INVESTMENT PERSPECTIVES

AUGUST 2025

Key Takeaways —

- Are Big Banks seeing the Big Picture?
- The fees lurking in your bond basket.
- What will move the market going forward?

CUE THE BIG BANKS

Mark Luschini, Chief Investment Strategist

At the end of each calendar quarter, publicly traded companies release their financial results for the preceding three-month period, and management opines on business activity and often projects what the company sees ahead for its prospects. Leading the parade of hundreds of releases over the ensuing weeks are the big, money-center banks. These include JP Morgan, Citigroup, Bank of America, and Wells Fargo. Early reports also come from those more closely associated with the capital markets, such as Goldman Sachs and Morgan Stanley, and even some regional banks like PNC and M&T Bank.

These financial institutions collect and warehouse copious amounts of detailed information about their customers; businesses, and consumers alike, putting them in a unique position to comment on the direction in which the economic winds are blowing. Are they seeing stresses building in the form of credit delinquencies or defaults, falling deposit balances, and weakening loan demand, or are customers' liabilities being met on time, and is spending trending at a healthy pace? Or perhaps there is something else emerging that has their attention, requiring further pursuit?

The recent guidance offered by the CEOs and CFOs of these companies reinforced the bullish thesis that has guided our expectations for the economy and stock market this year. The read-through suggests that the economy is resilient, most importantly due to consumers holding up well. To be sure, a few banks noted that more stress is detected among the lower-income bands, but not alarmingly so. Others remarked on the strength in households observed through growing net worth and healthy account balances. On the business side, some banks reported weaker loan demand, but more saw quarter-over-quarter improvement, especially in the closing month and a half of the second quarter. As a sign of risk appetite, the investment banks reported an active pipeline for mergers and acquisitions (M&A), initial public offerings (IPOs), and financial advisory work. Collectively, this measure is usually coincident with an upbeat or brightening outlook.

To be sure, risks are lurking that could undermine these positives. Inflation has yet to be fully tempered, and the recent release from the Consumer Price Index indicated that imports of home furnishings, apparel, toys, and a few other goods items printed higher prices attributed to tariffs. This may be foreshadowing what could be seen in the forthcoming monthly data, which has possible monetary and economic implications. In addition, while affluent households have propped up spending, even they are not immune to building precautionary savings in the case of sharply rising unemployment and lost economic momentum if tariffs take a stronger bite or a new risk intrudes.

Since the economic reports over the last several months, and likely at least the next few, are compromised by behavior dictated by tariff-related uncertainty and the developing consequences of their imposition, it makes it difficult to host a high conviction call on the economy or markets. Even so, our view has been and remains that the economy will avert a recession, and a catch-up by some of the pro-growth features of President Trump's recently passed One Big Beautiful Bill will at least counteract some of the trade-related friction.

Indeed, a low level of unemployment, wages that are growing on an inflation-adjusted basis, moderate but positive activity across the manufacturing and services industries, and some easing of trade uncertainty that could unlock risk-taking support that contention. Consequently, corporate earnings over the coming quarters should exceed the low bar that the analytical community set for profit growth, and, in turn, the stock market should respond positively. The Investment Strategy Group favors cyclical sectors, including Technology, Communication Services, Industrials, and Financials. We add the historically defensive Utilities sector to that list as the rapidly growing data center and infrastructure buildout will devour energy and power resources for the foreseeable future. ■

HIDDEN COSTS OF FIXED INCOME INDEX FUNDS AND ETFS

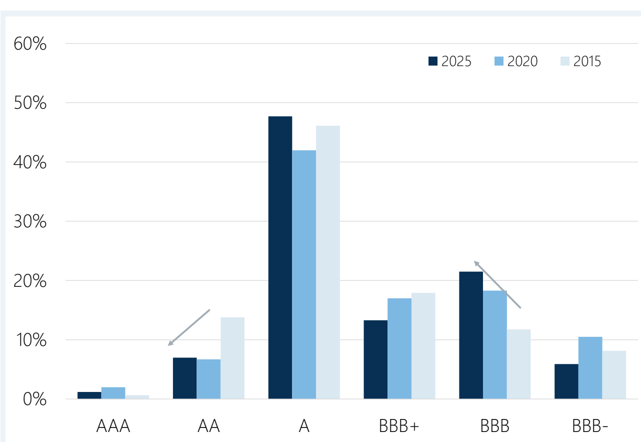
Guy LeBas, Chief Fixed Income Strategist

The rise of indexing as an investment strategy has transformed the landscape of equity markets. Mutual funds and exchange-traded funds (ETFs) that track major equity indices have benefited from trillions of dollars of inflows since pioneer John Bogle launched the First Index Investment Trust in 1975. It took another 11 years before indexing came to fixed income, but it was not until 2009 that the idea of fixed income indexing gained real traction. While indexation can offer lower fees, diversification, transparency, and better liquidity in small sizes, its application in corporate bond investing can create unintended risks as well.

Arguably, the biggest—and perhaps most overlooked—issue is that corporate bond indices are market-value weighted. As a result, the more debt a company issues, the larger its representation in the index. Concentration risks are subtly different in fixed income than in equities. In equity indexing, larger companies earn more weight because of investor confidence and performance, whereas in fixed income indexing, weights are correlated with credit risk.

In bond indices, the weighting mechanism rewards the most indebted companies, not the most stable. If Company A, with decades of history, and Company B, which is a recent start-up, both issue $10 billion in debt, they get the same weight regardless of credit quality, operating margins, or revenue volatility. This skew means an indexed investment in corporate bonds will end up owning more of heavily-levered issuers, and less of higher-quality credits. The pro-leverage weighting is somewhat worse in investment-grade corporate bond funds since many high-yield funds recognized this problem early and capped allocations to any single issuer. Still, the biggest issuers in the high-yield index have 1.5% – 2.4% allocations, while the median issuer has less than 0.20%.

Chart 1: Over Last 10yrs Largest IG Corporate Bond ETF Migrated Lower in Ratings



Source: Janney ISG; Blackrock

Sector-wise, certain industries like telecom, energy, and banking are chronically overrepresented in indices, due to their capital-intensive models and frequent debt issuance. Investors relying on index-based strategies may therefore be unwittingly doubling down on macroeconomic factors specific to those sectors.

Another downside to fixed income indexing is that corporate bond markets have less liquidity and more fragmentation than equity markets. Bonds do not trade on centralized exchanges, and securities can go days without a single trade, leaving uncertainty in pricing, especially in volatile markets. In addition, when a fund rebalances (and index funds do so more regularly than other funds), transaction slippage creates a drag on performance. Clever trading technology has reduced but not eliminated the problem. Generally, less-liquid sectors like emerging market and high-yield bond funds suffer from these slippage issues more than investment-grade funds.

A third downside to fixed income indexed investing applies mainly to open-ended funds and equally to indexed and non-indexed fixed income funds. That downside is herding behavior. In stressed times and corporate bond sell-offs, many fund investors trim or sell their exposures. That trend forces funds to sell their holdings, pushing spreads wider and (for open-ended funds) leaving existing holders with capital losses. Since indexed funds have to sell fairly evenly across holdings to cover outflows, these funds end up selling weaker credits at exactly the time weaker credits are out of favor. While herding is a risk with all mutual fund types, the problems are more problematic for less-liquid and higher-risk asset classes.

Indexing can be an efficient way to invest in a wide range of markets, but for corporate bond strategies, indexed investing carries structural quirks that are not present in equity or government bonds. In corporate bond investing, sometimes the smartest move is not following the index.

IS IT TIME FOR A DEEP BREATH?

Gregory M. Drahuschak, Market Strategist

The speed of the stock market's advance from the April 7, 2025, low has been astounding. From the April 7 intraday low (4835.04), the S&P 500 reached as high as 6409.26 for a 32.56% gain. From the applicable closing prices on each date, the S&P 500 gained 26.22%, all in 76 trading days. Perhaps even more remarkable is that it took only 55 trading days to reach a new all-time closing high. For perspective, consider that after the COVID-induced low in March 2020, it took 103 days to reach a new high, or that after the March 2009 low, 1021 trading days passed. It took 1462 trading sessions for the S&P to reach a new high after the October low in 1974, when the market and the economy were rocked by political turmoil and the dramatic rise in the price of crude oil.

The next closest period between a notable low and a new high came after an August low in 1998, when the S&P 500 took only 59 days to reach a new high on November 23, 1998.

Market volatility in recent years has been relatively high. However, it is important to remember that since the late 1950s, the market has had numerous drawdowns of 14% or more before eventually moving on to new all-time highs. The recovery from this year's April low followed a 48-day drop before the robust rebound began. Today, a key question some investors have asked is whether the recent rapid lift off the April low has created a time to pare back on equity exposure. We think not.

The key after any of the volatile market moves is what the economy and earnings offer moving forward. Aside from a few interim corrections, when economic conditions remained solid, the market responded with strong recoveries, as it did most notably in 1998, 2011, and 2018. The U.S. economy is remarkably robust. The most recent assessment of GDP for the second quarter showed a 3.0% growth rate that was helped by consumer spending that rose at a faster pace than it did previously. However, it should be noted that the expansion benefited from a 30.3% drop in imports. However, early in 2025, the biggest fear was that a recession was in sight. That concern largely has disappeared.

Rate cuts again were on the market's mind after the July 30, 2025, Federal Reserve Open Market Committee meeting (FOMC). As widely expected, the Committee kept the fed fund target range at 4.25% - 4.50%. Still, for the first time since 1993, two Committee members voted against the policy statement, preferring that the group take a step to lower interest rates now. Initially, the stock market interpreted the policy statement as having a dovish tilt, but Chairman Jerome Powell's press conference changed that as Powell said that the Fed has not decided on a September rate cut and inflation is somewhat above the Fed target. Stocks weakened soon afterwards.

Interest rates, earnings progression, and technical factors are likely to be driving influences as to whether the market can continue its upward trajectory without first pulling back for a time. These factors, plus an extended S&P 500 as well as seasonal conditions that often inhibit the market in August through the middle of October, suggest temporarily taking a more measured approach to new equity buying, but with an eye on positioning portfolios for a potentially robust November–December rally.

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