INVESTMENT OUTLOOK

A PEAPACK PRIVATE PUBLICATION

SECOND QUARTER 2025: CONCLAVE!

We all have the duty to do good.
-Pope Francis

The imposition and subsequent deferral of tariffs by the US was the most globally significant event for the economy and financial markets in the second quarter.

The second quarter featured another globally significant event, the election of a new pope following the death of Pope Francis. The process by which cardinals gather and choose a pope to lead the Catholic Church—and its 1.1 billion followers—is known as a conclave. (Conclave derives from the Latin, 'with key,' referring to being locked in isolation.)

The papal conclave is traditionally held in the Sistine Chapel within Vatican City. It typically begins within 15 to 20 days after the death of the previous pope. This timeframe allows for a period of mourning, the pope's funeral, and the gathering of cardinals from around the world.

The cardinals engage in a number of rounds of votes. After each round, the ballots are burned and smoke billows from the chimney of the Sistine Chapel. Black smoke indicates that no one received the requisite two-thirds majority to be named pope. The successful election of a new pope is signaled to the world with puffs of white smoke (*fumata bianca*).

In the US, we hold a conclave every four years to elect a president. The conclave doesn't require the death of the seated president, and we're not locked away. But we debate vigorously, and our ballots are cast in secret.

When our secret ballots were tabulated last November, we elected Donald J. Trump to the office of the president. Once inaugurated, President Donald Trump held a conclave with his economic and trade advisors, the outcome of which was the re-ordering of the world trade system as outlined in the 'Liberation Day' announcements.

HOLY SMOKES! MARKETS RALLY

To accomplish great things we must not only act, but dream; not only plan, but believe.
-Anatole France

I think there will be more smiles when the smoke clears.
-Shaun Alexander

In the second quarter, investors looked past disruption and dreamed of a brighter future; they set aside misgivings over announced policies and instead put their belief in policymakers.

The period was a turbulent one for financial markets. Equity, bond and currency markets cratered in April in response to US tariff declarations, but rebounded strongly as those tariffs were largely put on ice. It was a confusing period in which trade positions were revised frequently, sometimes daily. That said, when the smoke cleared it was apparent that asset prices had rallied smartly.

Asset Class	Index	2nd Quarter Returns	Year to Date Returns
US Large Cap Stocks	S&P 500 Total Return	10.9%	6.2%
US Large Cap Stocks	S&P 500 Equal Weighted	5.5%	4.8%
US Large Cap Stocks	NASDAQ Composite	17.9%	8.3%
US Small-Mid Cap Stocks	Russell 2500	8.6%	0.4%
International Developed Markets Stocks	MSCI EAFE	11.8%	19.5%
Emerging Markets Stocks	MSCI EM	12.0%	15.3%
Real Estate Securities	MSCI US REIT	-1.1%	-0.1%
Commodities	Bloomberg Commodities Futures	-3.1%	5.5%
Bonds	Bloomberg Barclays US Aggregate	1.2%	4.0%
Cash	FTSE USBIG 1-Month Treasury Bill	1.1%	2.2%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

Market gains were once again led by international stocks, up double digits. Developed markets are benefiting from loosening monetary policy and the prospect of looser fiscal policy, with European nations poised to dramatically increase defense spending. US equities also rallied strongly, on a partial diminution of tariff uncertainty and robust first quarter corporate earnings reports. Real estate securities failed to advance, in the face of relatively elevated interest rates, and commodities were weighed down by weak oil prices—a function of higher OPEC+ output quotas and weak demand. Returns on bonds and cash were healthy.

CONCLAVE AT THE FED

Our work is to enlarge the tent.
-Pope Leo XIV

The Federal Open Market Committee (FOMC) holds a conclave every six weeks, where it reviews policy to drive economic growth—to enlarge the tent. Its chief tool to accomplish this goal is the setting of interest rate policy. At the end of each meeting, instead of blowing smoke, the FOMC issues a statement, and the Chair holds a press conference. At its most recent meeting in June, the FOMC once again maintained its orthodox position of holding interest rates steady.

Every three months, at the conclusion of the conclave, the FOMC updates its Summary of Economic Projections, and in the June revision the FOMC reduced growth expectations and raised inflation projections.

Summary of Economic Projections

	MEDIAN[1] (PERCENT)				CENTRAL TENDENCY[2] (PERCENT)				RANGE[3] (PERCENT)			
VARIABLE	2025	2026	2027	Longer run	2025	2026	2027	Longer run	2025	2026	2027	Longer run
CHANGE IN REAL GDP	1.4	1.6	1.8	1.8	1.2–1.5	1.5–1.8	1.7–2.0	1.7–2.0	1.1–2.1	0.6–2.5	0.6–2.5	1.5–2.5
March Projection	1.7	1.8	1.8	1.8	1.5–1.9	1.6–1.9	1.6–2.0	1.7–2.0	1.0–2.4	0.6–2.5	0.6–2.5	1.5–2.5
UNEMPLOYMENT RATE	4.5	4.5	4.4	4.2	4.4–4.5	4.3–4.6	4.2–4.6	4.0–4.3	4.3–4.6	4.3–4.7	4.0–4.7	3.5–4.5
March Projection	4.4	4.3	4.3	4.2	4.3–4.4	4.2–4.5	4.1–4.4	3.9–4.3	4.1–4.6	4.1–4.7	3.9–4.7	3.5–4.5
PCE INFLATION	3.0	2.4	2.1	2.0	2.8–3.2	2.3–2.6	2.0–2.2	2.0	2.5–3.3	2.1–3.1	2.0–2.8	2.0
March Projection	2.7	2.2	2.0	2.0	2.6–2.9	2.1–2.3	2.0–2.1	2.0	2.5–3.4	2.0–3.1	1.9–2.8	2.0
CORE PCE INFLATION[4]	3.1	2.4	2.1	–	2.9–3.4	2.3–2.7	2.0–2.2	–	2.5–3.5	2.1–3.2	2.0–2.9	–
March Projection	2.8	2.2	2.0	–	2.7–3.0	2.1–2.4	2.0–2.1	–	2.5–3.5	2.1–3.2	2.0–2.9	–
MEMO: PROJECTED APPROPRIATE POLICY PATH												
FEDERAL FUNDS RATE	3.9	3.6	3.4	3.0	3.9–4.4	3.1–3.9	2.9–3.6	2.6–3.6	3.6–4.4	2.6–4.1	2.6–3.9	2.5–3.9
March Projection	3.9	3.4	3.1	3.0	3.9–4.4	3.1–3.9	2.9–3.6	2.6–3.6	3.6–4.4	2.9–4.1	2.6–3.9	2.5–3.9

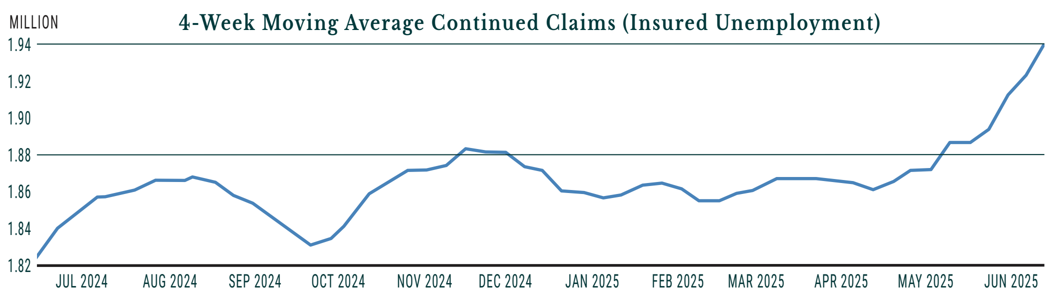
(1) For each period, the median is the middle projection when the projections are arranged from lowest to highest. When the number of projections is even, the median is the average of the two middle projections. (2) The central tendency excludes the three highest and three lowest projections for each variable in each year. (3) The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year. (4) Longer-run projections for core PCE inflation are not collected.

SOURCE: THE FEDERAL OPEN MARKET COMMITTEE (FOMC)

Like the rest of us, the FOMC is in wait-and-see mode, uncertain as to the potential inflationary and growth impacts of higher tariffs. The prospective effects of the just-passed One Big Beautiful Bill Act are also adding to economic uncertainty.

The Fed has two mandates: full employment and price stability. On the employment front, the Fed appears to be on target. Unemployment has held steady at just over 4%, a historically low level, and new job creation has kept pace with population growth. But there are signs that labor market conditions are softening.

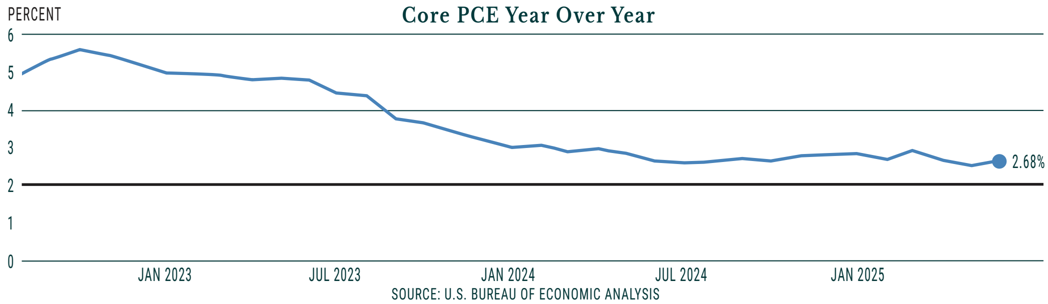
4-Week Moving Average Continued Claims (Insured Unemployment)



SOURCE: U.S. EMPLOYMENT AND TRAINING ADMINISTRATION

As the chart above shows, the number of Americans receiving continuing unemployment benefits has been rising recently, indicating that it is becoming more difficult for labor market participants to get re-employed. In addition, weekly new unemployment claims have been creeping higher, the number of unfilled jobs has been gradually declining, and the hiring rate is sluggish.

On the price stability front, the FOMC's preferred inflation gauge, the core Personal Consumption Expenditures price index, is up 2.7% over the past year.



Although this is a substantial reduction from peak inflation levels in 2022, it remains some distance from the FOMC's 2.0% target. The prospect of additional potential inflation from tariffs stymies the FOMC from lowering interest rates, as it might do otherwise to guard against further softening in the labor market.

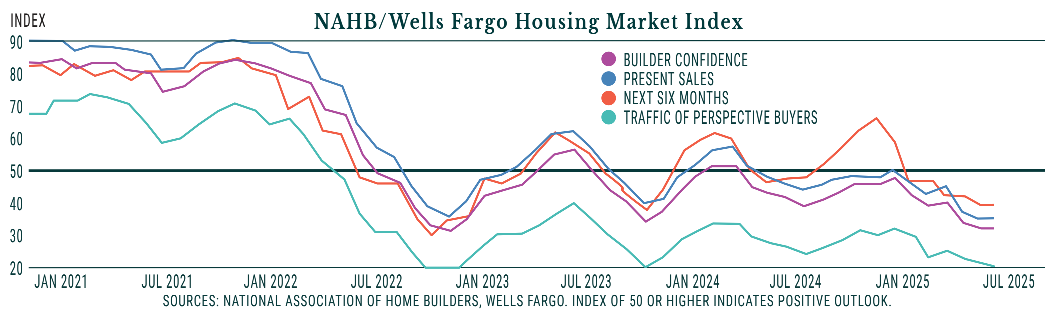
POWELL: STICKING TO OUR MISSION

Do not allow others to rob you of the ideal of a true mission.

-Pope Francis

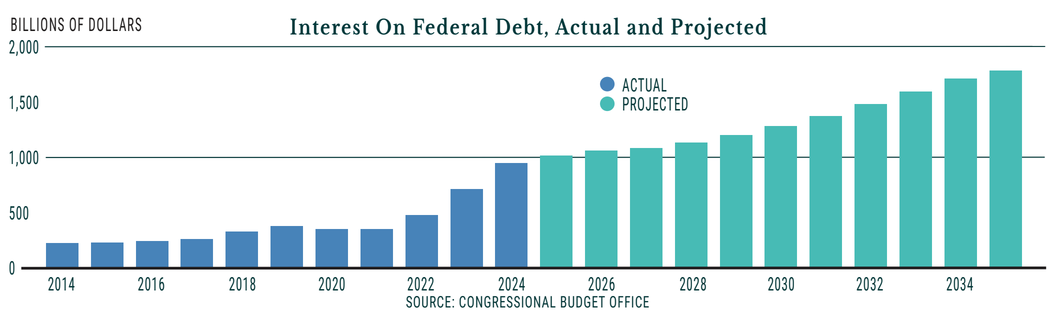
With some regularity, Fed Chair Jerome Powell repeats for a variety of audiences the Fed's mandates, as laid out by the legislation that established the Federal Reserve Bank. He has clearly felt obliged to reiterate the Bank's purpose and goals in the face of ancillary damage resulting from the FOMC's monetary policy stance.

One victim of Fed interest rate policy has been the housing market, where the combination of relatively high mortgage rates and high home prices has kept turnover moribund. Homebuilders report sluggish new home sales, and housing permits and starts have been at depressed levels for over two years.



As the chart above indicates, home builders foresee gloomy prospects for the single-family home market. The NAHB/Wells Fargo Housing Market Index is at its lowest level in 2 ½ years.

The other obvious victim of Fed interest rate policy is the US government as it continually issues more debt to fund its deficit spending. Interest on the federal debt, as a percentage of all federal spending, has risen to 14%, and is projected to exceed $1 trillion next year.



Trillion-dollar-plus deficits as far as the eye can see, added to the $36 trillion of existing outstanding US government debt, suggests that ever higher percentages of government spending will be absorbed by interest on Treasury obligations. In this context, President Trump's pleas for lower interest rates are more than understandable.

But a robust housing market and low government borrowing costs are not part of the Fed's mandate, and Chair Jay Powell's resistance to calls from the Administration to lower rates is not surprising. Further tempering of the inflation impulse and indications of weakness in the labor market will be necessary to drive FOMC monetary policy looser in the months ahead.

ON PAPAL INFALLIBILITY AND INVESTOR COMPLACENCY

We are wonderful creatures, but we are limited, with qualities and flaws.
-Pope Francis

Papal infallibility, in Roman Catholic dogma, describes the belief that when a pope speaks definitively as the supreme pastor and teacher on matters of faith and morals, he is protected from the possibility of error.

Financial markets participants at times also exhibit a dogmatic faith in the infallibility of markets. According to the efficient markets hypothesis (EMH), securities prices are always appropriate because they reflect all important determining information. In other words, individual securities—and, implicitly, the market as a whole—are always fairly priced, and not over- or under-valued.

Investors who don't worship the EMH (Warren Buffett once quipped, "I'd be a bum on the street with a tin cup if the markets were always efficient.") look askance at today's equity and fixed income markets, seeing full (not to say rich) valuations that reflect a perhaps surprisingly sanguine view.

Commodities Returns

		12-MONTH CHANGE
Gold Price (oz)	$3,369	+45.5%
Silver Price (oz)	$36.74	+24.5%
Copper Price (lb)	$4.85	+7.8%
WTI Oil Price (bbl)	$74.62	-8.2%
Bitcoin Price	$104,933	+60.1%

SOURCE: BLOOMBERG

Equity and Fixed Income Measures

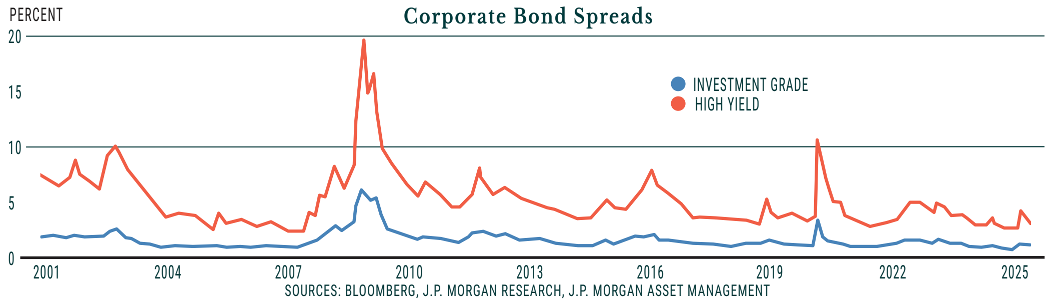
CAPE Ratio	36.5	Very High U.S. Market Valuation
Market/GDP	199%	Very High U.S. Market Valuation
CAPE ERP	-1.66%	High U.S. Market Valuation
10 Year Yield	4.39%	2.38% Inflation Rate (CPI)
10 Year – 3 Month	0.04%	2.31% 10-Year Breakeven

SOURCE: BLOOMBERG

As the graphic above illustrates, asset prices have risen substantially (over the past year, among commodities gold has appreciated over 45% and among cryptocurrencies bitcoin has appreciated over 60%). Various equity market valuation metrics all tell the same story: stocks trade at historically high levels. The S&P 500's forward price/earnings ratio is north of 21 times, versus its 30-year average of 17 times. Equity investors today are an optimistic lot.

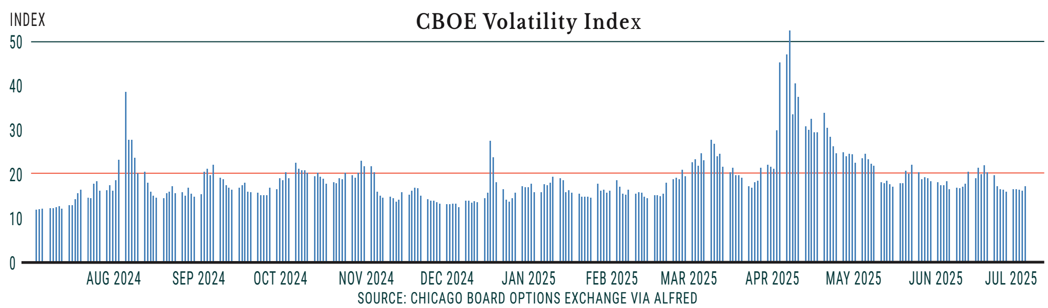
It is no different in the bond market. Despite lingering inflation and large US deficits, interest rates have declined this year. The 2-year US Treasury has fallen 50 basis points (0.5%) to 3.74% and the 10-year US Treasury has fallen 29 basis points (0.29%) to 4.28%. Bond investors manifest little concern about the potential inflationary effects of tariffs or of the fiscal stimulus effects of the OBBB Act.

Bond investors exhibit a similar what-me-worry attitude regarding the outlook for economic slowdown or recession. Spreads in the bond market—the extra yield corporate bond issuers have to pay above the 'risk free' US government borrowing rate—widened out significantly following Liberation Day announcements, and have returned swiftly to historically tight levels.



As the chart above illustrates, spreads on investment grade are currently 88 basis points (0.88%) versus the 25-year average of 148 basis points. For high yield (formerly junk) bonds, spreads are currently 315 basis points (3.15%) versus the 25-year average of 510 basis points. Such tight spreads indicate that investors perceive limited default risk and therefore do not demand meaningful additional compensation for risk assets.

In short, across asset classes, investors are exhibiting remarkable complacency—especially in the face of geopolitical conflicts, tariff uncertainty, elevated deficits, and fraying supply chains. This complacency is evident not only in valuations, but also in a variety of data points. Among them: the CBOE volatility index, or VIX. The VIX expresses the market's expectations for the relative strength of near-term price changes of the S&P 500 Index. Also known as the Fear Index, the VIX generally falls when stocks rise. VIX readings below 20 generally correspond to stable, stress-free periods in the markets.



The VIX has been below 20 since mid-May, and has fallen below its 200-day moving average—an indication that investors are sleeping well at night.

MARKETS: THE UN-CONCLAVE!

Without fear, united in hand with God and each other—let us go forward.
-Pope Leo XIV

If a conclave is generally any private or secret meeting, often involving a gathering of people with authority or influence, then financial markets are anything but. Buyers and sellers cast their 'ballots'—what they're willing to bid or ask for a given security—not in secret but in full transparency on open exchanges.

Attempts to find parallels between the Catholic Church's papal election process and financial markets may seem strained—how great the distance between these spiritual and secular realms! After all, markets are not divinely inspired. However, they do demand articles of faith, if you will.

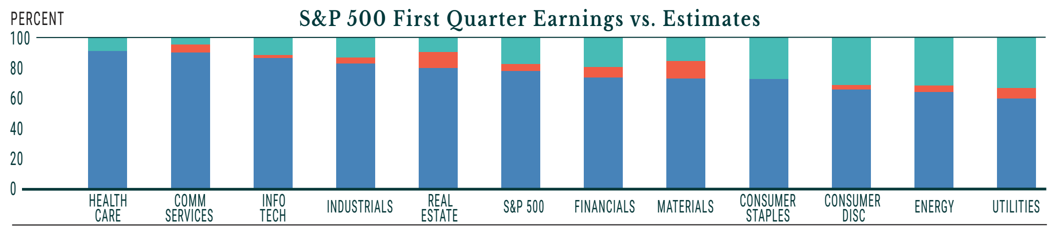
Among investors' articles of faith: Perceptions of future inflation drive bond yields. Estimates of future corporate profits are the ultimate driver of stock prices. Reversion to the mean is a powerful force, even if it's not a great timing tool.

As noted, markets reacted strongly, even violently, to the Administration's initial reciprocal tariff announcements, and bounced back smartly when a reprieve was granted. As we moved from Liberation Day to so-called TACO (Trump Always Chickens Out) Tuesday—midnight July 8th, when the 90-day tariff reprieve was slated to end—we anticipated some 'deals' (agreements in principle, or frameworks), some further extensions, and some reimpositions of previously announced tariff levels. And that's what we got.

At this time of considerable uncertainty—fiscal, monetary, geopolitical—US equities are once again at all time highs, with cyclical and growth stocks out-performing defensive and value stocks. What is supporting lofty equity valuations?

In the first quarter, with US equities under-performing and the world trade order on reset, a lot of ink was spilled decrying the possible end of American exceptionalism. But perhaps reports of its death were greatly exaggerated. (After all, the papal conclave ended with the announcement of the first-ever US-born pope!)

S&P 500 First Quarter Earnings vs. Estimates



	HEALTH CARE	COMM SERVICES	INFO TECH	INDUSTRIALS	REAL ESTATE	S&P 500	FINANCIALS	MATERIALS	CONSUMER STAPLES	CONSUMER DISC	ENERGY	UTILITIES
BELOW	9%	5%	12%	13%	10%	18%	19%	15%	28%	32%	32%	33%
IN-LINE	0%	5%	2%	4%	10%	4%	7%	12%	0%	2%	5%	7%
ABOVE	91%	90%	86%	83%	80%	78%	74%	73%	72%	66%	63%	60%

SOURCE: FACTSET

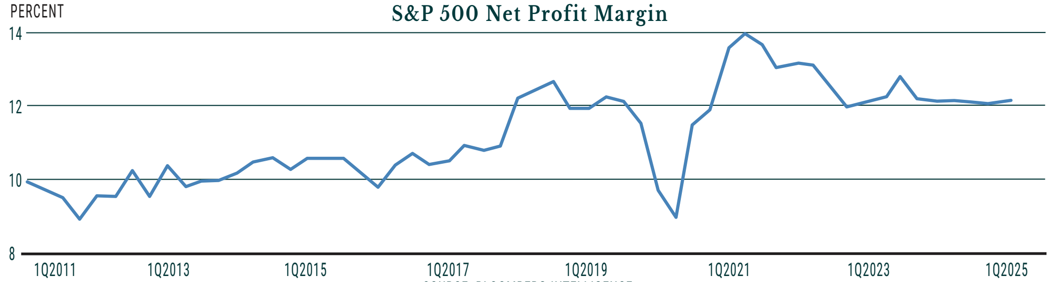
As corporate profit reports for the first quarter rolled in, they were surprisingly robust. Earnings for the S&P 500 grew 12.9% in the first quarter, the second consecutive quarter of double-digit growth. An unusually high 78% of companies' actual earnings per share exceeded estimates.

And it was newly evident that the technology juggernaut driving US equity indices is undiminished. For the Magnificent 7 megacap technology companies, first quarter earnings grew 27.7% (estimates were for 16.0% earnings growth); the remaining 493 companies in the index grew earnings by a lesser but still healthy 9.4%.

Also providing support for equities? Record stock buybacks of $293 billion in the first quarter (21% above the prior quarter), another manifestation of the strength of American companies' prodigious cash flows.

That said, a lot of good news is priced into equities at current levels. Earnings growth for the Magnificent 7 are projected to decelerate significantly over the next four quarters, to 10.2%. Profit margins are at risk as businesses may absorb tariff costs; in turn, companies may seek to protect margins with reductions in force. Job losses, in turn, would crimp consumption.

S&P 500 Net Profit Margin



SOURCE: BLOOMBERG INTELLIGENCE

US large cap stocks, notwithstanding lofty valuations, could grind higher, propelled by healthy earnings growth, prospective interest rate cuts, reduced regulatory burdens and tax relief—but elevated uncertainty could limit gains. US small cap stocks, which have lagged US large cap stocks, may be more challenged to maintain profit margins.

The backdrop for international equities, for both developed and emerging markets, continues to be constructive. Both monetary policy and fiscal policy are constructive across numerous countries. Add in notably more modest valuations, and recent out-performance could be sustained.

In fixed income, absolute yields are still comparatively attractive in both the short and intermediate parts of the curve. Moderate duration extension has been constructive, and in an environment when the most likely direction for interest rates is lower, that continues to be a reasonable strategy. Policy uncertainty and a potential economic slowdown argue for a focus on higher-rated debt instruments, as do tight credit spreads on riskier bonds.

For investors overall, a cautionary note. Complacency suggests a lack of humility. Markets may well be, fundamentally, the Un-Conclave, but they do nonetheless have this in common with conclaves: outcomes are mysterious, uncertain, often contrary to what one might expect.

Habemus mercatus. We have a market. The market has yet to cast its ballot on the evolving policy front. It may be many months, perhaps years, before we know how radically altered spending, taxing, regulatory and immigration priorities and programs impact the economy and financial markets. For now, *fumata negra*. No decision. Stay with quality stocks and bonds. And keep the faith.

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