

# Summer Fun or Summertime Blues?



**ERIK MOSHOLT, CFP®**  
Chief Investment Officer

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It's the dog days of summer and investors may feel like they've been on an extended ride on an old Jersey-shore roller coaster. In early April, following the release of much-higher-than-anticipated trade tariffs, stock markets plunged 10% in only two days - just the 4<sup>th</sup> time that's occurred since WWII. Then, the S&P 500 rallied back nearly 25% in three months after the Administration backed off its initial tariff policies. How rare was that rally? It was **the fastest ever** recovery from a 15% decline to all-time highs.

But there's more to the story than that. Non-U.S. stocks have surged over 19% year-to-date. The level of outperformance by non-U.S. stocks over U.S. stocks in the first half **was the largest margin in 23 years!**

Return dispersion wasn't limited to U.S. vs. non-U.S. stocks. Asset class performance varied across the board and leadership fluctuated in this year's first two quarters:

Asset Class	2 <sup>nd</sup> Quarter	Year-to-Date
U.S. Large Caps (S&P 500)	10.9%	6.2%
Tech Stocks (Nasdaq)	17.7%	5.5%
<b>Non-U.S. Developed Stocks</b>	4.8%	<b>19.9%</b>
<b>Emerging Market Stocks</b>	7.9%	<b>15.6%</b>
<b>Core Bonds</b>	<b>1.2%</b>	<b>4.0%</b>
Cash	1.0%	2.1%
<b>Real Estate</b>	<b>-1.0%</b>	<b>1.7%</b>
Multi-Strategy Alternatives	0.7%	2.8%
<b>U.S. Dollar</b>	<b>-7.1%</b>	<b>-10.8%</b>

While the strong, double-digit year-to-date performance of Emerging Market and International stocks jumps off the table, Core Bonds' return of **4.0% in only six months was solid**. Of course, the U.S. Dollar's 10.8% decline in such a brief period is much more remarkable – it was **the worst first half for the Dollar since 1979**. Within Alternative strategies, as the table shows, Real Estate continues to languish and Multi-Strategy Alternatives posted positive,

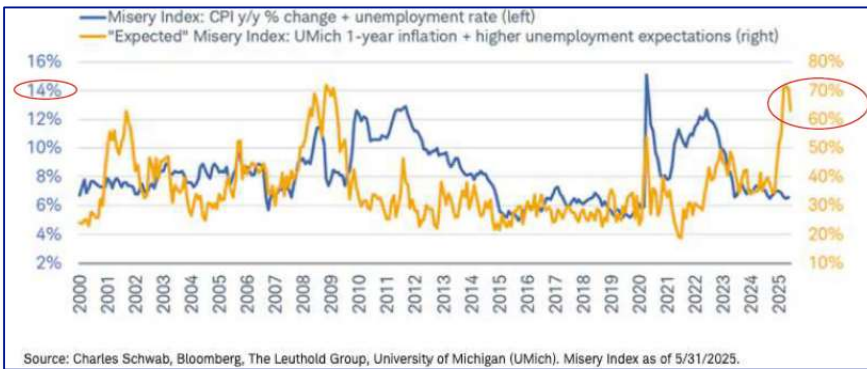
but low returns. The Real Estate story is complicated, as the sector is poised to benefit from continued supply-demand imbalances, but is begging for lower interest rates. Notably, Alternative strategies that follow established trends both long and short suffered sharp declines this year as they are ill suited for the fierce drawdowns and sharp bounce back rallies resulting from seemingly daily news-driven market fluctuations.

While much of the volatility this year was triggered by tariff related announcements, markets are ultimately linked to the economy. Currently, within the finance community, there are **large divergences in outlooks for the rest of the year**. We've seen analysts claim the U.S. is currently in a recession, while others say the odds of a recession this year are near zero. Perhaps the most obvious chasm is among stock analysts (and the stock market itself) and academic economists. The consensus among the theory-driven PhD economists is that the economy will slow in the face of headwinds from higher tariffs and low CEO and consumer confidence. On the other hand, the stock market (a leading indicator for the economy) is up sharply and stock analysts continue to predict strong earnings growth. These two outlooks are in violent disagreement.

When looking at the economy, one non-traditional metric acting unusual is something called the "Misery Index", which combines the inflation and unemployment rates. Peak misery for workers and consumers is when the combined inflation and unemployment rates are high, and peak good times are when they are low.

The good news is that **today we have a relatively low Misery Index** as inflation has cooled to below 3% and unemployment is just a tad over 4%. So, what's the problem? Well, thanks to the uncertainty around tariffs, a politically polarized population, and a 24-hour news cycle full of stressful headlines, Americans' collective *forecast* for

the Misery Index is currently very high – at levels **only seen once before in the last 25 years**. This chart shows the large gap between the actual Misery Index (blue line) and the Expected Misery Index (Gold line):



Once again, we have a big disagreement – this time between the actual current situation and the anticipated pain of Americans. This gap is unlikely to remain. While we do think both unemployment and inflation are likely to tick up, they're unlikely to get as bad as Americans are forecasting. Why? Well, on the unemployment side of things, Small Businesses are indicating a reluctance to hire, and corporate pre-announcements of layoffs are edging higher - both phenomena are good leading indicators of a rise in unemployment. But for many reasons, including the shrinking labor market, the Tech- and Service-dominated nature of our economy, strong corporate profit margins, and healthy corporate balance sheets, it's hard to see a path to sharply higher unemployment in the short-term.

What about inflation? If not for the tariff issues, we'd feel confident saying inflation was low and getting lower. A non-government sponsored measure of inflation, which seeks to measure "true" inflation, estimates **actual current inflation at only 1.78%**. Recently, however, as the mercury and humidity have risen, the noise around tariffs has risen as well. The June inflation report (just released) showed some evidence that the early tariffs are affecting prices on certain imported goods. And just this month, the President announced some strangely high tariffs on countries like Brazil and products such as Copper, as well as an August 1 deadline for tariff negotiations with many countries.

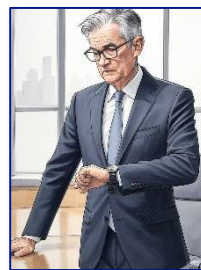
Regardless of how the next few weeks and months play out, and we don't think anyone can predict an outcome with much confidence, one thing is clear – this Administration is going to implement tariffs at levels not seen in over 100 years. Besides the "fairness" and reshoring of jobs arguments, they expect it to be a significant revenue generator for the U.S. And they're likely right. Tariff revenue collections in June were about \$27 billion – more than 4x the amount collected in June 2024.

The question, of course, is what are the tariff's secondary effects on the economy and inflation?

We think most commentary on the linkage of tariffs to the economy is oversimplified. To us, the impact of tariffs is **complex and hard to predict** - we do not agree with the doctrine that all tariffs are directly inflationary, and that all of the costs will be passed on to consumers in the form of higher prices. There are simply too many players involved in the supply chain from manufacturing a product in a foreign country to distributing it on "store shelves" in the U.S. Several players can choose to absorb a portion of tariffs, or to find alternative suppliers. One example – The prices of cars

exported from Japan to the U.S. **dropped over 16%** in April and May. Not because they wanted to lower prices, but to offset tariffs and preserve the competitiveness of their pricing to the end consumer. Another example - China's share of exports to the U.S. quickly declined from 15% at the end of 2024 to 9% in May, while they have increased exports to the EU and the rest of Asia.

Thus, on the two important subjects of employment and inflation, we think both will worsen a little the rest of the year, but not too badly, and with a little time, that yellow line (expectations) in the Misery Index chart above will come down more than the blue line (reality) will go up.



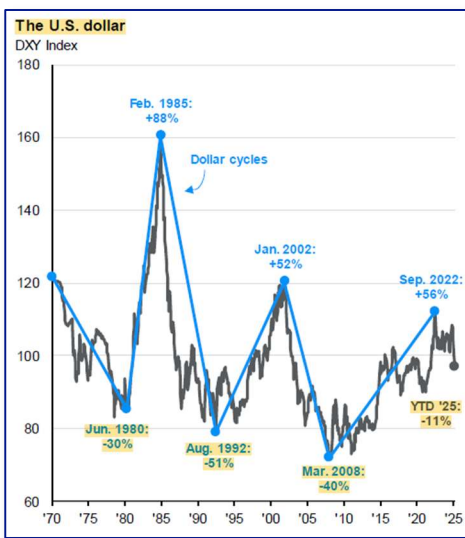
The Federal Reserve is, of course, watching all this closely and continues to take a "wait and see" approach with interest rates. They last lowered interest rates in December and there are good arguments that they should be cutting rates further - traditional measures of the gap between

inflation and interest rates suggest rates are **1.00% too high right now**. So why are they waiting? Even though inflation is back below 3.0%, it's still far from the Fed's target of 2.0%. And the Fed has been vocal that they are concerned about the uncertain impact of tariffs on inflation. Most analysts, us included, think one or two more rate cuts this year, beginning in September, is the likely path forward, but the recent firmness in inflation will likely give the Fed more reason to wait.

Besides the head spinning volatility (in both directions) of stocks over the past four months and the Fed's reluctance to lower rates, the other main story of 2025 is that 10.8%

year-to-date decline of the U.S. Dollar. Make no mistake – this is a big deal. Investors now have to wonder – Is this the start of a long-term trend or has the Dollar fallen too far too fast. The answer may be “yes” to both.

In the short run, the U.S. Dollar has dropped so much so quickly that it is technically “oversold” and due for a bounce. But looking at the big picture, as measured by the Purchasing Power Parity (PPP) metric, the U.S Dollar has been more than 20% “expensive” for over 3 years – an unprecedented length of time, suggesting a more intermediate-term correction is warranted. If we step back and look at the Dollar from a cyclical perspective in this chart, we see that since 1970 the Dollar has had three long-term bear markets where its value relative to other currencies has **declined 30%, 51% and 40%**.



We do not need to look far for catalysts or arguments that the Dollar will continue to weaken. For one, the failure of Washington to address our fiscal deficits, and the recently passed “OB BB” tax and spending bill, can only hurt investor confidence in the Dollar. And geopolitically, we think the confrontational developments of the last six months will have many foreign nations and non-U.S. investors moving money “closer to home”, which could mean more and continued selling of U.S. Dollar assets.

This is not, however, a call for a severely weaker Dollar or a currency-related inflation spike. Economists that we trust argue that the weaker Dollar will nudge inflation up only slightly. And there is **no practical reserve currency alternative** to the Dollar, meaning the Dollar will continue to benefit from the significant worldwide demand associated with being the global reserve currency.

So, investors now find themselves in a strange spot. Markets have rallied strongly, putting a smile on everyone’s face and a spring in our step. Yet so many

important questions remain unanswered:

- *Is inflation really tamed? Or will it spike again?*
- *Will unemployment rise too much?*
- *Will the Fed cut rates? When? By how much?*
- *Will energy and gas prices stay low?*
- *Will tariff “wars” re-ignite?*
- *How much tariff revenue will the Government collect?*
- *How will immigration policies affect the labor market?*
- *When will the Real Estate market wake up again?*
- *How will the One Big Beautiful Bill (OB BB) affect consumer confidence and spending?*
- *Has the U.S. Dollar begun a multi-year cyclical decline?*
- *Will foreigner investors in U.S. assets look to return some of their money “back home”? If so, how much?*
- *Who will be right – bearish economists or bullish stock market analysts?*



We could spend pages trying to answer all these questions. When confronted with so much uncertainty, **it’s often best to simplify things**. To that end, look to the stock market itself. The market’s historic bounce over the last few months is a sign of strength and confidence. Confidence that on balance, things will work out OK. That we’ll avoid a recession and that inflation won’t be too bad. And look to the economy – it has surprised many with its **remarkable resiliency and adaptability** in recent years. Notably, over the last 45 years, recessions in the U.S. have been hard to come by compared to decades prior, when our economy was much more industrial and cyclically oriented.

Perhaps the biggest risks today are the anxiety-producing factors driving that expected Misery Index to such heights – **Policy**. Much like earlier this year, the risks of a policy error from the Administration are high once again. We’re a bit concerned that over the next few months, the White House will be overly emboldened and confident on the heels of some trade deal wins, high tariff revenue, military action on Iran, and the passage of the OB BB.

But we’re **not going to lose sleep over this**. Our concerns are tempered by conviction that the Administration does not want to trigger another stock market selloff. We’re clearly not alone – this month the market shrugged off and essentially ignored the most recent (extreme) tariff policies announcements, which are similar to those which triggered the historic market correction in April.

Unfortunately, a **potential policy error is not limited to the**

**White House.** The Fed is so focused on waiting to see proof that inflation is tamed, that there's a risk they keep interest rates too high for too long and do real damage to the economy. We are comforted on this front as well, this time by the fact that the economy has withstood a few years of higher rates already, so what's another 3-6 months?

In addition to policy risk, we can't ignore something we've written a lot about the last year – that the risks in popular U.S. stock market indices are still elevated. The **S&P 500 is very expensive** by nearly every valuation measure and still significantly concentrated in its top 7 stocks. These are the conditions from which long-term periods of poor relative performance are born.

Looking out over the short-term, we would be unsurprised if stocks continued to advance in July but then struggle in August and September. There are fundamental factors at play that we've already mentioned – potential bump ups in unemployment and inflation that could easily trigger another risk-off episode. However, simple seasonality may play a role as well. Consider the monthly return patterns of the S&P 500 over the last ten years:

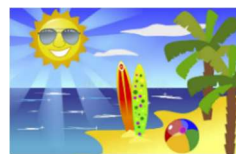
Month	% Positive	Average Return
July	100%	3.4%
August	50%	0.0%
September	40%	-2.0%

Plus, following the recent rally, investor sentiment (a contrarian indicator) is highly elevated and near levels consistent with short-term market peaks.

It's important to remember that any volatility over the next few months, if it comes, is **really just short-term noise**. Looking out further, over the intermediate term, we think it's easier to reach a bullish conclusion than a bearish one. Importantly, we think a recession is increasingly unlikely. The OBBB is stimulative. The Fed will likely lower short-term rates this year. And corporate and household balance sheets are on solid footing.

Looking at portfolio design, perhaps the biggest story is the potential impact that currencies, valuations and capital flows will have on the relative performance of U.S. and non-U.S. stocks. The possibility that we are in the early days of a multi-year period of non-U.S. stock outperformance is the **strongest it's been in a long time**. With that said, we have high conviction that with the advent of Artificial Intelligence (AI) and growth in robotics, innovation should remain an important theme in portfolios, and that's an area where the U.S. is likely to continue to dominate.

And the **opportunity set goes far beyond stocks** – We're excited that we may be entering a new investment period where solid returns can be achieved in many types of investments, and not just U.S. tech stocks. For conservative and balanced investors, bond yields are healthy and can now hold their own in a diversified portfolio. Looking at Alternatives, we're not concerned about the relatively weak performance of certain strategies this year –one of the main reasons to own these strategies is to zig when core assets like stocks and bonds zag. Plus, in today's environment, many Alternative Investments remain particularly attractive for both their return opportunities and diversification benefits considering the combination of inflation risks and the currently high correlation of returns between core assets like stocks and bonds.



The next few months should prove "interesting" as many of the questions listed above will be answered by year-end. Yet, we don't need all the answers to have the

proper response. Investors **should neither be paralyzed by the uncertainty nor blindly ignore the risks**. To us, a globally diversified portfolio, tilted toward innovation, with dedicated exposure to alternative strategies and inflation sensitive diversifiers, is the appropriate solution to today's shifting political, global, economic, and investment landscape – whether we suffer some summertime blues or get to enjoy more fun in the sun.

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