PCM

PEAK CAPITAL MANAGEMENT

War, Tariffs, and the Economy

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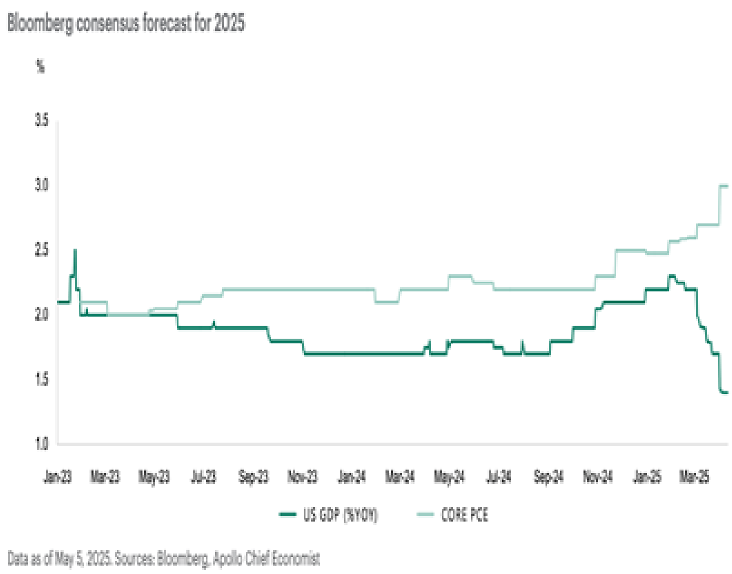
Imagine a scenario where we were staring down the barrel of WWIII breaking out in the Middle East, Trump's Liberation Day tariff's go into effect in about a week, and the Fed resisting pressure to cut rates, leaving mortgage rates at multi-year highs. Most investors would likely interpret that environment as a time to head for the stock market exits and move to a risk-off portfolio. Instead, the stock market is hitting new highs while the serious headwinds keep piling up.

There is a tenuous ceasefire in the war between Israel and Iran that the US inserted itself into when Trump ordered bunker-busting bombs to be dropped on Iranian nuclear sites. I think the odds seem high that either side will accuse the other of breaching the ceasefire and bombs and missiles will resume, especially given Iran's proxies in the region. Oil prices surged 17% following the start of the 12-day war between the Middle East nations but have since reverted to the mid-$60's where it has traded much of the year. According to IMF data, a $10/barrel oil shock would be expected to increase inflation by approximately 0.5% and lower GDP by 0.2% at a time when many analysts are forecasting stagflation.



The potential Liberation Day tariffs would be adding gasoline to the stagflation fire. The impact on inflation would be obvious when considering more than 1/3rd of the products sold in Walmart, the world's largest retailer, are imported and would be impacted by tariffs. Target has stated that 30% of the products they sell are made in China alone with total imports being close to 40% of inventory. When you factor in retaliatory tariffs that other countries will apply, such as what is taking place between the US and Canada, I suspect the economic impact might be bigger than being forecasted today.

> **"The potential Liberation Day tariffs would be adding gasoline to the stagflation fire."**

Both equity and debt markets are historically sensitive to Fed expectations on rate moves. Market expectations, per data from the CME, were for a rate cut by June 2025 and a total of 3 or 4 cuts for the year. The Fed dot plot was more cautious and guided to only 2 rate cuts in 2025. Fed Chair Powell has resisted White House pressure to cut rates even as core inflation has fallen in the first half of 2025. However, several Fed Governors have gone on the record recently with their belief that rate cuts might be appropriate at their next meeting in late July.

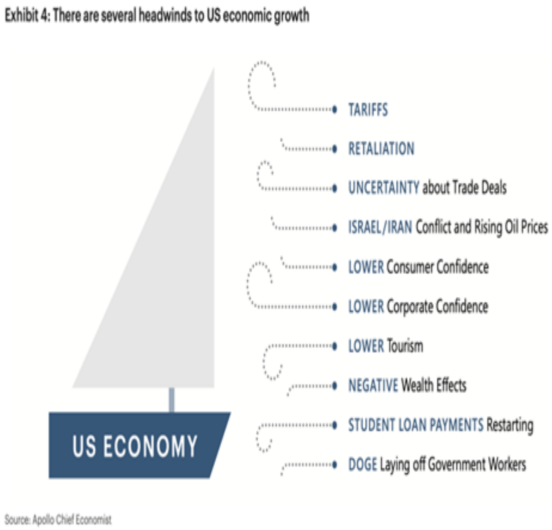
Despite all the market turmoil, 82 companies hit all-time highs during June representing various sectors. Technology giants like Microsoft, Nvidia, Broadcom and Jabil all hit record highs. Financials rose lifting Capital One, Goldman Sachs and Intercontinental Exchange to new highs. There were new highs in healthcare with Cardinal Health and McKesson as well as consumer stocks like Netflix and Spotify hitting highs. The market's ability to shrug off economic headwinds has been impressive, but will it remain or will institutional money begin to sell into the recent strength?

While headwinds like war and tariffs can be resolved through diplomacy and negotiations, other economic headwinds are not going away. The most important of these is the rising national debt which now tops more than $37 trillion. While much has been reported about the success DOGE has had identifying waste and fraud, it remains a relatively small part of the overall budget deficit problem in the US and most of the developed world.

The cost of servicing the national debt is quickly becoming an urgent matter. For the first time in history, the US spent more of its revenue on interest on the debt than it spent on national defense, an ominous sign. Deficit spending does provide some economic stimulus but CBO data shows the overall benefit today has a negative multiplier effect. For example, $1 of deficit spending in 1981 had a multiplier effect of $3.15 in GDP. In 2024, $1 of deficit spending only generated $0.81 of increased GDP, of multiplier effect of -19%. Banking laws are being rewritten to help facilitate financing the annual deficits but virtually every economist would tell you we are on an unsustainable path.

While some companies will thrive in the AI/quantum world we are transitioning into, many other will see their earnings fall and stock prices drop. Stocks seem to be priced for perfection when that seems like an increasingly unlikely environment for record corporate earnings. The Fed is likely to step in and help the markets but it may be a case of too little, too late. We remain cautious about the short-term market prospects and believe hedges will be increasingly important.

Drivers of Stagflation



Stagflation is an economic environment marked by high inflation, stagnant economic growth, and rising unemployment. This was prevalent in the 1970's when inflation and unemployment both reached double-digits and economic growth was muted. Tariff's are the leading cause in many economic forecasts for stagflation as they simultaneously expect to reduce economic growth and drive prices higher. The uncertainty surrounding where tariff policy will land has also led to slower corporate spending as evidenced by capex being revised lower in 2025. Rising oil prices and higher energy costs are also drivers of stagflation as it requires consumers to reduce spending on discretionary items as budgets are increasingly allocated for gas and energy. Lastly, foreign supply chain disruptions are expected as nations implement retaliatory actions against newly imposed US tariff hikes reducing growth expectations.

- Many economists are adopting a "higher for longer" approach to US interest rates believing the Fed will have a more difficult time cutting rates with the risk of an inflation spike from tariff's looming.
- While final tariff rates have not been determined, the deadline on the postponement of new tariff's is July 8th and the average rate would be 15.8%, the highest in many decades.
- The unemployment rate, while still historically low, has begun to move higher in recent months and there has been a clear slowdown in hiring while continuing claims is rising.

Sector Rotation

A quick glance at sector performance reflects our changing economic outlook. The chart to the left shows the year-to-date performance of both the S&P Consumer Discretionary (-4.5%) and Staples (3.5%) sector indexes. Not surprisingly, consumer staple stocks as a group have held up relatively well compared to discretionary stocks and the broader S&P 500 Index. Staples such as Costco (COST) and Walmart (WMT) have driven the sector index higher. Conversely, discretionary stocks such as Amazon (AMZN) and Tesla (TSLA) have pulled their sector index lower for the year.

- The dispersion of performance is not too surprising considering the prospect of a recession on the horizon. With higher interest rates and overall higher prices (based on CPI above the Fed's long-term target of 2%), discretionary spending could come under pressure in the coming months, particularly if the Fed holds rates steady to contain inflation.
- From a valuation standpoint, discretionary stocks are still trading at a rich multiple of roughly 27x forecast earnings despite the recent pullback. Conversely, consumer staple stocks are relatively cheaper trading at roughly 20x forecast earnings. Should we enter a recession the relative outperformance of staples could continue.

Trade Framework Eases U.S.-China Tensions

The U.S. and China have formalized a trade framework aimed at easing tensions around rare earth exports and technology restrictions. According to China's Ministry of Commerce, the agreement includes provisions for China to review and approve export applications for certain controlled items, while the U.S. will cancel various restrictions previously imposed on Beijing. This development follows high-level negotiations in London and builds on the preliminary Geneva agreement, which included a 90-day suspension of most tariffs. While the announcement signals progress, analysts caution that key details—particularly around which rare earth curbs will be lifted—remain unclear, suggesting that critical sectors like rare earths will continue to serve as leverage in future talks.

- The U.S. and China agreed to suspend the majority of tariffs on each other's goods for 90 days following the Geneva agreement.
- China's commitment includes easing rare earth export restrictions, though specifics are largely limited to magnets.
- The U.S. will roll back certain tech-related restrictions and visa limitations previously imposed on Beijing.

Quinn VandeKoppel

Macro View – Trade Optimism Rally

U.S. stocks hit record highs Friday as optimism over U.S.-China trade progress fueled a broad rally. The S&P 500 closed at 6,177.14 and the Nasdaq at 20,218, both all-time highs. Markets rebounded sharply from April lows—when the S&P was down nearly 18%—after President Trump eased tariff threats and signaled progress on deals with China and other major partners. A strong recovery in AI stocks, led by Nvidia and Microsoft, also powered gains. The rally persisted despite headwinds like Middle East tensions, rising oil prices, and a hotter-than-expected 2.7% core PCE inflation reading for May. Investors remain hopeful that inflation stays manageable and that the Federal Reserve will begin cutting rates later this year, helping sustain the market's upward momentum.

Fixed Income – Dollar Drops on Rate Bets

The U.S. dollar fell to a three-and-a-half-year low against the euro Friday as weak economic data raised expectations for deeper Federal Reserve rate cuts. Consumer spending unexpectedly declined in May, jobless claims hit their highest since 2021, and Q1 GDP was sharply revised down. Fed Chair Jerome Powell's dovish comments, suggesting rate cuts if inflation stays subdued, added pressure, along with speculation that President Trump may replace him with a more dovish successor. Traders now expect 65 basis points of rate cuts by year-end, up from 46 basis points last week. Broader concerns linger over the dollar's long-term strength as investors continue shifting away from U.S. currency reliance, partly tied to lingering effects of prior sanctions policies that weaponized the dollar in global conflicts.

Taking Stock – Tesla's Remarkable Run

Fifteen years after its IPO, Tesla has transformed from a niche EV startup into one of the world's most valuable companies, driven by Elon Musk's relentless vision. Musk pioneered the EV revolution with the success of the Model 3 and Model Y, helping reshape the global auto industry and accelerate clean energy adoption. Now, Musk is betting Tesla's future on breakthroughs in autonomy and humanoid robotics, believing these technologies could drive the company's next growth phase. Despite recent headwinds—slowing EV sales, rising competition, and reputational challenges tied to Musk's political involvement—Tesla's success remains tightly linked to Musk's bold ambitions and ability to disrupt entire industries. His track record of overcoming skepticism continues to define Tesla's narrative and its long-term potential.

Technical – SPY Breakout Rally

After a significant downtrend from March to April 2025, SPY successfully broke above a key descending resistance line in mid-May, signaling a trend reversal. Since then, it has been making higher highs and higher lows. The price is currently trading at $616.49, well above its 20-day ($601.55), 50-day ($581.25), and 200-day ($581.72) simple moving averages (SMA), confirming strong upward momentum. The moving averages are aligned in a bullish order (20 > 50 > 200), which further supports the strength of this uptrend. Trading volume appears steady but not excessively high, suggesting steady accumulation rather than a blow-off top. Overall, the chart indicates continued bullish sentiment with potential support near the $600 psychological level and the 20-day SMA.

International Equities

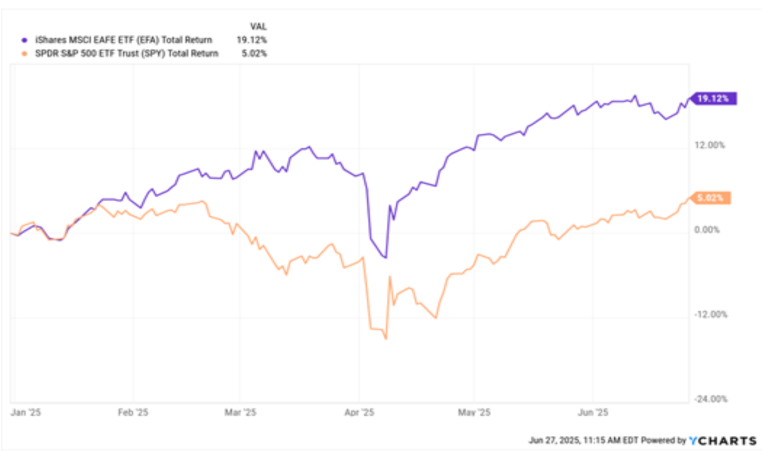
Clint Pekrul, CFA

Since the onset of COVID in 2020, roughly five years ago, the S&P 500 index has returned approximately 120% on a cumulative basis including dividends. The index measures the performance of large-cap domestically traded equities.

In comparison, the MSCI EAFE Index, which measures the aggregate performance of equities traded in the developed markets of Europe, Asia and the Far East, has delivered a cumulative return over the same period of roughly 60%, or roughly half the performance of U.S. equities.

This substantial return disparity has frustrated international investors for several years and perhaps has led many to question the efficacy of investing in overseas developed markets.

This year, however, has painted a different picture. As illustrated in the chart below, international stocks, as measured by the MSCI EAFE Index (unhedged) have gained roughly 19% year-to-date compared to a return of approximately 5% for the domestic S&P 500 Index over the same period. Indeed, patience has been rewarded for international investors.



Likewise, emerging markets have far outpaced the S&P 500 Index so far this year as measured by the MSCI Emerging Markets Index (unhedged), which is higher by roughly 17%.

At first glance, investors might assume that international outperformance is due to superior economic growth prospects overseas, but a look under the hood reveals that much of the outperformance is due to a weakening dollar, as exhibited in the chart below.

The USD has declined approximately -11% year-to-date relative to a broad basket of foreign currencies. When investing overseas, a declining dollar is a tailwind for those domiciled in the U.S. For example, companies overseas make revenues in Euros or Yen, which is a strengthening currency (relative to the dollar). This currency translation increases total returns for U.S. based investors.

Investors should realize the importance of currency translation with respect to performance overseas. Specifically, foreign equity returns equate to the change in the price of shares traded on international exchanges and the effect of exchange rates (plus or minus). In particular, the outperformance of international markets can depend in large part on whether your exposure is hedged or unhedged against exchange rates.

The recent decline in the U.S. dollar is understandable given the current fiscal state of the federal government. Growing concerns over ballooning deficits and uncertain trade policy (i.e. tariffs) have left global investors questioning the continued status of the dollar as the world's reserve currency.

But investors should think twice about shunning dollar-based assets over the long term. While this year has been somewhat of an anomaly compared to recent history, the U.S. still maintains a robust equity market with promising prospects for earnings growth and multiple expansion.

While this year has been rewarding for allocators overseas, it could be short lived if the currency effect wanes over time and the dollar eventually strengthens again.

Q: Is the extra yield on junk bonds worth the risk?

Not today, given the historically low spread between high yield bonds and Treasuries. In late 2024 and early 2025 the spread between non-Investment Grade bonds (junk bonds) and Treasuries fell below 3% meaning investors were willing to take on considerably more default risk for a nominal increase in yield. According to Bloomberg data, the average spread over the last 30 years was 5.26%. There is tremendous economic uncertainty today driven by global trade and tariffs and geopolitical conflict in the Middle East. Default rates on junk bonds tend to be very sensitive to economic conditions. Over the last 10 years, default rates on high yield debt has ranged from 2.5-3.0% according to ratings agencies S&P Global and Fitch. Recently Fitch raised their expected default rate to 4.0-4.5% on junk bonds and 5.0-5.5% on leveraged loans (the cousin to high yield bonds). There has also been a rush by companies with poor credit ratings to get bonds sold in the market. Bank of America noted there was more than $32 billion of junk bonds sold in May and that figure was expected to be eclipsed in June as companies tried to raise proceeds prior to trade volatility impacting economic forecasts.

High yield bonds historically trade with a volatility similar to value stocks but are particularly susceptible to recessions when default rates spike. I would be cautious on junk bonds at least until spreads approach the long-term average.

Investors generally require a higher yield, or interest payment, for holding risky corporate debt compared to investment-grade bonds. This difference in yield is known as the “spread” and represents the extra compensation investors receive for assuming default risk. When times are good and corporate profits are generally stable, the high yield spread will tend to narrow. Likewise, when times are tough and corporate profits are more uncertain, the high yield spread will tend to widen.

Currently, high yield bonds are paying roughly 6.5% based on the ICE BofA US High Yield Bond Index and the spread is roughly 0.9%. By comparison, when Trump announced his tariff strategy in early April, the high yield spread widened to roughly 1.2% and during COVID in March of 2020, the spread widened to roughly 4% as investors demanded a hefty premium for holding risky corporate debt. Today, we have the prospect of a recession and potential stagflation and a Federal Reserve that is in no hurry to lower interest rates. This would suggest an elevated spread. However, it is worth considering how healthy corporate balance sheets are based on overall leverage, which is why the spread isn’t higher today. It seems investors are being adequately compensated given current debt levels and corporate profitability.

Q: Is the potential for war bullish for gold?

Geopolitical uncertainty with what is playing out in the Middle East might be bullish for gold in the short run but historically not been a long-term driver of gold prices. Gold is more traditionally known as an inflation hedge so conflict in the Middle East that results in higher oil and energy prices leading to higher inflation would likely lead to higher gold prices. The short-term impact of tariffs are equally bullish for gold as it is assumed by most analysts that new tariffs will be inflationary. Gold and commodities like oil are typically effective inflation hedges but tend to protect investors from different causes of inflation.

Oil and commodities tend to effectively hedge against inflation caused by supply issues. Gold, on the other hand, historically hedges best against inflation that is the result of monetary policy or lack of confidence in those setting monetary policy. Both types of inflationary shock are possibly in today’s environment suggesting gold could see prices rise and potentially reach $4,000 in the next 12 months.

While physical gold has risen over the last year, driven, in part, by Central Bank purchases of bullion, many of the gold miners have not kept pace. Even slight increases in the spot price of gold could lead to a rally in the miners if economic uncertainty rises during the Summer months.

Historically, gold has generally been considered a safe-haven asset given its scarcity. While it doesn’t pay a dividend or generate any earnings like a common stock, gold has demonstrated time and again resiliency during times of turmoil. If tensions in the middle east explode into full blown conflict, I would expect gold to perform relatively well compared to assets such as equities.

Fundamentally, if war does break out in the middle east, what will likely drive the price of gold higher is the potential cost of the conflict for the United States (for reference, the combined wars in Iraq and Afghanistan cost an estimated $8 trillion). Considering our already strained fiscal condition and mounting deficits, a new war would only add stress to our nation’s budget deficits and could push yields higher. For example, we could see a scenario where Treasury yields, which typically fall during times of turmoil, rise given how far stretched our fiscal situation has become. The prospect of slower GDP growth in addition to a new war could provide a compelling backdrop for gold. Furthermore, if inflation flares up again, I expect gold, along with commodities in general, to outperform paper-based assets such as bonds.

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