

QUARTERLY MARKET INSIGHTS – SECOND QUARTER 2025

To the Clients and Friends of Hilltop Bank Trust and Wealth Management:

As you may have noticed, a roller-coaster of a year has continued on in the second quarter. Equities ended the second quarter up 4.5% year-to-date after being down as much as 20% after the announcement of reciprocal tariffs in April. As a microcosm of the disorder, the index was down 10.5% over April 3rd and 4th, before gaining 9.5% when those tariffs were paused on April 9th. How is that for a reminder not to try to time the market?

Now, a quarter since our last discussion on tariffs, and announcements about them, both their implementation and postponement have become commonplace. The market now takes both in stride. While I don't ever claim to be in possession of a crystal ball, the uncertainty such pronouncements produce makes any intuition about how the rest of the year might go especially cloudy. What I can say is that they *are* starting to have an impact on both the real economy and markets.

In the real economy, the full impact is likely yet to be truly felt. Our gross domestic product, which rose 2.8% last year, was down -0.5% in the first quarter, and is currently growing at about a 2.6% annualized rate. That averages out to an annualized 1.1% rate of growth for the first half of this year. Real disposable income growth has slowed to about half the rate it was before the pandemic, and that has resulted in a slowing of consumption as well.

For the markets, it's caused equities in developed markets outside the US to jump 19% YTD, while equities in emerging markets are up 15%. The US Dollar is down 12% against the Euro and 8% against the British Pound. Gold, which produces no income and has limited industrial uses, is up 25%. 10-year Treasury yields are back up to 4.425%, after being as low as 4.0% back in April.

The markets also appear somewhat contradictory. The bond market is currently pricing in interest rate cuts, based on the theory that the economy will continue to slow. On the equity side of things, cyclical stocks (stocks that do better when the business cycle is in expansion) are outperforming defensive stocks, which points to the opposite expectation, that growth will accelerate. Similarly, the consensus economic forecast is for slower growth, while the forecasts for individual company earnings are accelerating. Either the economists and bond market are wrong, or the financial analysts and equities are.

Moving on from tariffs, the other big economic news in the first half of 2025 was the budget bill passed by Congress.

In short, our current spending is on track to increase our deficit by about \$3.2 trillion over the next ten years. In relative terms, it will increase the size of US debt relative to our GDP from about 100% today to 160% by 2055. In order to fund that mountain of debt, we will need to sell a lot of Treasuries.

As with any other market, the Treasury market is subject to the laws of supply and demand. As we increase our debt, we increase the supply of bonds for sale. On the demand side, those Treasuries are bought by all kinds of investors from individuals like you or me to large insurance companies, and even other governments.

In fact, a substantial portion of those investors (about 30% of the Treasury market) are foreign entities. Foreigners hold those bonds for a number of reasons: First, the Treasury market is deep and liquid. That means that a large amount of funds can be deployed without distorting it much. Second, the US government has traditionally been seen as an exemplary credit risk. Third, as we discussed last quarter, when other countries sell a lot of goods to the US, it's easier for them to take the dollars they receive and invest in US assets rather than exchange them for a different currency and repatriate them. Even trade that is not conducted with a US counterpart often takes place in the form of dollars. This final point is what makes the US dollar the global reserve currency, which is sometimes derisively referred to as our "exorbitant privilege". It allows us to service our debt at a lower rate than the market would otherwise require.

For reasons that are fairly obvious, but including our on-again-off-again tariffs and growing deficits, some of these foreign investors are now rethinking the amount they allocate to US holdings. The evidence, mentioned above, is the outperformance of ex-US assets, a declining dollar, and higher interest rates.

On the supply side of the Treasury market, there are only a limited set of options to slow down our accelerated fiscal trajectory. As listed by Harvard economist Greg Mankiw, they are 1) extraordinary economic growth, 2) government default, 3) large-scale money creation, 4) substantial cuts in government spending, and 5) large tax increases.

While option one would be the least painful, it may also be the hardest to achieve. After all, if it were simple to accelerate growth, it would have already been done. The general theory, however, is that if the economy grows faster than our debt, that debt will be easier to service in the future – we lower debt-to-GDP by increasing the denominator (GDP). Some have pointed to advances in AI as our potential savior, suggesting it may accomplish something similar to the Industrial Revolution. That is, permanently increasing our productivity and thus the growth rate of GDP. While we can all hope for that, it's worth noting that the internet also changed all of our lives (and jobs) in immense ways. Nonetheless, the resulting economic growth, while helpful, has not been extraordinary. From 1970 to 1994, labor productivity was growing at an average of 1.8%. From 1994 to 2004, it did pick up to a 2.9% annual average, but after 2004, it was back to 1.5%. A similar trajectory will hardly rid us of our debt, not to mention whatever knock-on effects to the deficit true artificial intelligence may generate.

The next option, default, has for a long time been written off as highly unlikely. This remains true, however, for the sake of argument I would have viewed 18% tariffs as unlikely as well. Simply put, we are not currently following an orthodox economic policy. Between you and me, the US has arguably defaulted before – in the 1930s, as we switched from the gold standard to fiat currency, some of our outstanding bonds were supposed to be redeemable for their value in gold. As a practical matter, this was infeasible, so Congress abrogated those clauses. Investors sued, and eventually the Supreme Court ruled that it was not a default. That being said, this lawyer doubts that any other borrower would be able to unilaterally change the terms of a contract and arrive at the same outcome. Regardless, a US default today would have catastrophic consequences across the globe.

Our third option, large-scale money creation, is one reason folks often point to as making default forever unnecessary. The theory goes that, because we issue our debt in our own currency, we can always print more money to pay it off. While that's true, the effect of such a policy, obviously, would be inflation, and in some instances (e.g., 1920s Germany, or 2000s Zimbabwe) it has been hyperinflation. Further, it's not at all apparent that inflating the debt away would be a much better option than default, as inflation creates chaos throughout the entire economy. One of the great benefits of having an independent Federal Reserve, that handles monetary policy without political interference, is that it can hinder this type of operation by raising interest rates. So long as that prevails, markets can have some peace of mind that Treasuries remain a safe investment.

That leaves us with options four and five, spending cuts and increased taxation. At its most basic level, deficit spending is a form of intertemporal redistribution. We are spending the inheritance of future generations to increase our consumption now. Sometimes, as in a crisis, this spending is prudent. It allows us to stimulate the economy, smooth out aggregate demand over time, and avoid the worst-case scenario of depressions. Once the economy has recovered, we can then scale back and pay down our debt. Since the pandemic ended, however, we have not made that choice. We continue to spend as if we are in crisis.

At some point in the future, the bill will come due, and with only about a quarter of the budget being spent on discretionary items, versus the more than half that goes to health insurance and Social Security, those cuts are going to require politicians of immense fortitude. Historically, cutting entitlements has been a good way to get yourself voted out of office.

A similar fortitude may be needed for our last option, which is to raise taxes. Broadly speaking, the US collects about 28% of its GDP in taxes. That makes us a relatively low-tax jurisdiction compared to our peers. For example, the UK collects 35%, Italy 43%, and France 46%. The average for advanced economies is 34%. While no one enjoys paying taxes, compared to options two and three on our list, a combination of four and five seems to me more achievable, with the potential for less pain.

In sum, we seem to be scaring off demand for our debt at the same time we are increasing the supply. The natural consequence of that should be higher rates and even more difficulty servicing that debt, but there is still time to change course. Otherwise, whether it's ten years from now or twenty, the market may frown on our profligacy and force a choice on us.

The real question is which generation of Americans will shoulder the burden.

Best,



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