

Fireworks

2nd Quarter, 2025

Summary

- U.S. large-cap stocks ended the second quarter up 10.9%, marking a new record high. U.S. small-cap stocks gained 8.5%, and U.S. intermediate-term bonds ended the quarter up 1.2%.
- The Big Beautiful Bill includes permanent Tax Cuts and Jobs Act extensions, tax relief for middle-income earners, and a new tax cut on tipped income and overtime.
- As the bill moved through Congress, the all-important Treasury market remained calm and credit spreads held steady, as markets suggested comfort with the ramifications.
- Should yields rise, credit spreads could indicate whether the rise in interest rates ends the economic and fiscal fireworks.

Overview

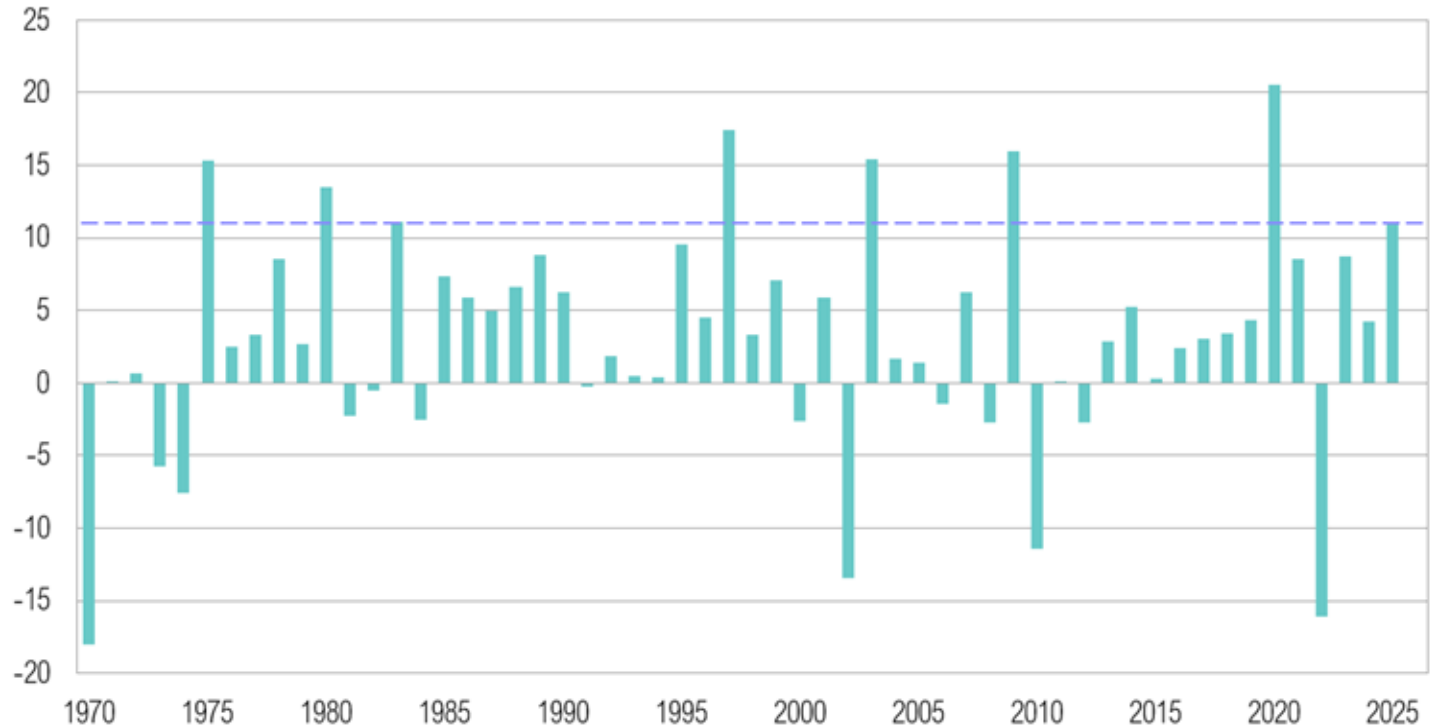
The second quarter began not with a fizzle, but with a bang. On April 2, the U.S. government announced “Liberation Day”, which entailed sweeping global tariffs: a baseline 10% on nearly all imports and higher rates targeting specific countries. This brought the average U.S. tariff rate to 22.5% (from an average of around 2.4%)—the highest level in over a century. On April 9, a 90-day pause on the tariffs was announced. The pause was driven by volatility in Treasury markets: the 10-year Treasury yield saw its largest weekly increase since 2001, rising from 4.0% to 4.5%, while the longer-term 30-year yield jumped from 4.4% to 4.9%. This represented the largest five-day rise since April 1987. White House National Economic Council Director Kevin Hassett noted that:

“There’s no doubt that the Treasury market made it so that the decision about the time to move [on the tariff pause] was made with, I think perhaps, a little more urgency.”

Over the quarter, several trade deals were struck between the U.S. and major trading partners. On June 26, a deal with China focused on the shipment of rare earth minerals to the U.S., part of a broader effort to resolve ongoing trade tensions. The European Union continues to push for a universal 10% tariff on exports to the U.S. while seeking exemptions for pharmaceuticals, semiconductors, and aircraft. In early July, the U.S. announced a trade deal with Vietnam. Under the agreement, the U.S. will place a 20% duty on Vietnamese imports and U.S. exports to Vietnam will not be subject to any tariffs. Vietnam has also agreed to a 40% duty on goods originating in other countries but routed through Vietnam for final shipment to the U.S.—a tactic reportedly often used by China.

COVID Aside, This Was the Best Q2 for U.S. Large Cap Stocks Since 2009

U.S. Large Cap Stocks Q2 Returns (1970 – 2025), %



Source: Bloomberg. U.S. large cap stocks as proxied by the S&P 500 Index (Total Return).

Despite a 20% drawdown to start the quarter, U.S. large-cap stocks, as measured by the S&P 500 Index, ended June up 10.9% and closed the quarter at a new record high. With the exception of 2020, this marks the best second-quarter return for the index since 2009. U.S. small-cap stocks gained 8.5% over the quarter, and U.S. intermediate-term bonds, as proxied by the Bloomberg U.S. Aggregate Bond Index, ended the quarter up 1.2%.

June marked three years since year-over-year headline inflation reached a four-decade high of 9.1%. Since then, inflation has gradually trended toward the Federal Reserve's official 2% target. In May, headline inflation eased to 2.4% year-over-year while core inflation held steady at 2.8%. Shelter costs remain the largest contributor to elevated prices. At its June Federal Open Market Committee (FOMC) meeting, the Fed reiterated its preference to keep interest rates on hold while maintaining expectations for two rate cuts before year-end. Markets are currently pricing in the equivalent of two to three rate cuts by December 2025.

The labor market remains resilient, supporting the Fed's decision to hold rates steady. Over the past three months, the U.S. economy added 449,000 new jobs, and the unemployment rate remains near historic lows at 4.1%. Wage growth remains above pre-pandemic levels, increasing by 3.7% year-over-year in June. The most recent JOLTS (Job Openings and Labor Turnover Survey) showed that vacancies in May rose to the highest level since November 2024 and remain well above pre-pandemic levels.

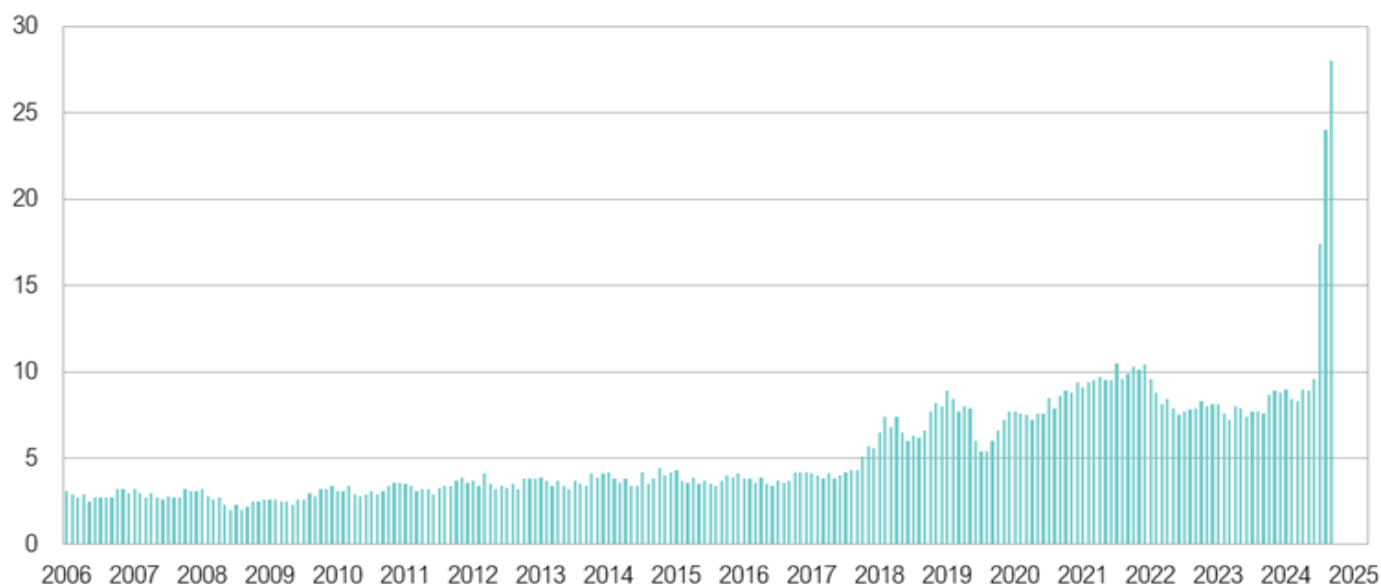
Fireworks

One of the key motivations behind the tariff hikes was to boost government revenue. June saw a record \$28 billion collected in customs and excise taxes. In the first half of 2025, the U.S. has collected \$97 billion in tariff revenue, already matching the total annual revenue from tariffs in 2024. Estimates show that the cost of extending the Tax Cuts and Jobs Act (TCJA) provisions, which are set to expire at the end of the year, could increase the fiscal deficit by between \$4 trillion and \$4.6 trillion over the next decade. Tariff revenue, which the Penn-Wharton budget model estimates could exceed \$200 billion per year, might offset nearly half the estimated cost of extending the TCJA. Extending the TCJA has been a key priority for the administration, since failing to do so would result in higher taxes and leave households with less disposable income. According to Charles Schwab Chief Investment Strategist Liz-Ann Sonders, not getting the 2017 tax cuts extended “*would be a huge economic hit.*”

The TCJA forms a central part of the One Big Beautiful Bill, a budget reconciliation package that permanently extends nearly all major provisions of the TCJA, while also cutting taxes on tips and Social Security payments and trimming funding to Medicaid. The Big Beautiful Bill (OBBB) was passed in Congress on Thursday, July 3, and signed into law on Friday, July 4. The Congressional Budget Office (CBO) estimates that the bill would add \$3.3 trillion to the federal deficit over the next decade. Lawmakers from both political parties have pushed back on the CBO’s estimates: Republicans argue that it understates growth (the CBO estimates 1.8% year-over-year GDP growth) and overstates the deficit impact, while Democrats say the methodology is too generous toward temporary provisions and doesn’t fully reflect long-term fiscal risks.

Medicaid cuts are one of the largest offsets in the spending bill. Estimates project that it could reduce the cost of extending the TCJA by nearly \$1 trillion.^{24,25} Between 2020 and 2023, Medicaid spending surged by 42%. The OBBB introduces stricter eligibility requirements for Medicaid recipients and limits how states can fund the program. Changes include work requirements of at least 80 hours per month and mandated eligibility verification twice a year. The effects may not immediately impact providers or patients, but experts caution that the most significant impacts could emerge around 2028. Other offsets to the spending bill are changes to student loan repayment rules and the phase-out of Inflation Reduction Act tax credits (which are expected to reduce the cost of the OBBB by over \$500 billion over the next decade).

Tariff Revenues Surged Over the Past Three Months
U.S. Treasury Deposits: Customs & Certain Excise Taxes, Monthly \$Bn



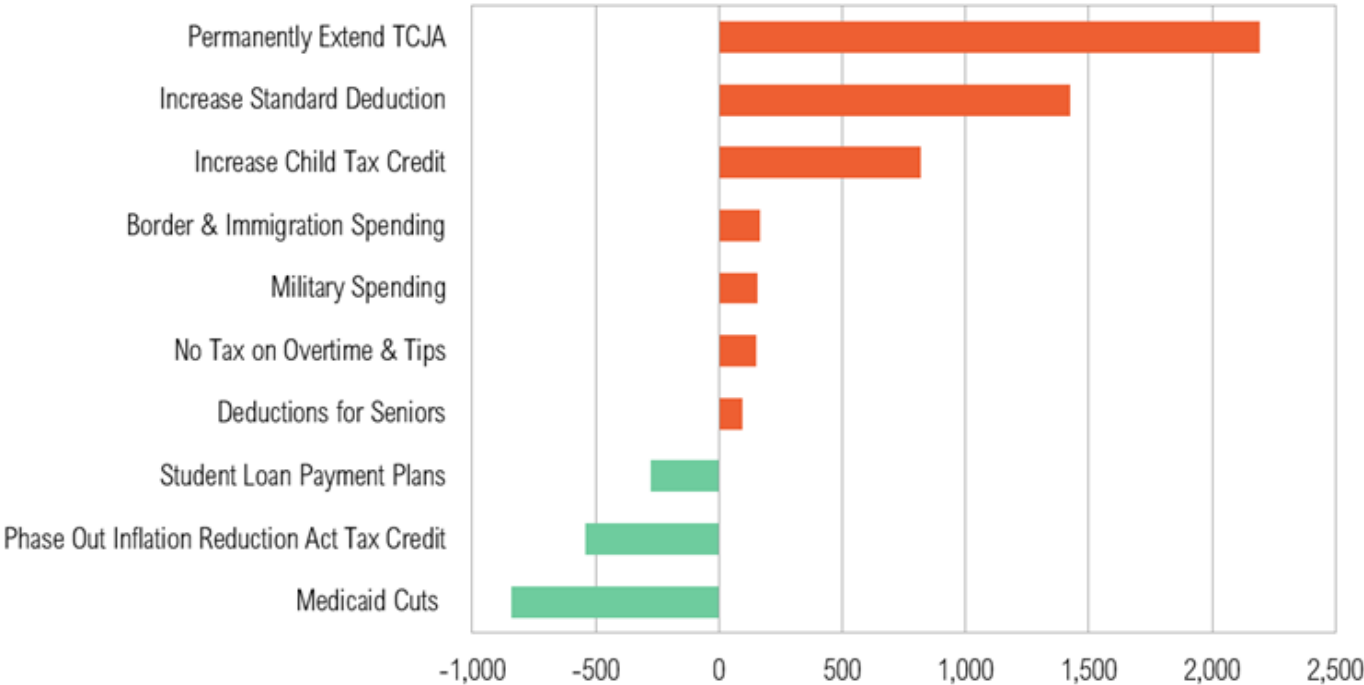
Source: Bloomberg. As of 6/30/2025.

One unique feature of the OBBB is its reduction of federal taxes on tipped income and overtime pay. It is estimated that between 2.5 and 5.2 million tipped workers stand to benefit, potentially boosting their collective income by \$39 billion over the next decade. According to Yale’s Budget Lab, these workers could see annual tax cuts ranging from \$1,700 to \$5,800. However, the bottom 20% of earners would receive much smaller cuts of around \$74 per year, largely because their incomes are already below the taxable threshold. The benefits are currently set to expire in 2028, do not apply to individuals earning more than \$150,000 per year, and are capped at \$25,000 in total deductions. The OBBB also allows certain workers to claim a tax deduction for qualified overtime pay, subject to limits similar to those applied to tipped income.

The OBBB also includes broader tax relief. According to the Social Security Administration, the OBBB “ensures that nearly 90% of Social Security beneficiaries will no longer pay federal income taxes on their benefits”. Individuals earning between \$30,000 and \$80,000 per year are likely to see tax bills reduced by nearly 15%, and the child tax credit is set to be permanently increased to \$2,200. The OBBB will also make the small-business tax deduction permanent, and provisions such as immediate expensing for new domestic factories and support for manufacturing are aimed at increasing domestic investment and job creation. Companies will benefit from expanded provisions around itemization and expenses, including a return of 100% bonus depreciation, letting businesses deduct the full cost of investments upfront, rather than spreading it out over three years.

Bond markets have largely taken the progression of the bill in stride. Treasury yields remained relatively contained throughout June as the bill moved through the House and Senate, suggesting little concern with the bill’s fiscal impact. Credit markets responded similarly, with credit spreads remaining stable, ending the quarter at 2.9% (after spiking to 4.5% on April 8).

Certain OBBB Components May Offset Some of the Increased Spending
Estimated Impact on the Deficit Over the Next 10 Years (2025 – 2035), \$Bn



Source: Congressional Budget Office, Washington Post, New York Times, Joint Committee on Taxation. Estimates based on the Senate version of the bill passed on 7/1/2025 and are subject to differ from the bill signed on 7/4/2025.

Markets

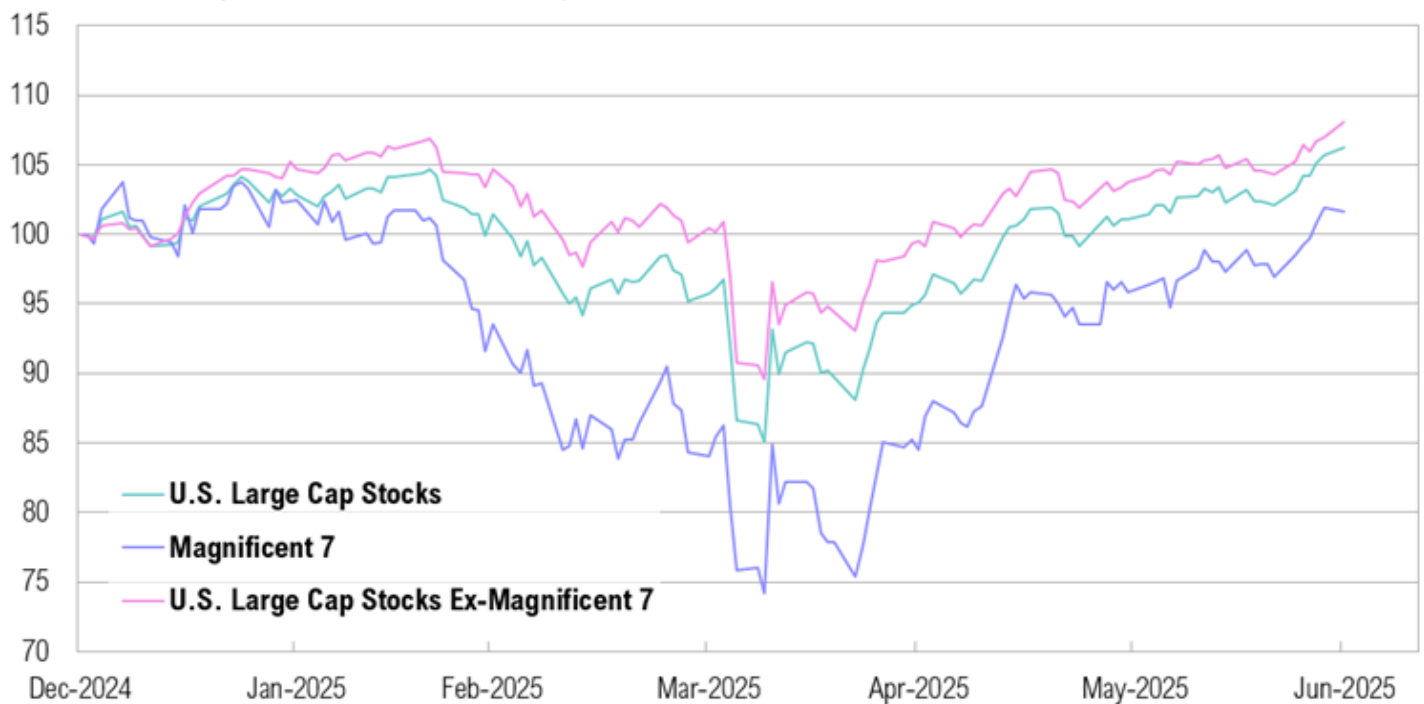
International equity markets outperformed their U.S. counterparts in the second quarter. International developed small-cap stocks gained 16.9% over the quarter, making them the top-performing major asset class. U.S. small-cap stocks ended June up 8.5% and remain in the red year-to-date (down -1.8%).

The rally in U.S. equities no longer appears to be driven solely by the Magnificent Seven, as gains among U.S. large-cap stocks have broadened, pushing the market to new highs. Year-to-date, the S&P 500 has outperformed the Bloomberg Magnificent 7 Index (Apple, Alphabet, Amazon, Microsoft, Meta, Nvidia, and Tesla) by 5%, with the former gaining 6% year-to-date and the latter ending the first six months of 2025 up 2%.

Full-year S&P 500 earnings growth estimates declined over the quarter, falling from 11% to 9%. The technology sector (+18%) and communication services sector (+15%) are expected to lead earnings growth in 2025. The consumer staples sector is experiencing an interesting confluence of growth expectations and valuation metrics. Growth expectations remain modest: revenue in the sector is projected to increase by a total of 8.2%, and earnings per share by 10.6% over the next two years. This puts forward-looking valuations in the sector to near the highest levels seen in at least a decade. In contrast, the technology sector is expected to post significantly better results, with revenue projected to rise by a total of 24.6% and earnings by 37.1% over the next two years. This divergence is perhaps best illustrated with an example: Nvidia, with a forward price-to-earnings (P/E) ratio of 32x, is cheaper than Walmart, which is currently trading at a forward P/E of 36x.

U.S. Large Cap Stocks Have Fared Well With or Without Mega Cap Tech

Growth of 100 (12/31/2024 – 6/30/2025)



Source: Bloomberg. U.S. large cap stocks as proxied by the S&P 500, the Magnificent 7 as proxied by the Bloomberg Magnificent 7 Index and U.S. large cap stocks ex-Mag 7 as proxied by the BITA U.S. 500 ex Magnificent 7 Index.

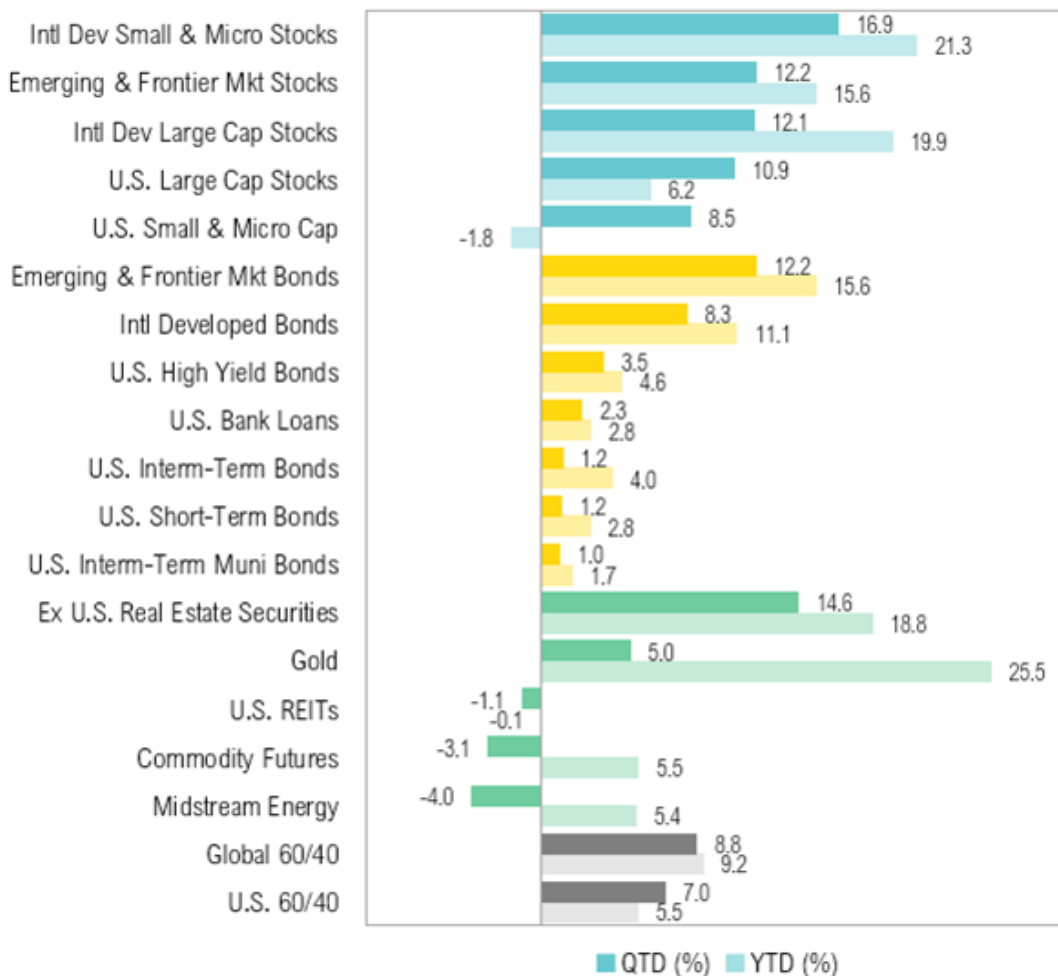
U.S. intermediate-term bonds gained 1.2% in the quarter. After rising to 4.6% in mid-May (following the Moody's U.S. credit downgrade), the 10-year U.S. Treasury yield ended June at 4.2%. The spread between the 10-year and 2-year Treasury yields remained positive throughout the quarter, ending June at 0.5%.

The second quarter contained more than one geopolitical conflict. In addition to trade wars, conflict in the Middle East escalated in June after Israel launched an attack targeting Iran's nuclear program, raising geopolitical risk in the region, which is home to key oil producers (and a critical part of global energy supply). Oil prices jumped 8% on June 13, reaching \$74 per barrel. On June 24, after nearly two weeks of fighting, a ceasefire between Israel and Iran was brokered by the U.S. after the U.S. bombed Iranian nuclear sites and subsequently applied diplomatic pressure to de-escalate the conflict.

Global capital markets showed a muted reaction to conflict, suggesting it was viewed as an isolated incident and resulting in a short-term energy price shock rather than a global systemic risk to economic growth. West Texas Intermediate (WTI) crude oil prices ended the quarter back at \$65 per barrel. The lack of response from U.S. markets also highlighted the U.S.'s advantage as a net exporter of energy, exporting more energy than it imports overall.

Gold, which ended the quarter up 5%, reached a record high of \$3,448 on June 16, in the midst of the escalating Israel-Iran conflict, reaffirming its reputation as a safe-haven asset.

Q2 2025 Key Market Total Returns



Source: Bloomberg



Looking Forward

We've consistently highlighted the importance of fixed income and credit markets in interpreting today's highly unusual policy environment. This environment is increasingly shaped by near-record fiscal deficits, which have played a key role in supporting economic growth and fueling risk asset performance. We continue to believe that as long as bond yields remain contained, this supportive backdrop can endure.

While we remain attentive to potential risks, it's worth noting that relatively low bond yields may be signaling that the recent policy measures could extend the current U.S. economic expansion. While a moderate rise in yields may not necessarily derail the economy, a more pronounced increase in Treasury yields could bring an end to the current fiscal and economic fireworks. This is a dynamic we will be monitoring closely in the months ahead.

As always, if you have any questions or would like to schedule a meeting with one of our investment professionals, please don't hesitate to call us at 508-693-8850.

Sincerely,



Luke Murphy

Managing Director,
Martha's Vineyard Investment Advisors

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Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

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