

ECONOMIC OUTLOOK

Summary

May's nonfarm payroll gain of 172,000 was materially stronger than expected and could meaningfully shift the Federal Reserve's thought process heading into summer. It would have been the largest monthly gain of the year on its own but was reinforced by 93,000 in upward revisions to the prior two months. Combined, the report came in more than triple consensus expectations. Also notable, the unemployment rate fell slightly on an unrounded basis, even though the published figure remained at 4.3%. After much of last year was defined by labor market softness, last month's data suggests a genuine rebound in employment conditions.

For the Federal Reserve, now led by Chair Kevin Warsh, the report changes the balance of risks in a meaningful way. Warsh has been viewed as more inclined to lower rates, particularly after a year of labor market weakness that gave policymakers reason to tolerate inflation above the Fed's 2% target. In late 2025 the Fed cut rates three times, even though price pressures had yet to return to target, because a softer employment backdrop allowed a more dovish interpretation of the data. If labor weakness is no longer part of the story, the case for near-term cuts becomes much harder to make.

The complication is that inflation was still proving sticky even before the war in Iran added a fresh layer of uncertainty. Central bankers are usually reluctant to tighten into an oil supply shock because higher rates do little to resolve the underlying problem and risk slowing the broader economy. If the labor market is firming while energy related price pressures continue to push inflation higher, some voting members may be more willing to look past the supply shock explanation and treat the move as evidence inflation is not yet contained. Three members of the Fed already hinted at this during the late-April meeting when they dissented in favor of removing the easing bias from the formal statement.

The next move is not necessarily a hike, but Warsh's broader preference to lower rates will likely not be acted on soon since it is unlikely he will gain enough support among voting members. Markets may need to reassess how much of the easing narrative depends on labor weakness remaining in place. For investors, the message from May's employment report is that the Fed's job has likely become more complex, not less.

Positives

ISM Manufacturing expanded for its fifth consecutive month (54.0 vs. 53.0 est.)

Job Openings and Labor Turnover Survey (JOLTS) job openings rebounded sharply (7,618k vs. 6,887k prior)

Durable goods orders rose 7.9%, well above the 4.0% estimate

Negatives

UofMich Consumer Sentiment Index fell to an even further all-time low (44.8)

Initial jobless claims rose to their highest level in 16 weeks (225k)

Q1 GDP was revised lower from 2.0% to 1.6%

EQUITY OUTLOOK

Summary

The impressive April stock market rally continued in May with the S&P 500 Index adding 5.3%, now sitting 11.3% higher year to date. Growth stocks maintained leadership in May with the Russell 1000 Growth Index gaining 7.2%, outpacing the 2.9% return in the Russell 1000 Value Index. The small-cap Russell 2000 Index rose 4.4%. The developed international MSCI EAFE Index and MSCI Emerging markets Index returned 3.1% and 9.7%, respectively.

Catalysts driving the markets seem to generally be the same in recent months: robust corporate earnings and the capex spending boom overshadowing geopolitical uncertainty. At times, the market's positive momentum feels nearly unstoppable, but history and experience warn us to use caution in that regard.

The mid-term elections are quickly approaching and are likely to have some impact on capital markets. During the last 16 mid-term election years dating back to 1962, the market has experienced an average drop of over 19% at some point during that year. This is likely because the political pendulum tends to swing away from the incumbent party, often shifting the balance of power. This uncertainty in legislative policy has the potential to create market volatility as it has done historically.

Whether it is the mid-terms or some other significant event, eventually something will stall the stock market rally. Still, this has been among the most resilient and defiant rallies in recent history. It is hard to see anything slowing it soon.

Positives

Corporate-earnings growth and profitability

Artificial intelligence boom

Negatives

Middle-East tensions and oil prices

Elevated equity valuations

Unknowns

Fed policy

FIXED INCOME OUTLOOK

Summary

Despite diplomatic efforts, a peace agreement with Iran remains elusive and periodic clashes test the fragile ceasefire. While the U.S. equity markets remain optimistic, the bond market has told a different story. The 10-year Treasury note yield continues locked to the price of oil. Since the start of the Iran war the correlation between the two has been +0.88. Yields rose across the curve each of the past three months, albeit more modestly in May. The higher movement has been particularly felt at the front end of the curve as market expectations have shifted from anticipating rate cuts to a growing possibility of a rate hike this year. The 2-year increased by another 14 basis points (bps) to end May at 4.00%. This is substantially higher than the 3.65% effective overnight rate and brings the three-month total increase to over 60 bps. The 10-year note increased 7 bps to end at 4.44%. The 30-year bond was essentially unchanged at 4.97%.

With the first four months of the year averaging over \$200 billion, issuance of investment-grade corporate bonds slowed to \$163 billion in May, which was still 22% higher than the previous 4-year average. Issuance breached \$1 trillion on the first trading day of June, which was faster than any year besides the pandemic-fueled pace of 2020, according to JP Morgan tabulations. Led by technology companies borrowing for AI infrastructure, this year is expected to set a record of more than \$1.8 trillion. Given tech companies tend to carry higher credit ratings, the A-rated or higher segment of the market has increased while the BBB-rated segment has declined to the lowest percentage of newly issued bonds in over a decade. Robust investor demand and few fears of an economic slowdown allowed credit spreads to narrow by 6 bps to end the month just 1 bp above the tightest level this century. Investment-grade corporate bond returns have significantly outpaced those of the Treasury bond market for the month and year-to-date period.

If the Iran war persists, there is little reason to expect longer-maturity yields to break their connection with oil prices. Even

so, we still believe the front end of the curve represents a significant opportunity as tighter monetary policy is rarely a good response to a supply shock. The 2-year Treasury note could decline by 25 bps or more even as the price of oil remains elevated. Longer-maturity yields would certainly respond to a resolution to the conflict but could remain stickier as the price of oil is unlikely to quickly fall all the way back to pre-war levels. We still recommend maintaining a neutral duration policy and rolling bonds inside of 18 months to the 2 to 3-year part of the curve. With credit spreads near multi-decade lows, we are fading our enthusiasm for corporate bonds. We are still maintaining higher exposure but becoming increasingly selective in new positions.

Positives

10-year yields higher than 96% of the time over the past 18 years

Markets are now expecting a Fed rate hike which is unlikely

If the war is resolved, oil prices and inflation concerns should subside

Negatives

Fed rate cuts are unlikely this year

GDP growth and the labor remain resilient

Record corporate bond issuance expected for this year

Unknowns

Resolution of U.S.-Iran war