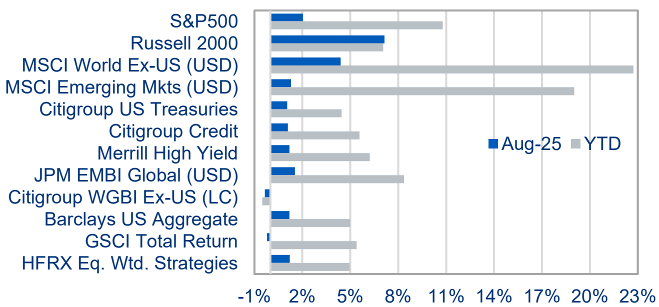
Global Market Review

The omni-rally continued in August. U.S. equities, bitcoin, and gold all closed the month near record highs while credit spreads narrowed to quarter century lows. Non-U.S. equity markets also enjoyed strong gains. Equity and bond market volatility fell. There remains scope for further froth. The Fed will almost certainly refresh the punch bowl in September, and more fiscal stimulus is on the way. Looser financial regulations are also on the horizon, increasing the scope for near-term reward and long-term risk. Despite a pull-back in August, AI stocks continue to dominate all aspects of the U.S. equity market this year– its narrative, earnings, price gains, and capitalization. AI capital expenditure is also having an outsized impact on GDP, representing an estimated 0.5 percentage points of economic growth. Whether these expenditures are rewarded commensurately by productivity gains and profits remains an open question. With the Fed expected to loosen policy, the yield curve steepened as short rates fell, and long-bond yields rose in anticipation of higher inflation. The U.S. dollar depreciated. Oil prices fell.

Performance of Major Market Indices

Sources: S&P, MSCI, FTSE Russell, Barclays, Citigroup, Bank of America Merrill Lynch, J.P. Morgan, HFR, Bloomberg.



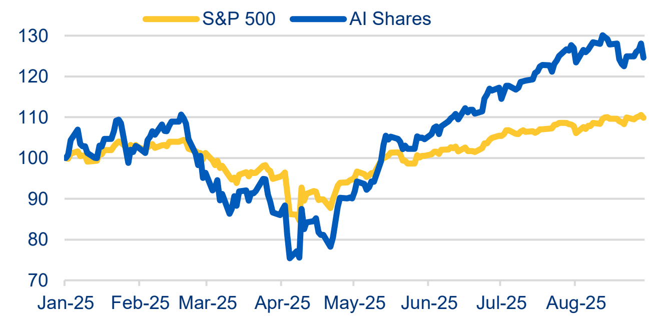
Global equities rose. U.S. stocks closed near record high.

U.S. Equities Gain in August Despite AI Pullback

The S&P 500 gained 2.0% in August, and ended the month near a record high, despite declines in AI stocks. AI's August tumble of 1.8%, follows its 8.3% gain in July. So far this year, AI stocks are up about a quarter (Exhibit 1). NVIDIA shares, which are up about 26% so far this year, declined 2% in August despite strong revenue growth. Whether August's decline reflects incipient investor doubts about the dominant AI narrative or a simple pause following heady gains remains an open question.

Exhibit 1. U.S. Equities Gain in August Despite AI Decline

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



Elsewhere in the market, growth stocks lagged value in August, gaining 1.3% versus a 3.4% increase in value stocks. For the year as a whole, however, growth (+11.2%) is outpacing value (+9.8%). Across sectors, consumer discretionary led all others in August, reflecting a jump in household durables purchases. Utilities lagged.

The U.S. equity market remains outsized relative to GDP, concentrated, and overvalued. AI shares represent about half of the U.S. market's capitalization and more than a third of its earnings. The Schiller CAPE is 37.9, slightly lower than its all-time high of 44.2 reached just prior to the popping of the tech bubble. The forward P/E ratio of U.S. stocks stands at 22.5, about 1.6 standard deviations above its long-term mean. Despite the U.S. equity market's overvaluation and concentration, price movements have been relatively subdued. U.S. equity volatility as measured by the VIX index is about half a standard deviation below its average level of the past 25 years. Relative calm also reigns in the U.S. Treasury market (Exhibit 2).

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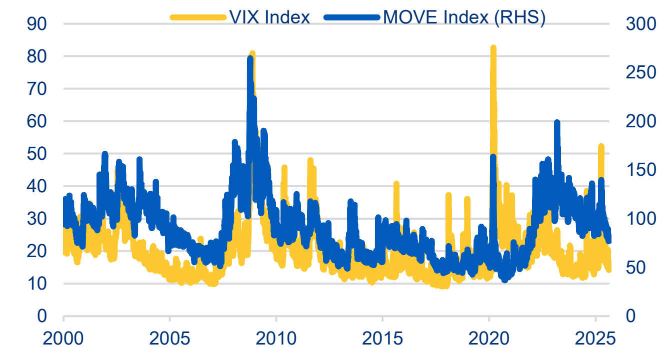
Exhibit 2. Subdued U.S. Equity and Bond Market Volatility

Source: Bloomberg. The VIX and Move indexes are option-based estimates of expected short-term volatility of the S&P 500 and the U.S. Treasury market, respectively.



Non-U.S. Equities Gain Helped by Falling Dollar

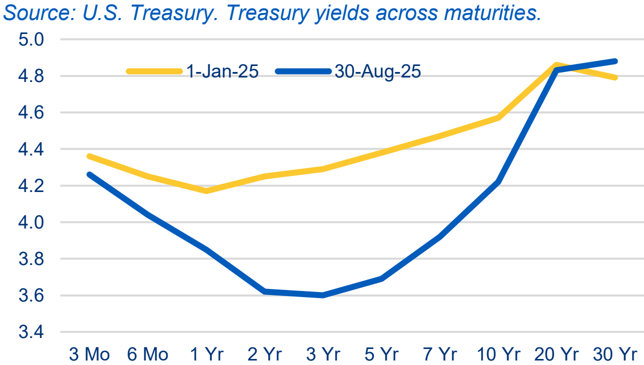
The MSCI World ex-U.S. index of advanced economy stocks jumped 4.4% in August, buoyed by strong performance across European and Japanese markets, which rose 3.4% and 7%, respectively. The depreciation of the U.S. dollar, which fell 2.2% against major currencies in August, also contributed to the strong returns of non-U.S. assets to U.S. based investors. Emerging equities were up 1.3% in August. They have gained 19% so far this year. The Chinese equity market, which is up 29%, has led all others this year despite persistent deflationary pressures, softening retail sales and industrial production, significant excess capacity, and rising tariffs on its exports.

Fed Widely Expected to Cut Rates in September

Futures markets are currently pricing in a 96% probability that the FOMC will reduce rates by 25 basis points at its September meeting. The U.S. Treasury yield curve is also signaling a move to easier policy rates (Exhibit 3). The 2-year U.S. Treasury yield, which is highly attuned to future policy rate changes, has plummeted. Longer term yields, however, have risen, contributing to a steepening of the yield curve. This reflects concerns over inflationary pressures as tariff increases are passed through to consumers as well as fears that the independence of the Fed may be undermined.

Exhibit 3. U.S. Treasury Yield Curve Steepens

Source: U.S. Treasury. Treasury yields across maturities.



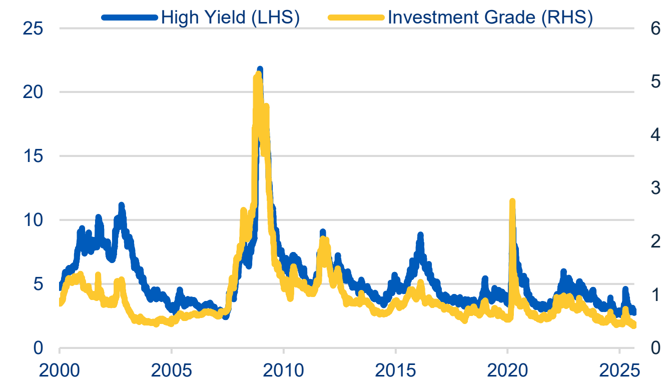
The potential loss of Fed independence is especially worrisome given the prospect of growing fiscal deficits, mounting debts, and a rapidly increasing debt service burden. The possibility that monetary policy could be dominated by fiscal considerations rather than the objective of price stability, has raised concerns that the Fed might keep its policy rate artificially low and use its balance sheet to monetize government debt. Such financial repression, if it were to materialize, would increase inflationary pressures, corrode confidence in the U.S. dollar as a reserve asset, and undermine the safe haven status of U.S. Treasuries.

U.S. Investment Grade and High Yield Spreads Narrow

As is the case with U.S. equities, risk premiums are compressed in the credit markets. Investment grade spreads are near 25-year lows, while high-yield spreads are about half a standard deviation narrower than their average over the period (Exhibit 4). Investment grade bonds are up 5% so far this year while high yield bonds have risen 6.3%. Both outperformed the 4.4% return on U.S Treasuries.

Exhibit 4. U.S. Treasury Yield Curve Steepens

Source: Bloomberg. Spread in basis points of investment grade and high yield bond yields over U.S. Treasuries.



The narrow spreads are supported by relatively stable credit fundamentals. Corporate earnings have met or exceeded expectations, earnings projections remain favorable, and balance sheets continue to appear solid, although rising rates have increased debt service burdens. Moreover, investor demand remains strong. Despite tight spreads, all-in yields on investment grade and high yield credit remain attractive given the increase in longer-term Treasury yields.

Performance of Major Market Indices through 08-31-2025

Sources: MSCI, FTSE, Barclays, Citigroup, Bank of America Merrill Lynch, J.P. Morgan, S&P GSCI, HFR, Bloomberg.

	1-Month	QTD	YTD	1-Year	3-Year	5-Year
S&P500	2.0%	4.3%	10.8%	15.9%	19.5%	14.7%
Russell 2000	7.1%	9.0%	7.1%	8.2%	10.3%	10.1%
MSCI World Ex-US (USD)	4.4%	3.1%	22.7%	14.9%	16.9%	10.5%
MSCI Emerging Mkts (USD)	1.3%	3.3%	19.0%	16.8%	10.8%	5.2%
Citigroup US Treasuries	1.1%	0.7%	4.4%	2.4%	2.1%	-1.5%
Citigroup Credit	1.1%	1.3%	5.6%	4.2%	4.7%	0.1%
Merrill High Yield	1.2%	1.6%	6.2%	8.1%	9.2%	5.1%
JPM EMBI Global (USD)	1.5%	2.7%	8.4%	8.0%	8.5%	1.6%
Citigroup WGBI Ex-US (LC)	-0.3%	-0.8%	-0.5%	0.1%	0.3%	-2.2%
Barclays US Aggregate	1.2%	0.9%	5.0%	3.1%	3.0%	-0.7%
GSCI Total Return	-0.2%	3.4%	5.4%	9.3%	1.7%	16.5%
HFRX Eq. Wtd. Strategies	1.2%	1.8%	5.0%	6.1%	4.5%	3.4%