MARKET UPDATE

Economic Market Update – Second Quarter, 2025

July, 2025

- Growth downshifts to a “muggy” ~1% pace while inflation stays above target, leaving the Fed on hold and tariffs trimming output even as elevated fiscal spending provides a partial offset.
- Equities rallied — S&P 500 +10.9% in Q2 — but gains were narrowly led by tech/communications; small caps remain negative YTD and developed international & EM stocks outpaced the U.S. by the widest margin since 2002.
- Fixed income participated: Bloomberg U.S. Aggregate (4.0% YTD) and global ex-USD bonds (+7.3%) as a weaker dollar and 10-yr Treasuries >4% restored competitive income, though the curve is still slightly inverted at the front end.
- Rising bond yields and cheaper overseas valuations make diversification across geographies, quality cyclicals, and AI infrastructure suppliers attractive while maintaining liquidity against elevated geopolitical and policy uncertainty.

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Markets are built to discount the future, yet almost nothing tests that discounting mechanism quite like the outbreak of war. Before balance sheets and supply chains enter the calculus, lives are upended: families displaced, cities reduced to rubble, and generations scarred by physical and psychological wounds that defy spreadsheet quantification. That human suffering is not peripheral noise – it is the main event – while markets merely trace the economic aftershocks. With war continuing to drag on at the doorstep of Europe and tensions escalating in the Middle East, geopolitical risk feels like it is at its highest level since the end of the Cold War. History may be of some solace, however. Across a century of major conflicts, the same recurring drama plays out: an initial spasm of fear – sometimes violent, sometimes fleeting – followed by a re-pricing that hinges less on headlines straight from the battlefield than on how the fighting ripples through to oil wells, supply chains, inflation expectations, and policy reactions.

The response to Pearl Harbor is the canonical reminder that even existential shocks can be absorbed swiftly. When trading resumed on December 8, 1941, the Dow Jones fell less than 5%, steadied within days, and soon began a multi-year climb as war mobilization soaked up idle capacity and rewired the U.S. economy for growth. The market swiftly pivoted from fearing sudden destruction to anticipating a fiscal/monetary supercycle of government spending, technological innovation, and – crucially – an eventual peace dividend.

Cold War flashpoints in Korea, the Suez Canal, Cuba, and Vietnam repeated the pattern in miniature: abrupt drawdowns, then rapid reversion to the mean once investors judged that nuclear escalation was off the table. The deeper lesson was that local shooting wars rarely derail a broadly expanding economy unless they throttle critical commodities. The Arab-Israeli conflict of October 1973 did just that. The oil embargo that followed caused crude prices to spike by over 300% by early 1974, sparking double-digit inflation and triggering a bear market in the S&P 500 that took almost six years to recover from in real terms. Here, geopolitics mattered because it rewired the macroeconomic environment: higher energy costs bled into wages and necessitated a forceful monetary policy response, while valuations, already stretched by the Nifty Fifty boom in years prior, provided no cushion.

Two decades later Saddam Hussein's invasion of Kuwait again spooked investors, but the parallel ends there. Between August 1990 and January 1991, the S&P 500 sagged roughly 15% as oil spiked, but the moment Operation Desert Storm began and crude collapsed 33% in a single session, equities surged and never looked back. Markets had priced catastrophe, so limited war and rapid success delivered a relief rally. Crucially, disinflationary credibility built in the Volcker and early Greenspan years gave policymakers room to ignore a temporary oil shock.

September 11 ranks beside Pearl Harbor in terms of collective psychological trauma, but, yet again, the investment consequences were relatively short-lived. When markets reopened after four days, the S&P 500 dropped nearly 12% in the first week, but then surged by more than 21% over the ten weeks that followed, even as U.S. troops entered Afghanistan. While the market went on to struggle in 2002 and 2003, market movements were driven by the aftereffects of the popping of the tech bubble, not the drums of war.

Fast forward to February 2022, when Russia's invasion of Ukraine rocked energy, grain, and metals supply lines far more integral to a globalized world than in 1973. Moscow's main stock index collapsed almost 9% in the first week post-invasion, other global equity markets slumped, and Brent crude flirted briefly with $130/barrel. Yet by midsummer the S&P 500 had recovered, reflecting both the West's energy diversification and the market's conviction that recession risk – while real – would be managed by central banks around the world.

Examining a database of 32 major geopolitical shocks compiled by Deutsche Bank shows the median drawdown in the S&P 500 is roughly 6%, the median time to trough is about three weeks, and the median time to full recovery another three. Only eight events since 1939 – Hitler's annexation of Czechoslovakia in 1939 and march into France in 1940, Pearl Harbor in 1941, North Korea's invasion of South Korea in 1950, the 1973 oil embargo, the Iranian Revolution of 1979, the 1990 Gulf crisis, and 9/11 – produced peak-to-trough losses greater than 10% in the aftermath. Of those, the 1973 oil embargo was the only geopolitical event that did not see the market recover within 12 months.

What explains this resilience? Three structural features stand out. First, diversified public markets monetize war spending even as they suffer demand shocks; defense contractors, energy producers, and cybersecurity firms often see earnings upgrades. Second, the U.S. dollar and U.S. Treasuries remain the pre-eminent safe havens, so global capital flows cushion Wall Street even when hostilities erupt far from home. Third, modern monetary frameworks allow policymakers to separate supply-shock inflation from underlying demand – with policy makers raising rates to protect credibility when necessary, but also deploying liquidity facilities to stave off funding panics when needed.

None of that means investors can ignore conflict. Commodity supply disruptions still propagate through headline inflation and inflation expectations, lifting real rates and potentially compressing equity multiples. Credit spreads traditionally widen into the uncertainty gap, punishing capital intensive or highly levered sectors until visibility improves. Emerging market currencies tied to commodity imports often bear the brunt of the pain, while producers with flexible fiscal policy can rally. Gold's status as a safe haven during turbulent times remains reliable, as seen this year with gold up more than 25% through June.

For portfolio construction, the historical record argues for humility, liquidity, and optionality rather than market timing heroics. Above all, the investor who stays invested in a well-diversified portfolio has been rewarded for the courage – sometimes within months, and nearly always within a handful of years.

Geopolitical risk is permanent. But so is the upward trajectory of global enterprise. The market does not trivialize war. It simply recognizes, sooner than most of us, that war's economic footprint usually proves smaller than the ingenuity of civilians who keep inventing, trading, and rebuilding while the bombs fly. The paradox of markets and militaries is that capital ultimately bets on peace – and history shows that bet has paid off, even when the news looked darkest.

U.S. Equity

A volatile first half for U.S. stocks, driven by headlines both at home and abroad, ended on a bright note, with the S&P 500 hitting the first all-time new high since February on the final day of the quarter. The S&P 500, the bellwether for US stock returns, finished the second quarter up 10.9%, pushing the index's year-to-date gain to 6.2%. Small-cap stocks rallied in the second quarter as well, up 8.5%, but still remain in the red on the year, down 1.8 YTD. All nine Russell and S&P style boxes finished the quarter in the green. U.S. equity performance varied widely by style, however, with large cap growth stocks regaining their leadership position, finishing the quarter with a strong rally. The Russell 1000 Growth Index finished Q2 up 17.8%, significantly outpacing the 3.0% return of the Russell 1000 Value Index. Value still leads year-to-date however up 7.6% compared to the 6.1% gain for the growth index. Performance also varied widely across sectors and industries. Nine of the eleven sectors in the S&P 500 were up during the quarter, but the concentration of technology and communications stocks in the index left the overall index return well ahead of the return of all but four sectors. Information Technology and Communications stocks were the biggest winners in Q2, with the Communications sector up 18.2% on the quarter and the Technology sector up 23.5%. The Industrials sector is the leader year-to-date however, up 12.0% through June. Energy and Health Care were in the red both in Q2 and year-to-date, but despite strong performance in Q2, Consumer Discretionary remains the worst performer year-to-date, down 4.2%.

International Equity

International stock markets continued to demonstrate the value of diversification in Q2 2025, with international stocks outperforming their U.S. counterparts by the largest margin since 2002 year-to-date. The MSCI EAFE Index, which tracks developed international markets, finished the quarter up 11.8% and is now up 19.4% YTD. Growth also outperformed internationally, with the MSCI EAFE Growth Index up 13.5% for Q2 compared to the MSCI EAFE Value's 10.1% return, but value continues to lead year-to-date, up 22.8% versus 16.0% for growth. Emerging markets were also positive on the quarter, with stocks in developing countries up 12.0% in Q2 and 15.2% for the first half of the year. **Summing up the global stock market in Q2, the MSCI All Country World Index, which tracks the global stock market, was up 11.5% and is now up 10.0% on the year.**

Fixed Income

The fixed-income market has also posted a strong first half amidst volatility. The Bloomberg U.S. Aggregate Bond Index, a broad measure of the performance of investment-grade fixed-income markets in the U.S., was up 1.2% for Q2 and is now up 4.0% YTD. Investment-grade credit, as measured by the Bloomberg U.S. Credit Index, was up 1.8% on the quarter and 4.2% on the year. Riskier areas of the fixed income market recovered strongly in Q2, with the Bloomberg U.S. Corporate High Yield Index up 3.5% on the quarter and 4.6% YTD. International bonds provided even stronger returns on the back of a weaker U.S. dollar; the Bloomberg Global Aggregate Bond ex-USD Index rose 7.3% on the quarter and is now up 10.0% on the year. Municipal bonds continued to lag, with the Bloomberg Municipal Index dipping -0.1%, now down -0.3% on the year. **Summing up global fixed income markets in Q2, the Bloomberg Global Aggregate Index was up 4.5% for the quarter and is now up 7.3% for the year through June.**

The Economy

As the calendar turns to the back half of the year, the American economy feels like a runner who has kept a sustainable but unspectacular pace through the first half of a marathon. Growth is positive, yet undeniably slower than during the post-pandemic sprint. Inflation is retreating, but it still lingers above the comfort zone, and policy makers are deliberately, almost stubbornly, waiting to see whether the next incline is gentle or steep before they adjust their stride. The six months ahead will tell us whether the runner coasts through the final miles or stumbles into the finish.

Real output has decelerated toward roughly a one-percent annualized rate, a level that neither imperils employment nor suggests that a recession is just over the horizon. Part of the slowdown is mechanical: consumers spent freely when pandemic restrictions lifted, but a slowdown is an inevitable part of economic cycles. Part is also structural: the tariff framework, despite a pause on full implementation through September, remains very much in place, even after the rollbacks. The extra paperwork and price friction are now baked into supply chains, trimming growth in steady, though still small, increments.

Offsetting that drag is a potential reacceleration of fiscal policy support. Despite initial calls for fiscal restraint, the "big beautiful bill" looks to keep federal disbursements high, especially in transportation, utilities and defense. Those dollars support payrolls and order books even as private demand cools. Monetary policy pulls in the opposite direction. With core inflation still above target, the Federal Reserve has held the policy rate in a restrictive range. Officials continue to signal that they need "greater confidence" before cutting. In practice that means they want more months of disinflationary data and a clearer view of wage dynamics and the impact of tariffs. The futures market, which has bounced around for much of 2025, now expects two quarter-point reductions by December.

Taken together, these forces create what Wall Street strategists have labeled "muggy growth." Nothing about the outlook points toward imminent contraction. Household balance sheets remain healthy. Mortgage delinquencies are low. Corporate cash ratios, while gently easing, still exceed pre-COVID norms. Yet neither does anything point toward an acceleration. The fiscal thrust is temporary, the monetary brake is persistent, and the trade backdrop caps upside surprises. The most likely path is a narrow lane of positive but sub-trend real GDP through year-end. Taken as a whole, the economic data points to an environment of still positive growth, but it's not an environment to get too excited about either.

Market Outlook

In the United States, a handful of giants now account for a share of the S&P 500 few imagined a decade ago. They earned the privilege through innovation, data dominance, and economies of scale only possible in the digital age. Yet when everyone piles into the same lifeboat, a pinprick threatens to soak them all. Valuations have returned to pre-Liberation Day levels, and currently sit above historical averages by a margin that works only if both growth and policy cooperate to deliver a Goldilocks scenario with the economy running neither too hot nor too cold. As recent years have taught us, that outcome cannot be ruled out. In the current environment, reasonable portfolio exposure to the Magnificent 7 is not only prudent, it's almost a requirement. But after lying dormant for what seems like ages, the benefits of diversification have begun to emerge from slumber this year.

Outside America, an entirely different market picture has emerged. Europe, Japan, and select emerging economies trade at discounts to both their own history and to the lofty levels found in the United States. That is not a promise they will continue to explode higher, but it does provide a hint that even small shifts in sentiment can reward investors willing to look beyond the friendly confines of the home field. Japanese reforms aimed at improving shareholder friendliness, a weak yen that flatters exporters, and a market chronically under-owned by foreigners combine to make Tokyo feel like a spring coiled by neglect. European financials and industrials, long considered plodding, have quietly improved capital discipline, and geopolitical developments have sparked a nascent revival in defense spending plans in Europe after decades of harvesting the post-Cold War peace dividend. India's demographic vibrancy and Brazil's reform agenda offer growth stories in emerging markets partly sheltered from China's ongoing economic slowdown. Diversification is looking more and more like a winning ticket in the near-term.

Themes for stock pickers also look ripe for the picking in this environment. Quality cyclicals – industrials and utilities tied to infrastructure spending and semiconductors selling picks and shovels for the AI gold rush – bridge defensive characteristics and growth. Banks with fortress balance sheets should benefit from a steepening yield curve that reflects healthier credit creation. Those banks may endure margin pressure in deposit franchises, but they walk into each earnings season armed with buyback programs that act as safety nets and the tailwind of regulatory reform at their back. The AI surge, meanwhile, favors the companies supplying the power, cooling, and manufacturing capacity long before end users decide whether the newest chatbot is worth the subscription fee. The more boring the supplier's narrative, the more likely its returns capture the value many overlook. Fruitful opportunities are there for the taking for those willing to look.

For a decade after the Great Financial Crisis, fixed income investing felt like being a kid looking to sneak some sweets from the dessert tray only to find that broccoli and Brussels sprouts were the only thing on offer. Today, ten-year Treasuries yield north of 4%, high-grade corporates 5.5%, and seasoned municipal bonds north of 6% on a tax-equivalent basis – a spread that hasn't greeted long-term savers since before Bitcoin existed. A simple truth governs bond math: starting yield offers a fair estimate of five-year returns when default risk is muted. That puts the hurdle for equities in a diversified portfolio closer to 7-8% rather than to the 10-12% average often engraved on financial planning brochures. If you can buy an income stream that meets half your goal with half the volatility, the rest of the portfolio no longer needs to swing for the fences.

The yield curve's shape, still slightly inverted in the front end at the end of June, tells another story. Investors expect the Fed to cut, but not soon. If policymakers merely whisper that restrictive policy has done enough, the inversion can flip in weeks. A gently positive curve significantly revives bank profitability and signals healthier transmission of credit. Portfolio managers can express the view through simple bond ladders or by holding positions that gain when long yields rise relative to short ones. Either approach values optionality; it keeps reinvestment flexibility rather than gambling on a precise timetable for rate cuts.

Credit spreads paint their own picture. Investment grade bonds sit a touch above a percentage point over Treasuries – no headline thrill, yet a respectable cushion against shocks. Historical odds favor such exposure when starting yields stand above the mid-fives, as they do today. High yield bonds, paying spreads in the mid-threes, tempt investors with larger coupons but also carry the seeds of default risk if the optimistic scenario wobbles. During late cycles, quality tends to matter more than yield. Many lower-rated companies are refinancing debt issued during the COVID lows at higher coupons, setting a clock that ticks more loudly should revenue falter. In the current environment, exposure to riskier debt is much like chili pepper – the appropriate amount should be enough spice to flavor the chili, but not so much that it burns on the way down.

History rarely repeats syllable for syllable, but it does share rhythm. And history provides plenty of late-cycle examples to keep in mind over the weeks and months ahead. In 1998, Russia defaulted, and a famous hedge fund imploded. The "Committee To Save The World" convened, the Fed cut rates, markets snapped back, and for a moment everyone believed the worst was behind them. Two years later, technology stocks cracked. The rescue had been the last hurrah. In 2013, the taper tantrum rattled bonds, yet by the following year both stocks and Treasuries had regained more than they lost. In 2016 and 2017, a strong U.S. dollar looked unstoppable until it simply stopped; depreciation followed because expectations overshot reality. Today's consensus for a weaker dollar may meander in similar fashion – slow, frustrating, but ultimately fruitful for those who wait patiently. Each of these episodes, however, ultimately teaches the same lesson: the path to long-term investment success is a plan and diversified portfolio tailored to your unique financial situation that you stick to over time.

The Path Forward

So, what does this all mean for portfolios in the months ahead? It means holding companies with durable cash flows and solid balance sheets. It means diversifying into international markets not because you have perfect foresight, but because humility demands recognizing you do not. It means embracing bonds again, especially when a blend of Treasuries, high-grade corporates, and carefully chosen securitized slices delivers income thought to be extinct just a few short years ago. Cash earns enough now to justify its weight as a reserve fund. In short, it means a portfolio designed so you do not panic when lightning strikes, because panic is the costliest position of all.

The emotional fabric of markets often unfolds through stories, not spreadsheets. Narratives guide us more than we admit. The prevailing narrative for the second half of 2025 whispers a cautious optimism, but uncertainty continues to abound. It is neither a drumbeat of doom nor a trumpet of triumph. It is a hum that says, "Steady as she goes, but tighten your grip when the wind shifts." Investors who mistake steady for stagnant risk selling quality just before it compounds. Those who confuse a shift in narrative for a guarantee of disaster might sit in cash long after Treasury bills roll down the yield curve.

Humility, then, becomes its own asset class. Wayne Gretzky once advised skating to where the puck is going, not where it has been. The trick is he never claimed to know the exact destination – only that movement beats stillness when the game is fast. The economic puck for the coming six months will not stay where it started in July. It might slide gently toward a soft landing, veer toward reacceleration on the promises of AI, or ricochet off policy error into something harder. Skating to open ice – owning quality, balancing domestic and foreign equities, embracing bonds that finally compensate savers, and carrying a responsible cash reserve – prepares investors for whichever bounce materializes.

The wise course is leaving room for surprise, because surprise, pleasant or painful, is the truest constant in markets. Fortune favors portfolios prepared for a multitude of possible outcomes. In an era when muggy weather passes for stability and small breezes feel portentous, readiness is not paranoia. It is prudence.

So we carry on through summer into autumn, mindful that growth may stay sticky, inflation may annoy rather than terrify, and policy makers may linger on the sidelines longer than fans prefer. We remember that quality ages well, concentration courts fragility, and income has returned as a respectable dinner guest. We remind ourselves that the best position is seldom the most dramatic. It is the one that lets an investor sleep while others debate the latest whisper from Washington or the next headline about tariffs. The economy might not sprint, but money growing slowly is still growing. Patience, amplified by humility, becomes the compound interest of temperament. And temperament, not timing, will decide whose portfolios claim the final run when the season ends.

We'll continue to share updates as the news continues to inevitably shift. In the meantime, if you're feeling anxious or just want to talk through what's going on – we're here. Always.

ABOUT THE AUTHOR

Matthew T. Brennan, CFA®

Chief Investment Strategist & Director of Institutional Investments

Matthew is the Chief Investment Strategist and Director of Institutional Investments for Fulton Private Bank and Fulton Financial Advisors. He was a National Merit Scholar at the University of Chicago, where he graduated with a B.A. in Political Science. He is a Chartered Financial Analyst (CFA®) charterholder and is a member of the CFA® Institute and the CFA® Society of Philadelphia.

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