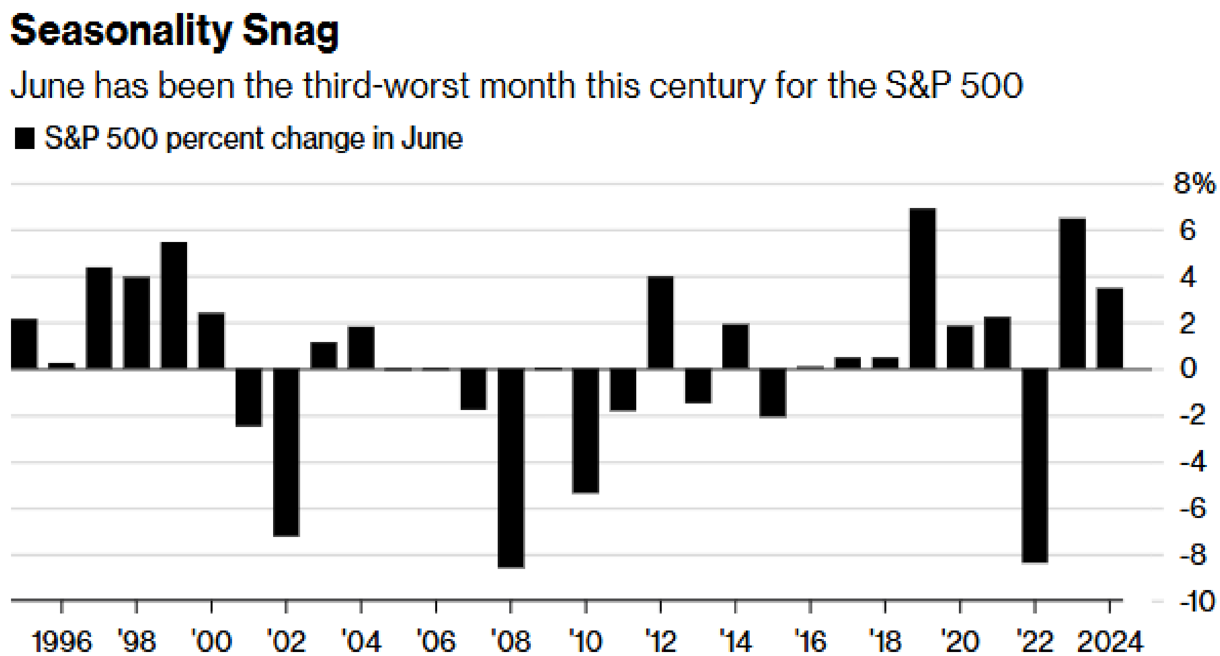


Short-term volatility may still occur if bond yields continue to rise. Raymond James notes that yields above 4.5% have been associated with flat or negative equity returns since 2021. But over longer time periods, Goldman Sachs finds no consistent relationship between yields and stock performance dating back to 1940.



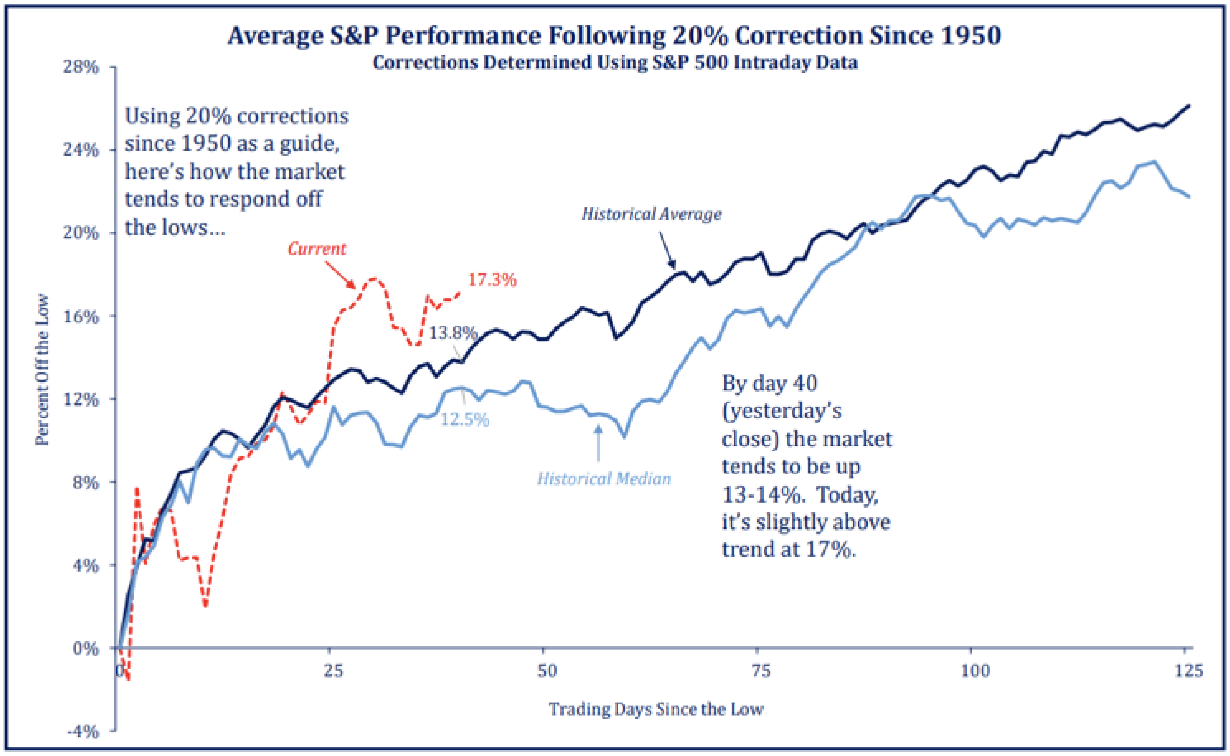
Looking Ahead

And yet, the market may be growing too complacent. June has historically been the third-worst month for the S&P 500 this century. Despite that, markets seem to have largely shrugged off bearish narratives; Sell in May, the Moody's downgrade, Liberation Day.



Strategas observes that the recent rally has outpaced what's typically seen after a major correction. Still, investor sentiment remains tepid. Surveys of institutional investors show a lack of conviction, despite the strength in equities over the past several weeks.

TODAY vs. HISTORY…



Perhaps this reflects the underlying tension in the Trump administration's economic strategy, attempting to rebalance trade while simultaneously increasing debt and making it harder to attract foreign capital. The economy and corporate earnings, particularly in AI-driven sectors, appear resilient for now. But markets may have already priced in much of the good news. Movements in the dollar and bond markets suggest some investors are starting to look more cautiously at what comes next.