Quarterly Economic and Market Review

Q2 2025

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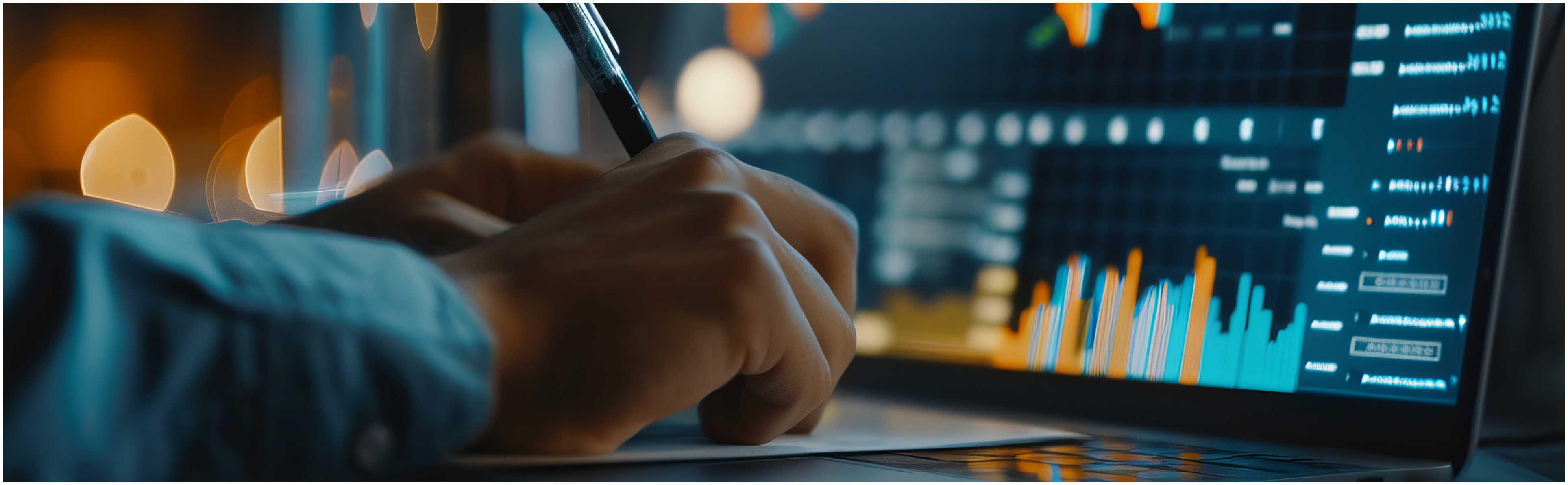


Markets Rebound Despite Policy Shocks and Geopolitical Tensions

David Lundgren, CFA

The second quarter of 2025 began in dramatic fashion following the surprise "Liberation Day" tariff announcement in early April. Equities experienced a swift and severe correction, with the S&P 500 plunging more than 12% in just four trading sessions after the announcement and had corrected 19% from the February 19 high. Investors were surprised by the administration's plan to introduce sweeping tariffs on key trading partners, reigniting fears of a global trade war at a time when market sentiment was already fragile. However, the market found its footing just as swiftly, staging a broad-based rally after the White House announced a 90-day pause on the new tariff implementation which was the beginning of a quarter ending new all-time high for the S&P 500. That tariff reprieve, coupled with the resumption of high-level trade talks, signs of easing inflation, and a better outlook for corporate earnings, helped restore confidence leading to the S&P 500 producing a very healthy 10.9% return for the quarter. By quarter-end, sentiment had shifted, and risk appetite cautiously returned. The volatility during the quarter underscored the market's increasing sensitivity to geopolitical and policy shocks even amid an improving earnings backdrop.

POLICY UNCERTAINTY TAKES CENTER STAGE

A swirl of policy risks dominated the narrative this quarter, further contributing to investor unease. Most prominently, the fate of the administration's proposed tax and spending package remained unresolved as of quarter-end. But after many days of negotiation, Trump's One Big Beautiful Bill garnered enough votes in time to be signed into law by the self-imposed July 4 deadline. This was a big win for the Trump administration and put to rest one of the uncertainties facing market participants.

Abroad, geopolitical tensions remained elevated. The Israel-Iran conflict, though somewhat de-escalated from its peak earlier in the year, continued to pose risks to global energy markets. Meanwhile, the war in Ukraine entered its fourth summer with renewed Russian offensives in the Donbas region, even as Western military support for Ukraine persisted. Market participants remain highly attuned to these hotspots, particularly with oil and commodity prices still vulnerable to disruption.

The tariff issue discussed above and throughout this review also remains a live wire. For businesses with global supply chains, uncertainty surrounding input costs and trade policy is once again complicating capital investment and hiring plans. These overlapping uncertainties—from Washington and abroad—continue to obscure the medium-term outlook for both investors and business leaders alike.

ECONOMIC GROWTH HOLDS STEADY AMID CROSSCURRENTS

Despite ongoing policy uncertainties, the U.S. economy has continued to show resilience. Second-quarter GDP growth is tracking at an annualized pace of 1–2%, slightly ahead of the first quarter. However, the underlying data presents a more nuanced picture. In Q1, a surge in imports ahead of the April tariff implementation widened the trade deficit, masking what was otherwise a strong quarter for domestic growth. That trend reversed in Q2, with a narrowing trade deficit now providing a boost to headline GDP. Yet much like the previous quarter, the trade data may obscure the total growth picture. Real private domestic final sales (PDFS)—which represent 88% of real GDP—are softening and are likely to contract from the more robust levels seen in Q1. This deceleration in core domestic demand signals a potential concern for the economic outlook.

Inflation data was perhaps the brightest development. The Core PCE Price Index—the Fed's preferred metric—continued its downtrend, rising just 2.6% year-over-year through May, the lowest since early 2021. Core goods prices remained tame, and even some core service categories reflected reduced pricing pressures. That said, labor markets may be softening around the edges. While the unemployment rate remained relatively low at 4.2%, job openings declined and quit rates fell, suggesting a cooling in labor market dynamics. Importantly, wage growth has moderated to a more sustainable 3.5% annualized pace, relieving a key pressure point for inflation.

> The volatility during the quarter underscored the market's increasing sensitivity to geopolitical and policy shocks even amid an improving earnings backdrop.

THE FED PAUSE MAY END SOON

The Federal Reserve maintained its "wait and see" posture throughout the quarter, keeping the federal funds rate unchanged at 4.5% (upper bound) as policymakers watched inflation trends closely. After starting the year with a hawkish tone, the tone the last couple of months has shifted meaningfully. With inflation approaching the Fed's 2% target; the labor market showing cracks; and real rates remaining restrictive; markets are now pricing in two rate cuts by year-end—likely one in September and one in December. Fed Chair Powell and other FOMC members, however, remain noncommittal, emphasizing the need for further inflation progress and sustained labor market balance before easing.

The U.S. bond market is off to its best start to a year since 2020 as the 2nd quarter provided more positive results. After a volatile start, interest rates across the curve generally declined, driven by moderating inflation data and growing expectations for Federal Reserve rate cuts later in the year. Short-term yields adjusted more quickly than longer-dated maturities, resulting in a gradual flattening of the yield curve. While bond prices benefited from the drop in yields, persistent uncertainty around economic growth and fiscal imbalances continued to weigh on investor sentiment. Credit spreads remained stable, and overall fixed income returns were modestly positive as the market began to price in a more accommodative policy stance ahead.

LOOKING AHEAD

Markets appear to be regaining some composure following a tumultuous start to the quarter, but the path forward remains clouded. Policy volatility poses a meaningful risk to economic momentum. Nonetheless, the economy's underlying strength, bolstered by real income growth, improving inflation, and a stabilizing labor market, suggests the soft-landing narrative remains intact—for now. While the storm may have passed for now, the horizon remains unsettled for investors. We'll be watching closely in the months ahead.

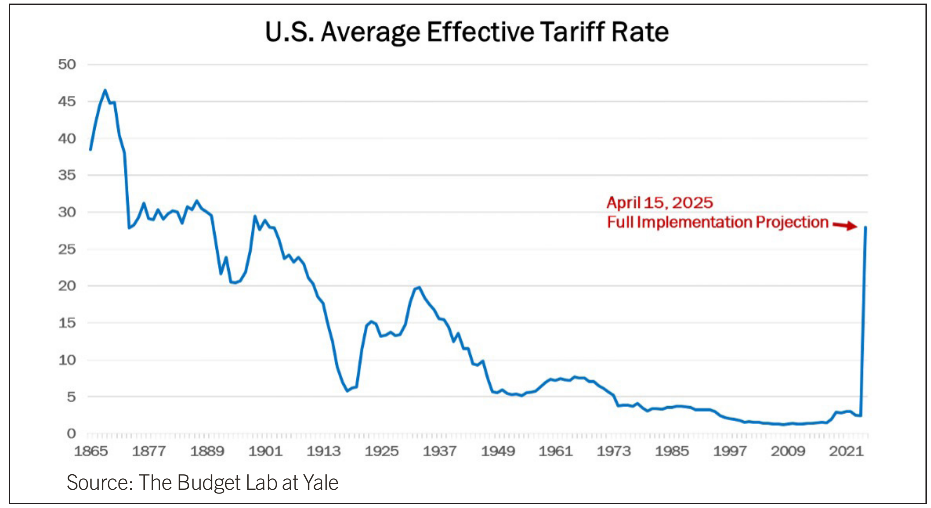
In the following pages, senior leaders of the Hancock Whitney Asset Management team delve further into these topics, providing comprehensive analysis and insight into the evolving financial landscape. We are available to discuss these issues in greater detail, offering a nuanced understanding of the market dynamics and their implications for your personal financial situation.

The Tariff Tango[9-14, 16-18, 21, 22, 24]

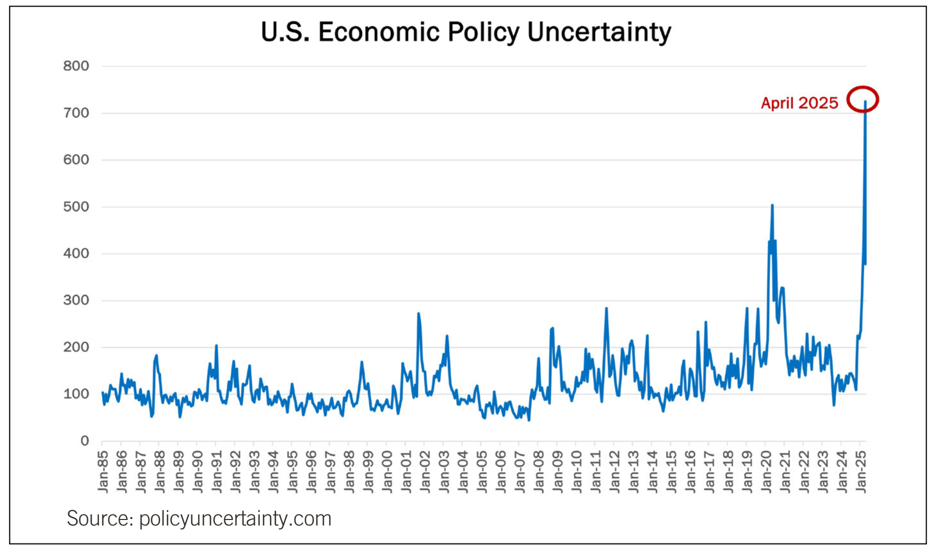
Stephen Morgan

TARIFFS SET THE TONE FOR THE QUARTER

Just weeks ahead of the 250th anniversary of the start of the American Revolution, President Donald Trump opened the quarter with another shot-heard-round-the-world, with an April 2 announcement of "Liberation Day" tariffs that would impose heavy levies on goods from some of the country's most important trading partners alongside a near-universal 10% tariff on most imports. Financial markets reacted with shock to the breadth and magnitude of the levies which, as announced, would have pushed the U.S. effective tariff rate from about 2.5% into the mid-20% range, a level not seen since the early 20th century in the tramp steamer era of international trade, potentially triggering trade wars. Economic policy uncertainty spiked, and stock markets gyrated as investors struggled to reorient themselves. In response to market jitters – especially anomalies emerging in bond trading – the White House announced a 90-day delay in rolling out the exceptional tariffs (other than China) while proceeding on schedule with the 10% universal tariff.

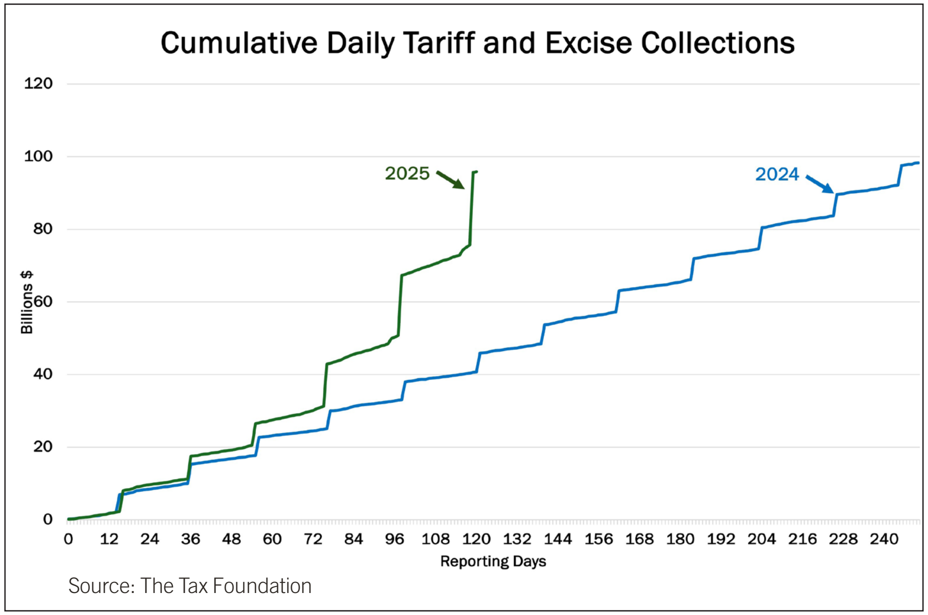


Source: The Budget Lab at Yale



Source: policyuncertainty.com

In announcing the pauses, the administration said that delaying broad portions of the new global tariff regime gave time for the U.S. to negotiate bilateral trade deals. Such agreements are notoriously complicated and subject to the internal politics of the nations involved, so few observers expected the process to be complete in the 3-month window. The sense of urgency did prompt a flurry of engagement as trading partners rushed to begin talks, but at quarter's end, only the United Kingdom had settled with the U.S. on an "outline of an agreement".



If the quarter began with an exclamation point, it ended with a question mark as investors remain unsure of how U.S. trade policy will evolve.

Unlike many other countries' wait-and-see approach, China ramped up their own tariffs on U.S. goods and restricted some exports – notably strategic rare earth minerals. Washington and Beijing rapidly exchanged escalatory tit-for-tat responses, until the two nations reached an agreement on May 12 when American tariffs on Chinese goods were cut from a base of 145% to 30% for a 90-day period (with China lowering its rates on imports from the U.S. to a 10% base). Rare earth minerals remained trapped within the Middle Kingdom, though some restrictions were lifted near the quarter's end. The fight is far from resolved, though. As part of a coordinated effort to reinvigorate U.S. shipbuilding, for example, the administration has announced plans to charge tariff-like port fees on vessels manufactured by China or flying under its flag.

Support for a domestic industry like shipbuilding can be one motivation for tariffs, but another goal can be revenue generation, and, in this regard, the tariff program is already having a notable effect. Collections so far this year are near the total collected last year. Of course, the state of tariff policy is highly volatile currently, but estimates suggest that a reasonably robust program could add trillions to federal coffers over the 10-year horizon. This both prods lawmakers to offset the additional tax burden by extending current tax rates, but also provides some revenue for them to do so.

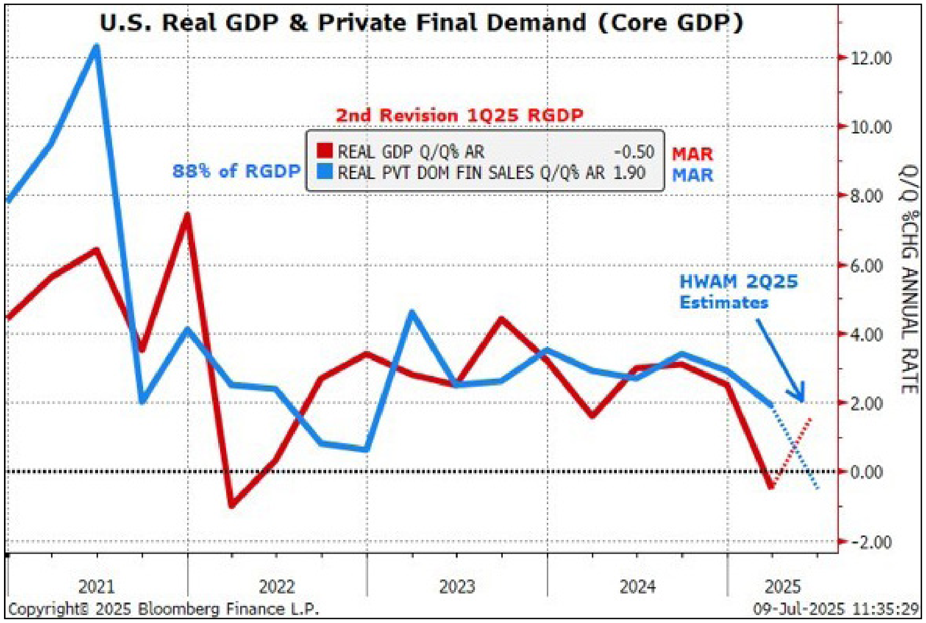
If the quarter began with an exclamation point, it ended with a question mark as investors remain unsure of how U.S. trade policy will evolve. It is unclear, for example, what will happen as we move to the end of the 90-day pause period at midnight on July 8 as some tariffs may come into play while others are paused longer. Meanwhile, the President has threatened other sectoral tariffs – like those already in effect on steel, aluminum, autos and auto parts – on other industries, notably pharmaceuticals and some semiconductor equipment. Even more surprisingly, he floated a company-specific tariff on Apple aimed at bringing iPhone manufacturing to the U.S. All of this comes against a backdrop of court rulings holding that the White House exceeded its authority in imposing most of the new tariffs under the legislation it cited (though most critical components could likely be reimposed using other legislation).

2Q25 Macroeconomics Review & Outlook [1-3]

Paul Teten, CFA

TARIFF HELTER SKELTER

The chaotic rollout of the Trump Administration's aggressive tariff agenda, entailing insults, pauses, threats to occupy Canada, Greenland and the Panama Canal, revenge-tinged reciprocal tariffs, on again, off again and erratic pronouncements, drove severe disruptions to economic activity in 1Q25 which have been reversing in 2Q25 thanks to the tariff freeze and expectations for a more rational outcome. Imports surged to front-run the April tariff start date and ballooned the U.S. trade deficit, which is unwinding in 2Q25, the former a major detractor to economic growth and the latter a boost. A lot of the imports ended up in inventory at the end of 1Q25 which appear to be working off in 2Q25, the former a boost to GDP growth and the latter a detractor, constituting crosscurrents with significant GDP impact. Capital equipment spending spiked in 1Q25, investment in future demand for soon to be tariffed imported equipment and components, which appears to be receding in 2Q25, along with commercial and residential construction. The one constant between the first and second quarters is sluggish household consumption; shocked by the prospect of high and widespread tariffs, consumers fled to the storm cellars in February and March where they remained throughout 2Q25. Real GDP growth is projected to bounce back in 2Q25 to 1-2% Q/Q annual rate, up from -0.5% in 1Q25, the Bloomberg Survey at the high end of that range and our assessment at the lower end. More germane in our view is the trend in the underlying core of economic growth, apart from the disrupted and correcting swing factors of the trade deficit and inventory liquidation. Real private domestic final sales (PDFS), constituting 88% of Real GDP, grew at a solid 1.9% Q/Q AR in 1Q25, but which we now expect the cascading disruptions to produce a -0.5% decline in 2Q25. The bigger perspective is Real PDFS averaged 3.3% AR growth over the second half of 2024 and will likely slow to an average rate around 0.75% over the first half of 2025, which is the real story here, demand destruction in the private sector.



TARIFF A-GO-GO

The secret sauce of the U.S. economy is its robust growth in inflation-adjusted, real disposable personal income (after withholding taxes), which accelerated from near zero last summer to 4.3% Q/Q AR through May, with a solid assist from decelerating inflation. The low 4.2% unemployment rate and strong real income growth together constitute a bulwark against recession risk. However, the U.S. economy may well languish another quarter or two as the contours of the tariff regime become clearer and supply chains stabilize. U.S. households appear able to rekindle a taste for acquisition if and when their confidence in a more stable economic outlook gains credence. But in the meantime there is a growing threat to that confidence in the form of the $70 billion flood of tariff receipts pouring into the U.S. Treasury since March. The $280 billion annual rate of tariff accumulation is a substantial tax on U.S. import consumption, conceivably shared among exporters, domestic import wholesalers and U.S. consumers. We see inconclusive evidence that Chinese, European and Mexican exporters may be absorbing a modest amount of the tariffs, offsetting the price pressure for importers to pass the tariffs through to consumers. We see no evidence at this point of pass-through to consumers, based on continuing low inflation reports. However, our assessment, consistent with Federal Reserve guidance, is that we are likely to see modestly higher inflation reports over the balance of the year as importers begin to share the burden with consumers. The Fed's view is that the core PCE deflator's Y/Y growth, its primary inflation weathervane, is likely to rise to 3.1% by year-end from current levels around 2.7%, then recede back to 2.4% by late next year, a fairly modest disruption to the disinflation trends in place since 2023. To the extent that consumers resist the presumed price increases by foregone spending, price increases which devalue real income growth, that demand destruction will contribute to continued sluggish economic growth.

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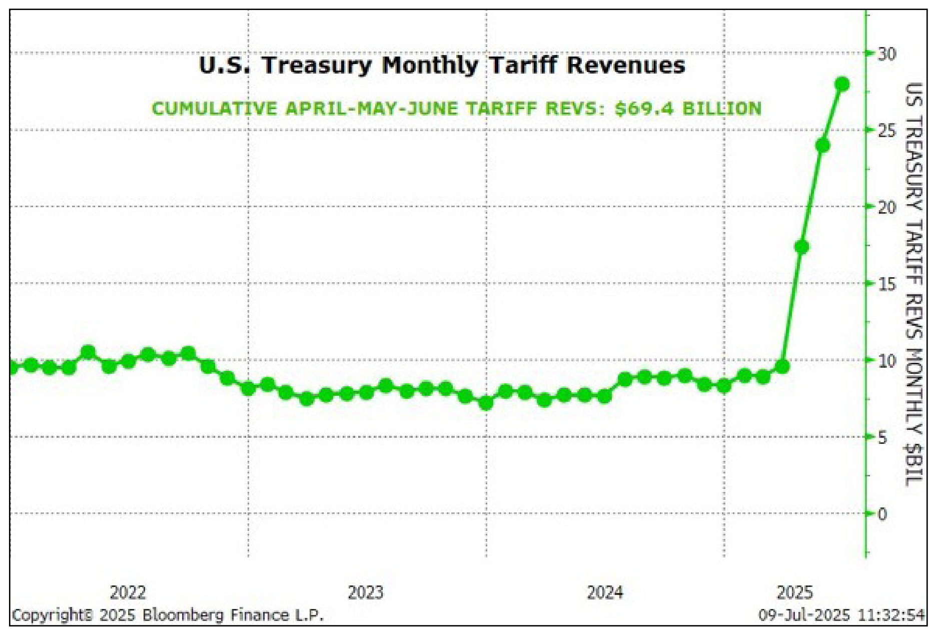
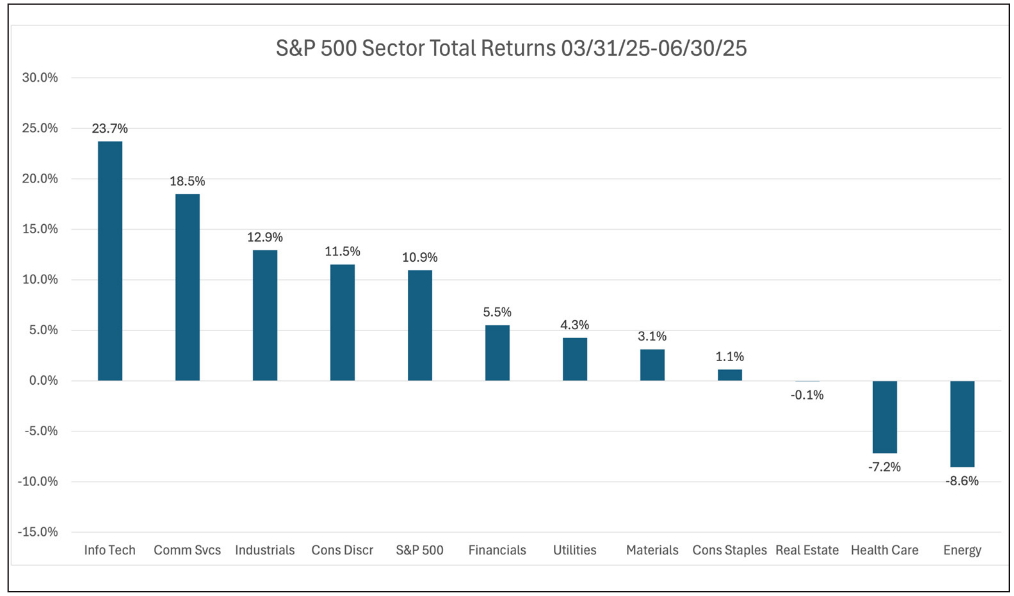


FAREWELL TO ARMS

Evidence is accumulating that the Trump administration's deportation agenda is beginning to impact the U.S. labor force. While media reports that Department of Homeland Security (DHS) deportations so far this year amount to around 150,000, the psychological effect on undocumented workers appears to be more profound. The Bureau of Labor Statistics (BLS) reported recently that the foreign born cohort of the U.S. labor force shrank by 1.15 million workers in 2Q25, a decline we suspect includes a substantial component of the self-deported and/or workers reluctant to report to work given the aggressive jobsite and other interventions to round up illegal migrant labor. 298,000 of the referenced foreign born workforce contraction occurred in May, plausibly connected to the 374,000 increase in job openings in May reported by BLS; 314,000 of which occurred in the hospitality and food services sector, one of several primary destinations for migrant labor. With a plethora of indications of waning demand for labor and slowing nonfarm payroll growth, the trend reversal to growing job vacancies, which until recently have steadily declined by 5 million since 2022, very plausibly points to job openings created by deportations, self-styled or otherwise. 85% of the growth in the U.S. labor force from March 2022 through December 2024 was sourced to foreign born workers. With the Southern border now securely closed to illegal migrant crossings and an aggressive deportation agenda which includes widespread dismissals of asylum parolee work permits, the U.S. economy faces the prospect of labor force growth that reverts to the much slower trend growth of the native born component. Slower labor force growth will likely be associated with slower economic growth. The undocumented, or formerly documented, workers who face deportation, self deport or otherwise withdraw from the U.S. workforce will not show up in the U.S. unemployment rate, as they are exiting the workforce and are no longer candidates for job openings. And if the jobs they had filled go unfilled for lack of available talent, the products and services they produced will go unproduced and unconsumed. Demand destruction is apparently migrating from the import-export supply chain and resistance to tariffs to the broader economy. The U.S. economy may remain relatively stagnant a while longer until the stimulative benefits of the One Big Beautiful Bill Act kick in next year.



Early Woes and Spiking Volatility [4, 5]

Martin Sirera, CFA

As the second quarter of 2025 began, stocks and other risk assets were in retreat. Major indexes had peaked at various points over the prior months and began declining as investors were becoming increasingly cautious about growth prospects. That retreat was energized on April 2, when the Trump Administration unveiled the details of a tariff regime, the so-called Liberation Day, which reinforced those growth worries.

A rapid sell off drove the S&P 500 down to a level not seen in over a year, quickly erasing all the gains built up as confidence drove the market higher leading up to the 2024 election and subsequent inauguration of President Trump. Throughout the rest of the quarter, however, fears subsided, and the rally was reignited, driving prices higher all the way through the very end of the period. The S&P 500 reached a new all-time high on the last day of the quarter, finishing with the best return, 10.9%, since the fourth quarter of 2020.

With stocks at all-time highs at the start of the third quarter, will expectations of slowing economic growth interfere with buoyant attitudes and drive volatility higher, or will growth outperform expectations leading to more gains?

Prior to the February-April retreat, investor psychology was ebullient. A new regime had come into Washington, D.C., and investors were keying on indications of friendlier tax and regulatory regimes for businesses. Hope was building that aggregate economic growth under this new regime would be boosted by a more efficient operating environment and the prospect of businesses and shareholders keeping more of what they earned. Those hopes began to dim as rhetoric about an international tariff battle engendered scary headlines harkening back to the last tariff war (in the 1930s) which helped drive the Great Depression.

The "Liberation Day" announcements seemed to confirm the worst fears as the narrative built that these huge new taxes would crush growth prospects. President Trump and his Administration seemed to be changing course rapidly, announcing pauses, then quick reimposition of high tariff rates, singling out certain categories for extra harsh treatment.

In this mercurial environment, stock price volatility, both the kind actually experienced, as well as the kind predicted in models like the VIX Index* rapidly spiked higher. News headlines were fueling a narrative that seemed to crush all hope of having a lower government burden, high growth future. Missed in all the early-quarter hysteria, was an allowance for the possibility that threats of tariffs by the President could merely be the first salvos in much broader negotiations about all the impediments to smooth international trade.

*The VIX Index attempts to measure the markets expectation of near term future volatility by analyzing the cost of stock price insurance via stock Index call and put options.

AN EMERGING NARRATIVE

But slowly that possibility began to enter into the market's collective vision. The world was already rife with all manner of burdens to efficient trade between countries. A new narrative was taking over: high tariffs were not an endgame. The endgame was to drive more international trade, to reduce burdens to trade. The threat of import tariffs imposed by the world's largest importer were the engine to drive toward that endgame. An episode with Canada, and its attempt to impose a "Digital Services Tax" perfectly illustrates this narrative. Under stern pressure from President Trump, the Canadian government finally relented and backed off of a tax that was a tariff in all but the name.

Here at the start of the third quarter, equity markets have gained back all that had been lost in the retreat down to the April 8th lows, and then some. The S&P 500 Index and the Nasdaq Composite Index have reached new all-time highs. With a new hopeful outlook about the trade environment, focus can shift to expectations uncluttered by high, growth-crushing tariffs.

Throughout the second quarter, Wall Street analysts reduced earnings growth expectations for current and near-term future quarters. The pace of those reductions slowed then stopped, and in the most recent past, expectations have been inching upward. With a significantly lowered bar, and with renewed optimism about technology-driven growth, a possibility is arising that S&P 500 EPS growth will surprise the market on the high-side. First quarter growth was much higher than expected, which, as it was reported through late-April and May, added fuel to the stock market rally.

The S&P 500 Index and the Nasdaq Composite Index have reached new all-time highs.

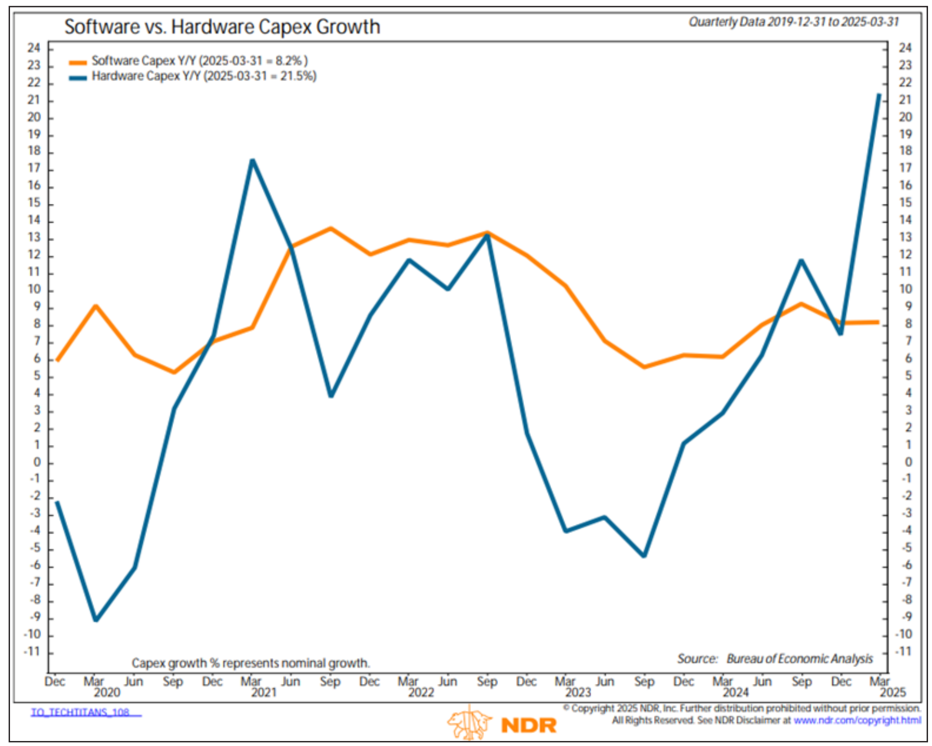
Investor psychology has evolved from excessively gloomy in mid-April to optimistic, maybe even ebullient as the second quarter begins. Valuation is the residual of psychology, and equity valuations are very high. The level of S&P 500 valuation today is lower than extremes reached in the fall of 2024 and in the worst part of the 2020/2021 economic shut down environment, yet it is higher than at almost any other time in decades. The potential for increasing volatility, especially the downside kind, grows as valuation reaches such levels, as does the potential for below-average long-term gains.

Given a potential economic slowdown and high stock market valuations, expectations about the positive benefits of a more efficient international trade environment, more business and shareholder friendly U.S. government policy, the potential for continuing strong business investment and better multi-national performance, have to be tempered somewhat. While the potential builds for better-than-average near-term stock market performance, a cautious to cautiously optimistic stance is best.

SOURCES OF STRENGTH AND SURPRISE

Looking ahead, analysts expect full-year EPS growth for the S&P 500 to be just under 9%, but for second quarter growth to have been under 5%. With the bar for second quarter set so low (reports about how companies performed in the second quarter will start coming out in mid-July), any positive surprise would drive the full-year expectation higher, perhaps over 10%. That would be a great result in an environment in which aggregate economic growth appears to be slowing. Companies have been accelerating their investments in growth-enhancing technology. Technology Hardware Capex grew by more than 21% in the twelve months ended March 31, 2025. Tech companies were the hardest hit in the earlier retreat but subsequently have rebounded the most. The S&P 500 Tech Sector had a total return of almost 24% in the second quarter as investors grew comfortable with the evolving tariff negotiations and the recognition that technology investment spending by businesses is not likely to slow down.

Corporate Margins are at multi-generational highs. High healthy profits are available for businesses to invest in more growth initiatives or to be distributed to shareholders for them to invest for growth. A weak dollar is making U.S. goods more attractive to foreign buyers and is raising the value of foreign-sourced business profits of U.S. multinationals.

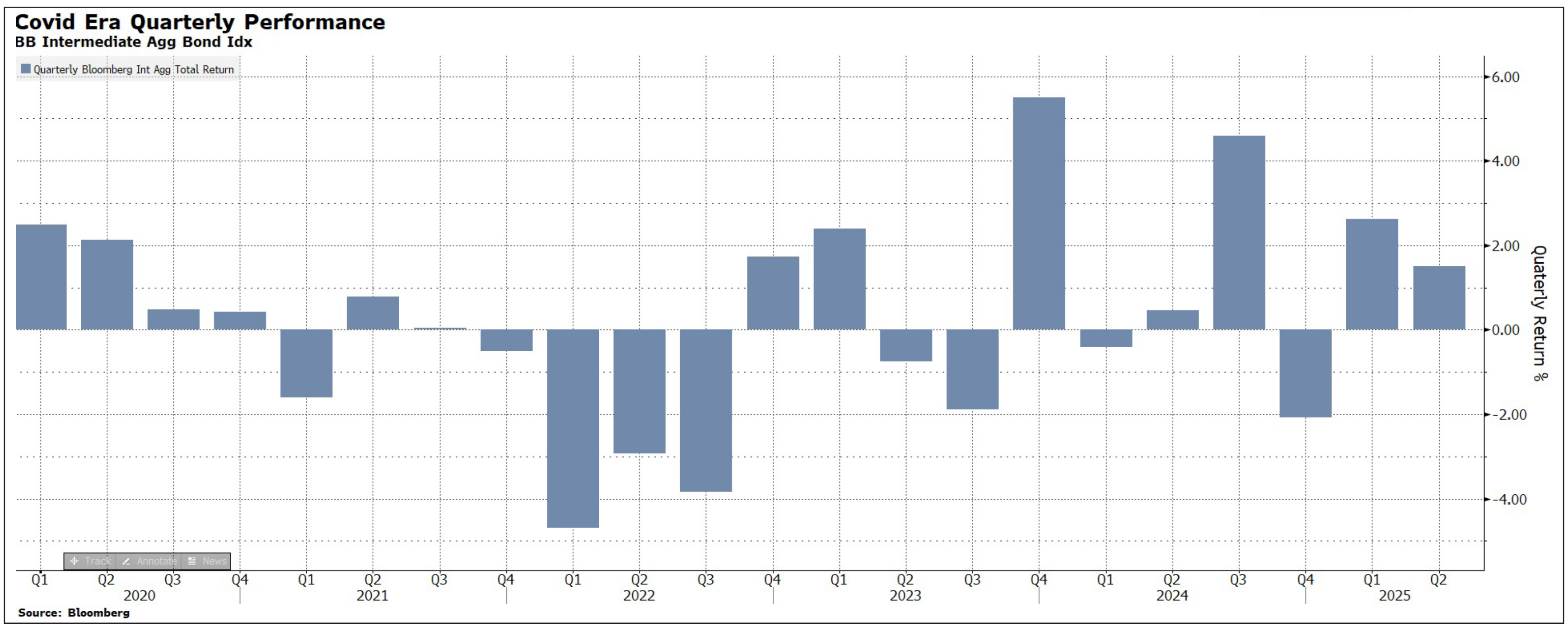


Bond Market Finishes Strong in 2Q25 [1]

Jeffery Tanguis

Ask most bond investors how they are doing so far this year and you are likely to get a sigh of exasperation and mumblings about tariffs, middle east war, nagging inflation and a vociferous President. The fixed income markets have been bombarded by a seemingly relentless barrage of setbacks and uncertainty this year only to recover and rally higher. The second quarter was barely underway before the Trump administration's bunker busting Liberation Day (April 2nd) tariff announcement sent shock waves through the stock and bond markets around the world. The likely intended effect. The financial press hyperventilated over worst-case scenarios. A Great Reset of an array of U.S. policies ranging from trade and defense to domestic spending and regulation was underway and it was unnerving to the financial markets. Bond investors fretted over stagflation, federal debt and deficit, U.S. dollar hegemony and even American exceptionalism. Moody's rating service finally downgraded the U.S. Treasury debt from AAA to AA+, the last of the big three rating agencies to do so. Meanwhile the markets eventually regrouped and churned forward. It may not feel like it but bond investors actually fared well in 2Q25 and very well in the first half of 2025. As a matter of fact, the 1.51% 2nd quarter unannualized total return for the Bloomberg Intermediate Term Aggregate Bond Index ranks well above average in the post Covid era while the 4.16% return for the first 6 months of 2025 ranks as the best start in 5 years. So much for all the naysayers.

By the numbers the benchmark U.S. Treasury 10 year note yield finished the 2nd quarter up 6 basis points to 4.23% and down 32 basis points year to date. The more Fed policy sensitive U.S. Treasury 2 year note yield ended the quarter 16 basis points lower to 3.72% and down 52 basis points year to date. Intermediate term corporate bonds led the charge for the quarter and year-to-date returning 1.99% and 4.38% respectively. Longer term U.S. government bonds, those having maturities of 15 to 30 years, generally lagged during the quarter as investors demanded a greater risk premium in exchange for the rising economic uncertainty and burgeoning Treasury debt load. European and Japanese governments added to the global pressure on long term rates by announcing their own increased borrowing plans to fund greater self-defense and economic stimulus spending, a move partly in response to President Trump's demands. For the quarter the U.S. Treasury 30 year bond yield rose 25 basis points to 4.77% and was unchanged year to date.



THE FED WILL WARM UP TO COOLER ECONOMIC TRENDS

The improving outlook for the U.S. bond market is rooted in the broader trends toward slowing economic growth, moderating inflation and loosening labor markets. Current economic data already justifies multiple Federal Reserve interest rate cuts according to Chairman Jay Powell but uncertainty around the possible future inflationary impact of tariff policy has kept the Fed on hold. The timing and magnitude of U.S. tariff policy continues to be the wild card in determining just how fast the broader economic trends play out. A likely tariff induced inflation blip appearing late summer or early fall will test bond investors resolve. Federal Reserve Chairman Jay Powell supports the view that the inflationary impulse of higher tariffs are real but will likely be "short-lived" allowing the Fed to discount the elevated reports. Powell also believes the current benchmark federal funds rate is high relative to inflation and is restricting economic growth. The clock is ticking on how much longer the Fed can delay rate cuts before causing unnecessary damage to the economy. A growing but vocal minority of Fed officials are challenging Powell's current "wait and see" policy approach and are building the case for lower rates. Better clarity on trade policy in the coming months combined with a softening economy will likely give policymakers the confidence to move ahead with rate cuts by fall. The Fed's June interest rate forecast indicates the policy committee believes 2 rate cuts before year-end are appropriate. Given Powell's desire to collect more economic data we believe the cuts will come at the September and December committee meetings.

THE PATH AHEAD

The outlook for bond returns for the remainder of 2025 remains generally positive. The bond market fundamentals that drove returns in the first half of 2025 are still in place but much of the good news has already been discounted. Still there is room for additional gains. As tariff uncertainty fades and the U.S. economy slows bond investors will focus more on federal debt and deficit which are longer term concerns. Federal Reserve rate cuts will drive short and intermediate term bond yields down helping lower borrowing costs for both consumers and the federal government. Fortuitous timing as the federal government will need to issue a tsunami of debt to refill its coffers after Congress raises the debt ceiling. Long term interest rates will only inch lower given continued investor worries over the global rise in government debt. President Trump has said he will soon announce his pick to replace Jay Powell as Fed Chairman when Powell's term expires next May. President Trump has made clear his intention to source a more balanced and accommodative individual to lead the Federal Reserve. Markets could get rattled if the nominee is not viewed as a serious inflation fighter. A few twists and turns along the way notwithstanding, the bond market backdrop remains a good one that should produce more favorable returns for bond investors in the coming months.

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Geopolitical Update 2Q25 [1, 6-9]

Richard Chauvin, CFA

GEOPOLITICAL RISK COMES OFF THE BOIL, OR HAS IT?

The second quarter came to an end in climactic fashion, with a stunning and historically memorable event – a night-time attack by the U.S. Air Force on Iran's nuclear industry, resulting, according to some accounts, in catastrophic damage to, if not the destruction of three nuclear sites known to be actively researching, storing and enriching uranium to a level just under weapons-grade. The Air Force's perfectly executed bombing mission may have far-reaching impact on geopolitical risk emanating from the Middle East, and potentially beyond. We will explain why in this quarterly update.

Meanwhile, Iran's reaction to its humiliating defeat by the U.S. and Israel is not encouraging, but expected. First, Iranian President Masoud Pezeshkian congratulated his nation on the great victory against Israel. This astounding statement illustrates a cultural phenomenon in the Middle East characterized by leaders who live in a state of detachment from reality, imagining illusory victories and refusing to accept accountability for failure. This behavior is common in the history of the region and argues for remaining skeptical about Iran becoming a peace-loving neighbor.

Iran has decided to go into quiet mode after last month's attacks. After formally cutting off International Atomic Energy Agency (IAEA) inspections last week, Iranian nuclear-safety regulators have stopped taking calls from the UN watchdog, according to two unidentified sources. Adding in the mystery surrounding the whereabouts of 900 pounds of 60% enriched uranium that the IAEA says it cannot locate, one can surmise that Iran may have settled on the Cold-War strategy of strategic ambiguity as its best defense against any further intrusion into its nuclear development plans.

POSSIBLE EXPANSION OF THE ABRAHAM ACCORDS

The Abraham Accords are a series of treaties that normalized diplomatic relations between Israel, the United Arab Emirates (UAE), Bahrain, Sudan, and Morocco. These were facilitated by the U.S. Administration between August and December 2020. Israel, with the help of President Trump hope to expand the Abraham Accords and may have been close to doing so before the October 7, 2023, terrorist attack on Israeli citizens by Hamas. With Iran humiliated by its failure to counter debilitating attacks by Israel on its proxy forces and on its own homeland, there appears to be a renewed opportunity and willingness for other countries to join the accords, Syria and Lebanon being the most promising candidates in the near future. Expansion of the Abraham Accords would help diffuse tensions in the region and from the U.S. perspective, solidify its role as a patron and guarantor of the accords as a counterbalance to China's rising influence.

WILL XI RECONSIDER HIS TAIWAN STRATEGY?

The successful bombing raid on the Fordow nuclear site may have an important deterrent effect when it comes to China's stated plan for "peaceful reunification" of Taiwan with the Peoples Republic of China. Though President Xi has called for the plan to be achieved peacefully, he has not renounced the option of using force to achieve it, particularly if Taiwan declares independence.

Officials in the U.S. and Taiwan now believe Xi will have to rethink his assumptions, having become convinced Trump has isolationist tendencies and thus his warnings about aiding Taiwan should China attempt an invasion of the island could be dismissed as bluster. Yun Sun, senior fellow at the Stimson Center, a Washington think-tank, believes Beijing would also have to recalculate whether its "grey zone" activities, including conducting air force and navy sorties near Taiwan, might provoke a response from Trump.

Trump's bold act to degrade if not dismantle Iran's nuclear program created another worry for Beijing. The attack exposed the vulnerability of an important source of China's imported oil to being cut off. China is the largest importer of Iranian oil, comprising 90 percent of Iran's production and almost 14 percent of China's total oil imports. Because Iran's oil is under sanctions by the U.S., China can purchase it at a discount, saving billions of dollars each year.

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NO SHORTAGE OF POLICY-DRIVEN GEOPOLITICAL RISKS

Unfortunately, there are ongoing geopolitical risks that may not be lessened by the success of the U.S. and Israel in curtailing the power and influence of Iran in the Middle East. National security concerns remain the driving force behind the strategic competition between China and the United States. The same is true regarding the strain on global trading relationships made more acute by tariffs and non-tariff barriers that have been erected in Trump's second term, with possibly more to come following the upcoming July 9 deadline Trump set for numerous bilateral trade deals between the U.S. and major trading partners. Since some have tagged Trump as TACO (Trump Always Chickens Out) because of his repeated delays and reversals in implementing new tariffs on trading partners, it is worth providing a view of what we might expect on the tariff front in the months ahead, and what risks are posed by current and prospective tariff plans.

We begin with a list of assumptions concerning Trump's viewpoint on tariffs. We base these assumptions on statements he has made and actions he has taken in his second term:

- Tariffs provide revenue to the U.S. Treasury, which makes room in the budget for pro-growth tax cuts.
- Tariffs create leverage to encourage other nations to remove trade barriers that are unfair to the United States.
- Tariffs help ensure the U.S. maintains a vibrant manufacturing base that supports national security and provides good jobs in Americans.
- Trump loves tariffs and in not likely to negotiate tariffs down to zero with any trading partner.
- Despite Trump's positive view of tariffs, he will reduce them when he is convinced they are causing harm to the U.S. economy.

We can expect the tariff negotiations between the U.S. and major trading partners to remain fluid in the months ahead. The July 9 deadline will likely not result in many detailed agreements, but several agreements in principle, the details of which would have to be negotiated over time. With each nation and for products involved in sectoral trade disputes there are unique and difficult negotiations in each case that may take months to resolve as each nation strives to preserve and enhance its own national and economic security. It is not clear how the numerous issues will finally settle, or if they get resolved at all during the remainder of Trump's term. Investors should be prepared for continued volatility as tariffs flow through the economy and into inflation data and/or corporate profits.

D.C. Dances to Trump-et Music [9-24]

Stephen Morgan

THE RECONCILIATION RHUMBA

While trade policy was being transformed on Pennsylvania Avenue, lawmakers on Capitol Hill were busy with a large bill to align the federal budget more closely with President Trump's priorities. At a high level, Republicans sought several broad goals:

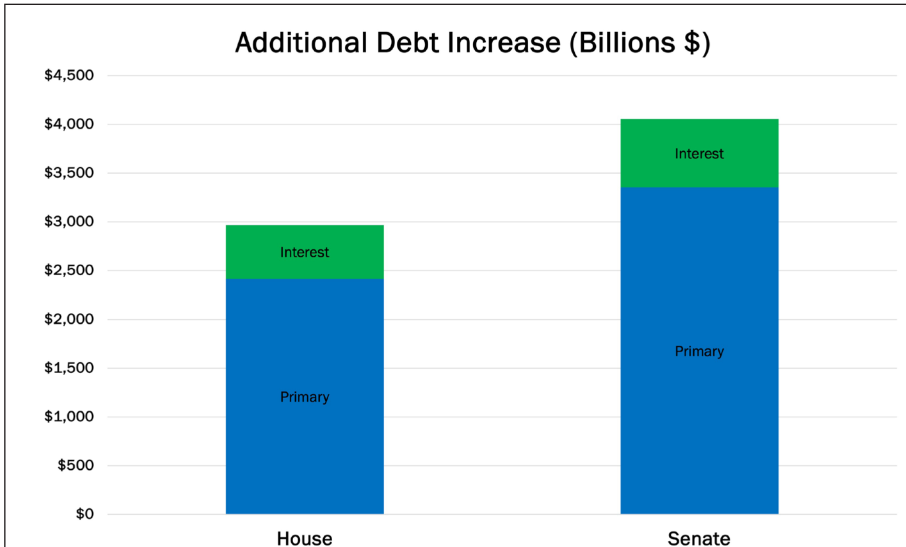
- Extend and expand personal tax cuts from the 2017 Tax Cuts and Job Acts, most of which are set to expire at the end of 2025.
- Provide targeted business tax benefits to stimulate growth.
- Contain federal spending.
- Provide additional funding for top priorities, notably immigration enforcement.
- Deal with the debt ceiling before cash available for spending is depleted.

The effort highlighted fractures within the GOP as fiscal hawks, focused on cutting the deficit, opposed a framework that was projected to expand the deficit by trillions over a 10-year horizon (though tariffs could help offset that). More vulnerable lawmakers, though, worried about cost-saving measures including cuts to Medicaid and food stamps as well as the level of caps on deductions for state and local taxes (a bugbear for Republicans in high-tax jurisdictions).

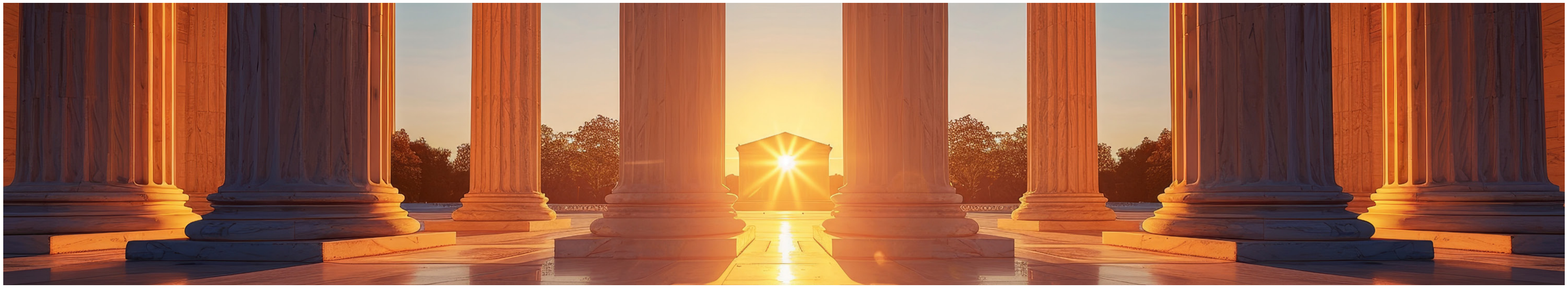
With heavy lobbying from the White House and a concerted effort by leadership, the House was able to reach a series of compromises to eke out a 215-214 passage for its version on May 22, kicking it over to the Senate which rode roughshod over the carefully calibrated concessions of the House version. Because the only chance of Senate passage was through the budget reconciliation process to avoid a Democratic filibuster, the chamber's Republican leaders had to work not only to balance competing interests but also to adjust the bill to stay in compliance with rulings from the Senate Parliamentarian. As the quarter ended, senators were in the midst of a 27-hour "vote-o-rama" in which amendments to the bill are offered from the floor (with compromises and parliamentary rulings as part of the package). In the end, Vice President JD Vance cast a tie-breaking vote after three Republican senators voted against the bill.

The victory is a landmark win for President Trump and his supporters early in the second term.

Speaker Mike Johnson called House members back from the July 4 recess to vote on the Senate version even as members of his conference expressed concern with additional Medicaid spending cuts, accelerated sunset of green energy tax breaks, and changes to the state-and-local-tax deduction limits. Fiscal conservatives were especially perturbed by projections that the Senate's final version would deepen the federal debt more than the House's, though the near-term impacts were much closer than those in the later years of the decade projection horizon. In the end, House leadership, assisted again by political blitzkrieg from the President, was able to cajole, coerce and cut bargains with enough GOP skeptics to secure a 218-214 passage of the Senate's version, though two Republican representatives joined Democrats in opposition. The victory is a landmark win for President Trump and his supporters early in the second term. It resolves substantial policy uncertainty – including debt ceiling worries – that had weighed on markets providing more clarity for decision-making.



Source: Committee for a Responsible Federal Budget



THE BORDER BALLET

Despite a regular drumbeat of news regarding legal fights around deportation, it remained somewhat in the background economically for much of the quarter, though anecdotal evidence was mounting that previously declared revocations of humanitarian parole were motivating many asylum seekers to self-deport, despite challenges in federal courts. Early enforcement actions appeared to be tied to a “worst first” policy of targeting individuals convicted of non-immigration crimes, particularly those of a violent nature. However, as the quarter progressed, news reports of workplace enforcement actions became more prominent. Protests of deportation policies broke out in Los Angeles, prompting the President to federalize the state’s national guard, deploying over 4,000 Guardsmen alongside about 700 active-duty Marines to protect federal property and law enforcement.

Business leaders also expressed concern about the expanded enforcement actions, prompting President Trump to suggest he would provide special protections to the agricultural and hospitality industries. Enforcement activities in many of those facilities were halted for a short period but restarted within days. We continue to believe that aggressive deportation enforcement could create disruptions in labor markets at least in the short-term.

THE SUPREME COURT SALSA

The High Court closed its term on Friday, June 24. The quarter saw a handful of decisions worth noting including a decision overruling lower courts to affirm the administration’s authority to revoke humanitarian parole. Perhaps the most economically impactful, though, was a decision that restricted judicial review of executive agency decisions, particularly in the case of environmental reviews of infrastructure projects. The decision allows large scale infrastructure projects to move more quickly to implementation assuming they pass agency muster and could trigger a bout of growth in energy and construction industries. Also of note, the Court curtailed the ability of lower courts to issue nationwide injunctions, potentially allowing administrative policies to continue in some regions while being halted in others. The Court also upheld portions of the Affordable Care Act which were being challenged on Constitutional grounds.

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