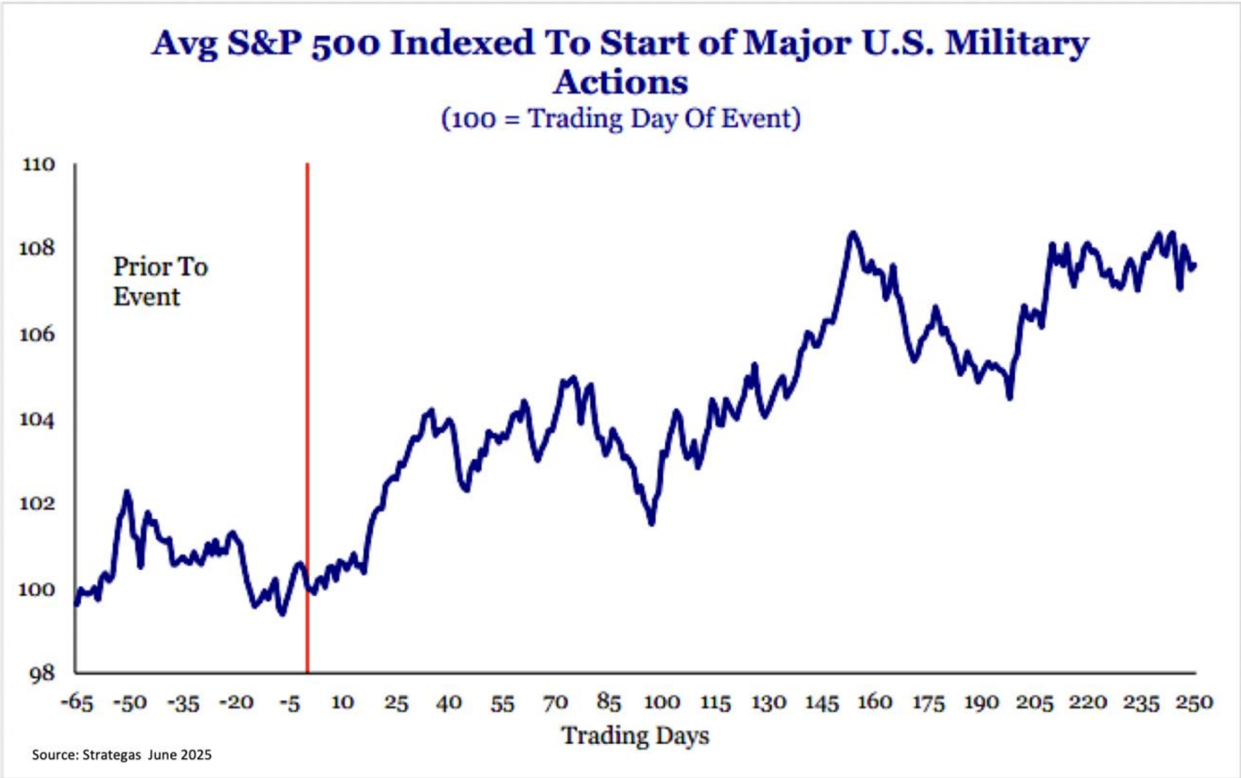
June Market Commentary | Growth on Borrowed Time?

By Rob Edel, Chief Economist

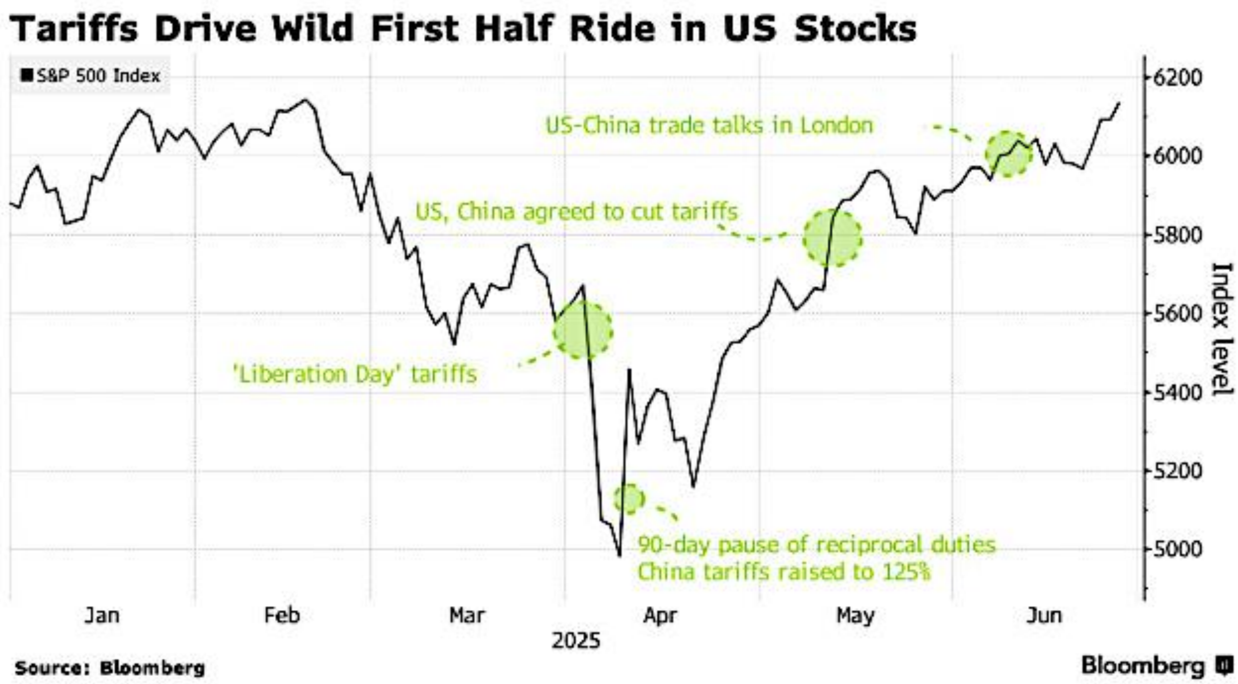
In June, Israel launched a targeted strike on Iran's nuclear infrastructure, prompting a swift retaliatory response from Iran. Despite this significant escalation, markets showed surprising resilience. Gold prices were flat, Treasury yields held steady, and the dollar extended its recent decline. Crude oil briefly spiked on fears surrounding the Strait of Hormuz but soon retraced.

While such geopolitical flare-ups may seem like catalysts for market volatility, history suggests their impact tends to be short-lived. According to Strategas, the S&P 500 is rarely down six months after major U.S. military action. Barring an extreme and prolonged conflict, investors seem more focused on economic fundamentals than global flashpoints.



Tariffs are front of mind, but not halting the rally.

While geopolitical risk made headlines, tariffs continued to dominate investor sentiment. According to Bank of America's Global Fund Manager Survey, trade wars remain the top concern, but even that anxiety seems to be easing. As Bloomberg noted, tariffs were the primary driver behind a wild first half of the year. After falling over 16% from its February 19 high, the S&P 500 abruptly turned around on April 8 and rallied nearly 25% by the end of June. Carson Investment Research puts the S&P 500 up 10.6% for the second quarter, one of the best quarters ever.

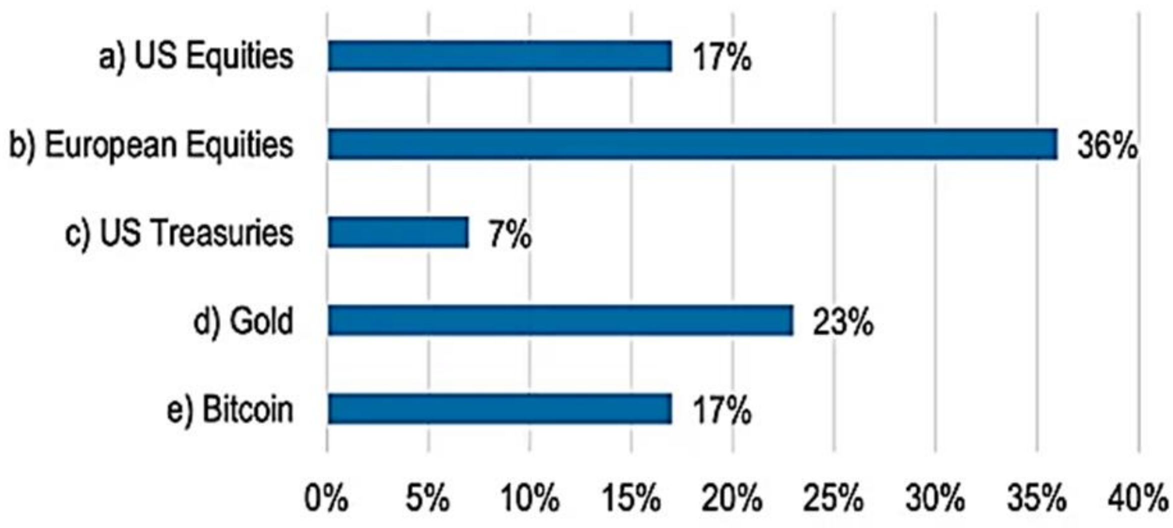


Interestingly, Canadian stocks outperformed U.S. equities year-to-date. The S&P/TSX gained 10.2% (total return in Canadian dollars) compared to the S&P 500's 6.2% (total return in U.S. dollars). In U.S. dollar terms, the gap was even wider. U.S. stocks did outperform in June, but only by 1.2% in common currency terms.

Politics may be shaping portfolio views.

Investor sentiment appears to be shaped by their political affiliation. According to J.P. Morgan, just 17% of clients expect U.S. equities to be the best-performing asset class this year, compared to 36% for European equities and 23% for gold. The June Bank of America Fund Manager Survey showed gold as the most crowded trade for the third consecutive month. However, Republican investors are significantly more optimistic about equity markets in the six months than Democrats. Why? They're more likely to support Trump's trade tactics and believe that his fiscal policy, dubbed the One Big Beautiful Bill Act (OBBBA), will drive growth, especially with the Fed cutting rates to pay for it.

Figure 2: What will be the best performing asset this year?

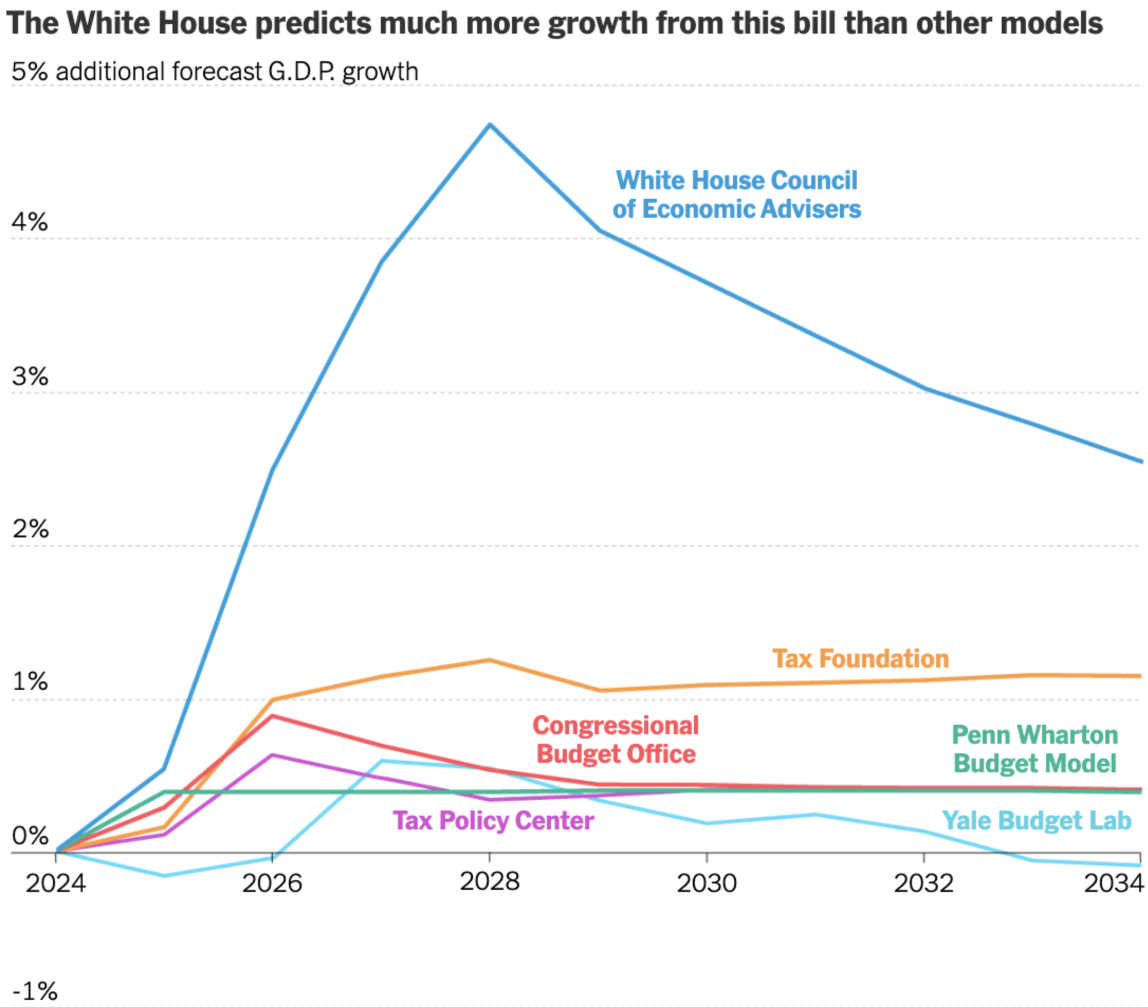


JPMorgan

Fiscal policy shifts into overdrive.

In early July, President Trump's OBBBA was narrowly approved by Congress and signed into law. For Trump, this marked a major political win, as it extended the 2017 tax cuts and introduced new spending initiatives. According to the White House Council of Economic Advisors, the bill is expected to have a substantial economic impact over the next several years. But not everyone agrees.

The Economic Benefit Is Negligible

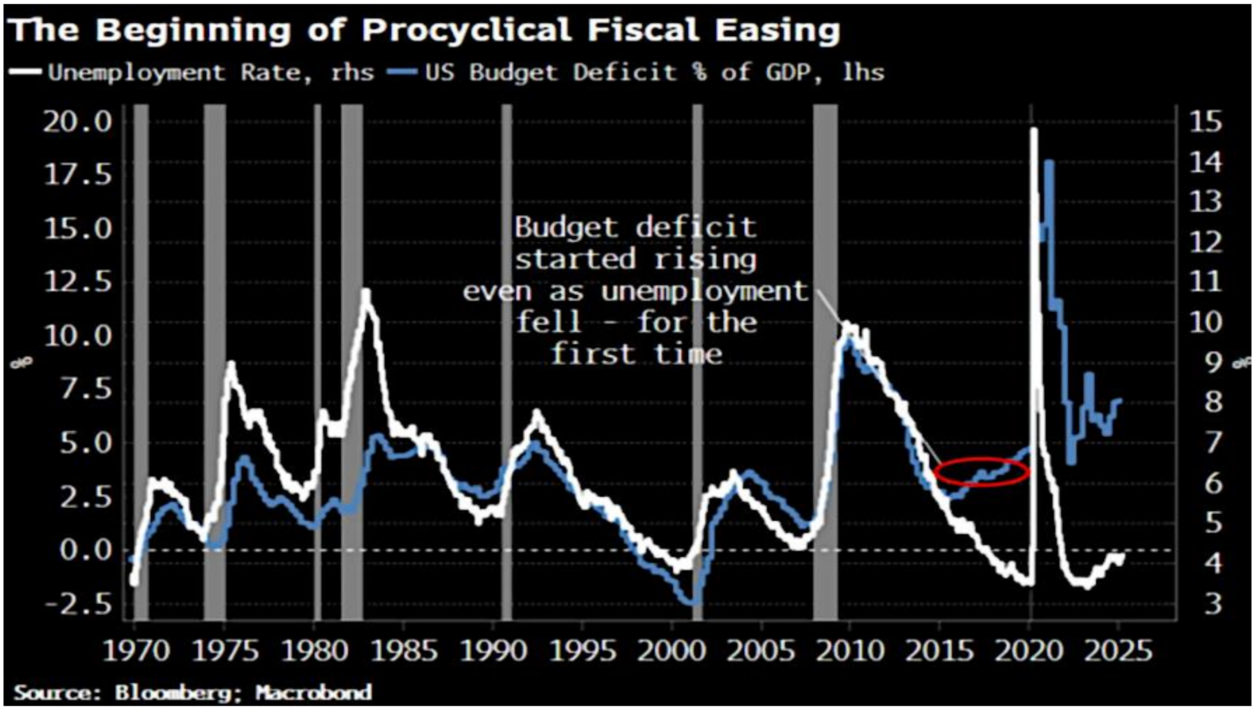


Source: Center for a Responsible Federal Budget • Note: Tax Foundation and C.E.A. estimates are based on the Senate version of the policy bill. All other estimates are based on the version passed by the House.

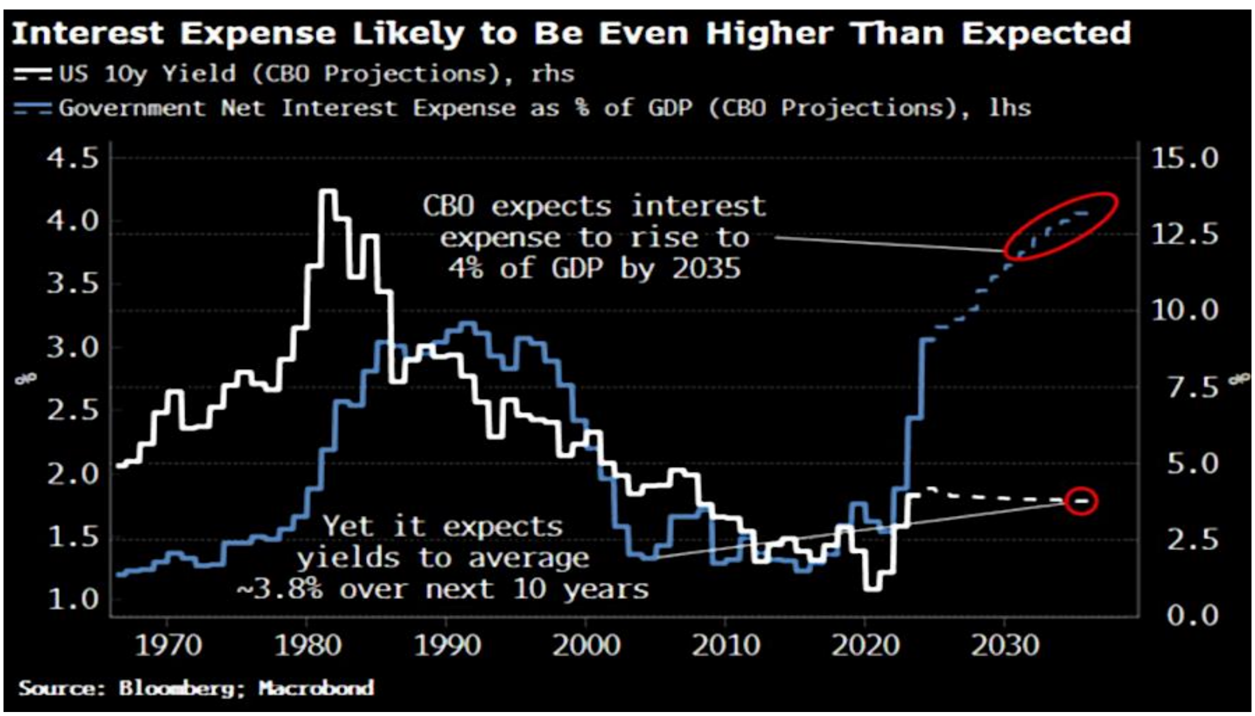
What they do believe is that it will significantly expand the U.S. deficit. The Congressional Budget Office (CBO) projects that the "big beautiful bill" will add more than $3 trillion to the national debt by 2034.

Deficits are growing in the wrong part of the cycle.

Goldman Sachs describes the current U.S. fiscal situation as unusually poor. Deficits and debt levels relative to GDP are climbing into territory typically seen only in times of crisis. Since the mid-2010s, deficits have begun rising pro-cyclically, meaning they're increasing even as unemployment falls. That's a troubling dynamic, especially now that yields are pushing higher.

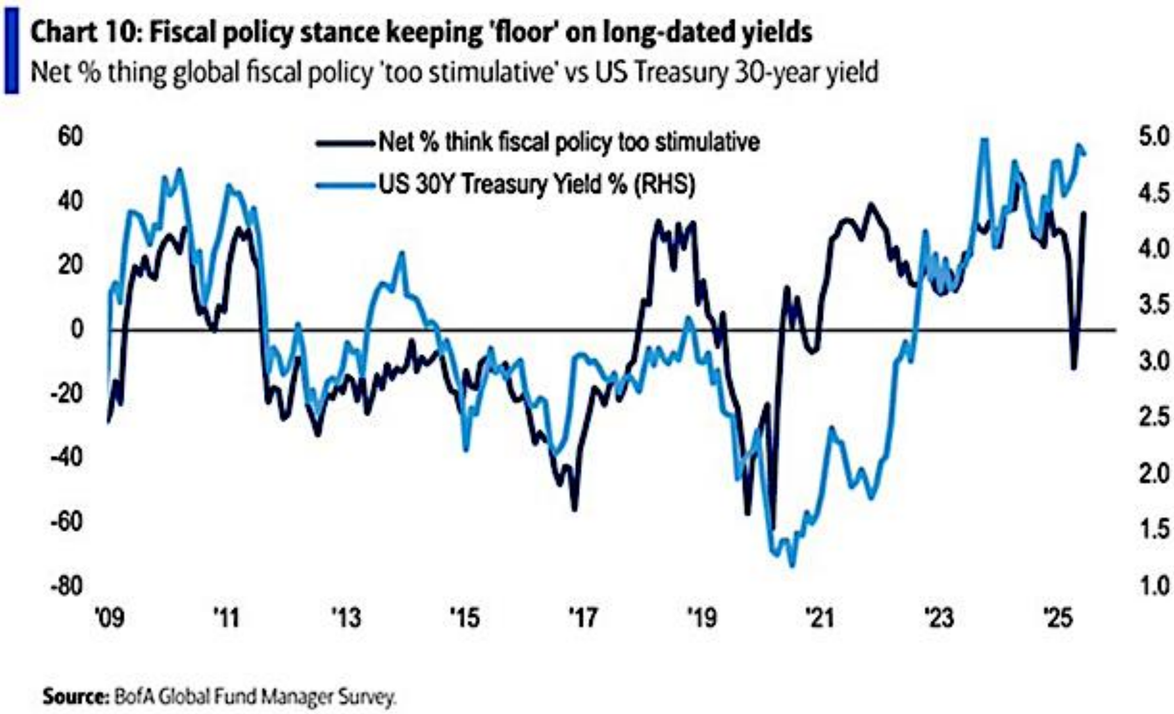


The CBO expects interest costs to rise to 4% of GDP by 2035, but that's based on a 10-year yield forecast of just 3.8%. With current yields already north of 4%, that estimate may be too low. Higher debt and deficits mean more bonds must be issued. This supply pressure tends to drive yields up.



A global rethink on long-term rates.

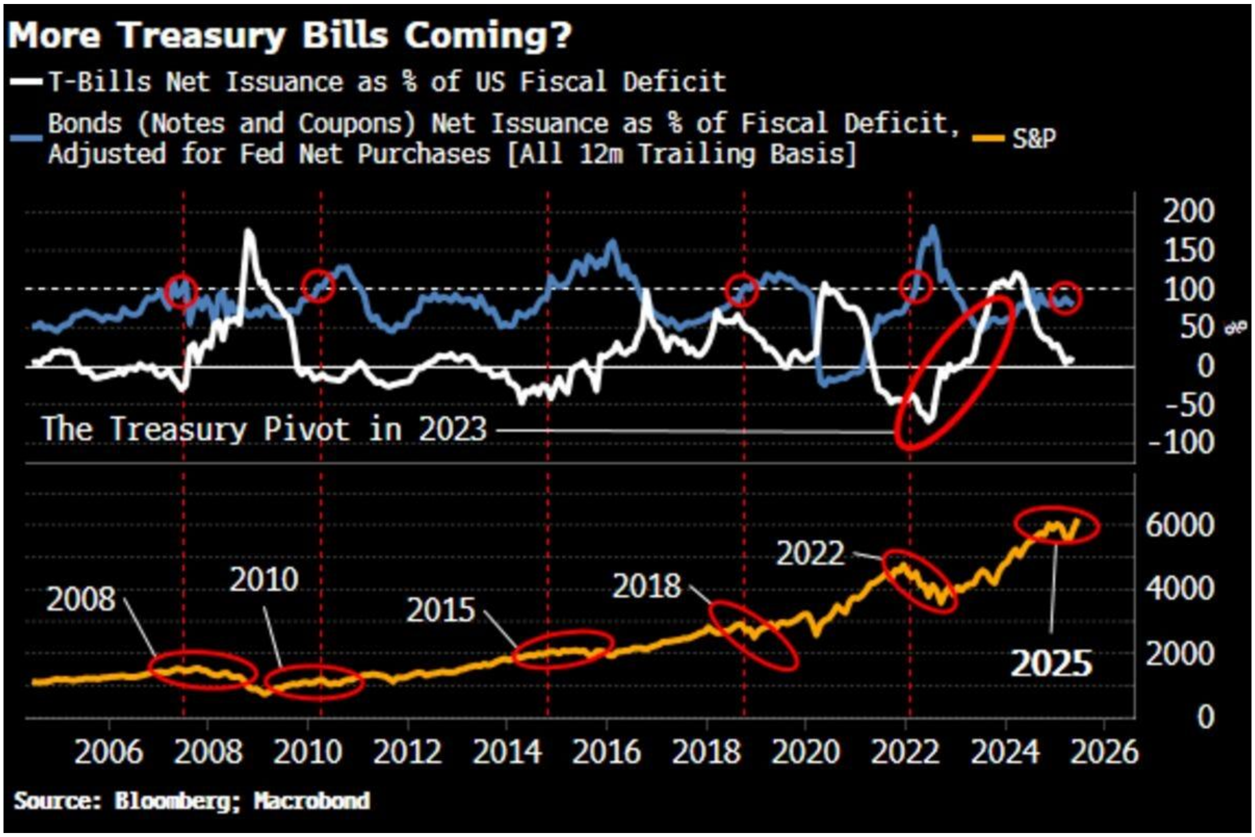
It's not just a U.S. problem either. Globally, long-term yields are climbing. Strategas highlights that most 30-year yields have increased since the start of the year, while 2-year yields have declined. According to Bank of America, investors see fiscal policy as overly stimulative, anchoring long-term yields at elevated levels.



Treasury and Fed coordination may become more important.

The U.S. Treasury and Federal Reserve have options to help manage borrowing costs. For example, the Fed can ease back on quantitative tightening, while regulators can tweak capital requirements to let banks hold more Treasuries. Both would help lower longer-term yields. More notably, Treasury Secretary Scott Bessant could issue more short-term, lower-yielding T-bills instead of long-term bonds.

According to Bloomberg's Simon White, equity markets tend to perform better when more T-bills are issued, but this can also precede periods of higher inflation.



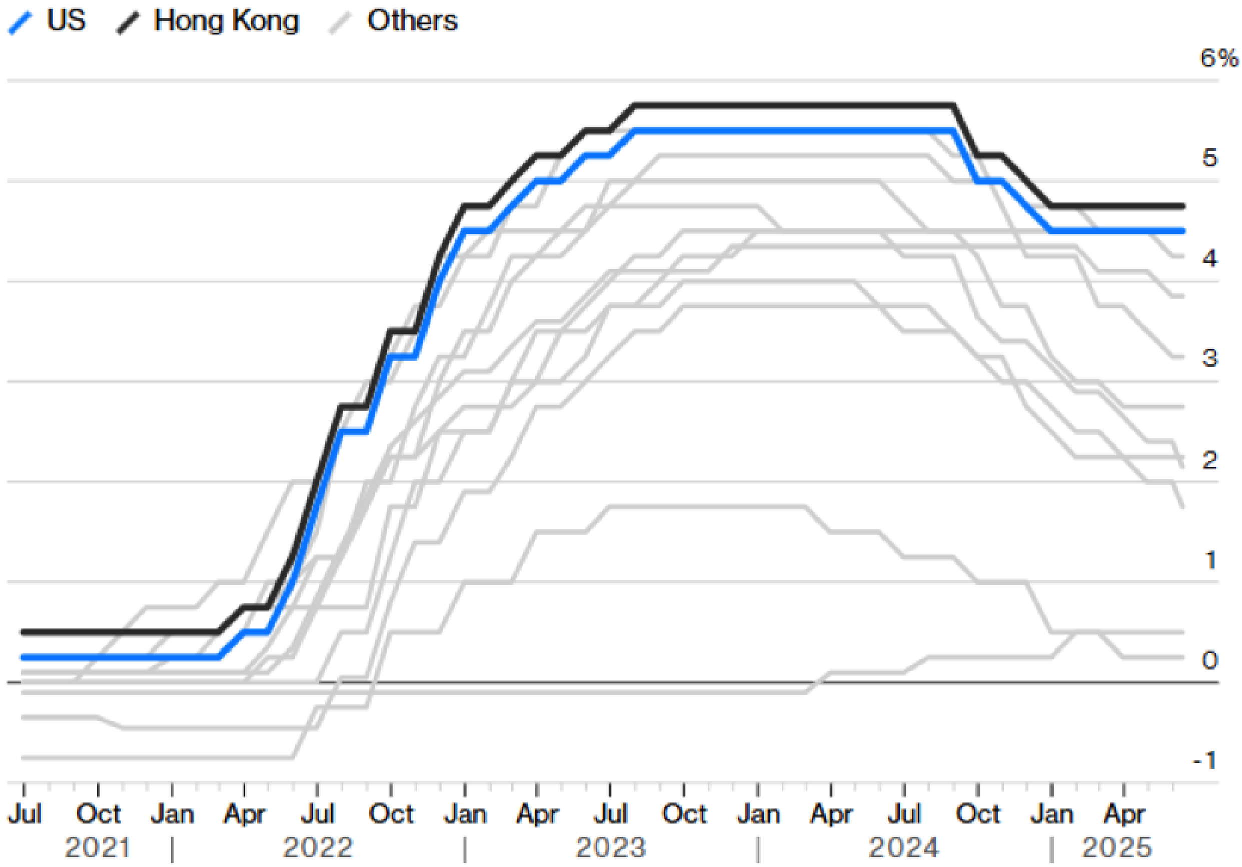
Trump's plan could face a Fed constraint.

Of course, issuing more T-bills only matters if short-term rates are low, which Trump needs to make the numbers work for the OBBBA. If interest rates are near zero, debt levels become largely irrelevant. The challenge for Trump lies with the Federal Reserve, led by Chairman Jerome Powell, which sets short-term interest rates and is an independent body. While Trump may have appointed Powell during his first term, he cannot force Powell or the Federal Open Market Committee (FOMC) to act in line with his wishes and cut rates.

Trump has been vocal in his criticism of Powell, arguing that higher U.S. interest rates are costing the country hundreds of billions of dollars. He believes that the Fed should move swiftly to cut rates, particularly as other central banks around the world remain more accommodative. However, the Fed's dual mandate is to maintain price stability and low unemployment, not appease the President.

US Rates Are Truly Exceptional

Interest rates in US versus other developed markets



Source: Bloomberg

While President Trump may have a point that U.S. interest rates remain high relative to other developed markets, that doesn't necessarily mean the Federal Reserve is wrong in holding firm. As Bloomberg's Simon White notes, the S&P 500 typically declines when the Fed begins cutting rates, unlike the current environment, where markets are rallying.

The market is rallying, but should it be?

Within the market, cyclicals continue to outperform defensive stocks, even with expectations of lower overnight rates. As highlighted by Apollo, cyclicals typically outperform during periods of strong economic growth and higher inflation, not an environment one would expect to be cutting rates in. Bloomberg's Financial Conditions Index also suggests U.S. financial conditions aren't particularly tight, especially when considering real Fed Funds rates, whether measured against one-year breakeven rates, core CPI, or 10-year TIPs.

Powell may be a scapegoat, not the problem.

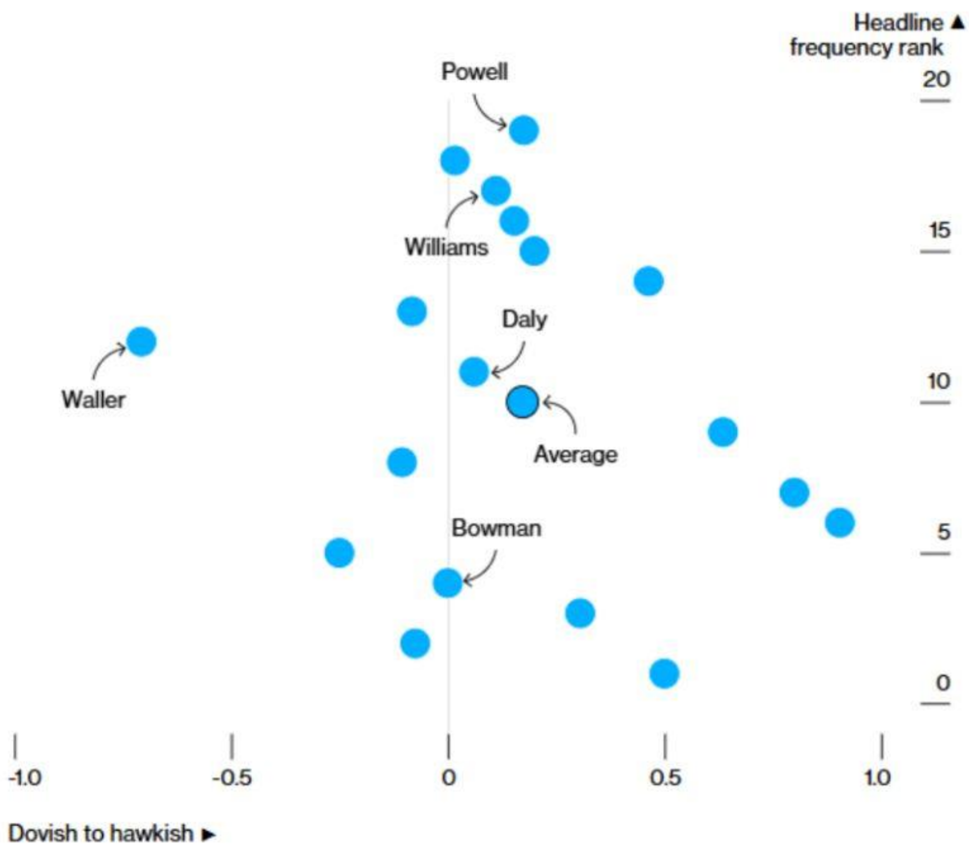
Despite all this, President Trump remains convinced that Chairman Jerome Powell is the main obstacle to lower rates. Time is running out, as Powell's term ends in May 2026, and it's unlikely Trump would reappoint him. According to Bloomberg's World Interest Rate Probabilities, markets expect the Fed Funds rate in [December 2026] to be lower under a new chair than current FOMC projections suggest.

Markets appear to be discounting the belief that Trump's next appointee will align more closely with his views on monetary policy and manage to sway the other 11 voting members of the FOMC. But that's far from guaranteed. Powell himself was a Trump appointee, and once confirmed, a Fed Chair acts independently.

Bloomberg data suggests that ahead of the July FOMC meeting, sentiment skewed hawkish, with Powell near the committee average. While the FOMC remains divided, no member sees rate cuts as aggressive as those Trump is hoping for. It doesn't look like replacing Powell will solve Trump's problem.

Most of FOMC Seems More Hawkish Ahead of July Meeting

Federal Open Market Committee members' sentiment scores

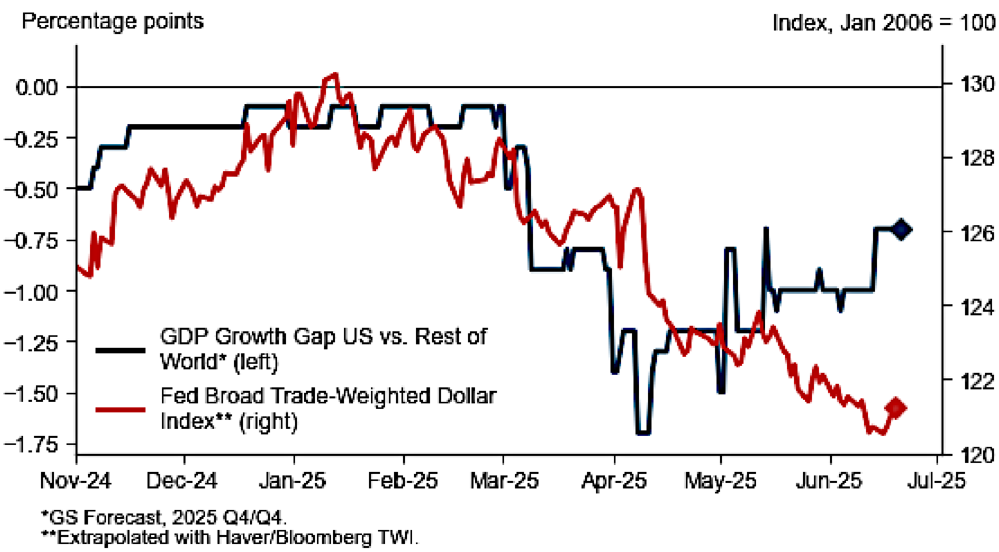


Source: Bloomberg Economics
Note: Scores are based on natural language processing to evaluate members public comments.

Politicizing the Fed carries structural risk.

Should Trump succeed in appointing a more compliant chair, the result could backfire. A politicized Fed might erode investor confidence, push long-term rates higher, and weaken the U.S. dollar. The dollar has already softened since Trump's inauguration. Bank of America recently pointed out that the historical relationship between the dollar and two-year Treasury yields has broken down. Normally, higher yields attract capital and strengthen the dollar, but that hasn't been the case. Goldman Sachs has also observed continued dollar weakness despite a partial recovery in relative U.S. growth.

Exhibit 9: The Dollar Has Weakened Further on Net Despite a Partial Recovery in Relative US Growth Expectations



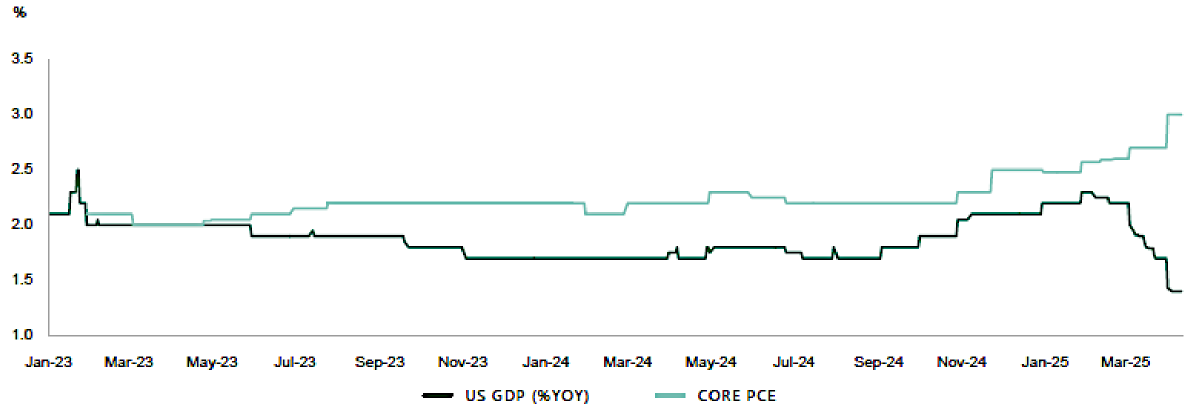
Source: Goldman Sachs Global Investment Research

Mixed signals make the Fed's job harder.

The path of interest rates will more likely be determined by economic strength and inflation. Apollo points out that while the U.S. economy faces headwinds, many, like tariffs, are self-imposed, making their effects harder to predict According to Goldman Sachs, soft data (such as sentiment surveys) has rebounded recently, but hard data (such as actual output and employment) is beginning to weaken.

Bloomberg and Apollo both cite forecasts calling for slowing growth, weaker employment, and rising inflation, an uncomfortable mix for markets and a challenge to the Fed's dual mandate.

Exhibit 20: Consensus forecasting GDP down, inflation up
Bloomberg consensus forecast for 2025

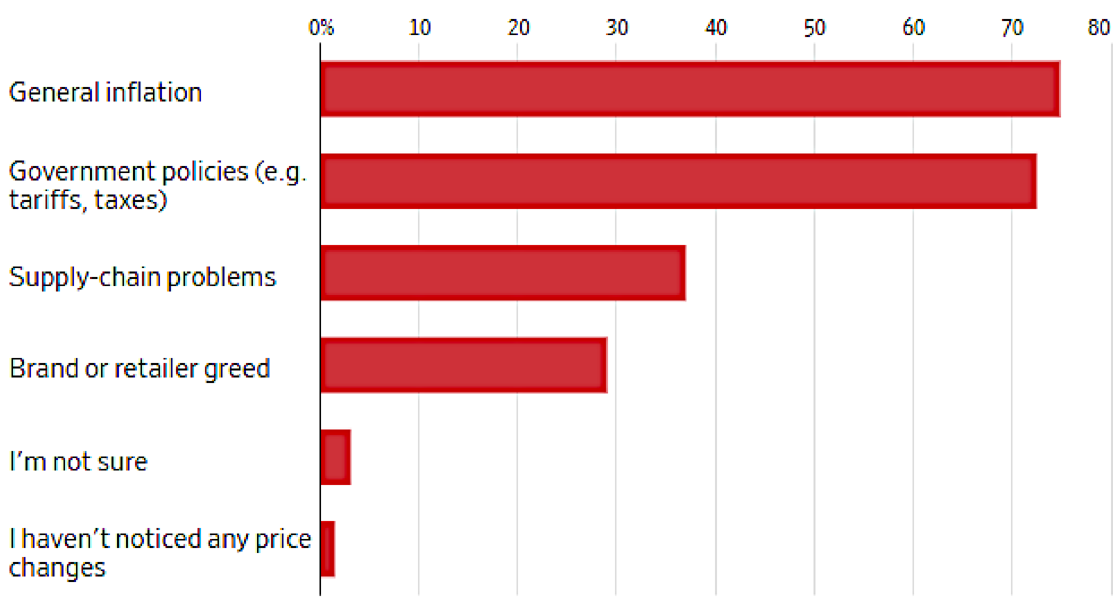


Data as of May 5, 2025. Sources: Bloomberg, Apollo Chief Economist

Inflation pressures may still be building.

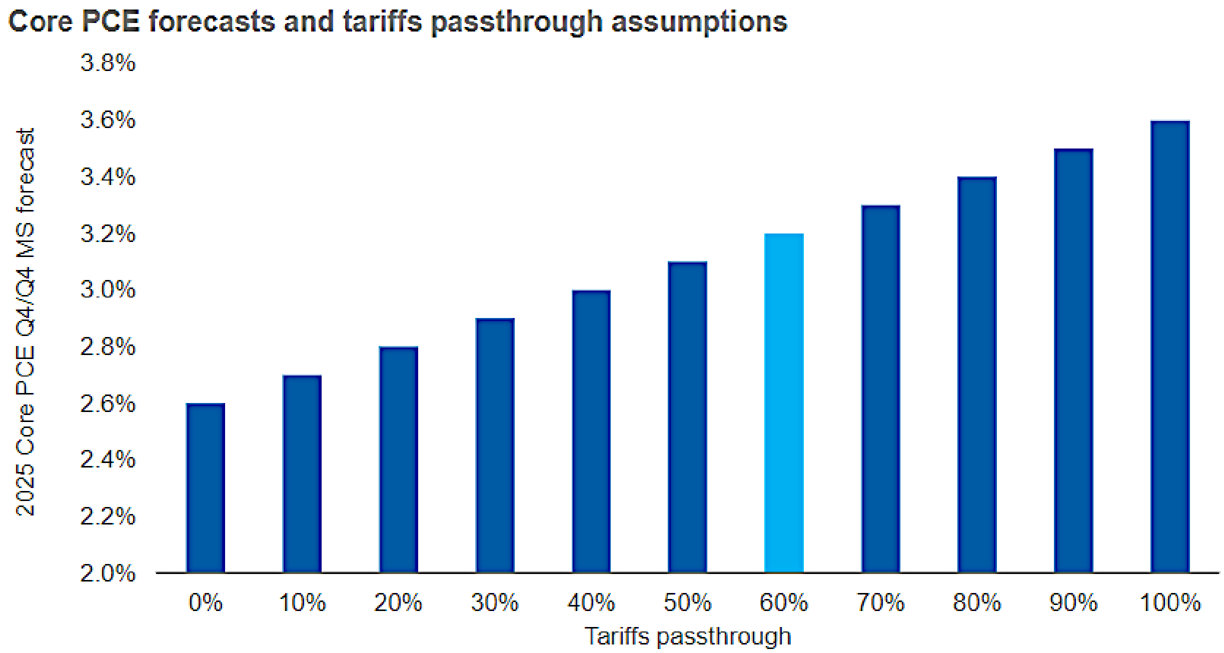
Inflation remains a critical factor. Without the inflationary overhang of tariffs, the Fed might already have begun cutting rates. While tariffs haven't yet shown up in the inflation data, the Fed remains cautious, preferring to monitor prices before starting to normalize monetary policy. Consumers are also unsure about the causes behind price increases. A May survey by consulting firm Kearney found that 75% of respondents blamed tariffs for rising prices, but a similar number cited general inflation.

Share of consumers who believe prices are increasing because of...



Note: Respondents could provide multiple answers. Data from May 2025.
Source: Kearney

A great deal of uncertainty still lingers around the future of tariffs. Goldman Sachs estimates that 70% of the tariff burden will eventually fall on U.S. consumers, higher than the 50% estimated in regional Fed business surveys. Morgan Stanley splits the difference, projecting a 60% pass-through, which would lift Core PCE inflation from 2.7% (May) to roughly 3.2%. However, if price increases are steep, companies may choose to absorb more of the cost and pass it through slowly over time.

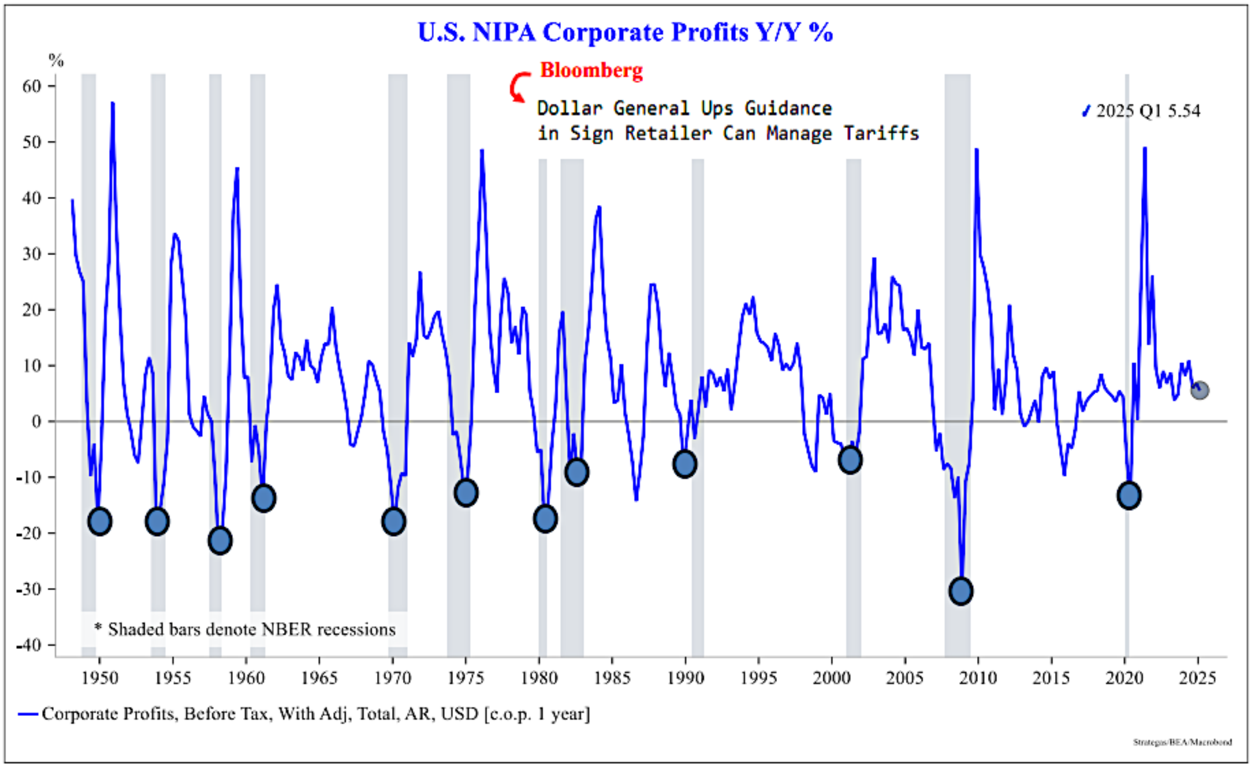


Source: Morgan Stanley Research forecasts

Uneven impact of OBBBA.

The OBBBA may be a net positive for growth in the near term, but its benefits are not evenly distributed. The lowest [30% of income earners] are expected to be worse off, while the wealthiest decile will benefit the most. Corporations are also expected to gain. Bloomberg reports that S&P 500 forward [earnings estimates] have recovered following the post-tariff slump. The good news is that U.S. recessions don’t usually happen when profit growth is positive.

BASED ON HISTORY, U.S. RECESSIONS DON'T HAPPEN WITHOUT PROFIT GROWTH GOING NEGATIVE Y/Y

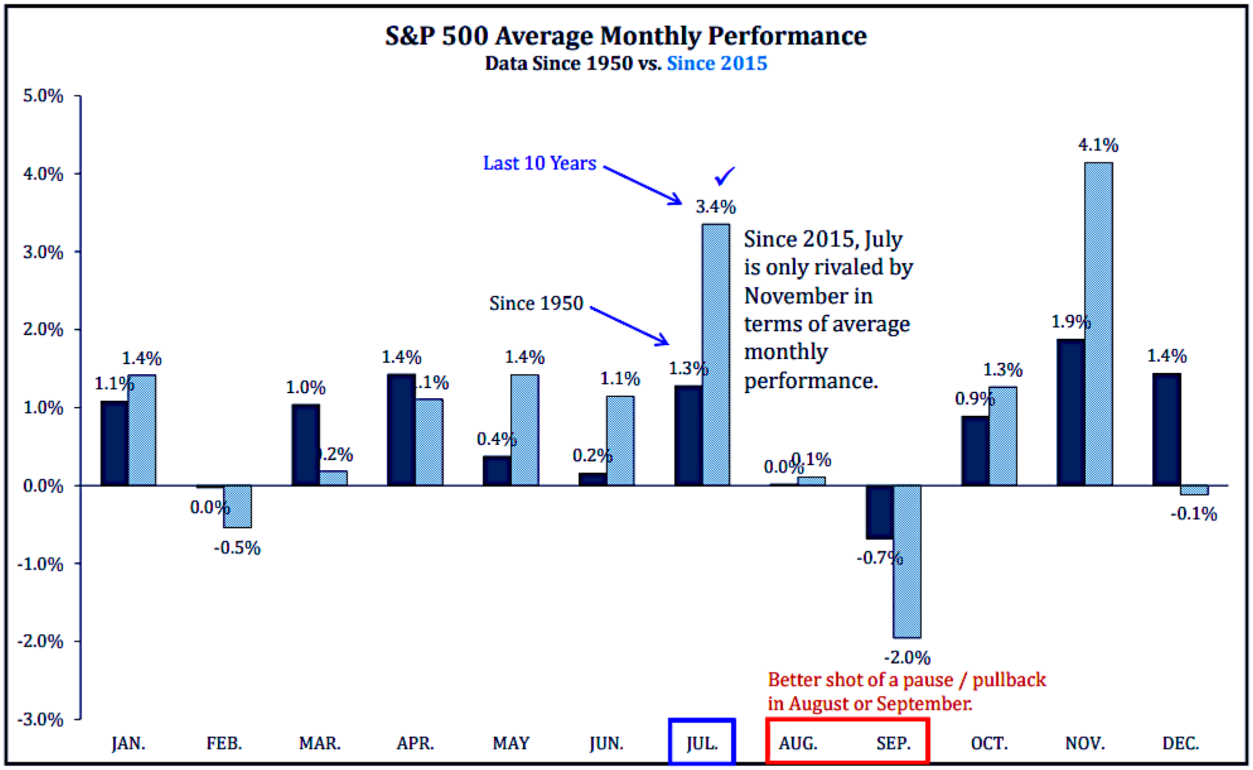


July may bring market gains, but outlook remains uncertain.

June and the start of July have been a relatively strong month for both the market and Trump. The New York Post chronicled Trump's "winning streak," citing actions like favourable Supreme Court rulings, falling unemployment, and the passage of OBBBA. Markets responded in kind: stocks, bonds, and credit all posted gains, prompting strategists to raise their year-end S&P 500 targets.

Markets seem to be taking Trump's tariff strategy in stride, assuming most levies will settle around the manageable 10% mark. The boost to corporate earnings from OBBBA and expectations for eventual Fed cuts are also contributing to market optimism. Strategas notes that historically, July is the second-best performing month of the year, adding to the bullish backdrop.

SEASONALITY REMAINS A TAILWIND THROUGH JULY



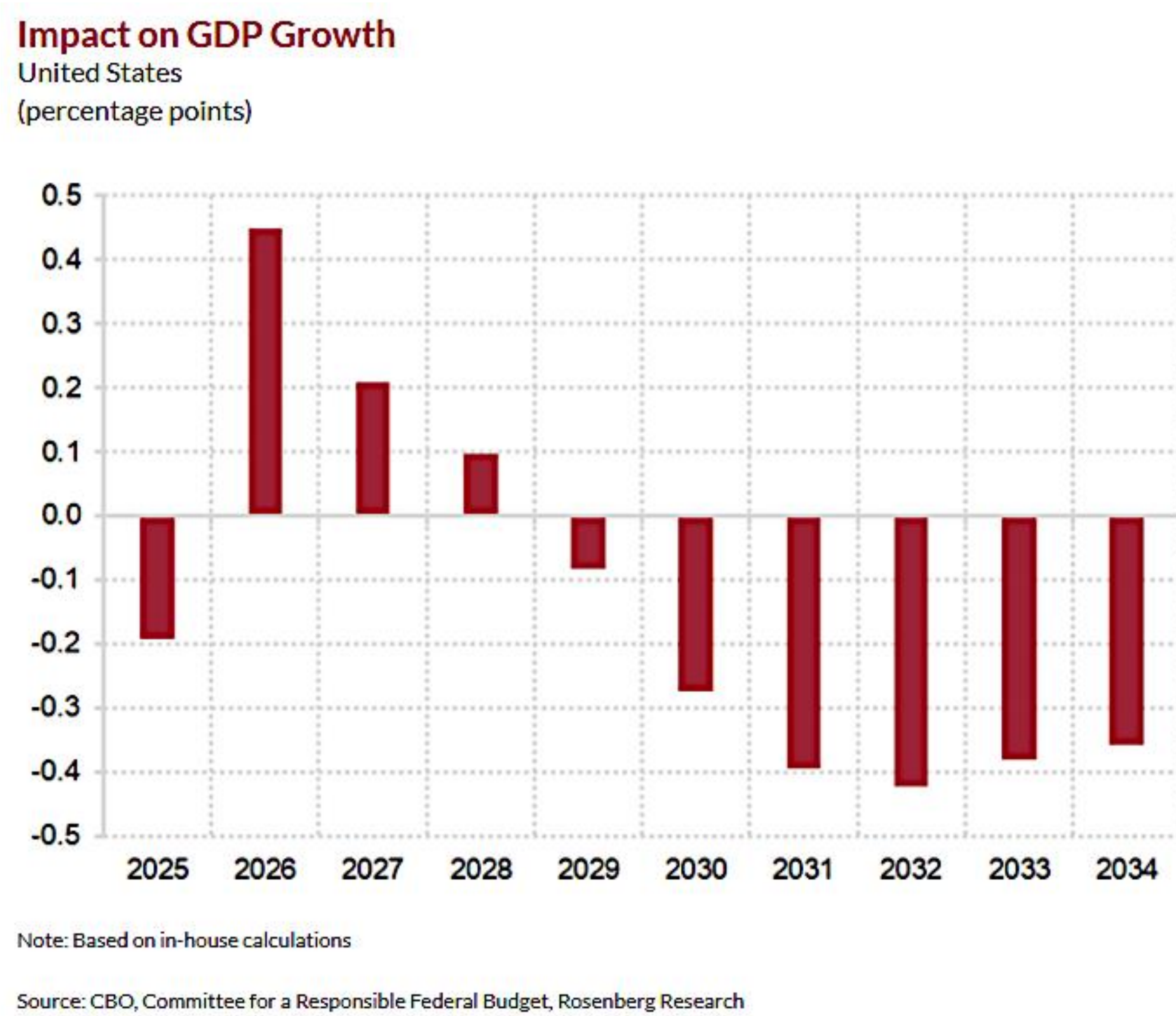
So, mission accomplished? Not so fast.

Perhaps President Trump will manage to secure favourable trade deals that boost growth without stoking inflation, but it’s far too early to declare victory. We still don’t know how high tariffs will go, or what their full impact on the U.S. economy will be. At a minimum, the uncertainty alone is likely to weigh on growth in the near term. And while inflation data hasn’t yet reflected the full effect of tariffs, we suspect that impact is coming, potentially pushing out the timeline for any Fed rate cuts.

To be clear, the Fed will likely respond with rates cuts if the labour market cracks. But that hasn’t happened yet. And with immigration quietly adding to labour supply, the U.S. economy doesn’t need to generate as many jobs to keep conditions tight.

As Bloomberg noted, the futures market overshot last year in its rate cut expectations, and looks overly optimistic again this year, Trump’s rants notwithstanding.

As for the OBBBA, it may give corporate earnings a short-term boost, but the impact on U.S. GDP is likely overstated. In the long run, it’s a drag on growth, and it certainly doesn’t steer America toward a more sustainable fiscal path.

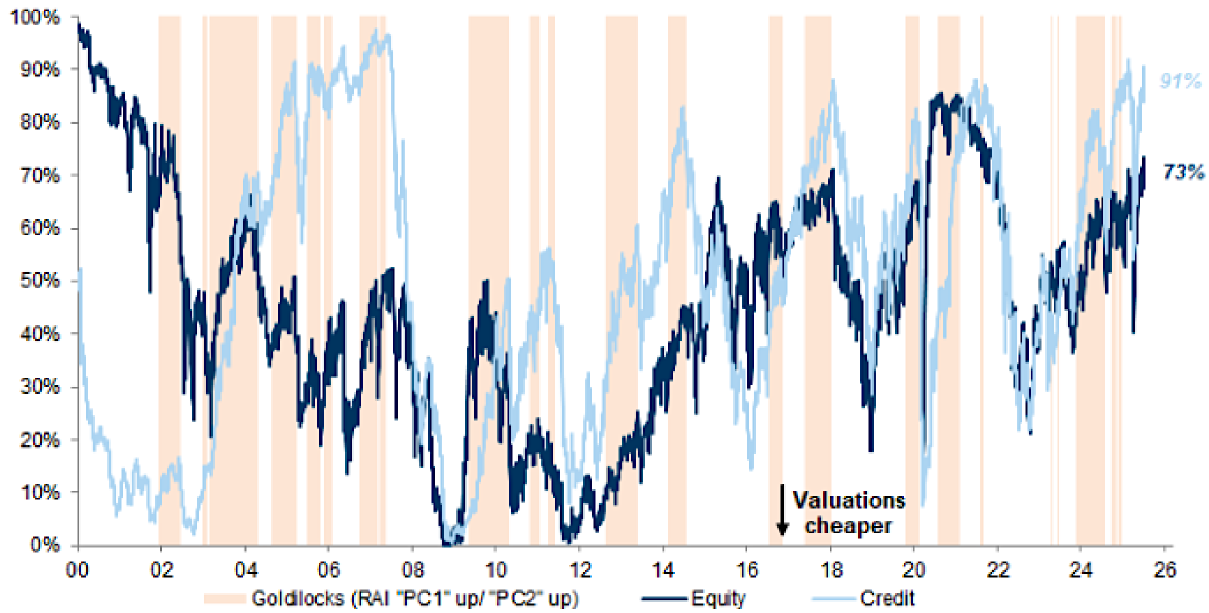


Treasury Secretary Scott Bessant may find ways to pacify bond vigilantes for now, but eventually the bond market and the dollar will demand a reckoning. Even Trump's so-called victory in the Middle East seems front-loaded. Iran's nuclear program may have been delayed, but its resolve has likely only hardened.

Against all these longer-term risks stands a market that once again looks richly priced. Goldman Sachs notes that risk assets are trading as if we're in a Goldilocks environment across both equities and credit. We'd urge more caution. The market is pricing in a lot of good news, at a time when a lot can still go wrong.

Exhibit 11: Risky asset valuations are elevated again, similar to previous 'Goldilocks' regimes

Average valuation percentile since 1990. Equity: NTM P/E of S&P 500, MSCI Europe, MSCI EM; Credit: spread of US HY & IG, EUR HY & IG, EMBI.



Source: Datastream, Goldman Sachs Global Investment Research

NICOLA WEALTH