Quarterly Market Commentary

Q2 2025

Bond Bully

"I used to think that if there was reincarnation, I wanted to come back as the president, or the pope, or a 0.400 baseball hitter. But now I want to come back as the bond market. You can intimidate everybody"

- James Carville, chief political strategist to President Bill Clinton, 1993

Financial markets have a hard time being boring, but the second quarter of 2025 will surely go down as one of the least boring in history—at least eight days of it anyways. We are, of course, referring to the days following President Trump's ironically named 'Liberation Day'. From the time the tariffs were announced on April 2nd to the morning of April 9th, the S&P 500 Index dropped nearly 14%, bottoming approximately 20% below its high set on February 19th. The tech-heavy NASDAQ retreated nearly 15% between April 2nd and April 9th, bottoming nearly 25% below its high set on February 19th.

Despite these stomach-churning numbers, corrections in any given year are not uncommon, and we have certainly seen larger drawdowns in an absolute sense. It is rare, however, for moves of this magnitude to occur over such a short period. On April 3rd and 4th alone, the S&P 500 Index plunged 10.5%, marking only the sixth time in 75 years the index dropped by more than 10% over a two-day period. These values also pay little justice to the intraday market volatility that reverberated through markets during this time. For example, on April 7th, the S&P 500 Index rallied from a loss of 4.7% to a peak gain of 3.4%, with the bulk of the move happening over a period of just ten minutes—one of the most extreme market moves ever recorded by the index. It was caused by a (then) rumour that President Trump was considering pausing his tariff policy; a rumour the Trump administration was quick to debunk. Following the denial, equity indexes swiftly resumed their march downward. The CBOE Volatility Index (VIX) jumped from a low of approximately 21 just before the announcement on April 2nd, to an intraday high of 60 on April 7th. The VIX index provides a real-time measure of the 30-day expected volatility of the S&P 500 based on the pricing of put and call options. It is colloquially known as the 'Fear Index', due to its tendency to rise substantially during periods of uncertainty. When the VIX trades at 20, the implied 'expected' daily volatility of the S&P 500 Index is +/-1.25%. When the VIX trades at 60, the expected daily volatility is approximately +/- 3.78%.

On April 9th, in a reversal few predicted (despite the aforementioned rumour), Treasury Secretary Scott Bessent took to the Whitehouse lawn and officially announced President Trump was indeed pausing tariffs on most countries for a 90-day period, ostensibly to negotiate individual trade deals with each country in good faith. The S&P 500 notched a gain of 9.5% that day; it's third-best single-day return since World War II. The NASDAQ finished up nearly 12.2%, representing the second-best percentage gain since its inception.

Words can be powerful, and headlines proved to move trillions of dollars during the first days of the quarter.

U.S. equities would go on to finish the quarter in positive territory. Indeed, the S&P 500 set a new all-time high on June 30th. If one had buried their head in the sand in February and pulled it out at the end of June, you could forgive them for thinking the prior two months had been quite boring in equity terms, if judging only by the relative price levels of the major U.S. indexes.

By now, we are all likely aware of the general 'story' outlined above. Equity markets get a lot of airtime on traditional media outlets, and they certainly got a lot of airtime following the Liberation Day announcements.

The bond market, on the other hand, tends to move around in the background in relative obscurity, not typically factoring heavily in news headlines. Bonds, however, are incredibly important. In large part, they form the basis for how governments and institutions across the world finance spending. In the case of governments, that spending allows nations to support citizens through social and medical programs, build defense capabilities to ensure security and protect sovereignty, and invest in their economy through research and the build-out of infrastructure, all of which is intended to promote a healthy, vibrant economy and improve the standard of living within the country's borders.

The U.S. Government is one of the largest bond issuers in the world. Distributed through the U.S. Department of the Treasury, they issue bonds of various maturity terms, generally ranging from 90 days (known as Treasury Bills) to 30 years (known as Treasury Bonds). When the Government spends more than it receives in tax and other revenue on an annual basis, they issue bonds to cover the deficit. In addition, when old bonds mature, they issue new ones to help pay back the old ones. Each bond represents a liability to the Government and adds to the total outstanding debt that is owed to lenders.

The U.S. Federal Government's total debt has been on a steady rise for decades. As was the case for nations across the world, total national debt increased substantially during the COVID-19 pandemic. Since that time, U.S. debt has continued to increase at an above-average rate as successive administrations have run increasingly large budget deficits to fund outsized fiscal spending. Total U.S. debt outstanding now sits at approximately $37 trillion. This represents 123% of annual U.S. Gross Domestic Product (GDP). Net interest on that debt is now the third-largest annual spending item of the U.S. Government, at $952 billion, representing 14% of total spending. This is exceeded only by Social Security at $1.572 trillion (22%), and Medicare at $1.15 trillion (14%). The cost of servicing the national debt surpassed total National Defense and Health spending in 2024.

U.S. bonds are highly desirable. They are owned in significant quantities by individual investors, local and foreign institutions, governments and associated entities around the world. They are generally considered to be about as 'risk-free' an investment as one can get. This stems from the fact that the market for U.S. Government bonds is one of the largest and most liquid in the world, with bonds being backed by the largest economy in the world. Bond investors demand compensation for (1) no longer having the opportunity to use the capital lent to the bond issuer for their own purposes, and (2) the risk the issuer won't pay their interest on time — or, worse, won't return the buyer's principal at the time of maturity. In theory then, the U.S. Government represents a very low-risk entity to invest in; it is considered highly unlikely they will fail to pay the interest or pay back the principal at the time of maturity.

Historically in periods of volatility, investors seek so-called 'safe havens' to stash capital while the turmoil of the market plays out. For the reasons noted above, buying US dollars, US treasuries & US bonds, have consistently been the pinnacle of the flight-to-safety trade.

During the days following the Liberation Day, then, one would typically have expected U.S. bond prices to rise as investors sought the relative safety of investing in the U.S. Government. This, however, turned out not to be the case. Far from offering a safe haven, prices on 10- and 30-year U.S. Treasury bonds plummeted, causing yields to soar. On Tuesday, April 8th and continuing into Wednesday, April 9th, 10-year yields jumped over 60 basis points, peaking at just over 4.5% (yields move inversely to bond prices). The 30-year yield jumped from a low of approximately 4.3% on April 3rd, up to a high of nearly 4.9% on April 9th, and even breaching 5% on April 10th.

The dynamics of bond markets are complex and the diversity of owners great, so it is difficult to pin down the underlying motivation for these moves. Several potential contributors are:

- One of the primary concerns around the tariffs proposed was their potential impact on inflation and growth. Tariffs would likely be inflationary meaning interest rates would likely remain elevated. Higher costs and considerable uncertainty present challenges for businesses and consumers, potentially leading to lower spending and slower economic growth. Reduce GDP and the debt-to-GDP ratio naturally rises.
- Higher interest rates mean new Government debt is issued at higher yields. Any new bonds issued to cover the budget deficit or pay back old, lower-interest debt, will carry higher interest rates and therefore cost more to service.
- Large hedge funds often use U.S. bonds as the foundation for large arbitrage trades. When prices start to move, these trades can force rapid selling.
- If the shift in U.S. foreign policy is increasingly confrontational and insular, how much U.S. debt do foreign nations want to hold?

The tumbling stock market got most of the attention during the days following Liberation Day, but the plummeting bond market — the key vehicle by which the U.S. Government finances its spending — may have been the bully that prompted President Trump's sudden reversal.

Later in the quarter, President Trump's administration tabled 'The One Big Beautiful Bill Act'. The proposed legislation extended existing tax cuts set to expire, added new cuts, and outlined an aggressive fiscal agenda. All combined, the Bill is projected to drive wider fiscal deficits and add trillions in additional debt over the next 10 years. Around the same time the bill was tabled, Moody's was the last of the three major credit-rating agencies to strip the U.S. Government of its triple-A credit rating.

Expanded fiscal agendas won't be unique to the U.S. On June 25th, NATO nations committed to an increased defense spending target of 5% of GDP, a massive increase from the prior 2% target. Their governments will be looking to finance that spending, in part, through bond issuance. Nations around the world may also be looking to support their economies to help combat potential tariff impacts and support growth. With long-term debt concerns, expanding deficits, trade uncertainty, and a potential for a flood of global bonds hitting the market, what interest rate do bond investors demand on government debt?

Q2 Market Update

The second quarter of 2025 proved to be a turbulent ride for investors. Beyond the volatility in April outlined above, the market faced rising geopolitical tensions between Russia and Ukraine, the 12-day war between Israel and Iran, the bombing of Iranian nuclear facilities by the U.S., ongoing trade salvos between the U.S., China, and numerous others, President Trump's One Big Beautiful Bill, downgraded global growth projections, and more. The market that hung on nearly every headline at the start of the quarter, shifted quickly to a market willing to look past the headlines through the end of the quarter.

Overall, U.S. equities, as measured by the S&P 500 Index, rebounded heavily in May and June following the swift correction in April. Both the S&P 500 and NASDAQ finished the quarter at record highs. The Magnificent 7 led the way down in April but recovered strongly following the pause in tariffs. Overall, growth stocks roared back in Q2 while value-oriented securities fell short in comparison; a complete reversal of their respective performance in Q1. Valuations also returned to their previous highs, with the S&P 500 finishing the quarter at an aggregate forward price-to-earnings ratio of approximately 22x (compared to the 30-year average of 17x).

After a brief downturn in April following Liberation Day, the Canadian stock market, as measured by the S&P/TSX Composite Index, ultimately carried on the strong performance posted in Q1. May was especially strong with the TSX rallying approximately 5.4%. The index would go on to hit record highs in June despite ongoing trade tensions with the U.S. which culminated in the country rescinding its planned Digital Services Tax set to take effect on June 30th. The strong rally during the second quarter was led by the materials sector (mainly gold), with the financials and consumer discretionary sectors also boosting performance.

Building off a strong Q1, international equities continued to shine in Q2, with a weakening U.S. dollar acting as a tailwind. European equities responded positively to the tariff pause and expanded rhetoric around increased defense spending. Using the MSCI World ex USA Index as a proxy (which tracks large- and mid-cap equities in developed markets outside of the U.S.), international markets have far exceeded returns posted by U.S. equities year-to-date at 19.5% versus 5.5% for the S&P 500 (returns in USD-terms as of June 30th, 2025). Even with the recent outperformance, the aggregate valuation of the MSCI World ex USA Index ended the quarter at 14.8x forward P/E, well below the 22x forward P/E of the S&P 500.

Year-to-Date Returns (local currency):

S&P/TSX Composite Index: 8.6%
S&P 500: 5.5%
Nasdaq: 5.5%
Euro Stoxx 50: 8.3%
Japan Nikkei 225: 1.5%
Shanghai Stock Exchange (SSE) Composite: 2.8%

Data: FactSet as of June 30, 2025; price returns

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