Birch Hill
INVESTMENT ADVISORS

Market View

July 2025

A CHOPPY REBOUND FOR US STOCKS

After peaking in late February, the S&P 500 Index fell sharply, declining -18.9% into early April as proposed tariffs on key trading partners fueled uncertainty and raised recession fears. However, a 90-day pause on the most severe tariffs, along with a preliminary agreement with China, sparked a sharp rebound in equities through mid-June. Momentum faded again toward quarter-end as geopolitical tensions flared following US and Israeli attacks on Iranian nuclear facilities. Despite the turbulence, the S&P 500 Index posted returns of +10.9% for the second quarter and +6.2% year-to-date.

INTERNATIONAL OUTPERFORMANCE

Global markets outpaced the US in the first half of 2025. The MSCI EAFE Index, which tracks developed international equities, returned +20.3% year-to-date, supported by a weaker dollar and improving growth expectations in Europe and Japan. The MSCI Emerging Markets Index was also strong returning +16.5%. Unlike China and a few other countries, such as Vietnam, most emerging economies remained largely unaffected by the new tariffs. Low valuations and a favorable currency backdrop also helped drive the rebound.

WHY HAVE US EQUITIES RECOVERED?

Despite a long list of risks—tariffs, inflation, slowing growth, geopolitical conflict, oil volatility, interest rates, and federal debt—US equities have clawed their way back to near all-time highs. The S&P 500 Index now trades at roughly 22 times the next twelve months' earnings, well above historical averages. Why? Markets appear to view the risks as either transitory, containable, or too distant to derail corporate earnings in the near term.

MARKET UNFAZED BY NEAR-TERM RISKS

If effective tariff rates stabilize in the 10%-15% range, many economists believe the US economy can weather the storm. Inflation is expected to rise modestly over the summer, but the increase is anticipated to be temporary. Consensus forecasts predict US economic growth will slow to +1.4% this year—down, but not recessionary. If inflation proves manageable, the Federal Reserve could cut

Market Indicators		6/30/2025
TOTAL RETURN		
US Stock Markets	12 Mos	Year-to-Date
S&P 500 Index	15.1%	6.2%
S&P 500 Equal Weight Index	12.7%	4.8%
DJ Industrial Avg.	14.7%	4.5%
S&P 400 Mid Cap	7.5%	0.2%
Russell 2000 Small Cap	7.7%	-1.8%
Int'l Stock Markets		
ETF Returns in US$		
EAFE Index (Europe, Australia, Asia, Far East)	17.7%	20.3%
Japan (MSCI Index)	12.5%	12.6%
China (FTSE 50)	45.5%	22.4%
Emerging Mkts Index	16.3%	16.5%
US Fixed Income Yields	12/31/2024	6/30/2025
6 Mo US T-Bill	4.24%	4.29%
2 Yr US T-Note	4.25%	3.72%
10 Yr US T-Note	4.58%	4.24%

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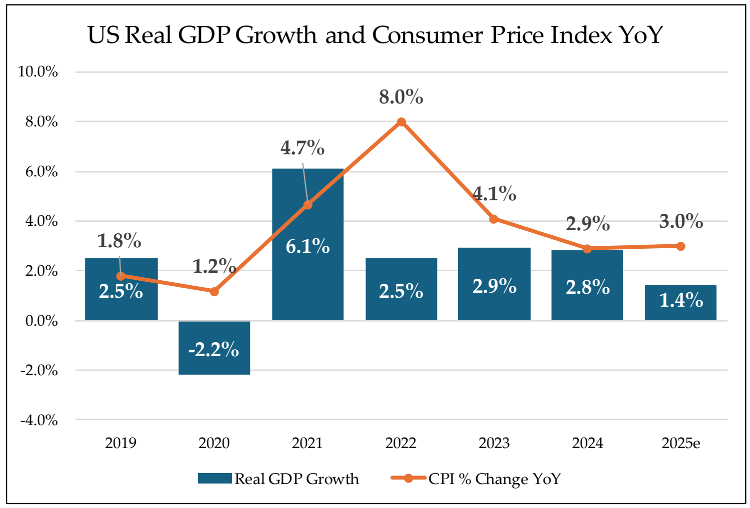
rates later this year. While the Fed held rates steady in June, its projections include two cuts by year-end. Meanwhile, geopolitical risks—particularly in the Middle East—remain a concern. However, the fact that oil prices have stabilized and the Tel Aviv Stock Exchange recently hit new highs suggests the market currently sees these tensions as contained.

WHAT COULD GO WRONG—OR RIGHT?

The market's optimism could be validated if inflation remains under control, growth stabilizes, and monetary policy turns supportive. But with valuations already elevated, disappointment in any of these areas could lead to increased volatility. Different combinations of growth and inflation affect equity performance differently, as shown in a study by S&P Dow Jones Indices, *A Historical Perspective on Factor Index Performance Across Macroeconomic Cycles*. Current forecasts suggest that we might experience the environment that has historically been worst for stocks. That's an environment in which economic growth slows while inflation rises (see charts to the right).



Historically, Amid Falling Growth and Rising Inflation, S&P 500 Returns Have Fallen and Volatility Has Risen

	Rising Growth Falling Inflation	Rising Growth Rising Inflation	Falling Growth Falling Inflation	Falling Growth Rising Inflation
Annualized Return	28%	18%	4%	-10%
Annualized Volatility	13%	11%	17%	17%

Source: S&P Dow Jones Indices LLC, Birch Hill. Data 7/31/95 - 6/30/24.

If this scenario unfolds, should investors exit the market? We don't believe so. Attempting to time markets is rarely successful. Instead, staying invested in high-quality companies with resilient business models and sound balance sheets has historically been the better approach—especially for long-term investors. While downside risks exist, there are also potential tailwinds. Artificial intelligence investment continues at a rapid pace. Fiscal stimulus and deregulation, particularly in the financial sector, may provide added support to growth.

LONGER-TERM RISKS STILL LURK

Beyond 2025, structural issues such as US debt, deficits, and fiscal sustainability remain major concerns. Despite ongoing political rhetoric, deficits are expected to widen this year and beyond. Eventually, this may lead to higher long-term interest rates. So far, markets have shrugged this off, with the 10-year US Treasury bond yield ending the quarter at 4.24%, down from 4.58% on December 31. Addressing the debt issue would require politically challenging steps: raising taxes, cutting spending, or tolerating higher inflation to grow out of it. The first two are difficult; the third carries its own risks, particularly for savers. If inflation becomes a tool for debt management, we believe investors should prioritize companies with strong balance sheets, low capital expenditure requirements, pricing power, and durable business models to help preserve purchasing power over time.

CONCLUSION: STAY DISCIPLINED

US stocks have largely recovered from their spring lows, but uncertainty remains high and volatility is likely to persist. While both risks and opportunities are present, long-term investors are best served by maintaining discipline. A diversified portfolio of high-quality companies can provide resilience in a landscape shaped by slowing growth and persistent inflation.

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