Weekly Market Commentary

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Economy in Uncharted Waters

We believe this more complex macro environment will force the Federal Reserve (Fed) to maintain its cautious stance on monetary policy for longer than markets originally expected. One factor adding to the complexity is the post-pandemic impact on economic and financial models. Another obvious factor is dynamic trade policy. Tailwinds from improved tax policy will help businesses wade through the uncharted waters. In general, the economy should be able to successfully charter through choppiness if the average effective tariff rate stays in the mid- to high-teens.

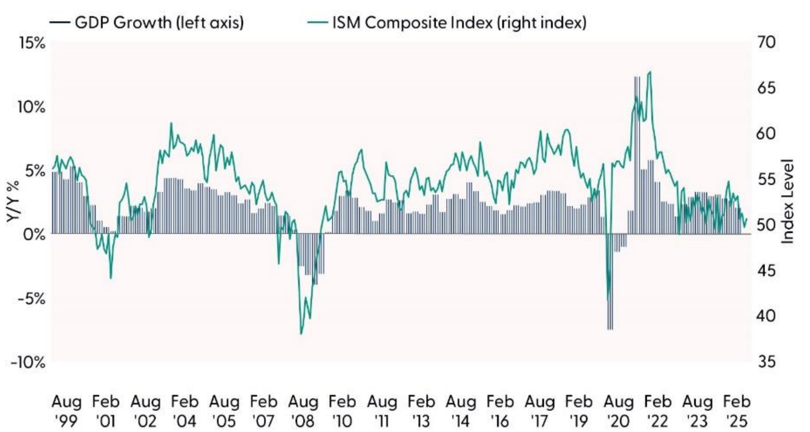
Muddied Outlook Because Pandemic Broke the Models

Last week, investors were reminded of the persistent impact the pandemic had on many macro models. In particular, the Leading Economic Index (LEI), which has historically been the Conference Board's accurate leading indicator of the business cycle, still points to a deep, imminent recession as of last month. Ironically, the LEI is at its lowest since 2015 and has signaled a recession since mid-2022, when businesses were madly raising wages to attract qualified workers and consumers — especially the upper-income — who were wildly spending discretionary dollars on travel, autos, and luxury items.

We highlight the LEI because it illustrates the challenging macro environment that the Fed and investors must navigate. Despite the models still being impacted by unusual fiscal and monetary policy, other metrics provide insight into the trajectory for growth and inflation.

The economy will likely post a solid second quarter after the first quarter was suppressed by a surge in imports from businesses front-running tariff threats. The subsequent rebound in growth might create a perception of a strong recovery, but we think this is likely a head fake. The whiplash in trade policy is adversely impacting official economic data and creating difficulties for investors, as it becomes almost impossible to discern whether the economy is genuinely rebounding or merely experiencing short-term fluctuations. Such distortions highlight the importance of looking beyond government statistics to industry reports from the likes of the Institute for Supply Management (ISM) to form a clearer picture of economic conditions. The ISM Composite Index, which gives insights into business views from across the country in both the goods and services industries, fell in recent months and points to a broader slowdown coupled with reaccelerating inflation.

Purchasing Managers Prepping for a Slowdown



Source: LPL Research, Bureau of Economic Analysis, Institute of Supply Management, 07/28/2025
Disclosures: Past performance is no guarantee of future results. All indexes are unmanaged and can't be invested in directly.

Business leaders' perspectives serve as a vital complement to official government statistics, which often suffer from low response rates and delayed reporting. Listening to these insights helps provide real-time signaling on industry health and emerging risks, which is even more crucial in uncertain economic times.

Fed officials have expressed concern over the difficult tradeoffs involved in navigating the current environment, especially as new tariffs and policy measures could exacerbate inflationary pressures. This echoes the past, when aggressive monetary tightening was implemented to tame inflation, often at the expense of economic growth, illustrating the delicate balancing act policymakers must undergo. And public attacks on the Fed chair for various items, ranging from an over-budget renovation project to high interest rates, further cloud the already muddied waters. For additional context on Fed independence, check out our "Federal Reserve Independence Depends on Your Definition" blog.

Comfortably Numb

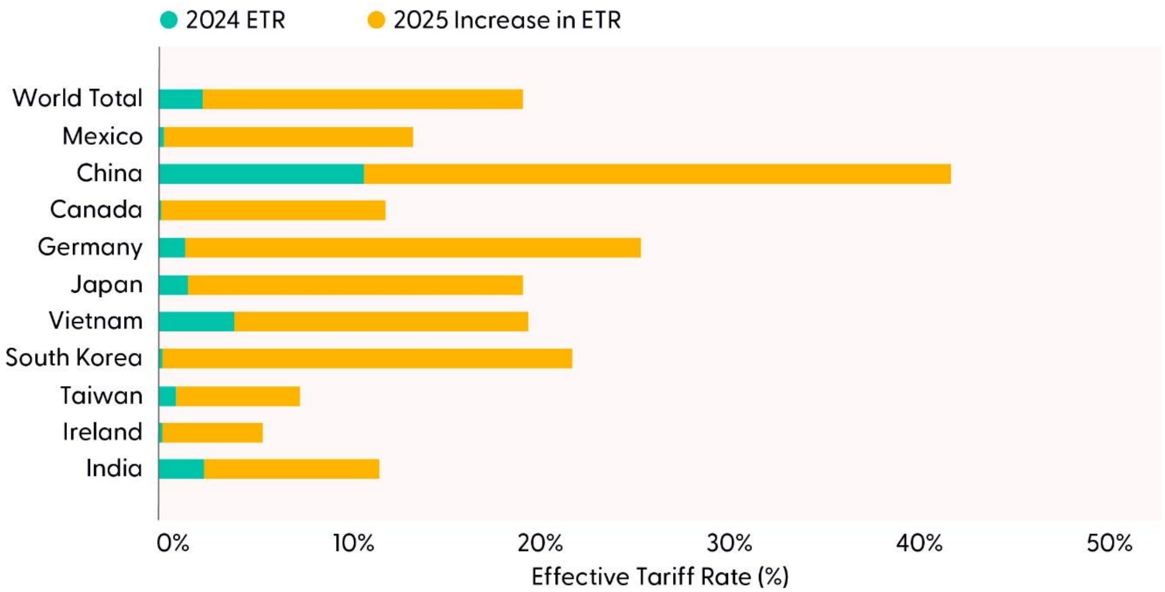
Capital markets appear comfortably numb to the headwinds of the economy, from reaccelerating inflation to high tariff rates, and rising delinquencies. One reason could be the apparent tailwind from tax policy changes within the One Big Beautiful Bill Act (OBBBA).

There is a little bit of everything packed into President Trump's OBBBA. Proponents tout its simplification of the tax code, the removal of uncertainty over the sunsetting Tax Cuts and Jobs Act (TCJA) tax provisions, pro-growth initiatives, an America-first framework, and its focus on protecting our borders and national security. Opponents believe it is too expensive, benefits the wealthy, threatens clean energy initiatives, and leaves too many Americans without healthcare or SNAP benefits. From an investor standpoint, healthcare insurers, especially with high Medicaid populations, the renewable energy space, and even longer-duration Treasuries could face headwinds from the bill, while small caps, defense and border security companies, and capital equipment and R&D intense firms could be outsized beneficiaries.

The bill does bring some certainty to the market regarding tax policy and the debt ceiling (the debt ceiling was raised by $5 trillion as part of the reconciliation bill).

The markets continue to reach new highs despite the uncertainty of trade. It's likely investors are optimistic about where they think the average effective tariff rate will settle. If trade deals emerge with the rest of our top trading partners and businesses can utilize free trade zones and receive generously granted exclusions and exceptions, the economy can achieve a soft landing and skirt a recession.

Economy Could Tolerate Average Tariff Rates Below 20%



Source: LPL Research, Fitch Ratings, Census Bureau 07/28/2025

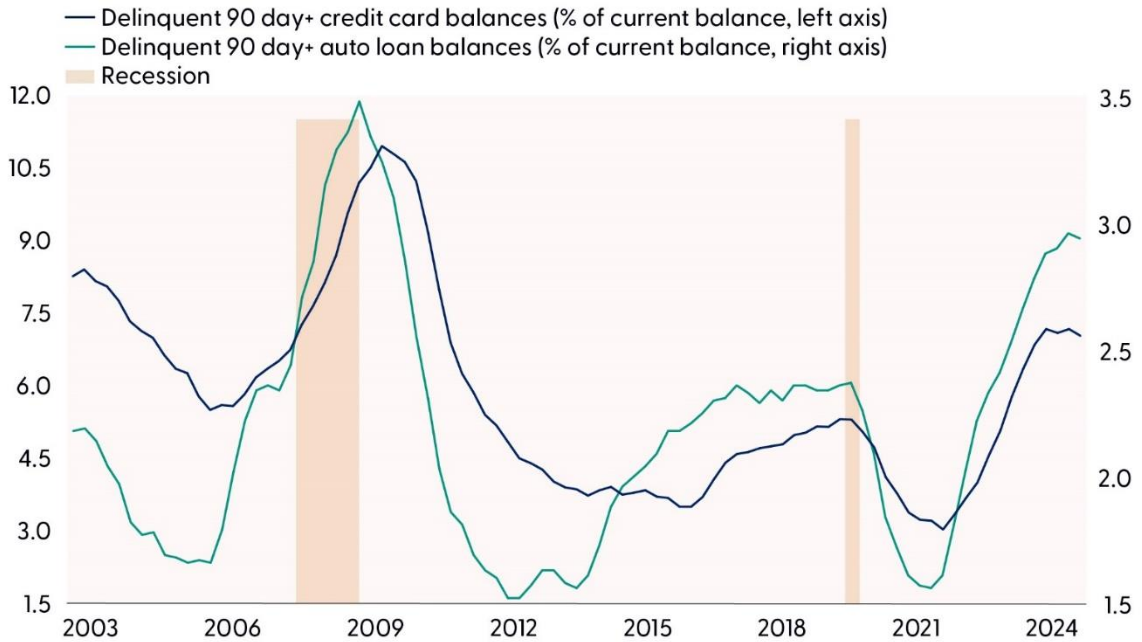
Rising Delinquencies Are Yellow Flags

We do think growth will remain positive this year as businesses realize the benefits from real personal income growth. However, investors should expect margin compression as businesses hold off raising prices because of customers' growing price sensitivity, according to the latest Fed Beige Book. Business leaders in several regions across the country plan to postpone both hiring and layoff decisions until they get clarity about trade policy. Given persistent cost pressures, we should expect an increasing likelihood that consumer prices will start to rise later this summer if businesses are successful in passing along higher input costs.

Overall business activity was up in the last month, but the outlook was slightly more pessimistic. We should be watchful for signs of margin compression at the business level, financial stress via rising delinquency rates, and a sluggish housing market as inventories rise.

As it relates to consumer health, credit card and auto loan delinquencies are elevated relative to previous stressful periods. We think this is worth monitoring and raises a yellow flag amid the optimism of pro-business tax policy, a stable labor market, and seeming U.S. exceptionalism.

Seriously Delinquent (90+ Day) Loans Are A Warning Sign



Source: LPL Research, New York Federal Reserve Bank 07/28/2025

The Call to Action

The future path of growth and inflation is critically important for several reasons. Inflation matters for stock valuations. Inflation's effect on stock valuations remains crucial (higher inflation dampens future earnings value, while historically, low inflation correlates with high stock valuations). The S&P 500 recovery has been remarkable since its April 8 correction low, driven by technology, communication services, and industrials.

While the technical setup continues to improve, fundamental and macro risks remain. A lot of good news is priced into the market; longer duration Treasury yields remain uncomfortably high, and trade policy uncertainty is still elevated despite some notable progress.

The call to action is to look for opportunities amid wider market breadth. We have witnessed a meaningful rotation in market leadership so far in 2025. After a prolonged run, U.S. mega cap tech stocks have taken a breather, creating space for other areas to shine. Notably, European markets — including Germany, the U.K., and France — have delivered strong relative performance, reversing years of underperformance. Emerging markets have also gained traction, with Hong Kong and South Korea posting impressive gains. Non-U.S. small cap stocks have emerged as key beneficiaries of recent U.S. tariff policy as well.

This shift in leadership has been supported in part by continued weakness in the U.S. dollar, which enhances the appeal of non-U.S. assets.

As this broadening continues, small cap equities — particularly in the U.S. — stand to benefit. Their relative undervaluation, domestic focus, and sensitivity to economic growth position them well in an environment where capital is flowing beyond the usual large cap leaders. After a sharp decline in the dollar during the first half of the year, a short-term reversal of the greenback could also put domestic small caps in a more favorable position.

Asset Allocation Insights

LPL's Strategic and Tactical Asset Allocation Committee (STAAC) maintains its tactical neutral stance on equities. LPL Research advises against increasing portfolio risk beyond benchmark targets currently, as the market seems to be factoring in a lot of positive news. Investors may be well served by bracing for occasional bouts of volatility until trade uncertainties are resolved. LPL Research continues to monitor tariff negotiations, economic data, earnings, the bond market, and various technical indicators to identify a potentially more attractive entry point to add equities on weakness.

During periods of policy uncertainty, LPL Research prefers to stray little from its benchmarks. In that spirit, the Committee recently upgraded emerging market (EM) equities to neutral, leaving regional preferences across the U.S, developed international, and EM aligned with benchmarks. The Committee still favors growth over value, large caps over small caps, and the communication services and financials sectors.

Within fixed income, the STAAC holds a neutral weight in core bonds, with a slight preference for mortgage-backed securities (MBS) over investment-grade corporates. The Committee believes the risk-reward for core bond sectors (U.S. Treasury, agency MBS, investment-grade corporates) is more attractive than plus sectors. The Committee does not believe adding duration (interest rate sensitivity) at current levels is attractive and remains neutral relative to benchmarks. The Committee would get more interested in adding long-term bonds if the U.S. 10-Year Treasury yield got closer to 5%.

Important Disclosures

This material is for general information only and is not intended to provide specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors or will yield positive outcomes. Investing involves risks including possible loss of principal. Any economic forecasts set forth may not develop as predicted and are subject to change.

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All investing involves risk, including possible loss of principal.

U.S. Treasuries may be considered "safe haven" investments but do carry some degree of risk including interest rate, credit, and market risk. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet or Bloomberg.