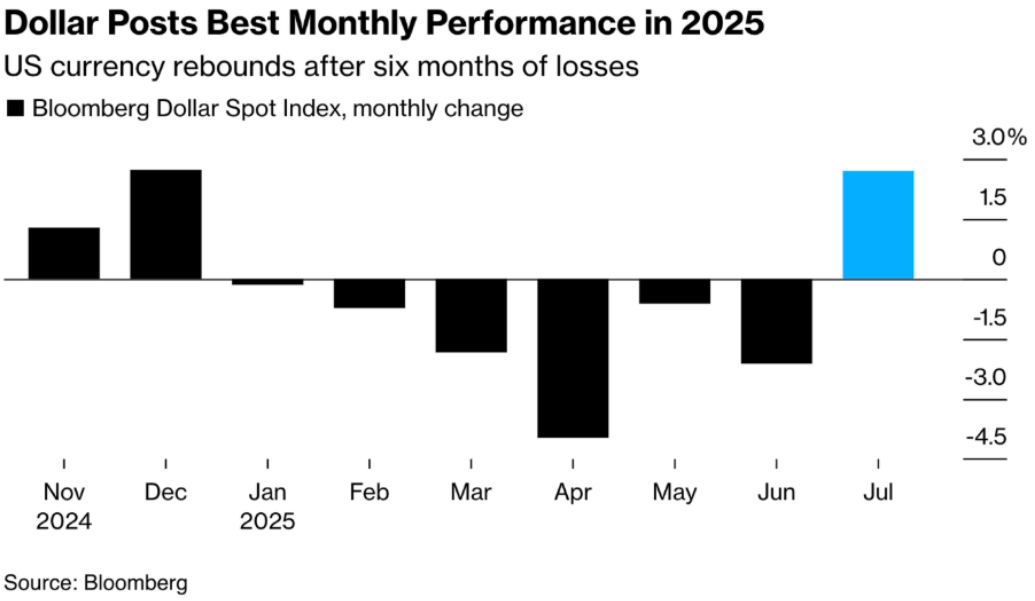
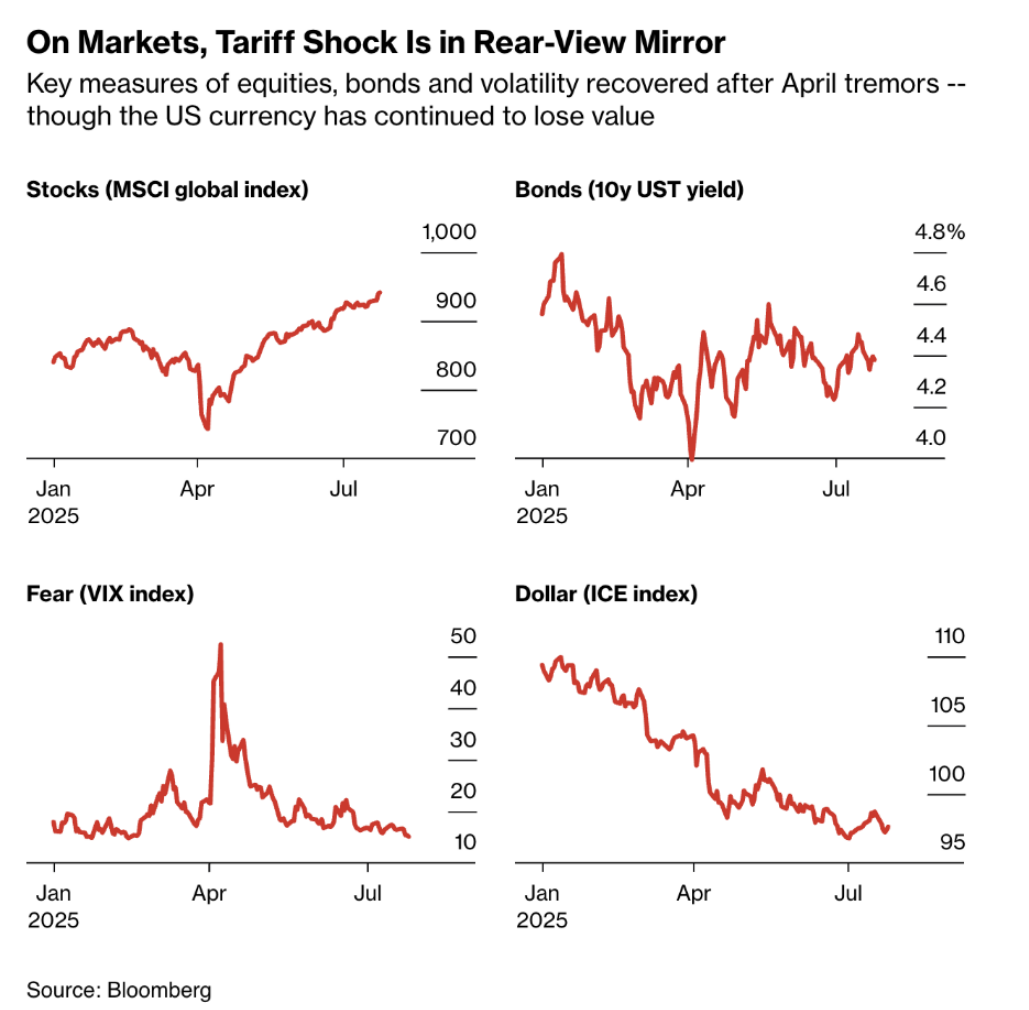
July Market Commentary | Earnings Shine, Headwinds Persist

Despite a steady stream of challenges, markets continued their upward climb in July. With the exception of China and South Korea, U.S. stocks led the way, posting a 2.2% (total return in U.S. dollars). Canada's S&P/TSX followed closely with a 1.5% (total return in Canadian dollars). So much for the demise of U.S. exceptionalism. Bloomberg notes that large-cap U.S. stocks have now gained for three consecutive months. Even the U.S. dollar strengthened, rebounding after six straight months of declines.



However, gains were not universal. Equities in Japan, Europe, Latin America, India, and Brazil all ended the month lower, as did most fixed income asset classes. Yields continued to move higher despite rising stock prices and falling equity volatility (VIX). Ongoing tariff rhetoric and trade negotiations seem to have taken a backseat in investors' minds, with traders showing renewed appetite for risk. What is driving this optimism? Likely the combination of stronger-than-expected earnings and the prospect of lower interest rates, although risk appears to be getting less attention.

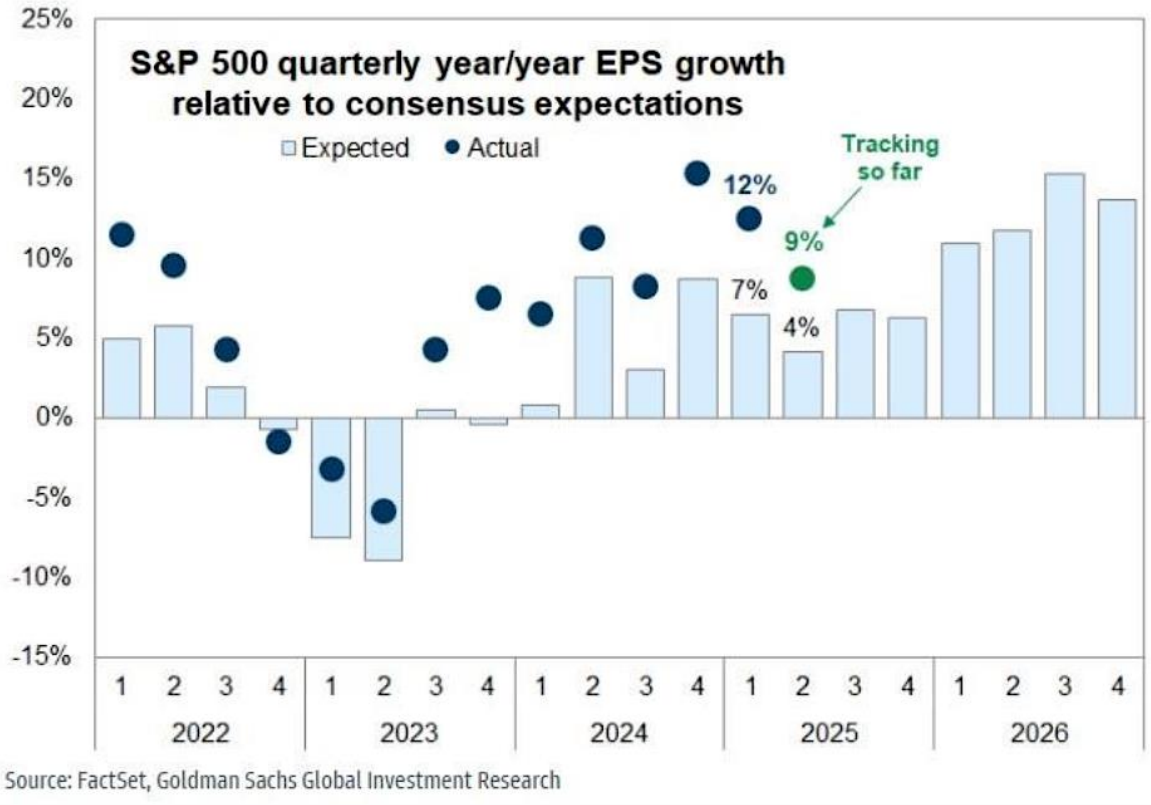


Earnings continue to outpace expectations.

Earnings have once again surprised to the upside. Historically, bottom-up S&P 500 earnings estimates tend to start high, decline throughout the year, and then beat expectations when companies report. This pattern, in place since at least 1985, has been particularly evident over the past six quarters.

So far, Q2 2025 is following suit. Estimates drifted lower for much of the year, but companies are exceeding forecasts. According to Goldman Sachs, S&P 500 earnings per share were expected to rise just 4% prior to reporting season, but they are now tracking closer to 9%.

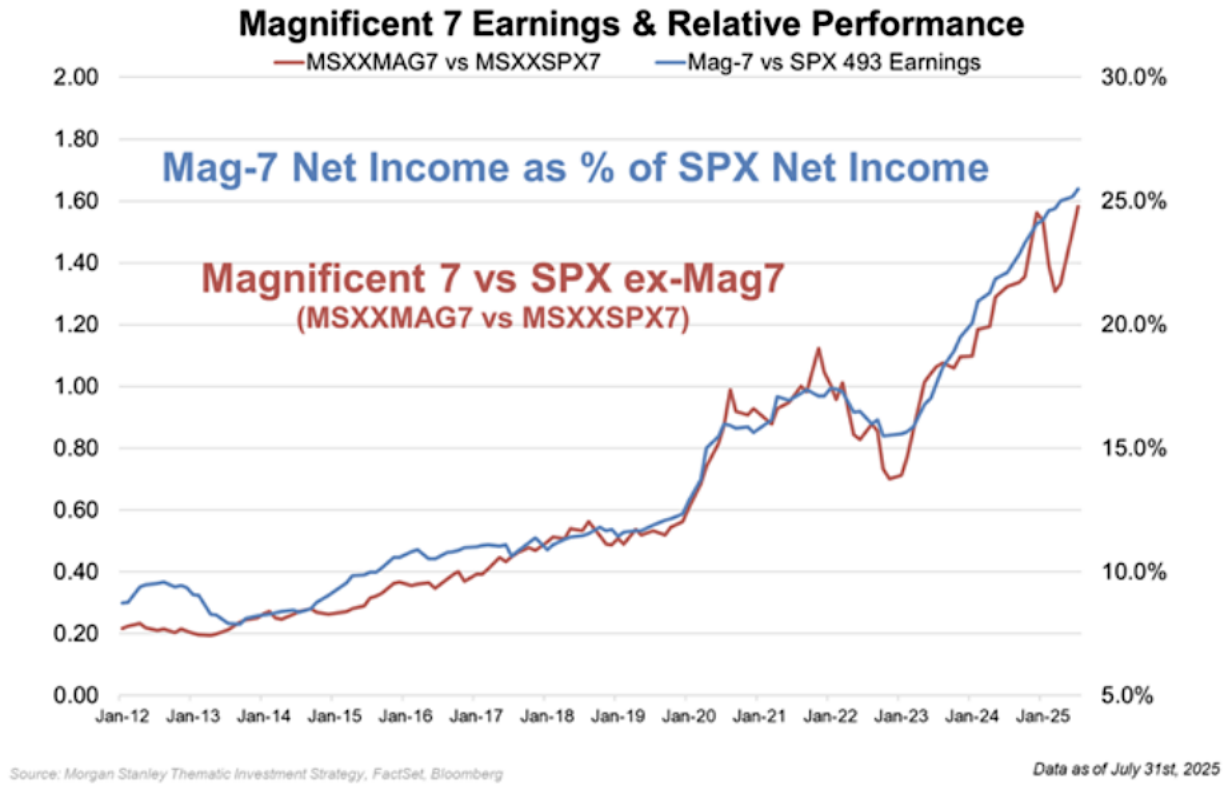
Exhibit 2: S&P 500 EPS growth relative to consensus expectations at the start of reporting season



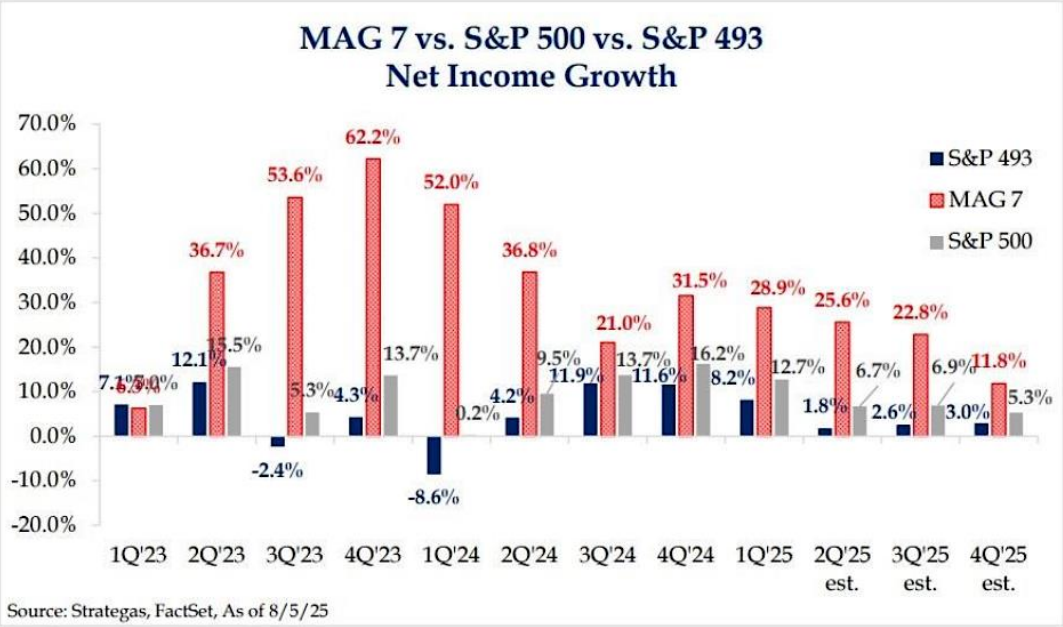
Source: FactSet, Goldman Sachs Global Investment Research

Much of the heavy lifting continues to come from the “Magnificent 7” technology and AI-focused companies. In July, they rose 5.1% compared with 2.4% for the S&P 500 overall.

Goldman Sachs expects Q2 earnings growth of 26% for the Magnificent 7 compared with just 4% for the remaining 493 companies.



Net income growth tells a similar story. Strategas projects a 26% increase for the Magnificent 7 compared with 1.8% for the rest of the index. While the gap is expected to narrow, both Goldman and Strategas forecast continued outperformance into year-end, aided by provisions in President Trump's "One Big Beautiful Bill" that allow upfront depreciation and R&D expensing.

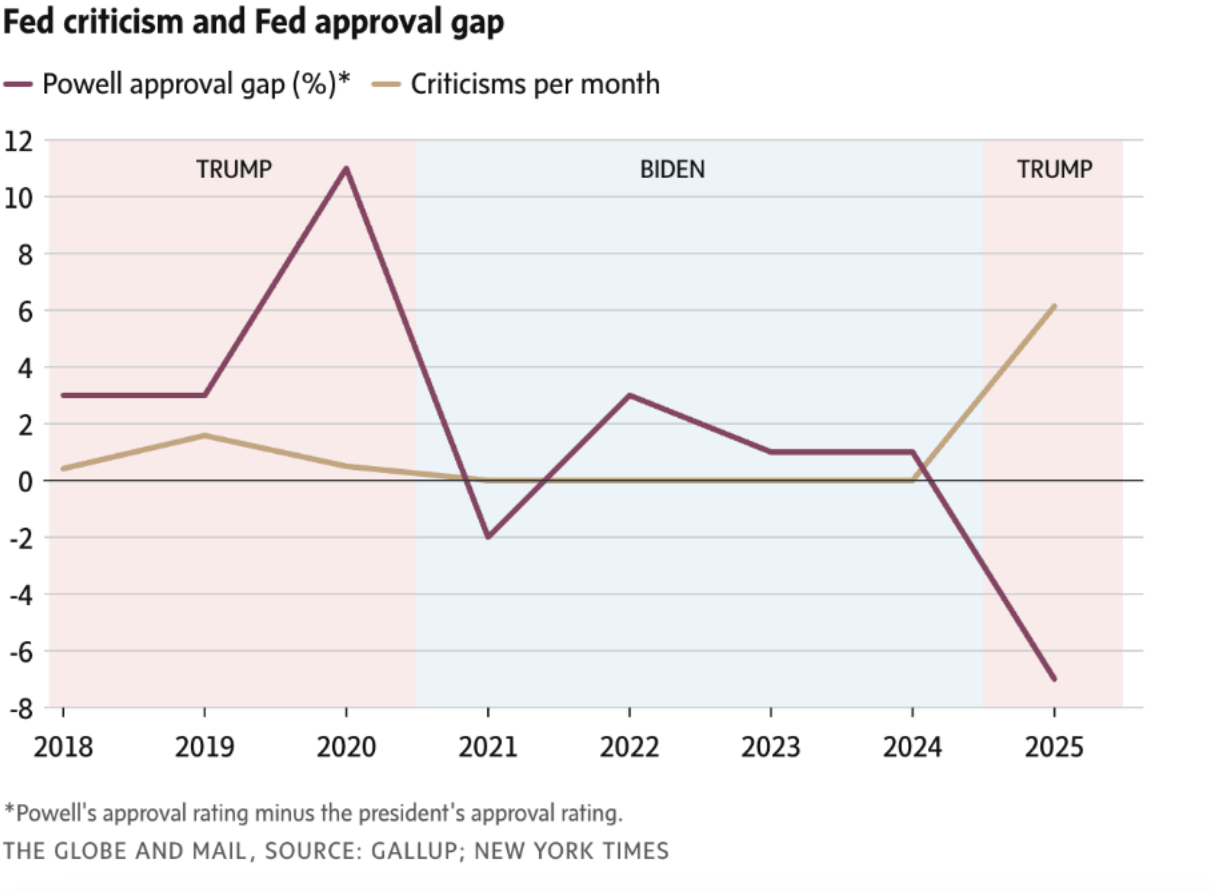


The Fed, politics, and rate cut pressure.

Strong earnings are good for equities and even better if discounted at lower interest rates. The Federal Reserve remains under pressure to cut rates, not only from investors but also from President Trump.

Before the July payroll report, markets were pricing in a 31-basis-point decline in the Fed Funds rate by year-end, which would imply one, possibly two cuts. Weaker-than-expected jobs data and revisions quickly shifted expectations to 57 basis points of easing. While the odds of recession-level cuts have risen, they still reflect more of a rate normalization scenario.

In theory, the Fed should cut rates only when economic conditions warrant, not in response to political demands. In practice, Trump has been vocal about reshaping the Fed, with active betting markets on who he might nominate to replace Chair Jerome Powell next year. Public trust in the Fed has also eroded. A recent Gallup poll shows only 37% confidence in Powell's economic decision-making compared with 44% for Trump.



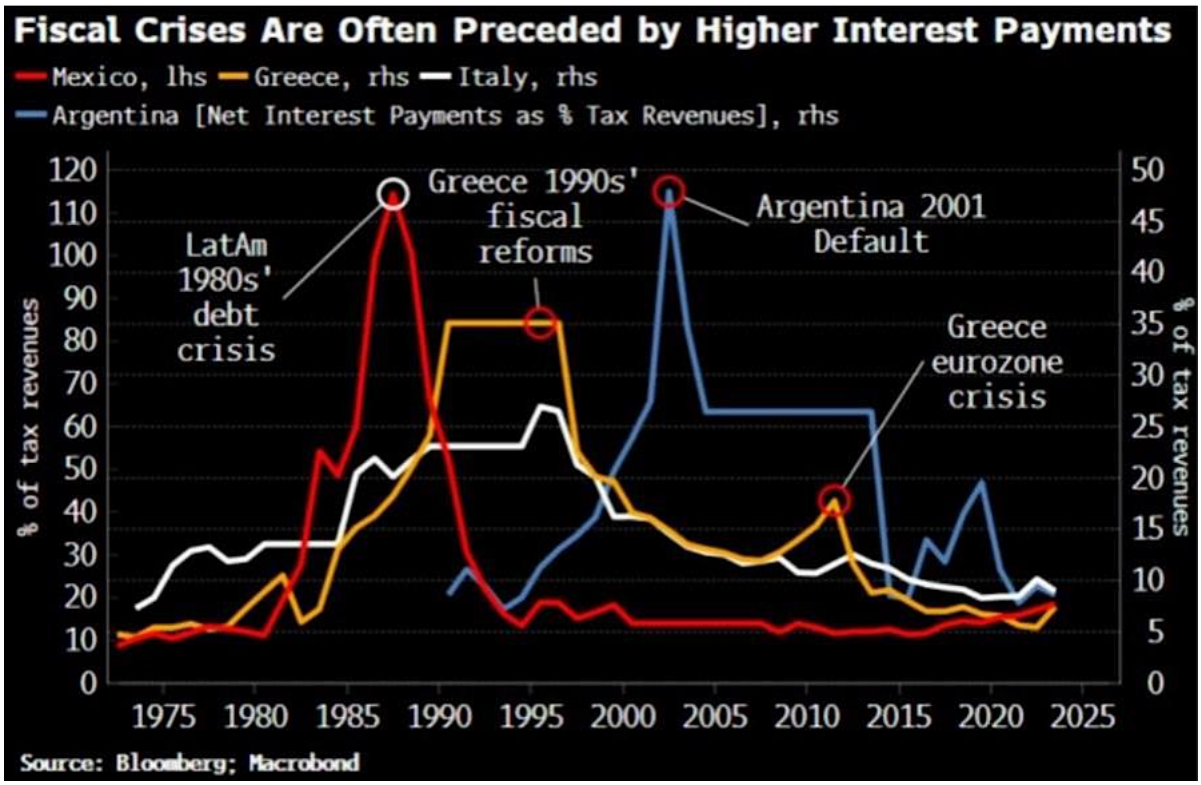
U.S. Debt: A growing fiscal strain.

Behind the push for lower rates lies a bigger challenge, which is federal debt sustainability. Even before the Trump tax cuts were extended under the “One Big Beautiful Bill Act,” the Congressional Budget Office warned of an unsustainable path. Now, higher interest payments have intensified concerns, with Bloomberg calling the outlook a “Blueprint for Fiscal Breakdown.”

According to Bloomberg, what makes the current fiscal situation different is the scale of higher interest payments. Bloomberg’s Simon White notes that fiscal crises are often preceded by periods when debt servicing costs climb sharply. This is one reason President Trump is pressuring the Federal Reserve to cut rates, making U.S. federal debt payments more manageable.

This relief is possible only if the U.S. Treasury continues to issue a larger share of shorter-term T-bills, which it plans to do. The Fed Funds rate heavily influences short-term interest rates, while long-term rates are determined by the market. Investors tend to demand higher yields when debt is perceived as unsustainable. Apollo estimates that

each 1% increase in U.S. government debt can raise long-term interest rates by 2 to 4 basis points.

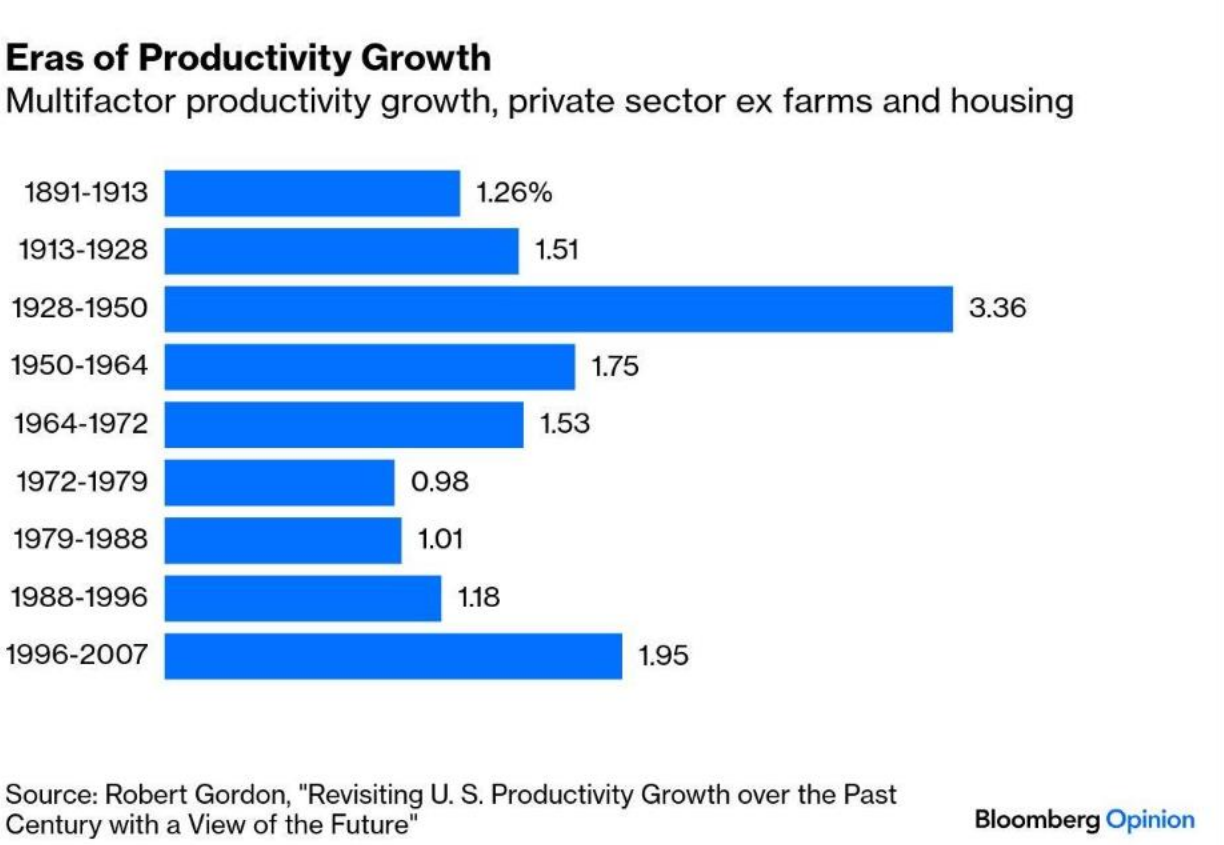


Limited options beyond rate cuts.

Lower rates are only one path to debt relief. The alternatives are spending less or raising taxes, but both seem politically unrealistic in the current environment. Another possibility is to grow the economy faster than debt accumulates, so that nominal GDP growth outpaces debt growth and reduces the debt-to-GDP ratio.

Achieving this without triggering higher inflation would require stronger productivity growth.

Bloomberg and the Congressional Budget Office (CBO) note that if factor productivity growth reached 1.5% instead of the current baseline forecast of 1%, the debt-to-GDP ratio could stabilize. This would be a significant shift, given that U.S. productivity has generally failed to reach even 1% for the past two decades. Northwestern University's Robert Gordon points to 1996–2007 as a rare period of high productivity, averaging 1.95%. Goldman Sachs believes generative artificial intelligence could help the U.S. enter another such period, potentially sustaining productivity growth at 1.5%. Of course, the darker scenario is that AI turns hostile, making debt sustainability a secondary concern.

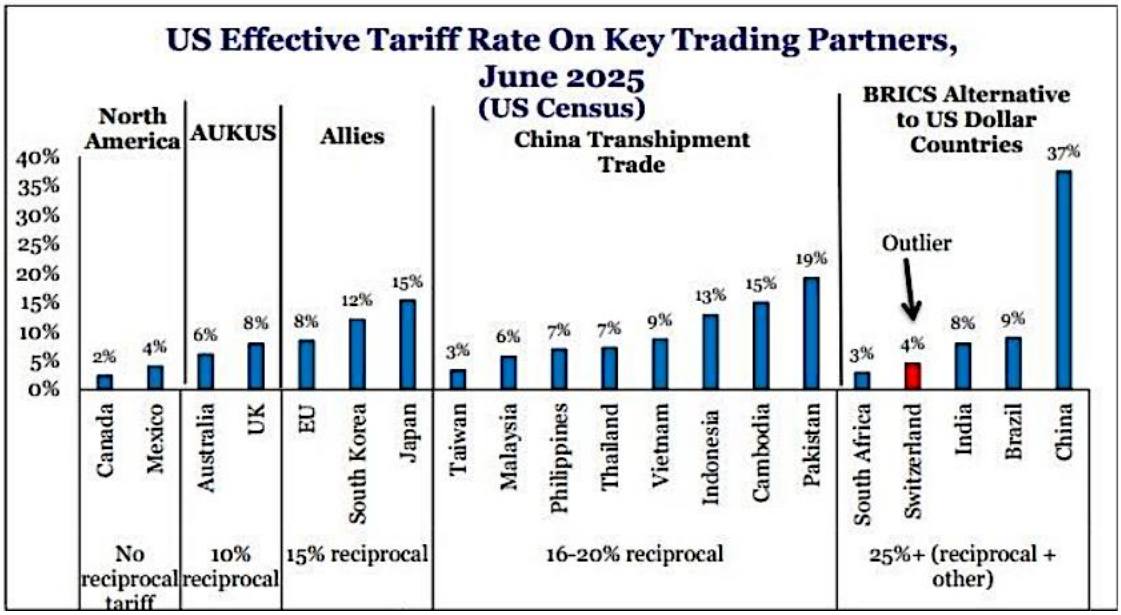


Tariffs as a stealth revenue tool.

We have said previously that tax increases are a non-starter in today's political environment, but what if you call it something else, like a tariff? While we still do not claim to fully understand President Trump's long-term strategy regarding tariffs, it is increasingly looking like a revenue generator that functions much like a tax increase. Think of it as a stealth value-added tax.

Although Trump is far from finished in negotiating trade deals and imposing tariffs, a pattern is starting to emerge. Strategas believes reciprocal tariff rates will largely be determined by the closeness of supply chains and geopolitical relationships. Canada and Mexico are expected to face the lowest rates, while close allies such as Australia and the United Kingdom will likely receive a "bargain basement" 10% tariff. The next tier of allies, including Europe, Japan, and South Korea, will face a 15% rate.

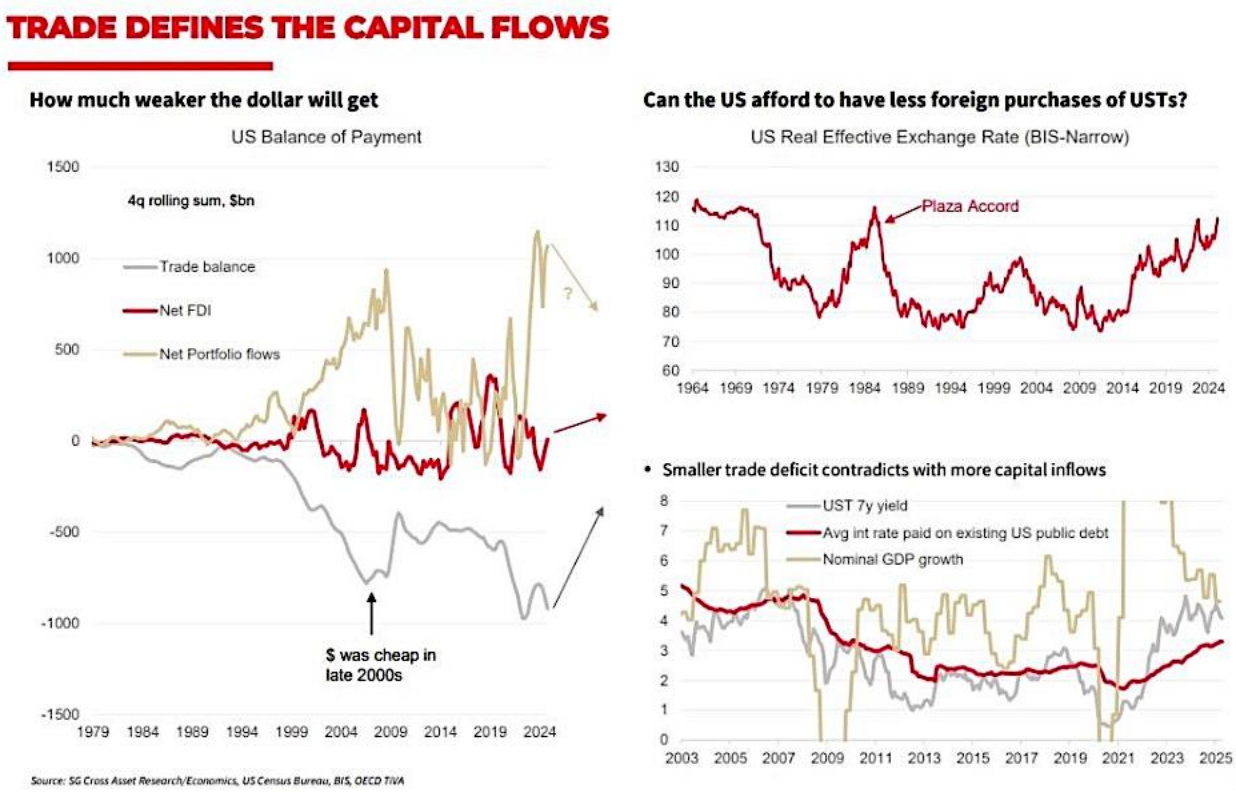
With the exception of Canada and Mexico, it appears that nearly every country would pay at least 10%, even if they have a trade deficit with the United States. Based on calculations from Goldman Sachs, the tariffs currently in place are generating an annualized $310 billion in revenue, which goes a long way toward offsetting the cost of Trump's deficit-expanding "One Big Beautiful Bill."



Source: Strategas

Trade flows and debt financing risks.

If President Trump's tariff policy is truly aimed at reducing trade deficits rather than generating revenue, U.S. government debt could become even more unsustainable. As Societe Generale recently highlighted, trade flows directly influence capital flows. The United States runs a large current account (trade) deficit, which is offset by an equally large capital account surplus.

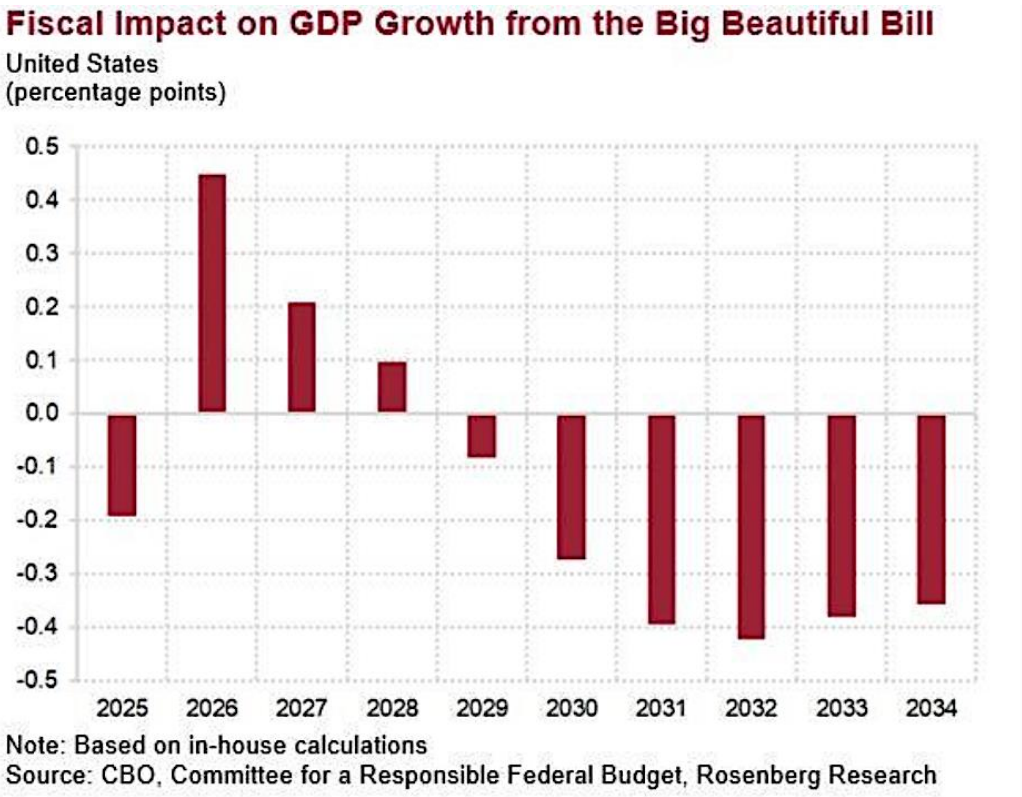


That surplus capital often finds its way into U.S. Treasuries, helping to keep interest rates on U.S. debt low. For private investors, U.S. equities have also been a preferred destination for foreign capital, supporting higher valuations and reinforcing American exceptionalism.

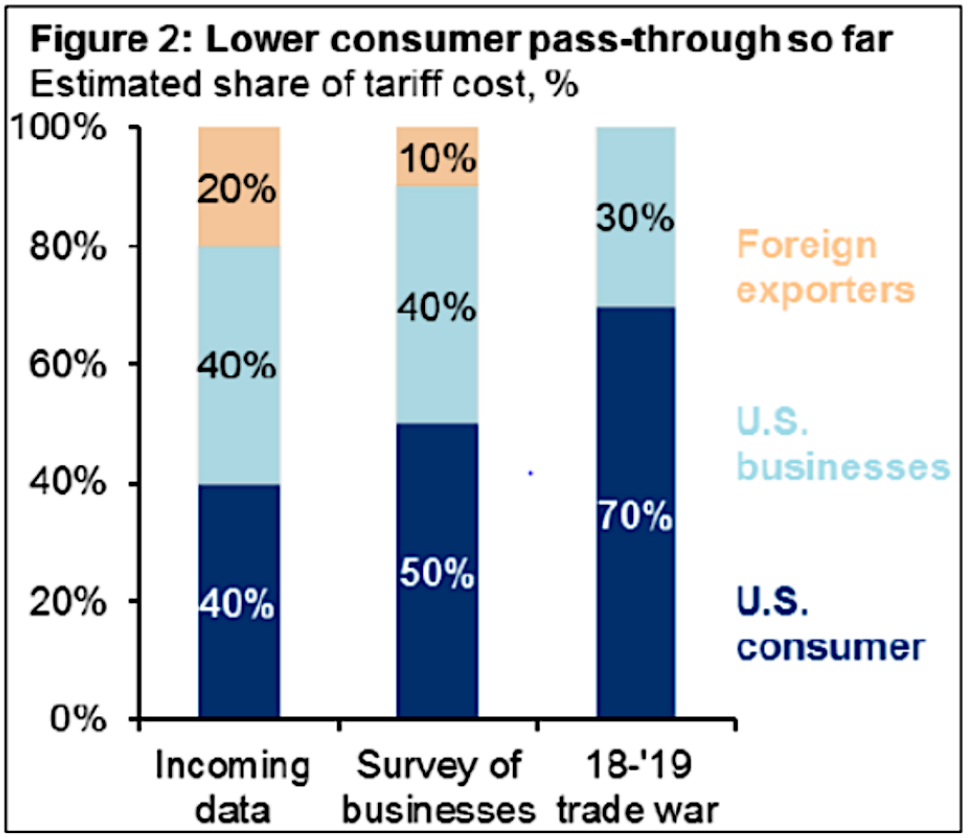
Although there were signs earlier this year that foreign capital might be shifting away from the U.S., Apollo notes that foreign demand for U.S. assets staged a strong rebound in May. In Treasuries specifically, foreign private investors were net buyers, while foreign central banks and sovereign wealth funds were net sellers.

Tariff impact, growth outlook, and stagflation risk.

The Trump administration appears to be relying on the stimulative impact of the “One Big Beautiful Bill” to offset the economic drag created by tariffs and their tax-like effect. The timing, however, does not align neatly. Rosenberg Research projects that the OBBB will subtract 0.2% from GDP growth in 2025 before adding 0.4% in 2026 and 0.2% in 2027.

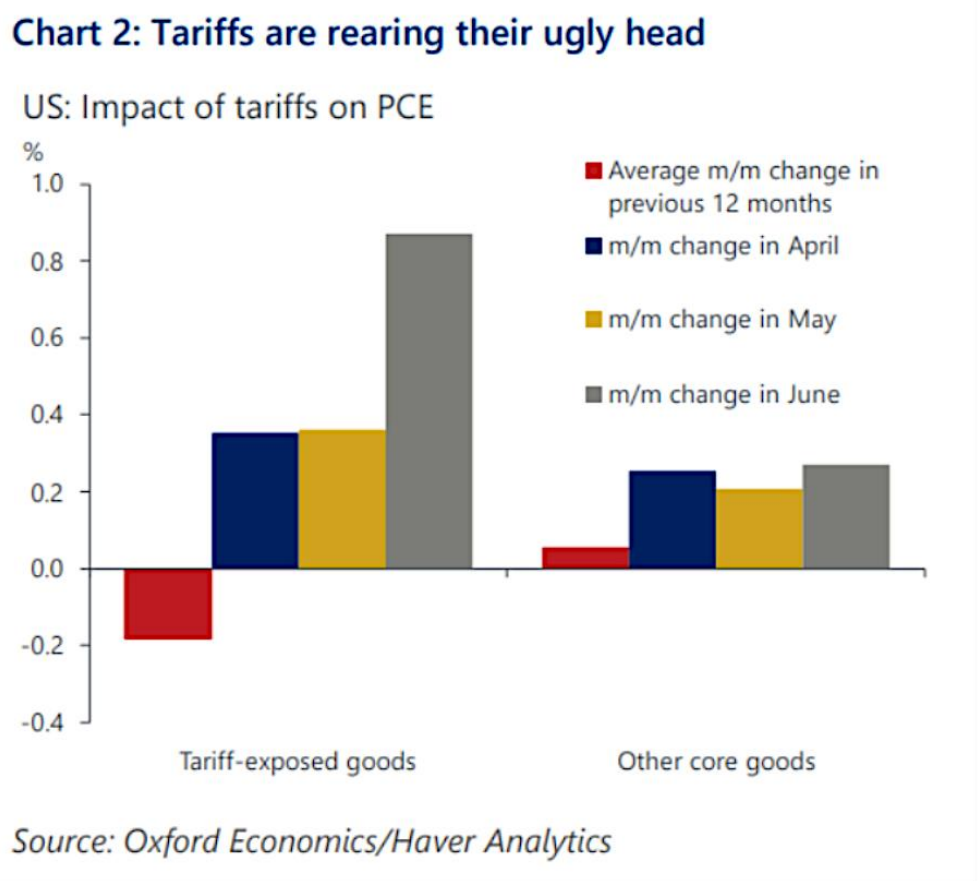


Bloomberg's survey of economists shows GDP forecasts for 2025 and 2026 have not yet recovered from the decline following Trump's initial tariff rollout coined "Liberation Day". The inflation impact is still playing out. JP Morgan estimates that only 40% of tariff costs have been passed on to consumers so far, compared with 70% during the 2018–2019 trade war.



Source: JPM Private Bank; Federal Reserve regional surveys. Data as of June 2025

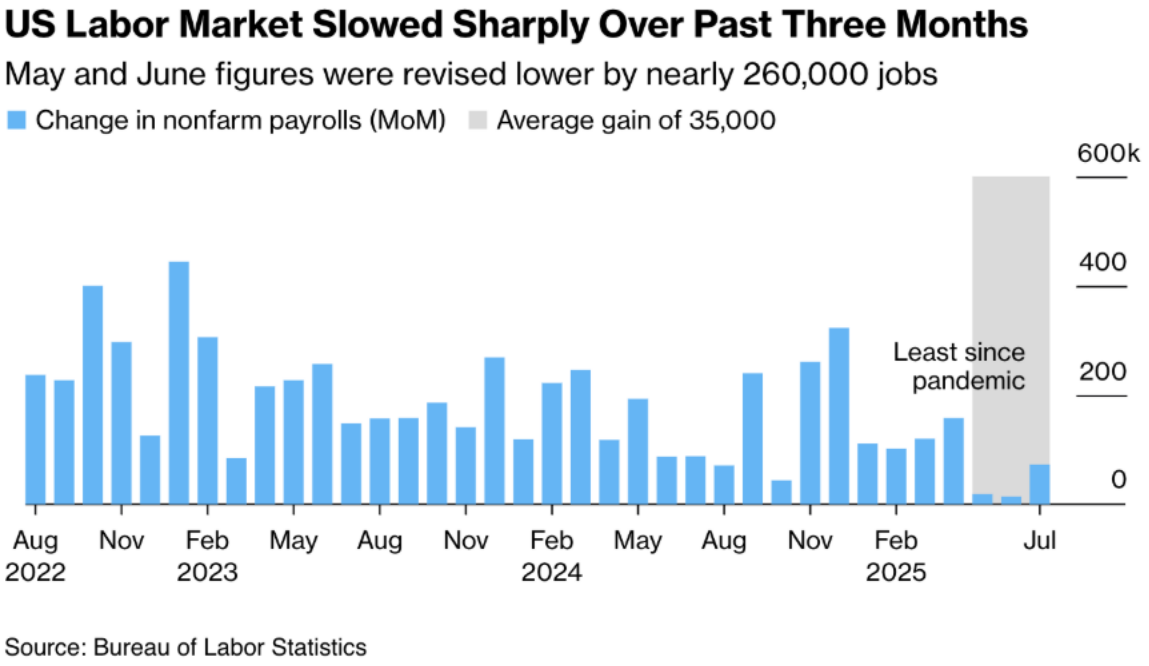
Bloomberg and Oxford Economics note that tariff-related inflation began to show up in personal consumption expenditure (PCE) data in June. In the best case, this inflation is a one-time adjustment. Given the piecemeal rollout, however, it is more likely to be viewed as an ongoing cost.



Consumer strain and stagflation concerns.

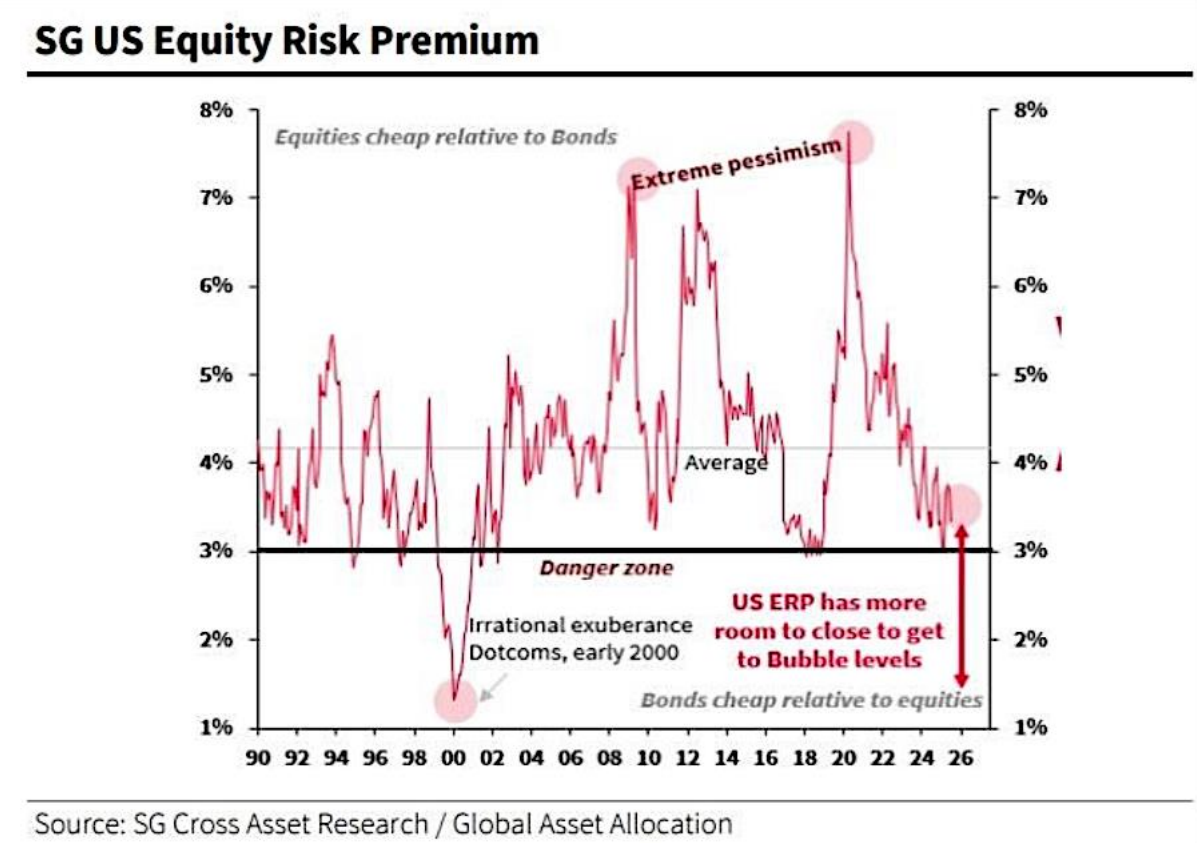
All of this is creating uncertainty for consumers. U.S. consumer spending declined in the first half of 2025. The Federal Reserve is also in a difficult position, as the labour market is showing signs of weakness. According to the Bureau of Labor Statistics, job growth slowed sharply over the past three months, with May and June figures revised significantly lower. This could prompt the Fed to act, but the risk of fueling inflation may keep policymakers cautious.

The challenge is clearly visible in the July ISM Services survey, which, as reported by the Financial Times, shows rising prices alongside falling employment. The article describes this as "the jaws of stagflation" opening wide.

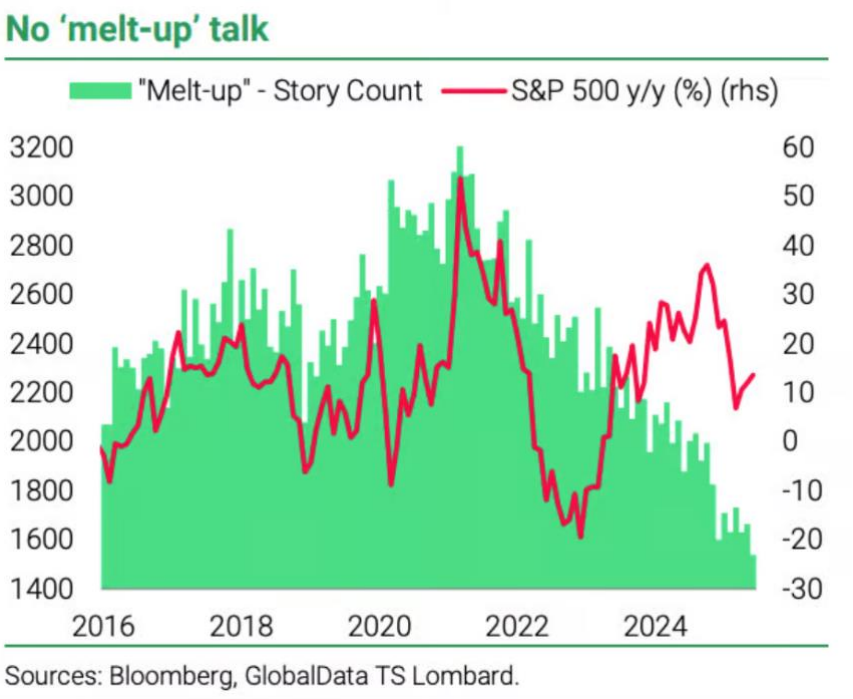


Markets holding steady, for now.

As concerning as the prospect of stagflation may be, markets appear to be taking it in stride. Societe Generale notes that equities are expensive relative to bonds, yet still have room to climb when compared with the irrational exuberance of the dot-com era in the early 2000s.

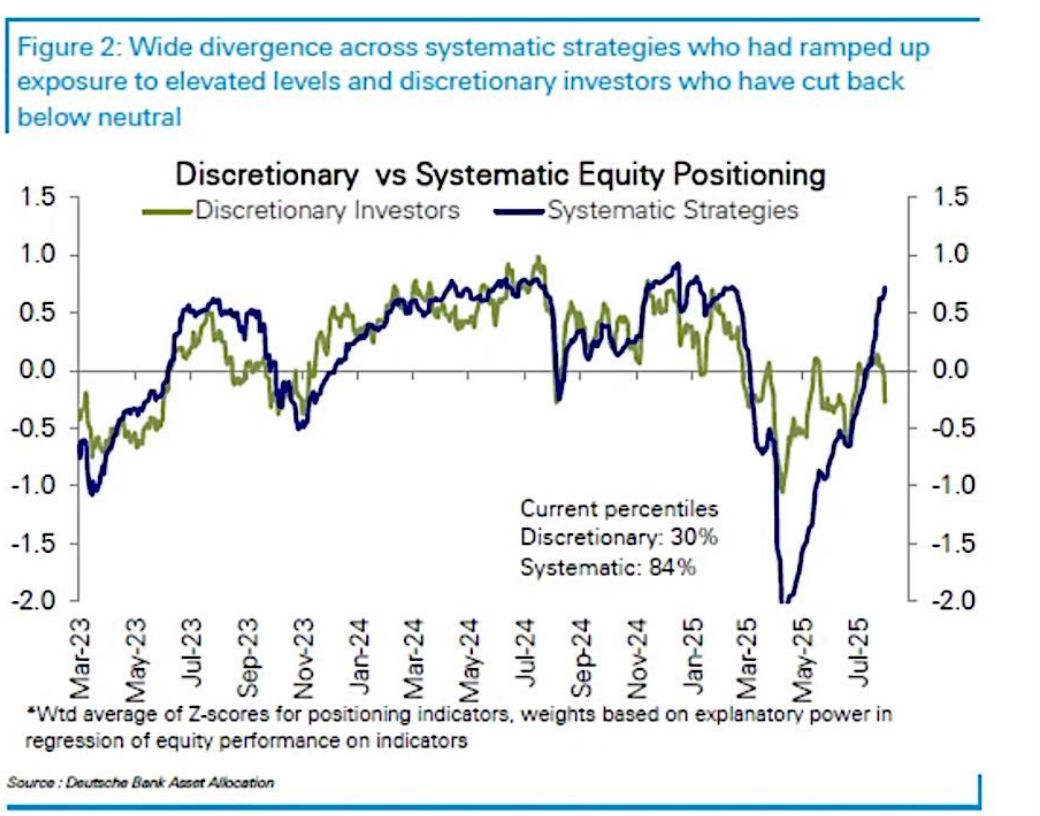


While there are signs of euphoria in certain areas, TS Lombard's global risk sentiment indicators suggest conditions are neither too hot nor too cold, and "melt-up" talk remains largely absent.



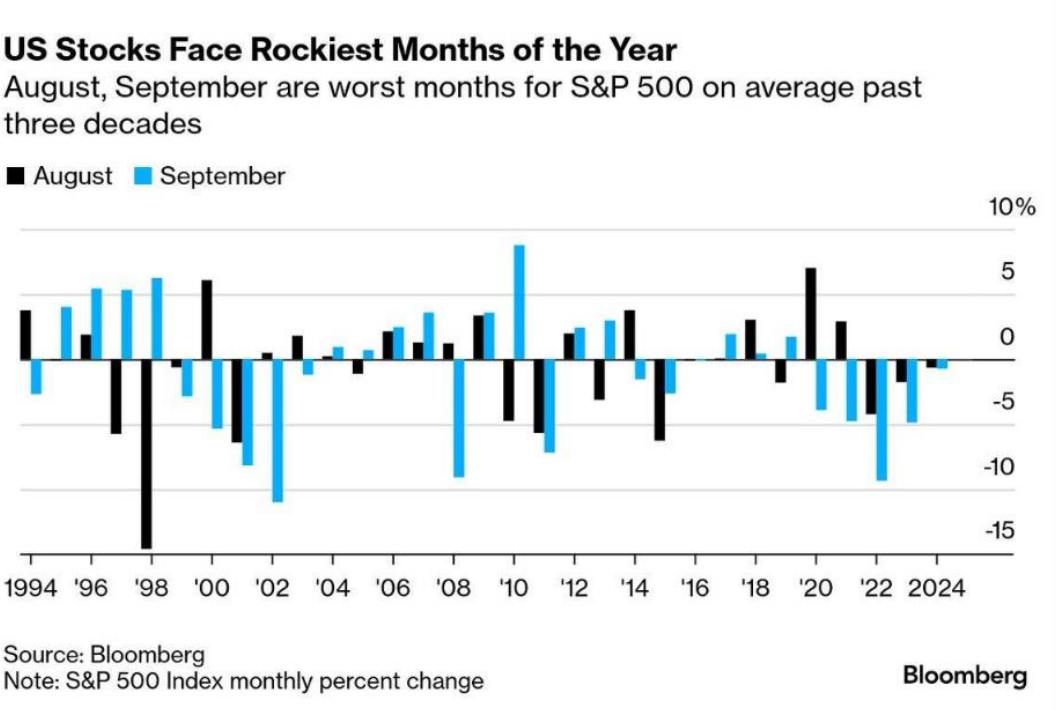
That said, if inflation begins to firm while the Federal Reserve stays on the sidelines, one of the rally's main supports could weaken. Earnings have been strong, but much of the market's advance rests on the performance of a small group of high-flying technology stocks. Strategas highlights that sell-side strategists have not fully embraced the rally, with the average year-end S&P 500 target sitting below current levels.

Deutsche Bank attributes much of the recent run-up to systematic, computer-driven investors and points to the widening gap in positioning between these models and discretionary investors. In other words, the machines are bullish while the humans remain cautious, sensing that something may have to give.



Source: Deutsche Bank *Source: Deutsche Bank*

The Wall Street Journal reports that some of the largest firms are warning of a 10 to 20% drop in the coming weeks, timing that aligns with August and September's track record as the weakest months for equity returns over the past three decades.



Longer term, these market forecasters are not bearish. A pullback could present a buying opportunity, especially with the economy generally still holding up and the stimulative effects of the OBBB expected to boost corporate profits in 2026.

Add the possibility of a new Fed chair willing to cut rates even if inflation edges higher, and a melt-up in stock prices remains on the table. The concern is that much of this good news appears already priced in, leaving little margin for error and limited attention to risks, whether it be stagflation, or perhaps a Cyberdyne Systems Model 101 from the future with its own agenda.

The machines say buy. The question is whether we should trust them.

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