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Forging Resilience

July 2025

No sooner had the first quarter of 2025 ended than the second quarter began with a proverbial swoon. Following President Trump's Rose Garden "Liberation Day" tariff announcement on April 2, the market shed over 13% in three days with the third fiercest spike in the VIX (a measure of market volatility) since the pandemic. By April 8, the President acquiesced to the volatility in the market and paused tariffs for 90 days, driving the S&P 500 Index ("S&P 500") back to within 3% of its pre-tariff announcement level. From there, the market settled into a steady upward march, fueled by impressive Q1 earnings reports, largely devoid of tariff impacts, and renewed enthusiasm around Artificial Intelligence (AI). The mid-June flare-up of hostilities in the Middle East, including U.S. airstrikes on Iran, rounded out the quarter's volatility; as of June 30, a ceasefire seems to be holding in the region. Despite these swings, the S&P 500 ended the quarter near its all-time high, up 10.94% for Q2 and 6.20% year to date.

Throughout the quarter, market participants focused on the impact to earnings results from tariffs and the tax bill proposal, as well as company management annual guidance changes; however, earnings results were benign, and outlooks were largely unchanged. Major tech companies, including Microsoft, Google and Nvidia, reiterated their plans for massive capital spending programs, despite last winter's introduction of Deepseek, an ultra-cheap but effective AI model by a Chinese developer. Soft economic data, such as consumer sentiment, weakened, but other hard data, such as consumer spending and employment, remained strong. By the end of the quarter, S&P 500 earnings growth expectations for 2025 moderated, but are still forecasted to be positive 3.95% for the year.

Outside corporate earnings, U.S. investors fretted about the "Big Beautiful Bill" slowly working its way through Congress. While the impact on specific companies varies widely, the net result seems to indicate continued federal government deficits. The risk of runaway government deficits was much discussed amongst investors U.S. government bond yields seem to have taken only moderate notice. Longer-dated government bond yields ticked higher in the quarter, with the 30-year bond ending at 4.78%, yet the yield on two-year notes actually declined to 3.72%.

Tensions in the Middle East reached a boiling point this quarter, with Israel and Iran trading missile attacks and the U.S. sending in B-2 bombers to strike Iranian nuclear sites. While damage to Iran's nuclear program is still unclear, a ceasefire (as of June 30) seems to be holding. The impact of these hostilities is most directly seen on crude oil prices, which spiked during the initial flare-up, only to return to their pre-June 13 level as of quarter end. Outside the commodity world, the U.S. markets seem not to have priced in any additional risks.

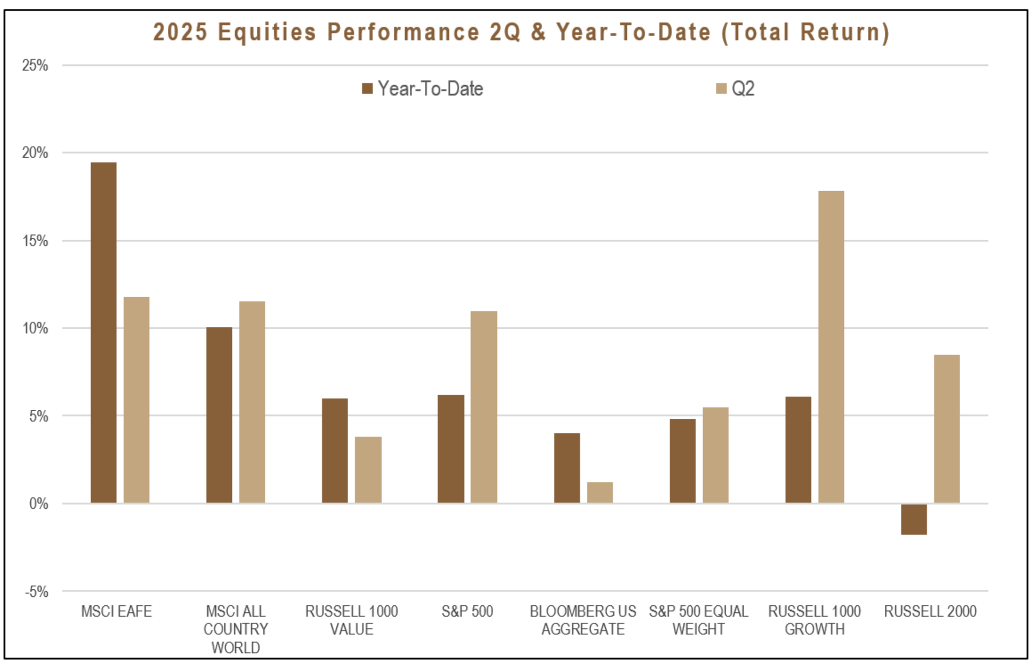
On one hand, despite all the quarter's angst over tariffs, deficits and war threatening the world's largest oil-producing region, the S&P 500 is hovering near all-time highs, showing the robustness of the U.S. economic machine. On the other hand, it highlights the risk in the markets, particularly the volatility of the equity markets. As a result, we think today is an opportune moment to balance optimism with caution and take stock of one's asset allocation.

Market Summary: Volatility and Key Drivers

The table below summarizes total returns across key market segments, reflecting the volatility experienced this year, especially since April. At the top of the list is the Russell 1000 Growth Index, which is up +17.84% in Q2 and 6.09% for the year. The recovery in these stocks helped propelled the S&P 500 higher, a potent reminder not to overreact to headlines.

European markets have outperformed, driven by Germany's historic €1 trillion stimulus package for defense and infrastructure—a significant policy shift for one of the EU's most fiscally conservative members. The move ushered in a broader conversation about addressing Europe's structural competitiveness (or lack thereof). As a result, investors have bid up European markets in the hopes that a new chapter has commenced.

Back in the U.S., small caps are the only corner of the market that continue to struggle as broader economic growth remains resilient, but insufficient to offset elevated interest rates and tariff uncertainty. Small businesses have not enjoyed the knock-on effects of the AI economy; nor do they enjoy the benefits of scale, which appear to be important drivers of returns for larger companies. Even the equal-weighted S&P 500, which neutralizes the impact of the "Magnificent 7" has handily outperformed the Russell 2000 Small Cap Index year to date.



Source: Neuberger Berman, FactSet. Information as of 06/30/25

The S&P 500 currently trades at 23x this year's earnings, which is slightly higher than where it began the year and toward the high end of its historical range. This level seems justified by the lasting resilience of the economy, including strong employment and the economy's ingenuity. We have written in the past about how P/E ratios cannot be compared over long periods of history because the underlying profitability of index constituents has changed dramatically, and today's largest companies boast a much greater and ever-expanding return on equity (ROE), a measure of profitability that we have written about in the past. For instance, in our final letter of 2024 we compared the S&P 500 average ROE of 43% to the MSCI EU Index at a mere 12%. This difference explains a lot of the valuation differential between these two markets. Even looking within our market, ROEs have expanded quite meaningfully.

Interestingly, however, the concentration of the S&P 500 in the “Mag 7” has fallen YTD, reflecting a healthy broadening out of market returns. Ultimately, though, tariffs will challenge all companies if they are prolonged. Without a lasting resolution, we expect the impact will begin to be felt in the second half of 2025, especially since we have seen just a single formal trade deal out of the 90 that the administration is aiming for by July 9th. By the same token, of course, the administration continues to signal positive trade announcements are coming. These could support the market and shift the focus to deregulatory initiatives, which might further enhance ROEs.

Given the balanced current risk/reward outlook, however, we would point out that the market has enjoyed an impressive stretch of late, annualizing returns at 14.37% since the end of 2019, which is well above the 40-year average of 11.50%. For investors with shorter time horizons, and in light of the harrowing events unfolding almost daily around the world, today does feel like a good time to revisit one’s asset allocation.

Trade War

On the question of tariffs, we believe one objective of the current administration’s initiative is rooted in industrial policy realignment to make America more resilient in the future.

The 90-day tariff suspension in May helped the market identify the Trump administration’s tolerance for near-term economic pain, and has led to a view that the use of tariffs will not become unhinged. Others argue that tariffs should be viewed as a continuation of the near-shoring policies which began under the prior administration in the wake of the supply-chain disruptions caused by the pandemic. While these policies may appear blunt, they could enhance U.S. economic self-sufficiency.

We recently had the opportunity to meet with the chairman of a major technology company whose assessment of the current landscape struck us as both apolitical and logical. China, while it is a large market, has not been a reliable trade partner to America and continues to exploit its trade asymmetry. As a result, we believe that America must cease to favor China in trade while redomiciling critical functions and capabilities.

With this relationship now being redesigned, it is possible that we are witnessing the end of unfettered globalization in favor of a system that rewards resilience over cost. Recall that China’s role as a supplier of goods was by America’s design following the Reagan administration of the 1980s. The thinking at the time was that including China would unlock the double benefit of accessing its cheap labor as well as setting it on a path to democracy. Unfortunately, the second objective has remained elusive. As a result, we have been jolted by the realization that any dependence on China is a weakness. Rather, we should aim for mutual, non-dependent trade.

One flashpoint is Taiwan and China’s enduring claim over it. Taiwan is home to the formidable TSMC, the largest and most advanced leading-edge semiconductor manufacturer on earth. Where Intel once dominated this field, TSMC has taken the lead, but this executive reminded us that America possesses all that it requires to retake that mantle; there is nothing structural about TSMC's lead. He reminded us that it was America, in its pursuit of profits, that intentionally sent semiconductor manufacturing to Asia—along with the instruction manual.

U.S. Productive Capacity: WWII and the American Miracle

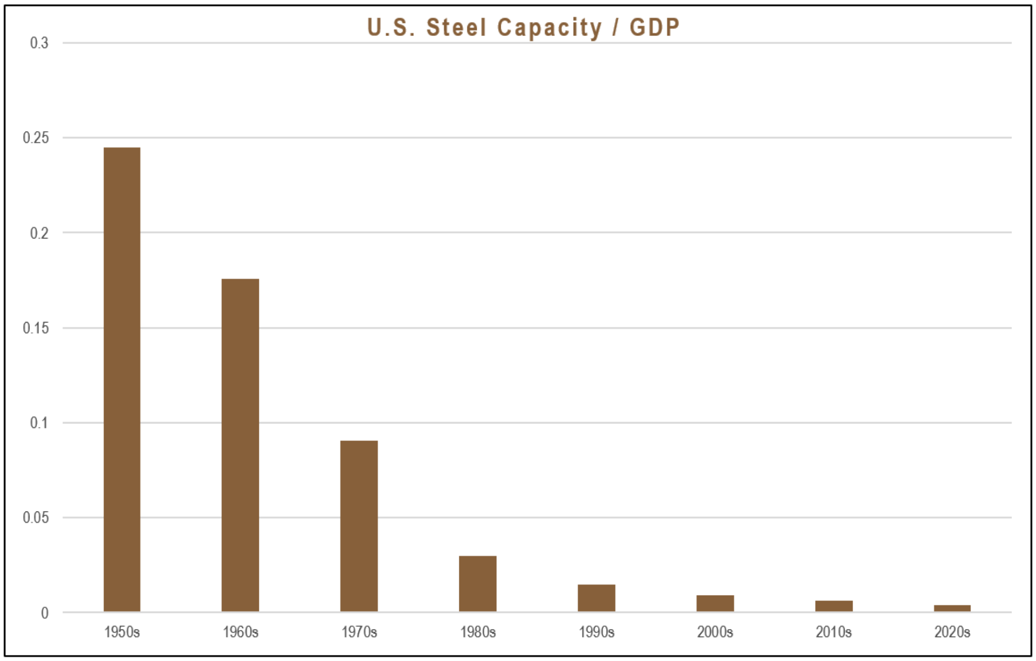
We recently read a fascinating book by Arthur Herman titled "Freedom's Forge" published in 2012. It tells the story of how American enterprise answered the call for armament during WWII and ultimately overwhelmed the Axis. Even Hitler himself was said to have been impressed, if not a little surprised, by America's sheer productive force. It was a fascinating reminder that America is home to one of the world's most impressive—if not THE most impressive—productive engines history has ever known.

America turned its capitalist system into an insurmountable advantage, where private enterprise diverted its primary activities to supply ships, aircraft, tanks, vehicles, munitions and countless other supplies at a scale that was previously unimaginable. In particular, auto companies proved to be critical contributors as they leveraged their expertise in complex assembly, engineering and resource management.

Herman also reminds us that the for-profit motive of America's enterprises, while highly criticized during a time of war, was instrumental in coaxing out the highest possible productivity: the Packard Motor Co. would assemble Rolls Royce Merlin engines in one third the time and cost than its British designers could. Chrysler would cut production time for the Swedish Bofors 40mm anti-aircraft guns from more than three hours to 15 minutes, and American-designed Liberty ships would ultimately get produced at a rate of one a week, from an initial rate of one every three months!

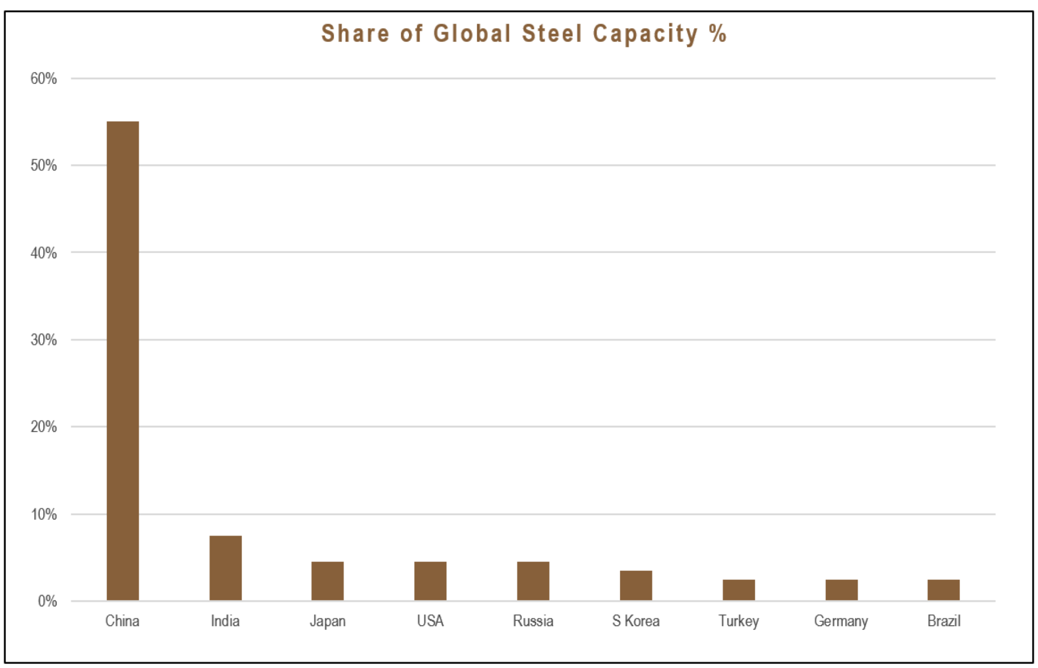
The book also served as a reminder that America must be vigilant about its dependencies. The pandemic jolted the nation into assessing its self-sufficiency, and it discovered some shortcomings. For example, President Biden's Chips Act was aimed at addressing our dependence on Taiwan for chips, and now President Trump's tariffs seemingly aim to address a much broader array of inputs, chief of which is China's dominant position in rare earths, steel and aluminum.

First, consider that America, prior to outsourcing much of its capital-intensive heavy industry in the 1970s and '80s, maintained a formidable steel capacity—much of it built on the back of WWII demands. Determining the optimal steel capacity for today's economy requires balancing the sometimes opposing goals of profit maximization and resilience. However, we would posit that America's steel capacity today has fallen behind the size of its economy as it is virtually unchanged since 1950 at ~100m metric tons despite our economy having grown 58x to over $25 trillion.



Source: Neuberger Berman, Bloomberg, FactSet. Information as of 03/31/25.

Of concern, China now controls well over 50% of global steel capacity. What's perhaps most troubling about this is that China does not possess any compelling comparative advantage in steelmaking. Certainly, its share of iron-ore and energy, which are key inputs for steelmaking are not 50% of the rest of the world's. In fact, prominent geopolitical strategist Peter Zeihan points out that "China is the most trade-dependent nation on earth, importing 75% of its energy." Rather, China does what it can do, and it has historically favored heavy industry for its employment benefits while accepting its associated pollution. That said, it seems reasonable to believe that the world should be less dependent on a single country for half of all steel. The issue is that Chinese state-subsidized steel finds its way into finished goods like ships, which then connect to the global economy.



Source: Neuberger Berman, Bloomberg, FactSet. Information as of 03/31/25.

On this particular example, China has turned its government-manipulated steel supply into an advantaged input for shipbuilding. This has become a focal point of the current administration. Remember that, like steel, America relinquished shipbuilding following the war. Much of that was ultimately absorbed by China, which today boasts a ~30m gross ton production capacity, dwarfing our remaining 1m gross tons.

Unfortunately, the list of imbalances does not stop at steel and ships. The picture is nearly identical for aluminum, where China represents over 40% of global production and in rare-earths, where China has made a concerted effort to expand its refining capacity to become dominant.

While we regret the hyper-politicization of these important topics, substantial bipartisan support to enhancing America's resilience does exist, and we are of the view that the administration's tariff proposals, imprecise as they are, could serve as a catalyst for this process.

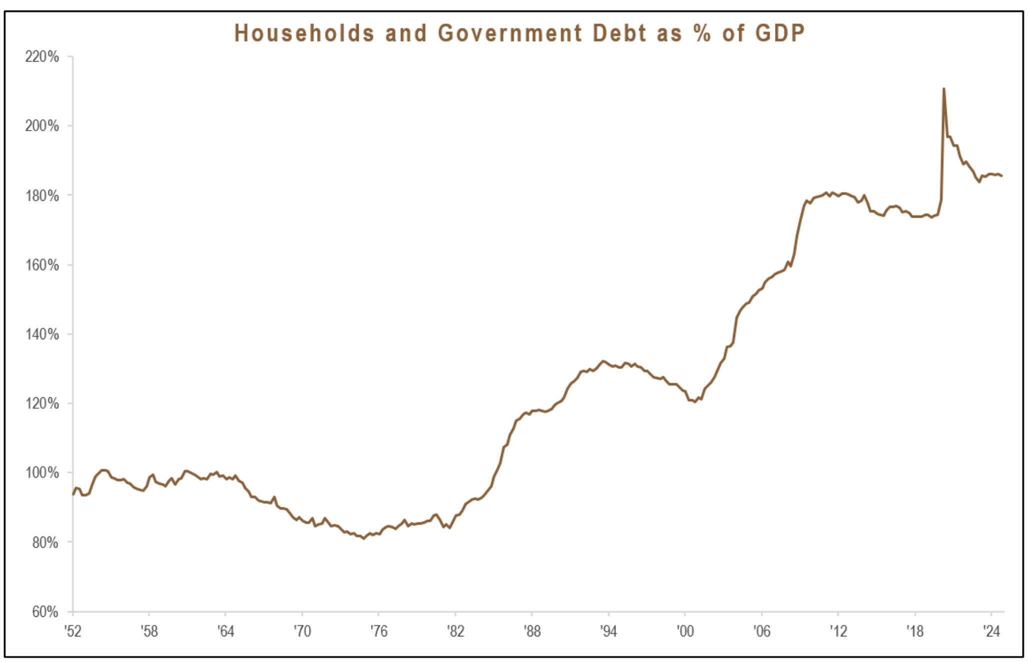
Debt and Deficits

Another hot topic lately has been the never-ending chorus of doomsday pronouncements on the back of the "runaway deficit." We have written a lot about this subject, including its seriousness and its impact on interest rates. The trouble is, however, that being early is the same as being wrong, and this issue has been present and stewing for a long time.

Admittedly, the pitch has gotten especially loud recently due to a confluence of several factors, which include Trump's policies sowing uncertainty, DOGE's theatrics, the strength in gold prices, the "Big Beautiful Bill" for which a Senate vote is due by July 4th and Moody's recent "negative outlook" warning on U.S. government debt (a mere 15 years after S&P said the same thing).

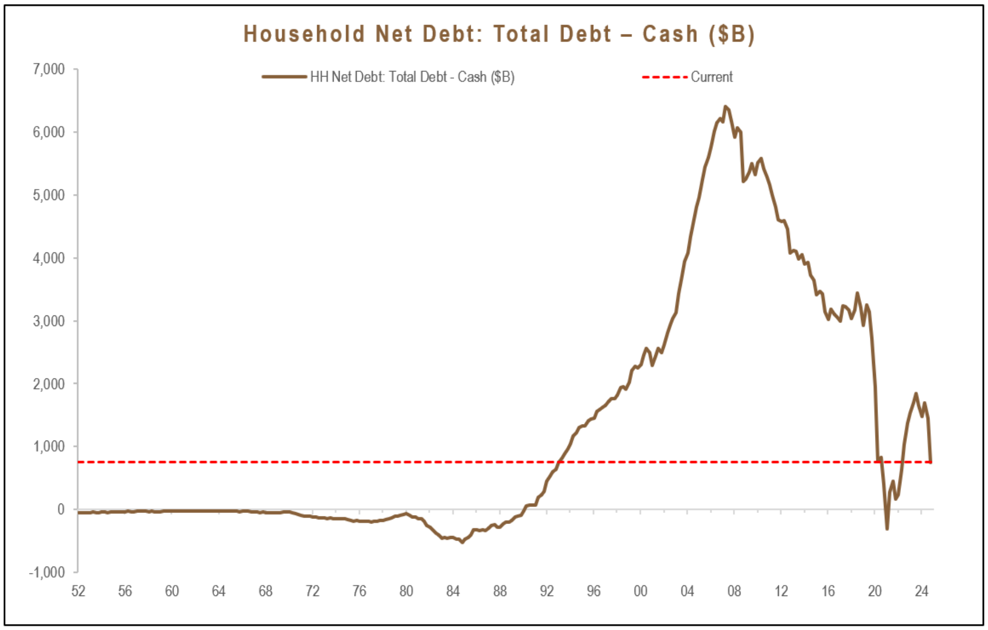
We believe that government spending absolutely should be checked, and prioritized. However, we also believe that the current discourse only tells part of the story.

Although government debt is at record levels—around $36 trillion currently—consumer debt as a percentage of GDP is at its lowest since the early 2000s. If we take the sum of government and household debt, it is only incrementally higher relative to GDP than where it was following the Great Financial Crisis of 2008.

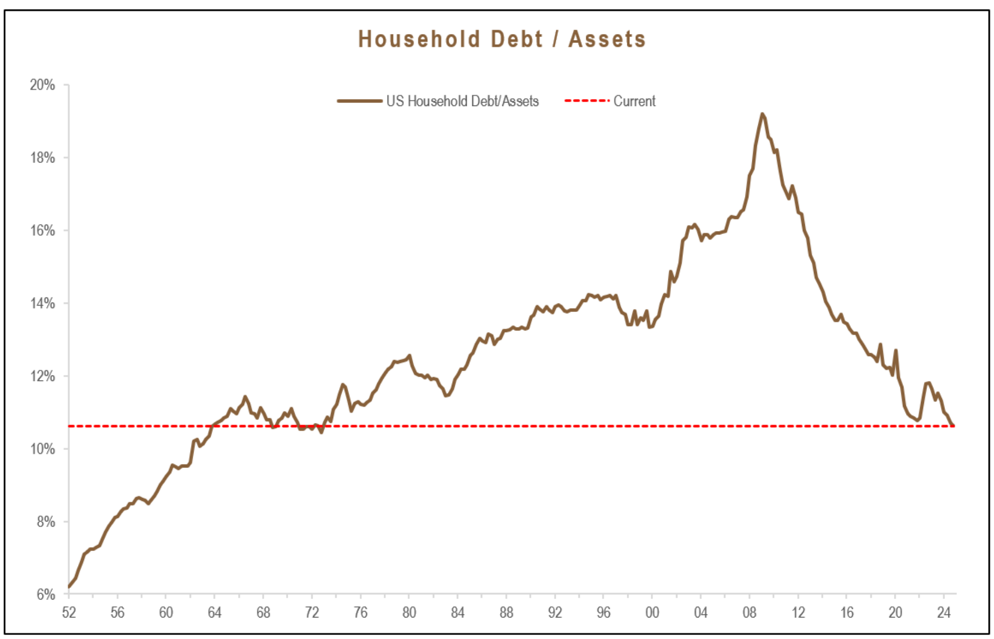


Source: Neuberger Berman, Bloomberg, FactSet. Information as of 03/31/25.

Focusing on the consumer side, consider that household debt-to-cash on hand hasn't been this low since about 1990. And if we compare household debt to the value of its broader assets, debt hasn't been this low since the early 1960s!



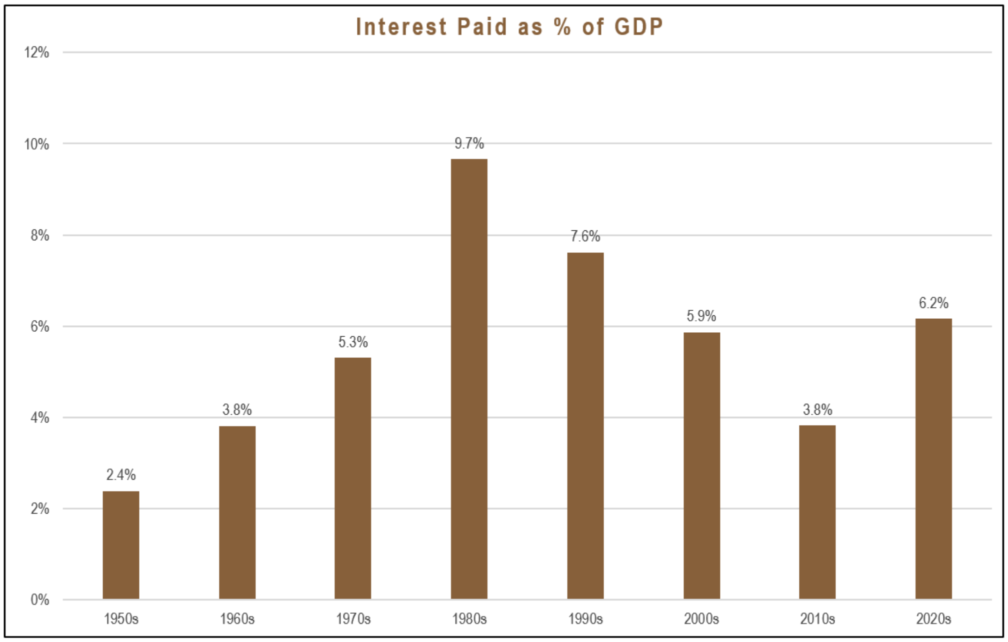
Source: Neuberger Berman, Bloomberg, FactSet. Information as of 03/31/25.



Source: Neuberger Berman, Bloomberg, FactSet. Information as of 03/31/25.

Home values are one large contributor to this ratio and Meredith Whitney, famous for having called out a crisis in the municipal debt market in the wake of the GFC, recently pointed out that Americans possess a record sum of untapped equity in their homes. She estimates that we have a collective $20 trillion saved up in our homes that could yet be used while remaining conservatively leveraged, and this includes $14 trillion in homes with no mortgages at all. That alone is equivalent to more than half of all outstanding government debt. Not only do Americans collectively deserve a pat on the back, but we think this side of the coin is integral to the debt debate.

Despite the increase rhetoric around the U.S. deficit, it is notable that the yield on the 10-year U.S. Treasury yield is lower today than where it started the year, suggesting that investors may not be pricing in heightened credit risk. Since the 10-year Treasury reflects the cost of serving our debt, we looked back at total U.S. interest expense by decade and compared it to GDP. On this measure, we have stepped up from the lows of the 2010s, but we appear in line with the last 40 years and far from levels that might warrant a panic.



Source: Neuberger Berman, Bloomberg, FactSet. Information as of 03/31/25.

While we do not see an imminent debt crisis, we continue to anticipate that interest rates will remain structurally higher than in the prior decade. As a result, we continue to favor businesses that are resilient to higher rates as well as keeping our bond durations short.

Conclusion: A Quarter of Extremes Highlights the Importance of Diversification

The second quarter of 2025 was a quarter of extremes—a bear and bull market all in one, with record VIX spikes and dramatic swings in policy, geopolitics and sentiment. Through these extremes, U.S. markets and the broader economy have remained resilient, supported by ongoing advances in AI, evolving industrial policy and a robust consumer. While volatility is likely to persist, we do not currently see evidence of imminent systemic problems.

Nevertheless, we remain vigilant in monitoring the many risks facing markets today. Given that the stock market sits near all-time highs, and the world remains as unsettled as ever, now is a good time to revisit your asset allocation. If recent volatility has caused you concern about your portfolio, we encourage you to reach out to discuss. We do not advocate timing the markets, but we do believe that careful planning, diversification and a long-term perspective will see you through even the wildest moments.

As President Roosevelt prepared the nation for the challenges ahead in 1939, skeptics underestimated America's capacity. History proved otherwise—and we believe that same spirit endures today.

Thank you for your continued trust and partnership.

Sincerely,

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