The Summer of Cautious Optimism

CAPITAL INTERNATIONAL

Looking back at the last 2 months, it's easy to forget just how volatile the first half of the year has been, both politically and economically. During the second quarter of 2025, markets faced notable instability as investors grappled with uncertainties tied to tariff policies and the continuing conflict in the Middle East. In both of these instances, the worst case scenario didn't come to fruition and most asset classes, equities in particular, delivered positive returns over the quarter.

The S&P is currently up 7.4% YTD at the time of writing, which doesn't sound too out of the ordinary for the index, however, if we were to look back to early April, following Trumps 'Liberation Day' it would have registered a decline of 17.6% on a YTD basis. Following the release of the broader, all-encompassing tariffs, markets posted sharp declines with the S&P dropping c.12% over a 2-day period. This marked one of the worst trading periods since 2008. The Nasdaq and oil fell by similar margins, down 6.0% and 15% respectively. The broad market sell off was driven by uncertainty over tariff details, deadlines, potential retaliatory measures and the potential adverse impacts still to come as the inflationary costs trickled downstream to consumers were analysed. Despite the initial shock and reaction, markets have been surprisingly resilient. By the 2nd of May the S&P had already erased the April losses to then go on and reach a record high on the 27th of June.

So what led to this remarkable recovery, where does it leave us now and what's around the corner? During this period, broader economic forces played a pivotal role in affecting market volatility. Inflation in the US was consistent at c.2.4% while unemployment was around 4.1%. Consumer spending was robust and Q1 corporate earnings largely surprised to the upside. There was some caution coming into Q2 earnings season as many were expecting Trumps tariffs to have taken effect and to have had a meaningful impact on corporate earnings, which thus far, hasn't been the case. We have seen some companies report weaker forward-looking guidance due to the remaining uncertainties, but the headline figures for the second quarter have been more resilient than expected, so far.

During all of this, Treasury yields in the US remained at elevated levels, continually flashing warnings signs. Interest rates have remained stubbornly high, which has coincided at a time where the debt picture has deteriorated significantly. The US now has the highest level of national debt in history at $36.2tn, with $1.37tn being added between July 2024 and July 2025 alone. It is a similar picture in Europe where modest GDP growth is set to resume in 2025 and 2026 following a period of prolonged stagnation with Eurozone GDP only 4.6% above pre pandemic levels. Interest rates have come down in a faster fashion in Europe with rates expected to reach 1.75%-2.00% by September 2025 as inflation has slowed to meet the ECB's target of 2%.

If we look at the recent economic data releases, it paints a complex and rather mixed picture of where we are currently, which makes the task of preparing for the future difficult. Hard data such as retail sales, GDP and employment metrics are still growing, but that growth is slowing. The soft data is pointing to increased and growing pessimism and a risk of further deceleration. Looking ahead, we expect the increased volatility we have been dealing with throughout 2025 to remain. There are still some important tariff deadlines coming up and negotiations to be made, which will have an impact on markets regardless of the outcome. The uncertainty around tariffs will continue to impact business sentiment and management's ability to accurately guide future spending and profit expectations and this is being seen already in Q3 and full year guidance from companies that have already reported. Diversification has been productive and profitable this year as market breadth has broadened and other regions (Europe, Japan and certain EM countries) have seen significant investment following a prolonged period of US exceptionalism.

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