

Key Insights

- **Policy-Driven Growth Surge:** The S&P 500 surged 6.29% in May with the Nasdaq leading at 9.65% as markets rallied on tariff policy relief and rebounding consumer confidence. The “Magnificent 7” tech giants posted 13.36% gains as investors rotated back into growth stocks, while defensive sectors like healthcare (-5.57%) lagged significantly in the risk-on environment.
- **Corporate Resilience Amid Uncertainty:** Q1 2025 demonstrated exceptional corporate strength with 78% of S&P 500 companies beating earnings estimates and 12.9% blended earnings growth - the second consecutive quarter of double-digit growth.
- **Bond Vigilante Pressure and Rising Yields:** The return of “bond vigilantes” drove the 10-year Treasury yield higher despite Fed rate cut expectations, while the 30-year yield topped 5%. Tepid demand at Treasury auctions and Moody’s credit downgrade reflect growing concerns about fiscal sustainability as proposed tax cuts could add trillions to the national debt over the next decade.
- **Federal Reserve Policy Paralysis:** The Fed adopted a cautious “wait-and-see” stance as conflicting signals from expansionary fiscal policy and contractionary trade policy create a modern policy trilemma. With tariffs potentially driving stagflation while tax cuts stimulate growth, traditional monetary policy tools face unprecedented constraints, forcing markets to recalibrate rate cut expectations for 2025.

Monthly Recap

The S&P 500 Index surged 6.29% in May, delivering a strong performance amid renewed market optimism. The tech-heavy Nasdaq Composite Index led major indices with a robust 9.65% gain, while the “Magnificent 7” tech giants posted an impressive 13.36% advance as investors rotated back into growth stocks after earlier policy uncertainty.

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Growth sectors dominated performance with Technology (+9.97%) and Consumer Discretionary (+8.38%) leading the charge, while defensive sectors including Healthcare (-5.57%) lagged significantly. Growth stocks substantially outperformed value counterparts across all capitalizations, and large-cap stocks demonstrated stronger momentum than small-caps, with the Russell 2000 Index advancing 5.34%. International developed markets posted solid gains (+4.70%) but underperformed domestic equities. Risk-on sentiment pressured safe-haven assets as the Bloomberg US Aggregate Bond Index declined 0.72% amid rising yields, while gold remained relatively flat (+0.02%) for May after its strong year-to-date performance. The 10-year Treasury yield faced upward pressure as investors repositioned for potential policy impacts, contributing to weakness across the yield curve as falling bond prices reflected changing interest rate expectations.

Key Drivers Of The Rally

Rebounding Consumer Confidence: The Conference Board’s consumer confidence index jumped 12.3 points to 98 in May after five consecutive months of declines, with short-term expectations surging 17.4 points as tariff anxiety subsided and fewer consumers expected a recession in the next 12 months.

Tariff Policy Relief: Trump’s strategic pullbacks on trade policy, including a 90-day pause on China tariffs following the May 12 US-China trade deal and delays on EU tariffs until July, significantly calmed market nerves and boosted spending plans for homes, cars, and vacations.

Solid Labor Market: Despite some softening in job availability perceptions, the unemployment rate remained at a historically low 4.2% with employers adding 177,000 jobs in April. Importantly, less than 25% of consumers worried about job loss, indicating underlying employment strength.

Cooling Inflation Pressures: Consumer prices moderated to 2.3% year-over-year in March from 2.7% in February, with core inflation declining to 2.6%. Gasoline prices fell to

\$3.17 per gallon (down from \$3.59 a year ago) providing additional relief to household budgets.

Earnings Strength & Corporate Resilience

According to FactSet, Q1 2025 delivered exceptionally strong corporate performance amid challenging economic conditions. With 96% of S&P 500 companies having reported results, 78% posted positive earnings per share surprises - above both the 5-year (77%) and 10-year (75%) averages, while 63% exceeded analysts' revenue expectations.

The blended year-over-year earnings growth rate reached 12.9%, marking the second consecutive quarter of double-digit earnings growth and the seventh consecutive quarter of year-over-year earnings growth. This robust performance occurred despite significant tariff-related uncertainty that dominated the business landscape throughout the quarter.

The S&P 500's forward P/E ratio stood at **21.1**, above both the 5-year average (19.9) and 10-year average (18.4), reflecting investor confidence in continued earnings momentum. Companies demonstrated pricing power and operational flexibility, with **251 companies providing positive 2025 guidance** versus only 8 withdrawals, showcasing corporate management's confidence in navigating current challenges while maintaining growth trajectories.

Topic of the Month: Navigating the Policy Trilemma: Tax Cuts, Tariffs, and Monetary Uncertainty

The current investment landscape presents an unprecedented confluence of competing policy forces that collectively create what economists might recognize as a modern policy trilemma. Unlike traditional economic trade-offs, today's environment features the simultaneous implementation of expansionary fiscal policy through tax cuts, contractionary trade policy via tariffs, and a Federal Reserve (Fed) caught in the crosscurrents of conflicting economic signals. This complex dynamic demands a sophisticated understanding of how these three forces interact and their implications for investment strategy.

The Mechanics of Policy Conflict

At its core, the current environment reflects a fundamental tension between policies pulling the economy in opposite directions. Tax legislation promises to stimulate growth through increased consumer spending and business investment, while tariffs threaten to dampen that same

growth through higher prices and supply chain disruptions. Meanwhile, the Fed finds itself in an increasingly difficult position, tasked with maintaining price stability and full employment in an environment where traditional policy tools may prove insufficient.

This policy mix creates what game theorists would recognize as a complex strategic environment. Unlike the relatively straightforward dynamics of free trade versus protectionism, the current landscape combines elements of both cooperation and competition across multiple policy dimensions. The result is an environment where traditional economic relationships may not hold, and where the normal correlations between policy actions and market outcomes become increasingly unreliable. Adding another layer of complexity, the Supreme Court's recent decision shielding the Fed from presidential removal powers—calling it a “uniquely structured, quasi-private entity”—ensures that monetary policy will remain independent even as fiscal and trade policies create conflicting economic pressures.

Policy-Driven Market Volatility: The Tax Cut-Tariff Paradox

The tension between tax cuts in the “Big Beautiful Bill”, (the BBB), and tariffs represents perhaps the most visible manifestation of current policy conflicts. President Trump's proposed tax legislation, while potentially stimulative in the short-term, carries significant long-term fiscal implications. The claim that tax cuts would cost “only” \$1 trillion assumes that temporary provisions will expire as scheduled - an assumption that history suggests is overly optimistic. When these provisions inevitably become permanent, the true fiscal cost could be substantially higher.

Simultaneously, the implementation of tariffs has created a separate set of economic pressures. The weighted average effective tariff rate has risen from 2.5% at the beginning of the year to approximately 15%, according to UBS economists. This represents a fundamental shift in trade policy that extends far beyond the targeted sectors.

The investment implications of this policy mix are profound. Sectors that might typically benefit from tax cuts - such as consumer discretionary companies - may find those benefits offset by tariff-induced cost pressures. Conversely, companies with significant domestic operations might experience margin expansion from tax relief while simultaneously facing input cost increases from imported components.

Corporate America's response to this uncertainty has been telling. The fact that only eight S&P 500 companies

withdrew earnings guidance during Q1 2025 - compared to 185 during the COVID-impacted Q1 2020 - demonstrates remarkable resilience. However, companies like Ross Stores and Deckers Outdoor have declined to provide full-year forecasts specifically due to tariff uncertainty, highlighting the selective nature of policy impacts.

The “sticky” nature of remaining Chinese imports presents a particular challenge for future policy implementation. The goods that were easiest to source from alternative suppliers have largely been shifted already, leaving behind products requiring specialized manufacturing capabilities or complex supply chain integration. This suggests that new rounds of tariffs could have more pronounced inflationary impacts than previous measures, as companies face fewer options for cost mitigation.

The Return of Bond Vigilantes: Fiscal Reckoning

The resurgence of bond vigilante activity represents perhaps the most significant shift in fixed income markets since the early 1990s. These investors, who collectively pressure governments perceived as fiscally irresponsible by selling bonds and driving up borrowing costs, have returned with a vengeance. The 10-year Treasury yield has risen significantly despite Fed rate cuts, while the 30-year yield has topped 5% - a clear signal that bond investors are pricing in higher risks of fiscal deterioration.

This vigilante activity extends beyond simple yield increases. Tepid demand at auctions for long-dated Treasuries suggests a fundamental shift in investor appetite for government debt. US bond investors are demanding the most compensation in a decade to buy long-term debt, reflecting concerns about the sustainability of current fiscal trajectories.

The global nature of this phenomenon adds another layer of complexity. Government debt worldwide surpassed \$100 trillion for the first time in 2024, leading to increased vigilante pressure on governments globally. Yields are rising in the UK, Japan, Germany, and Australia, suggesting that fiscal concerns are not uniquely American. The increasing long-term yields in Japan are particularly important to monitor, as any shift in Japanese government bond policy could trigger significant capital flows that impact US Treasury markets. Japan remains the largest foreign investor in U.S. government debt, holding over \$1 trillion, or about 12.4% of the total debt held by foreign countries.

Credit rating agencies have taken notice, with Moody's downgrading the US government's credit score citing large

deficits and fiscal proposals. These downgrades serve to refocus attention on America's debt situation and may contribute to skepticism regarding the dollar's long-term role as the world's reserve currency.

The investment implications are far-reaching. Rising borrowing costs impact not only government interest expenses but also borrowing costs across the broader economy. Mortgage rates, corporate bond yields, and consumer credit costs all move higher, creating a drag on economic growth that could offset the stimulative effects of tax cuts.

For equity investors, rising yields present both challenges and opportunities. Higher discount rates pressure valuations, particularly for growth stocks and companies with significant debt burdens. However, sectors that benefit from higher long-term interest rates - such as banks and insurance companies - may see improved fundamentals.

Federal Reserve Policy Paralysis: Caught in the Crosscurrents

The Federal Reserve finds itself in an unprecedented position of policy paralysis, caught between conflicting economic signals and uncertainty about the ultimate impact of competing fiscal and trade policies. Fed officials have acknowledged that tariffs and related policy initiatives could constrain economic growth while contributing to higher inflation - a classic stagflationary threat that presents no easy policy solutions.

The central bank's “wait-and-see” approach reflects the complexity of the current environment. Traditional monetary policy tools are less effective when economic disruptions stem from policy choices rather than natural economic cycles. The Fed's reluctance to adjust interest rates reflects not indecision, but rather a recognition that premature action could prove counterproductive.

Atlanta Fed President Raphael Bostic has explicitly stated that if tariffs begin to influence inflation expectations, monetary policy intervention would be warranted. However, the nature of that intervention remains unclear. Traditional rate cuts might prove ineffective against supply-side inflation pressures, while rate increases could exacerbate any growth slowdown caused by trade policy uncertainty.

This policy limbo creates particular challenges for rate-sensitive investments. Real Estate Investment Trusts (REITs), utilities, small company stocks and growth stocks - all sensitive to interest rate expectations - face heightened uncertainty about future financing costs. The temporary

de-escalation in trade tensions may stimulate growth thereby diminishing the probability of substantial rate cuts that were previously anticipated, with swap contracts no longer fully pricing in two cuts for 2025.

The broader implication is that investors can no longer rely on Fed policy to provide a consistent backstop for risk assets. In previous economic downturns, the Fed's ability to cut rates provided both economic stimulus and support for asset prices. In the current environment, the Fed's effectiveness may be constrained by the inflationary pressures created by trade policy.

Investment Strategy in the Policy Trilemma

Navigating this complex environment requires a fundamental shift in investment approach. Traditional asset allocation models, based on historical relationships between economic variables and asset returns, may prove inadequate in an environment where policy creates unprecedented cross-currents.

Quality Focus: The emphasis on quality becomes paramount in uncertain environments. Companies with strong balance sheets, predictable cash flows, and pricing power are better positioned to navigate policy-induced volatility. The earnings resilience demonstrated in Q1 2025 suggests that high-quality companies can adapt to changing conditions more effectively than their weaker counterparts.

Sector Rotation: The policy mix creates clear winners and losers across sectors. Technology companies, while benefiting from tax cuts, face headwinds from trade uncertainty and supply chain disruptions. Conversely, domestic-focused sectors like utilities and consumer staples may prove more resilient to trade policy volatility while still benefiting from fiscal stimulus.

Geographic Diversification: The dollar's potential loss of safe-haven status, evidenced by its decline even as yields rose, suggests the need for greater international

diversification. However, this must be balanced against the global nature of fiscal pressures and the interconnectedness of modern economies.

Tactical Flexibility: Perhaps most importantly, the current environment rewards tactical flexibility over rigid strategic allocations. The ability to adjust positioning based on evolving policy developments may prove more valuable than traditional buy-and-hold approaches. This is not the time to carry a large position in illiquid investments.

Conclusion: Adapting To The New Reality

The current policy trilemma represents a fundamental shift in the investment landscape that extends far beyond typical economic cycles. The simultaneous implementation of expansionary fiscal policy, contractionary trade policy, and constrained monetary policy creates a unique set of challenges that require new approaches to portfolio management.

Success in this environment will depend on understanding the complex interactions between these policy forces and their differential impacts across sectors, regions, and asset classes. The traditional relationships between economic variables and asset returns may not hold, requiring investors to develop new frameworks for analysis and decision-making.

The policy trilemma may persist for some time, as the underlying tensions between fiscal stimulus, trade protection, and monetary stability reflect deeper structural challenges in the global economy. Investors who recognize this new reality and adapt their approaches accordingly will be better positioned for success in what promises to be a challenging but potentially rewarding environment.



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