

Global Market Review

Following a tariff-induced spike of volatility in early April, global equities bounced back buoyantly in the second quarter. The U.S. market closed at a record high. Global credit markets across the ratings spectrum also enjoyed strong gains. The U.S. market's cheer withstood continued sour business and household sentiment, elevated policy uncertainty, slowing economic growth, a looming tariff-induced increase in prices, a short-lived war in the Middle East, and the prospect of mushrooming fiscal debts, deficits, and debt servicing costs. Despite a 7% jump in oil prices following the attack on Iran's nuclear capabilities, oil prices closed the quarter sharply lower. The U.S. dollar index fell in the second quarter, bringing its decline in the first half of the year to 10%. Gold and crypto, in contrast, rose further. As we explore in this quarter's Special Topic, the dollar's fall in a period of market turmoil has raised doubts about its safe haven status.

Exhibit 1

Performance of Major Market Indices

Source: Bloomberg. Quarter ending June 30, 2025.



Global equities and bonds bounced back in Q2.

Market Cognitive Dissonance

Markets and investors are displaying symptoms of cognitive dissonance. The U.S. bond markets is pricing in an economic slowdown, while stock market ebullience suggests a much more optimistic growth outlook. Surveys of households and businesses point to expectations of declining output and sharply rising prices. Surveys of investor attitudes, in contrast, report expectations of real equity returns of over 12%.

There is no neat explanation for this dissonance, but some context may help. A combination of momentum, leverage, and hopes for an AI productivity revolution are among the factors driving U.S. equities higher despite high levels of uncertainty. In addition, after back-to-back years of gains over 20%, recency bias may be influencing investor expectations.

Erratic policy swings no doubt contribute to the confusion. It is important to put these in context. Although announced tariffs would increase the average tariff rate to about 20%, the highest level since the 1930s, their macro impact has yet to be felt. Moreover, the U.S. is a relatively closed economy; imports represent only 14% of GDP. Assuming that the tariffs announced as of July 13 are implemented, the Yale Budget Lab estimates that the growth impact relative to baseline would be 0.9 percentage points in the short run and 0.5 percentage points over the long term. Given the Congressional Budget Office's baseline projections of GDP growth of 2.1% in the short run and 1.8% over the long term, the projected hit to growth from tariffs would be substantial but would not trigger a contraction. The real impact of tariffs on economic growth is more insidious and would be felt in the form of a persistent and compounding shortfall in output and prosperity from the levels that would otherwise have been achieved.

The impact of tariffs on prices also needs to be put in perspective. The 2.1% short-run tariff-induced increase in prices projected by the Yale Budget Lab would raise the inflation rate to about 4.8% from current levels. Inflation would be more than double the Fed's target, but well below the peak of the post-COVID inflationary spurt. A much more serious risk to inflation would arise if the tariff-related jump in prices shook confidence in the Fed's ability or willingness to maintain price stability. Reducing Fed independence could unanchor inflation expectations and amplify these risks.

AI Frenzy Fuels Record U.S. Equity High

The S&P 500 gained 10.9% in the second quarter. It is up 6.2% so far this year. The path taken to this respectable gain was anything but smooth. After a tariff-induced plunge of 15% to its early April trough, the S&P 500 has gained nearly 25%. The rebound reflects the dissipation of fears over the economic and market impact of tariffs and a renewed speculative frenzy for AI stocks. Since the market's April trough, an index of AI-related stocks and the Magnificent 7 index of mega-cap tech stocks have risen 44% and 37%, respectively (Exhibit 2). The AI sector has benefitted from strong earnings growth as well as speculative demand fueled by the belief that AI represents a transformative technology that will revive productivity growth.

Exhibit 2

AI Frenzy Propels U.S. Equities to Record High

Source: Bloomberg. Index January 1, 2024 = 100.



Strong Non-U.S. Equity Market Gains

The MSCI World ex-U.S. index of advanced economy stocks rose 12% in the second quarter, bringing its gain so far this year to 19%, outpacing the U.S. market's gain of 5.1% by a wide margin (Exhibit 2). European markets continue to perform well. They are up 23% in the first half of the year. To U.S. dollar-based investors, this gain reflects in part the strong appreciation of the euro versus the dollar. Moderating inflation and easing monetary policy have supported European equity markets. Over the past 12 months, the ECB has cut rates eight times for a cumulative rate reduction of 200 basis points. However, with euro area inflation now in the vicinity of its 2% target, the ECB appears to be approaching the end to its current rate-cutting cycle.

Exhibit 3

U.S. Stocks Lag other Markets

Source: Bloomberg. Index. January 1, 2025 = 100.



Emerging equities generated strong gains in the second quarter, rising 12%. They are up 15.3% in the first half of the year. Chinese equities, which have risen 17.3% so far in 2025, have contributed to the broader emerging equity market rally. Continued fiscal and monetary stimulus and other measures designed to bolster economic growth and household sentiment have supported the equity market despite lingering fragilities. These include the persistent contraction of the highly levered property sector, restrained household consumption, continued deflationary pressures, and the uncertain effects of tariffs on an export-driven economy.

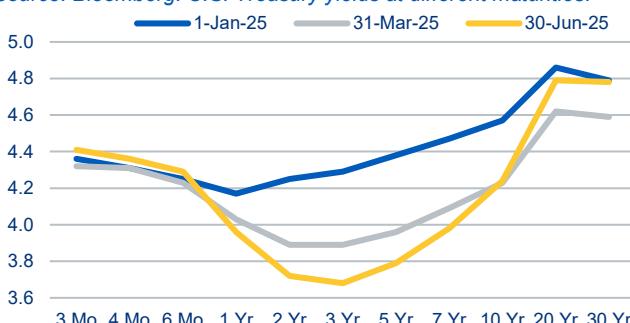
U.S. Treasury Yield Curve's Belly Sags

Shifts in the U.S. Treasury yield curve have been limited this year, but the movements have not been parallel across maturities. At the short-end, yields have remained little changed, reflecting the steadiness of Fed policy. Yields at the long end of the curve have experienced a round trip, falling modestly in the first quarter, but rising since on fears of somewhat heightened long-term inflation risks. The middle of the curve, however, has fallen significantly, suggesting expectations for slower growth ahead (Exhibit 4).

Exhibit 4

Yields Fall in the Middle of the U.S. Treasury Curve

Source: Bloomberg. U.S. Treasury yields at different maturities.



Hedge Funds Generate Steady Gains

The HFRX equal-weighted hedge fund index rose 2.2% in the second quarter. It is up 3.1% so far this year. High volatility and valuation dispersion have especially favored equity-related strategies focused on adding value through security selection.

Real Estate Repricing Continues

Real estate, as measured by the NCREIF Open-End Funds Core Index (reported with a delay), rose 2% in the 12 months through March 2025, reflecting income growth that more than offset a decline in prices. Significant price declines since 2022 have created a more attractive entry point for new investments.

Venture Strategies Continue to Lag

Based on preliminary estimates, the Thomson Reuters/Cambridge Index was up 7.6% for the year ending December 2024, extending its period of steady performance in a low transaction environment. Buyout and growth equity strategies continue to outperform venture.

Outlook & Strategy

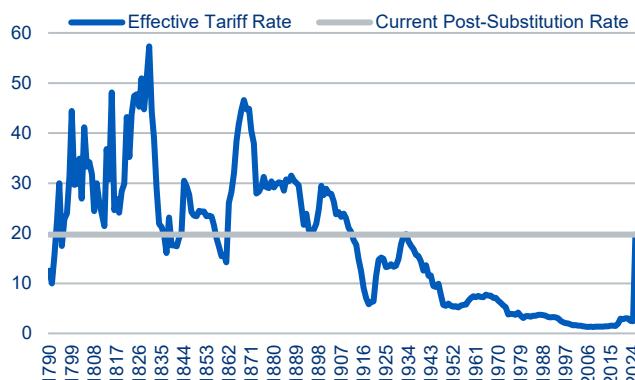
Shifting Sands

Core tenets that have guided post-war economic policy and the assumptions of economic agents around the world are being shaken. Free trade, central bank independence, the role of the U.S. dollar as the anchor of the global financial system, and that of U.S. Treasury securities as the ultimate safe haven all appear subject to doubt (Exhibit 1). The prospect of surging U.S. fiscal deficits and debt are further shaking confidence in these fundamental pillars of the dollar-centric international trade and payments system. The international monetary and financial system appears to be resting on shifting sands.

Exhibit 1

Announced Tariffs Increase Rates to Smoot-Hawley Levels

Source: Yale Budget Lab. Effective U.S. import tariffs in percent. The effective tariff rate is the post-substitution rate, which includes projected shifts in consumption patterns as import prices rise. The current post substitution rate reflects tariffs announced as of July 13.



The scope and magnitude of the tariffs announced on April 2 sent an initial tremor through markets. The shock waves quickly dissipated, however, as markets soon learned from frequent policy reversals to discount more and more heavily each successive policy twist and turn.

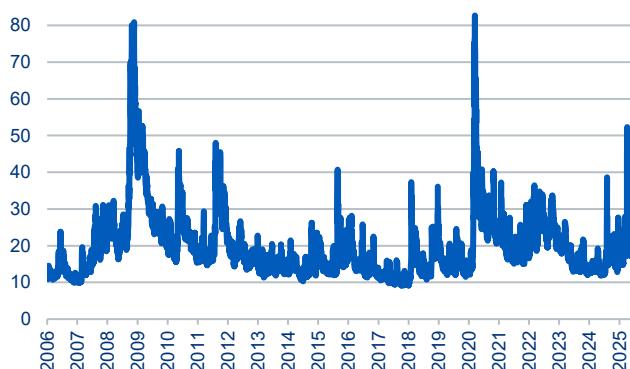
Nevertheless, the swings in market sentiment and prices were considerable. After a spike in volatility in early April, the VIX index, also known as the fear gauge, moderated (Exhibit 2). The S&P 500 index rebounded nearly 25% from an initial 15% plunge. Non-U.S. equity markets also experienced extraordinarily large swings in the first half of the year, although not as pronounced as that of the U.S. The tariff shock followed a similar pattern in the credit markets, where spreads initially widened sharply but soon tightened. The only asset not to recover was the U.S. dollar, whose uncertain fate we consider in this quarter's Special Topic. The other outlier in this period was gold, whose price rose through the turmoil as it

took on, at least on this occasion, the U.S. dollar's safe haven mantle.

Exhibit 2

Equity Market Volatility Moderates from April Spike

Source: Bloomberg. The VIX is an option-based measure of short-term volatility of the S&P500. Data as of July 17.



The market dynamics of the first half of the year highlight the risks of being whipsawed and reinforce the importance of maintaining a steady hand when managing portfolios. This experience strengthens our long-held belief that top-down asset allocation positions carry high risks and should be taken only when valuation anomalies across asset classes are at extreme levels, and then only sparingly.

Deep Foundations

Deep foundations are needed to build in shifting sands. The bedrock of our investment philosophy is the belief that the best way to add value and foster portfolio resilience is through bottom-up security selection aimed at exploiting valuation anomalies across individual securities. Fortunately, the valuation spread between the most and least expensive securities remains quite wide, creating abundant opportunities for skilled managers to add value.

We have found strategies that focus on exploiting anomalies in the pricing of individual securities to be the most rewarding, most persistent, and most reliable sources of alpha. Moreover, portfolios encompassing many uncorrelated sources of value added are inherently more resilient, a critical feature in the current volatile environment.

Our approach to designing each asset class portfolio is guided by our goal of maximizing the sources of value added from security selection. Our public equity portfolio employs extension strategies so that valuation anomalies can be exploited through both long and short positions. Our fixed income portfolio is built on a barbell structure that opens up opportunities in higher yielding segments of the credit markets. And our broad allocation across strategies and managers in our hedge fund portfolios facilitates the spreading of active positions across a wide range of risk factors.

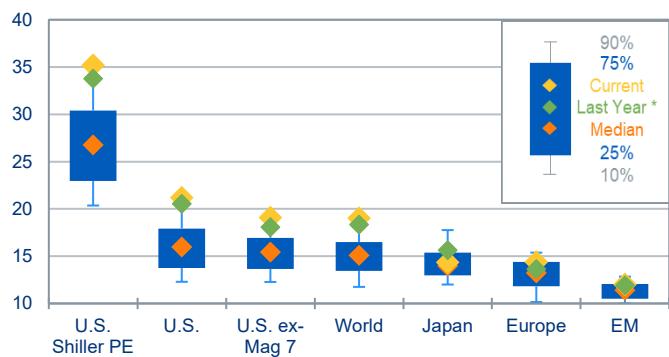
Record U.S. Equity Prices and Valuations

The U.S. equity market closed the quarter at a record high. Its valuation is also near record levels both compared to its own history as well as the valuations of other equity markets (Exhibit 3). Based on the Shiller CAPE, the current valuation of the U.S. equity market is at the 97th percentile of its range over the past 100 years, and has only been exceeded a handful of times, most notably during the tech bubble of 1999-2000. The market is also highly concentrated, reflecting the dominant performance of AI-related shares. Indeed, the valuation of the 10 largest firms in the S&P 500 (all of which are tech stocks) exceeds the valuation of the 10 most highly capitalized stocks during the tech bubble of the late 1990s.

Exhibit 3

U.S. Equity Valuations Remain High Despite Declines

Sources: Shiller Data, FactSet, and Strategic calculations. Shiller Cyclically Adjusted Price Earnings Ratio (CAPE) calculated using 10-year smoothed real earnings per share. Other data are 12-month forward P/E ratios. Data as of May 31, 2025.



In light of these valuations, we are retaining an underweight allocation to the U.S. equity market, while maintaining a neutral allocation to public equity overall. We continue to structure the U.S. equity portfolio to include active managers using a combination of quantitative and fundamental techniques, risk-controlled extension and portable alpha strategies, and industry-focused specialty managers in the biotech sector. This structure increases the scope for adding value through security selection, diversifying the sources of portfolio return, and enhancing the resilience of the portfolio.

Outside of the U.S., we continue to target a modest overweight to advanced and emerging equity markets reflecting their more attractive valuations. We recently expanded our roster of country specialist managers to be better positioned to exploit pricing anomalies within individual markets. We continue to restructure our emerging market portfolio and have recently added a manager focused on India, while continuing efforts to identify opportunities in East Asian markets. We also continue to evaluate our current non-core emerging market manager line-up.

Neutral Stance in Duration and Credit

We continue to target a neutral stance to duration and credit exposure in the fixed income portfolio. Our barbell approach to portfolio construction using U.S. Treasury securities to balance exposures to higher yielding credit products provides us flexibility to exploit anomalies in the pricing of credit securities and adapt bond portfolios to changing circumstances. The heterogeneous and segmented credit markets continue to offer attractive opportunities to specialist managers with the requisite experience to discriminate among issuers in niche segments of the market.

We have recently completed a search for long-credit managers. We are also exploring opportunistic investments in less liquid credit strategies and in the direct lending market.

High Alpha, Low Beta – Hedge Fund Ideal

The high levels of uncertainty and market volatility experienced this year underscore the importance of hedge funds as a portfolio diversifier and source of potential value added. Volatility and valuation dispersion have been especially high in the equity markets, creating a rich environment for skilled managers to add value through security selection. To best exploit these opportunities and control risk, we plan to continue to allocate the hedge fund portfolio broadly across strategies and to diversify sources of tracking error across managers. We target a neutral allocation to hedge funds. This neutral target weight aims to balance the benefits of hedge funds against the desirability of maintaining sufficient liquidity to rebalance client portfolios in case of asset market swings.

Selective Opportunities in Real Estate

The real estate market remains under pressure. We continue to delay new commitments to open-end funds and are shunning new investments in the office sector. However, prices have fallen significantly over the past few years, creating a much more attractive entry point for certain new investments such as favorably valued properties in the industrial sector, which is benefiting from accelerating e-commerce growth, and the housing sector, which is facing tight supply. We are retaining a neutral allocation to TIPS as another source of real yield and a further inflation hedge.

Private Equity Opportunities

Private firms represent a large, growing, and dynamic segment of the U.S. economy that offers attractive opportunities for strong returns and added value. We continue to exploit these opportunities by focusing on lower and middle market firms with solid earnings growth in the industrial, technology, and consumer sectors. Our portfolios include a combination of buyout and growth equity funds at their core combined with smaller positions in venture capital investments. We continue to make co-investments with select managers. We are also considering opportunities in the growing secondary market across private equity strategies.

Special Topic

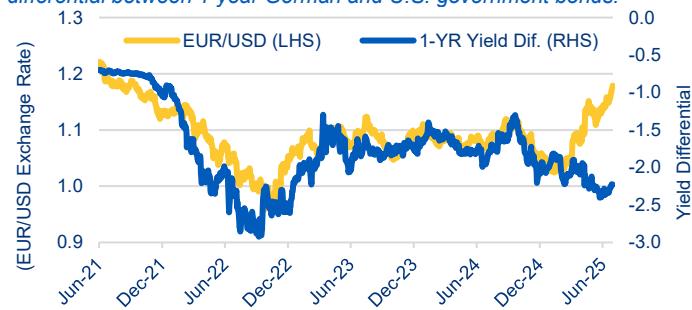
Downsides to Dollar Downslide

The dollar has fallen against the euro and other major currencies despite widening interest rate differentials that would normally support dollar appreciation (Exhibit 1). Gold, meanwhile, has soared (Exhibit 2). This has led to speculation that the dollar was losing its safe haven status. It is important, however, to put the dollar's recent decline in context. The dollar's real effective exchange rate opened the year near 40-year highs, close to the level that led to the concerted effort in 1985 to depreciate the dollar under the Plaza Accord. Even after its 10% fall in the first half of 2025, the dollar remains at historically high levels. Whether its recent decline reflects falling confidence or is merely a partial correction remains to be seen.

Exhibit 1

Dollar and Yield Differentials Diverge

Source: Bloomberg. Euro/USD exchange rate (LHS) and yield differential between 1-year German and U.S. government bonds.



The Indispensable Dollar

The US dollar represents 58% of central bank currency reserves, 40% of global export invoicing, 88% of foreign exchange spot and derivatives turnover, 39% of outstanding global bonds, and 43% of total global equity market capitalization. It is the safe haven and anchor of the global monetary and financial system. The Fed sets the risk-free rate and is the ultimate source of global liquidity in times of crisis. The perceived stability of U.S. institutions, macroeconomic policies, and legal structure; the depth, liquidity, openness and efficiency of its financial markets; the ready convertibility of the dollar; the size of the U.S. economy; and the U.S.' hegemonic military power are the bulwarks supporting the dollar's preeminence as the world's ultimate safe haven.

Exorbitant Privileges

All countries in the dollar system have benefited, albeit with significant periodic hiccups, from the trade and capital flows facilitated by the dollar's safe haven role. The U.S. has itself been richly rewarded. Foreign investors own 18% of U.S. equities, 33% of U.S. Treasuries and 21% of U.S. agency and corporate bonds. Strong foreign demand for U.S. assets has helped keep asset prices high and bond yields low, reducing the cost of capital to U.S. corporations. Foreign capital inflows

have helped finance chronic fiscal and external current account deficits. Even in times of crisis, investors flock to the safety of the dollar, sparing the U.S. the classic crisis symptoms of spiking yields and a plunging currency. The dollar's preeminence gives the U.S. outsized influence on global payments systems, reinforcing its geopolitical power.

Risks of Dollar Decline

A sudden shift out of U.S. dollar assets triggered, for example, by a combination of erratic policies and unsustainable U.S. debt dynamics would result in a massive global financial crisis. Even a gradual erosion of the dollar's preeminence would be disruptive. The lack of a clear dominant currency would lead to the fragmentation of the global monetary system, increasing frictions to trade and capital flows and creating a drag on innovation, competition, and growth. U.S. firms would face a higher cost of capital and global liquidity conditions would tighten. There would no longer be an unambiguous global risk-free rate forming the basis for asset pricing. With no single central bank playing the role of liquidity provider of last resort, uncertainty would increase, volatility would rise, and global financial crises would be deeper and longer.

Exhibit 2

Dollar Outlook Darkens While Gold Shines

Source: Bloomberg. DXY is an index of the U.S. dollar relative to major currencies.



Gradual Erosion, Not Replacement

While the dollar is unlikely to face a sudden loss of confidence, its preeminence is being eroded, and that process could accelerate. As tariffs reduce U.S. imports, capital inflows – the natural counterpart of trade flows – will also fall. Countries are already working to circumvent the dollar-based international payments system. Central banks around the world are developing digital currencies to make cross border flows more efficient. Gold is looking more attractive as a store of value, especially among countries worried about U.S. sanctions. Even in the underground economy, reckoned to represent up to 20% of global output, the iconic stacks of \$100 bills are losing market share to cryptocurrencies.

No single currency has the economic, market, and geopolitical heft to assume the dollar's safe haven mantle. We face instead a gradual evolution to a more fragmented monetary system that will doubtless amplify already high levels of uncertainty.

Note: Opinions expressed herein are current as of the date appearing in this material and are subject to change at the sole discretion of Strategic. This document is not intended as a source of any specific investment recommendations.