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Market Update

May 2025

The Bureau of Economic Analysis reported that real GDP decreased at an annual rate of 0.3% in the first quarter of 2025, marking the first economic contraction in three years. This decline was primarily driven by net exports, which contributed -4.8% to GDP-likely due to front-loaded imports, particularly in pharmaceuticals and computer parts-and by decreased government spending. These were partially offset by increases in investment, consumer spending, and exports. While this contraction is concerning at first glance, it appears partly attributable to calculation methodology rather than underlying economic weakness, as private domestic spending remained resilient, rising 3.0%.

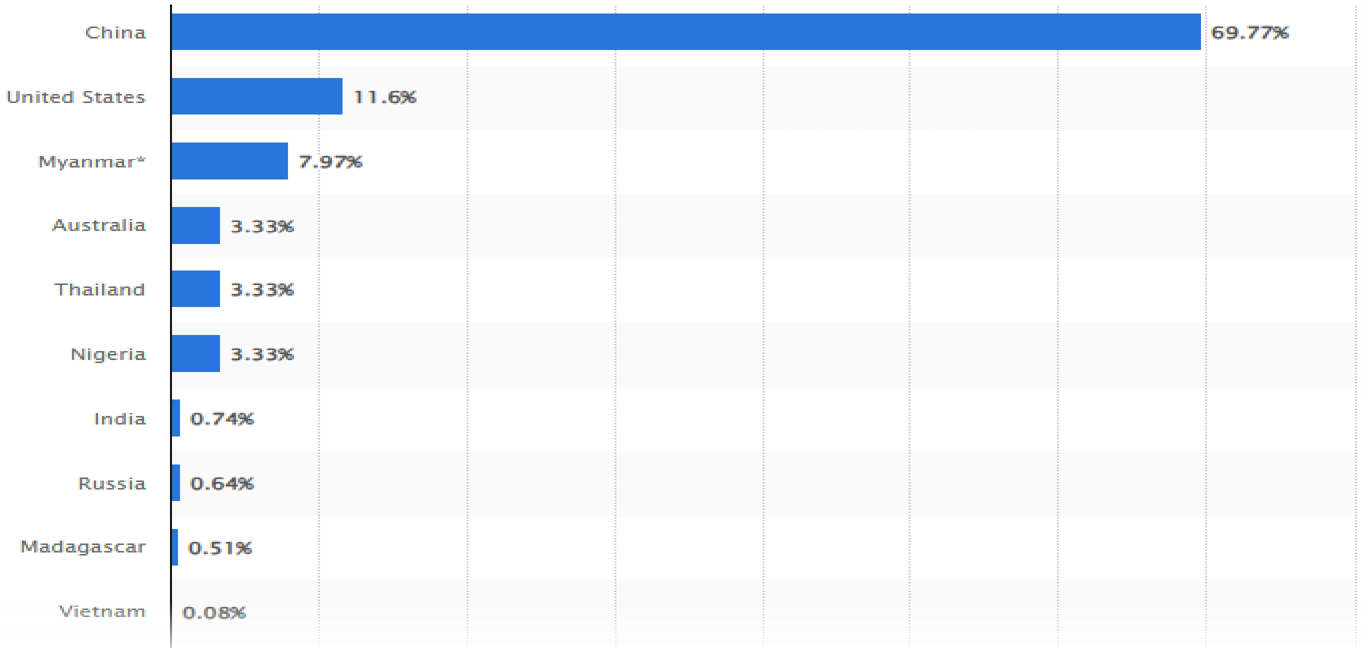
Inflation indicators stayed elevated above the Federal Reserve's target, with the Q1 2025 PCE price index rising 3.6%, up from 2.4% in the previous quarter. Year-over-year Core PCE, which excludes food and energy, increased 2.6% for March, compared to 2.8% the previous month. Additionally, the University of Michigan's five-year inflation expectations jumped to 4.4% in April from 4.1% in March and have been on an escalating trajectory over the past few months.

April's employment report was a bright spot, showing nonfarm payrolls increasing by 177k and unemployment holding steady at 4.2%. Average hourly earnings rose 0.2% month-over-month, representing a 3.8% year-over-year increase. This resilience highlights the labor market's ongoing strength, although employment is considered a lagging indicator and could weaken if uncertainty among corporations persists.

On the geopolitical front, we anticipate bilateral trade agreements with close allies such as India and Japan, which would likely be viewed positively by investors as progress on trade policy. However, a resolution to U.S.-China trade tensions appears unlikely in the near term. The best-case scenario may involve a pause or reduction in tariff rates, or at minimum, an agreement to continue negotiations, which could provide some market stability. Trade policy with China remains highly complex, given China's role in producing affordable goods for U.S. consumers, its dominance in rare earth minerals, and ongoing intellectual property concerns.

With inflation data trending higher and growth forecasts being revised downward, the Federal Reserve Open Market Committee is likely to remain on hold until there is greater clarity about how inflation and tariff policies will interact. While a July policy easing remains our base case, continued uncertainty could delay any rate cuts further into 2025.

Global Rare Earth Production (2024)



Source: United States Geological Survey, Statista

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Product Views

Rates: The 2-year Treasury finished the month 28 bps lower, reflecting expectations for more aggressive Fed action. Meanwhile, the 10-year yield was little changed as persistent inflation and ongoing bond market volatility kept investors cautious. The 2s10s yield curve steepened to a mid-month high of 65 basis points-the widest spread in three years. On April 9th "Tariff Tantrum Day", the 10-year Treasury saw a cumulative 100 basis point swing from the totality of all the day's intraday moves.

We continue to recommend adding duration in the short- to intermediate-end of the Treasury curve. While the recent rebound in yields after a strong jobs report keeps us moderately constructive, rising economic and policy uncertainty-especially with new stagflation risks-remains a concern.

Credit: Credit markets largely tracked the performance of broader risk assets over the last month, with investment-grade credit spreads widening by 21 basis points for the month and 33 basis points year to date. While corporate fundamentals remain generally stronger than in previous cycles, spreads are still running below their long-term median.

Securitized: Nominal agency MBS spreads widened significantly in April and remain elevated. We see potential for the MBS option adjusted spread (OAS) to tighten by year-end, particularly if interest rate volatility eases.