

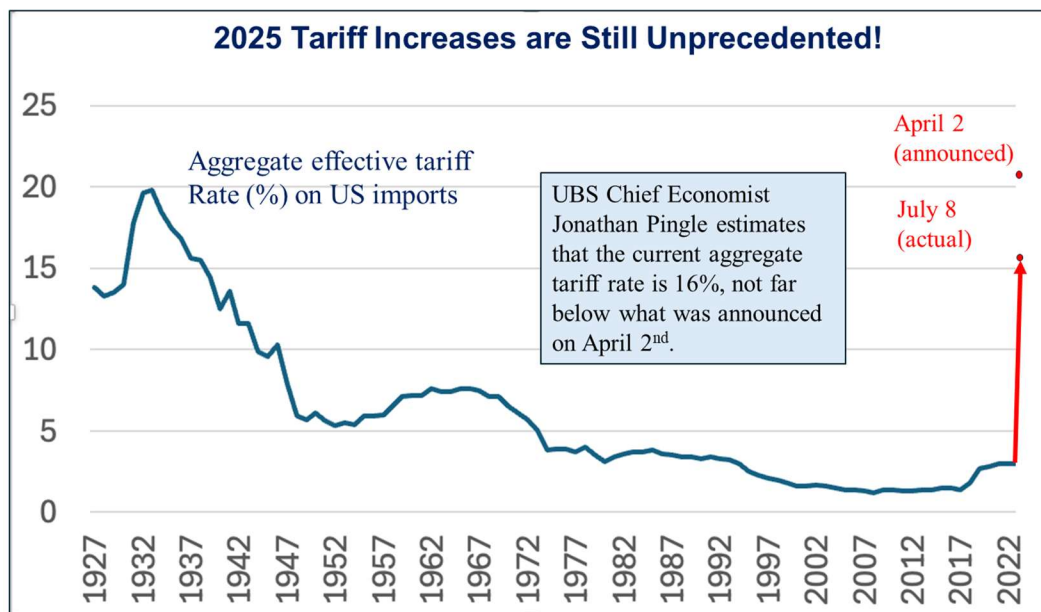


Investment Commentary—July 2025

What a difference three months makes! As we put pen to paper for April’s commentary, the S&P 500 index was down 15% on the year, reeling from President Trump’s “Liberation Day” tariff announcement. The April 9th decision to delay the most aggressive tariffs for ninety days on every country but China stabilized capital markets. Worries persisted, however, as tit-for-tat tariff escalations with China threatened to grind trade with China to a halt.

On April 22nd, investors sensed that tensions with China were easing and U.S. stocks rallied sharply. By the end of the second quarter, the S&P 500 was up 24% from the April bottom, up 11% for the quarter and up 6% year-to-date.

What prompted the stock market to rally to all-time highs? Is it all about the TACO (“Trump Always Chickens Out”) trade? Is the market convinced that when all is said and done tariffs won’t be all that high? Not likely. In fact, as is clear from the chart below (an update from April’s commentary), **the tariffs that are already in place are very high** and not much lower than those laid out on Liberation Day.



The above chart is adapted from paulkrugman.substack.com with historical information from the US International Trade Commission and 2025 estimates from UBS.

The financial press has focused extensively on the country-by-country “reciprocal tariffs” that were suspended pending negotiations. (The deadline, originally July 9th, was recently extended to August 1st.) Focus on reciprocal tariffs has obscured the 10% baseline tariff on most imports that is currently in effect. When the baseline, which by many accounts is very unlikely to be

negotiated away, is added to preexisting tariffs as well as additional tariffs imposed over the last several months on products such as autos, auto parts, steel and aluminum, you get the 16% aggregate tariff now in place. This is likely a floor, with the details of trade deals determining whether tariffs shake out closer to 16% or closer to the 21% that UBS estimates would have resulted from the Liberation Day announcement.

If we are already living with a tariff regime higher than anything since the 1930s, without earth-shattering consequences, was the angst in early April much ado about nothing? We don't think so, but it's striking that after three months of dramatically higher tariffs, it's hard to find a lot of economic damage. Consumer spending is soft, but, except for the lowest income consumers, spending hasn't declined. The June jobs report was very solid, showing 147,000 jobs created. And, at least thus far, capital expenditures seem to be holding up, bolstered in part by investment in artificial intelligence (AI) related infrastructure. Higher tariffs have led to significant price hikes on goods such as appliances, household furnishings, used cars, sporting goods and toys, all of which is beginning to show up in broader gauges of inflation. The impact has been muted though by falling gas prices and the fact that the U.S. is predominantly a services economy.

While the economic data has been encouraging, it's way too early to sound any kind of an all-clear. Companies began stocking up on inventory early in the year knowing that tariff increases were coming. Historically, when businesses experience higher costs, they increase prices very gradually to hold onto market share. With companies still working down inventory imported from before Liberation Day (or inventory made from materials or components imported before Liberation Day) the process of passing cost increases on to consumers is in the early stages.

Further, as dramatic as the existing tariff hikes have been, the worst may be yet to come. The ten percent across the board tariffs are modest enough on a percentage basis that they can be absorbed without a dramatic impact on consumer prices or profit margins. The highest tariff rates of 50% apply to steel and aluminum but these are commodities and manufacturers are used to managing around big swings in commodity prices.

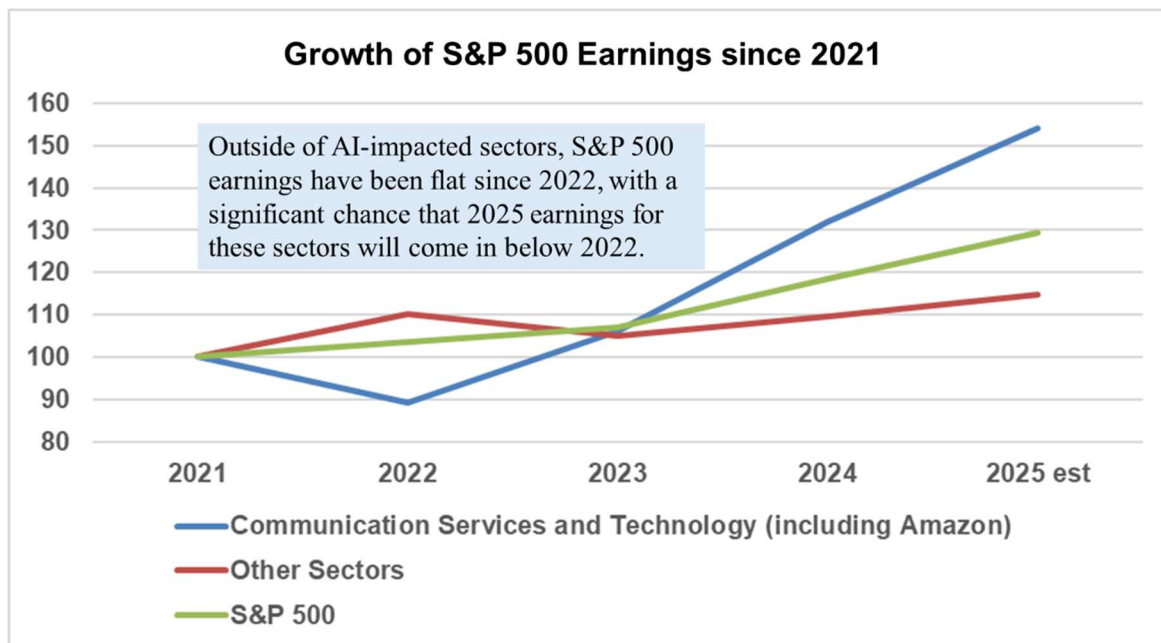
The 145% tariffs on China that were in place for around a month before Trump backed off would have been extremely disruptive had they continued much longer. If additional country by country tariffs —most recently President Trump has threatened 30% tariffs on Europe—are put into effect in the coming weeks or months, they have the potential to push inflation meaningfully higher, eat into profit margins and wreak havoc with supply chains. Notwithstanding the TACO meme, Trump could be emboldened to hold the line based on limited (thus far) economic damage from previous tariff actions and a buoyant stock market.

JP Morgan Chase CEO Jamie Dimon, who is probably worth listening to, warned earlier this month that markets seem to be complacent regarding tariffs. Dimon sees a 40% to 50% chance that tariff-related inflation will force the Federal Reserve to raise interest rates, something that is very much not on investor radar screens and would likely send the U.S. stock market tumbling.

Ultimately what the stock market cares most about is corporate earnings. As of now, analysts are forecasting earnings growth of 9.4% for calendar 2025, but that is backloaded, with the first half forecast to come in 5.8% above the year ago period, accelerating to 12.8% growth for the second half of 2025. Investors will be paying very close attention to forward guidance during second quarter earnings calls. In April, it was easy for companies to dodge questions about tariffs, since

everything was still in flux. With the baseline and other tariffs now in place for several months, tariff questions will be harder to avoid. Earnings calls will also be revealing as to any signs that either consumer spending or capital expenditures may be waning.

As has been the case for over two years, market optimism seems tied to enthusiasm over AI. As the chart below shows, AI has indeed been fueling rising earnings. The chart illustrates earnings growth since 2021 for AI-impacted sectors and for the rest of the S&P 500. The Communication Services sector is dominated by Alphabet (Google's parent) and Meta (Facebook's parent). The Technology sector is dominated by NVIDIA, Microsoft and Apple. We have also included Amazon in the Technology sector, although it is typically included (inappropriately) in the Consumer Discretionary sector.



Source: FactSet. Earnings for each group are indexed to calendar year 2021.

The red line in the chart may be the most striking. If analyst estimates are achieved, annualized earnings growth from the end of 2022 to the end of 2025 in “Other Sectors” will come in at a paltry 1.3%. If, as is common, earnings forecasts are too optimistic, earnings could be flat to slightly down over that period. Despite mediocre earnings performance (at best), price-earnings ratios in these sectors range from 16.9 to 25.9, numbers historically associated with decent to very strong earnings growth. At current levels, investors in large company U.S. stocks seem to be betting that the economic damage from tariffs will continue to be manageable, that AI-fueled earnings growth will continue at its current pace for the foreseeable future, and that earnings growth in other sectors will pick up. That’s a lot to count on!

*Boston, MA
July 15, 2025*

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