Midland Wealth Management

QUARTER 3

# MARKET OUTLOOK

AT A GLANCE

Resilient economic data and easing inflation reinforce expectations for rate cuts, even as developed markets grapple with persistent deficits and rising debt-to-GDP ratios. Equity markets soared to record highs in Q2 2025, lifted by growth stocks and policy optimism. With fiscal pressures mounting, emerging market debt is increasingly attractive as investors seek diversified, forward-looking opportunities.

## ECONOMY

### BEAUTIFUL BILL PASSES

The landmark bill passed, but questions remain about its impact on the federal deficit.

## FIXED INCOME

### RATES HOLD STEADY

The Fed is holding its 4.25–4.50% target rate steady as markets continue to absorb evolving economic data.

## EQUITIES

### POSITIVE Q2

| | |
|---|---|
| S&P 500 | +10.94% |
| MSCI EAFE | +11.78% |
| MSCI EM | +11.99% |

"PORTFOLIO MANAGEMENT COMBINES DATA-DRIVEN STRATEGIES WITH INTENTIONAL PLANNING TO GROW AND PROTECT WEALTH. WE AIM TO OPTIMIZE RISK AND REWARD TO SUPPORT OUR CLIENTS' GOALS, SECURE THEIR LEGACIES, AND GUIDE THEM TOWARD FINANCIAL FREEDOM WITH CLARITY AND CONFIDENCE."

Denise Melton
Portfolio Manager

Global Economy

# DEFICITS, DEBT, AND THE "BIG BEAUTIFUL BILL"


## SUMMARY:

Persistent deficits and growing debt levels in developed markets highlight long-term risks and support globally diversified thinking.


## OUR PERSPECTIVE:

### TRADE POLICY TAKES THE SPOTLIGHT

As macro conditions soften due to a longer period of elevated rates, persistently high debt levels in the United States (US) and abroad may prompt investors to look elsewhere for safety from volatility.

#### TAX AND SPEND OR SPEND AND TAX

The fiscal landscape in developed markets, particularly the US, is becoming increasingly complex. While debt has always played a role in sovereign finance, the current magnitude and structure of deficits in the post-COVID, post-Great Financial Crisis (GFC) world present long-term challenges that merit close attention. Policymakers continue to rely heavily on debt as a policy lever.

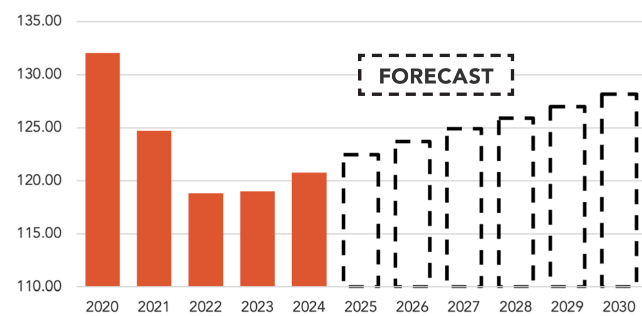
A current example is a major omnibus proposal in Washington—dubbed the "One Big Beautiful Bill"—which includes provisions to make Trump-era tax cuts permanent, expand deductions for research and development costs and business interest expenses, and reinstate full expensing of depreciable assets. These measures are designed to stimulate short-term investment but are estimated to add $2.4 to $3 trillion to the federal budget over the next decade. While aimed at boosting investment and economic growth, the bill further underscores a policy pattern of stimulus through borrowing.

The bill also expects to boost spending on defense, immigration enforcement, and infrastructure. Proposed offsets, such as reductions in Medicaid and food assistance, may soften the fiscal impact but are unpopular with several lawmakers on both sides of the aisle and unlikely to eliminate it. Coupled with a proposed $5 trillion debt ceiling increase, the bill reflects a continued reliance on deficit financing.

#### MORTGAGING THE FUTURE

As the chart shows, the US debt-to-GDP ratio currently stands at approximately 120% and is projected to rise to 130% by 2030. This is set against the backdrop of ~2% long-term GDP growth expectations, as recently highlighted by the Federal Reserve. This would not present a long-term sustainability problem as long as economic growth and/or productivity outpace the deficit's growth rate. Put simply, debt is growing faster than the economy.

**Debt-to-GDP Ratio (%)**




Source: Bloomberg

While the US continues to benefit from its status as the world's reserve nation, supported by global demand for dollars for both trade settlement and investment, this advantage is ultimately rooted in trust and credibility. A sustained trend of rising debt could test that foundation over time.

Historically, deficits have been used strategically to stimulate the economy during downturns and invest in long-term economic growth. However, in recent decades, deficits have become more structural in nature. From the post-WW2 decline in debt levels, we transitioned through the GFC, the Eurozone Crisis of the early 2010s, and the COVID-19 pandemic into an environment where deficits are increasingly persistent.

To put this into perspective:

- During the Great Depression, US debt peaked at 80% of GDP.

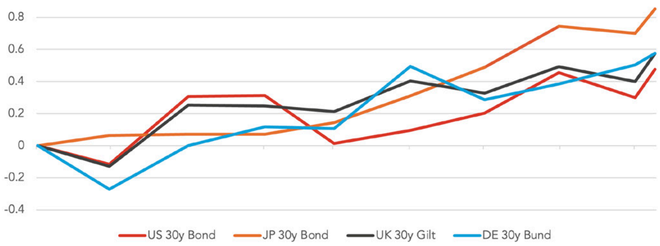
- During WW2, it surged to 150% of GDP.
- After falling, debt rose sharply during the GFC and again during COVID.

Today, we manage peacetime deficits and debt levels without an acute crisis, suggesting a new regime. Though not cause for immediate alarm, it warrants thoughtful portfolio positioning.

BOND MARKET PUSHBACK

As the fiscal ambitions of developed nations expand, markets are beginning to show signs of resistance. While central banks in many developed economies have shifted toward easing, long-end yields are moving in the opposite direction. This divergence reflects a subtle but growing tension between monetary policy and fiscal behavior.

**Developed Market Long 30y Rates Since First Fed Rate Cut**




Source: Bloomberg

In recent months, 30-year government bond yields have risen even as central banks cut policy rates or signal dovish intentions. This trend has emerged across several developed markets, including:

- US: The Treasury curve has steepened due to concerns that continued deficit spending will keep the Treasury supply elevated.
- Germany: Bund yields have firmed despite a weak growth backdrop, mainly in response to constitutional debates over fiscal expansion.
- Japan: The Bank of Japan's shift away from yield curve control has coincided with a rise in Japanese Government Bond yields, reflecting investor uncertainty over the fiscal trajectory.
- United Kingdom: The market's adverse reaction to unfunded fiscal proposals in 2022 remains cautionary.

> **THE TRADITIONAL PARADIGM THAT DEVELOPED MARKETS ARE INHERENTLY SAFER THAN EMERGING ONES IS EVOLVING**

What's happening here is more than a technical market adjustment—it's a signal that credit markets are beginning to price in fiscal risk at the sovereign level. In effect, markets demand a higher risk premium for long-duration government debt in countries that rely heavily on borrowing without a clear path to debt consolidation.

This creates challenges for both policymakers and investors. For governments, rising yields increase debt servicing costs and complicate future stimulus efforts. For investors, it raises critical questions about how to position fixed income allocations traditionally viewed as conservative.

This macro backdrop opens the door to reconsidering where conservatively oriented capital might go, especially if the insular benefits of developed government bonds are somewhat diminished. The traditional paradigm that developed markets are inherently safer than emerging ones is evolving. By expanding their global opportunity set, investors may uncover greater relative value and more balanced risk profiles.

This is not a recommendation to exit developed market fixed income entirely. Rather, it's a call to rethink what resilience looks like in a world where debt sustainability is no longer a given. Emerging market debt, particularly denominated in the local currency, may offer diversification benefits, return potential, and a hedge against fiscal drift in the developed world. This asset class is one potential option worth considering.

By Emil Suqi, CFA®; Jake Stapleton, MBA

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# HOLDING STEADY, LOOKING GLOBALLY

## SUMMARY:

Rate cuts are still expected this year amid lingering inflation and gradually increasing unemployment data. Many developed countries have seen their debt-to-GDP ratios climb and are offering reasons to explore EM debt.

## OUR PERSPECTIVE:

The Federal Reserve (Fed) continues to debate the timing of its next move, which is widely expected to be a rate cut. Two 0.25% cuts by end-of-year are predicted.

HOLDING STEADY FOR NOW

The Federal Open Market Committee held rates in the range of 4.25-4.5% for the fourth consecutive meeting. The committee continues to allude to elevated uncertainty and data dependency in its rationale for the decision.

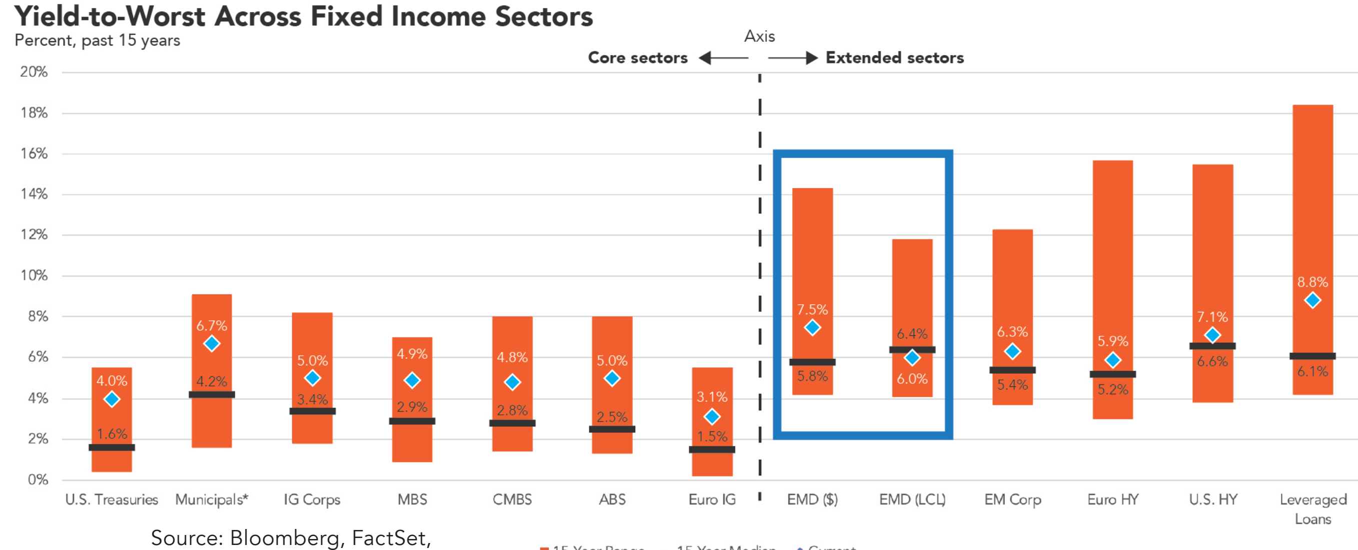
Fixed income, as measured by the Bloomberg Aggregate Bond Index, returned ~4% in the first half of the year. With current yields near multi-decade highs and the potential for rate declines if the Fed resumes cuts, the environment may be favorable for both income generation and capital appreciation.

Perhaps a more interesting observation in the first half of the year has been the resilience of long-end rates in developed nations. It is relatively rare for central banks to cut overnight rates while rates at the long end of their sovereign curves rise simultaneously. Earlier commentary explored potential causes, but ballooning deficits in many developed market (DM) economies continue to weigh on economic growth.

The increasing costs of servicing this growing debt reduce spending on other productive investments. These rising debt levels are not sustainable long-term and will contribute to fiscal stress in DM economies.

A complementary trend that our team has taken note of is the declining value of the US dollar. The US dollar has fallen more than 10% year-to-date—the steepest first-half decline since the early 1970s. Emerging markets (EM) are benefiting from this decline. Many EM countries borrow in US dollars. When the dollar weakens, this dollar-denominated debt becomes cheaper to repay by strengthening EM currencies (see chart, which displays both dollar-denominated and local currency-denominated EM debt yields). The weakening dollar also boosts commodity prices since they are typically priced in US dollars globally. EM economies that export commodities earn more revenue and improve trade balances when the dollar weakens.

**Yield-to-Worst Across Fixed Income Sectors**
Percent, past 15 years



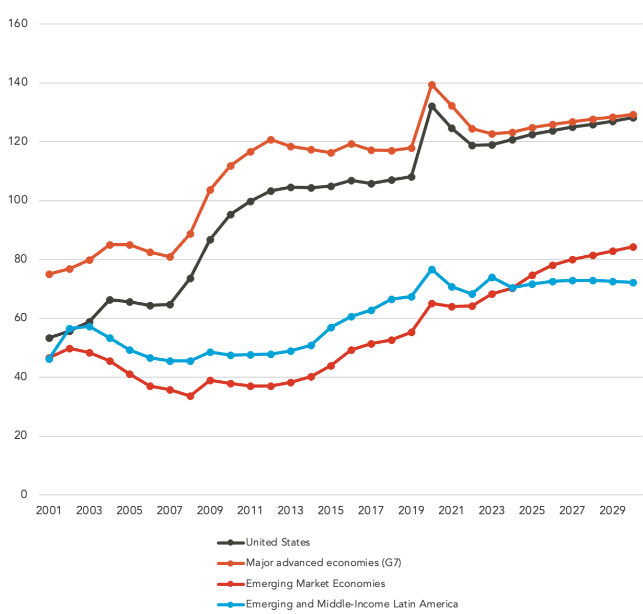

Source: Bloomberg, FactSet, JP Morgan Credit Research

## AN APPEAL TO REASON

Our investment team regularly discusses our equity and fixed income portfolios and the appropriate allocations within each. Key considerations within fixed income include credit, interest rate, liquidity, currency, and geopolitical risks. Equity diversification has historically included an allocation to international stocks, but what about fixed income? Fiscal risk in the domestic bond space could make yields go higher, which would cause prices to fall. Could international bond exposure offer an appealing area of diversification within fixed income? Let's take a closer look.

Historically, EM debt has offered higher yields than DM debt due to perceived higher risks. This perception stems from political instability, currency volatility, and lower credit ratings. However, many EM economies now show strong fundamentals, such as lower government debt-to-GDP ratios and external net creditor statuses. The average government debt-to-GDP ratio in EM economies is 69.4%, compared to 126.5% in DM economies. These strong fundamentals reduce the likelihood of crises and enhance portfolio diversification benefits through low-to-moderate correlation with equities and DM bonds.

**General Government Gross Debt, % GDP**




Source: IMF, Bloomberg

**Example: Mexico's Debt-to-GDP Overview**

**Current Level:** Mexico's gross government debt-to-GDP ratio is estimated at 50–55% as of 2024-2025. This includes both domestic and external debt.

> FISCAL RISK IN THE DOMESTIC BOND SPACE COULD MAKE YIELDS GO HIGHER, WHICH WOULD CAUSE PRICES TO FALL.

**Historical Context:**

- Debt levels have remained relatively stable over the past decade, generally between 40% and 55%.
- Following the 2008 financial crisis, Mexico kept debt growth moderate compared to many other emerging markets.

The COVID-19 pandemic led to a modest increase in debt, but Mexico avoided a sharp spike in borrowing.

**Global Comparison:**

- Mexico's debt level is moderate for an emerging market—higher than countries like Chile or South Korea, but well below higher-debt peers such as Argentina or Brazil.
- For context, the US debt-to-GDP ratio is around 120%, while Japan's exceeds 250%.

**Credit Rating:** Mexico generally holds an investment-grade credit rating (e.g., BBB/Baa2), reflecting moderate risk.

## PORTFOLIO IMPLICATIONS

Holding EM debt may provide an opportunity to earn attractive yields and diversify your portfolio. Portfolios may benefit from improving EM fundamentals, currency appreciation, and a supportive global economic backdrop. While risks remain—such as geopolitical tensions, inflation, and external shocks—the risk/reward profile looks compelling compared to many DM fixed income alternatives. It stands to reason that the more traditionally conservative elements of a typical investor's portfolio may not be as conservative as once believed.

By Tonia Maly, CFP®, CRPC; Denise Melton

Equity

# NARROW GAINS, BROADER HOPES



## SUMMARY:

Markets surged to all-time highs in Q2 2025, led by growth stocks and policy-driven optimism, even as earnings expectations softened on margin pressure and global cost concerns.


## OUR PERSPECTIVE:

While investor sentiment improved meaningfully in Q2, gains remain narrow and concentrated. We believe upcoming policy initiatives, particularly the "One Big Beautiful Bill" (OBBB), could broaden market participation and support new growth initiatives. However, staying diversified is essential in a still-volatile macroeconomic landscape.

### SENTIMENT SPEAKS

After a turbulent start to the second quarter, including a brief slide into bear market territory in April, US equities staged an impressive recovery. Major indices not only regained lost ground but finished the quarter at record highs.

The rally was fueled by a swift shift in sentiment, driven by renewed trade deal momentum, strong corporate earnings from Big Tech, and optimism surrounding the administration's OBBB, a sweeping policy package focused on boosting defense, manufacturing, and infrastructure spending.

The Nasdaq 100 led the charge with an 18% gain, powered by strong performance in technology and communication services, sectors closely tied to the ongoing surge in artificial intelligence (AI) investment.

Technology topped all sectors with a ~23% gain, lifted by booming AI demand, particularly in semiconductors and data center infrastructure. Communication services followed with a ~13% increase, bolstered by similar AI-driven momentum and a recovery in digital advertising revenues.

Yet beyond the tech-heavy gains, performance across the broader market was uneven. The energy sector declined 8.5% amid heightened geopolitical instability, volatile oil prices, and regulatory uncertainty. Healthcare also lagged, falling ~7%, as rising medical costs, elevated utilization trends, and Medicaid-related policy ambiguity weighed on the sector.

### EARNINGS RESET THE BAR

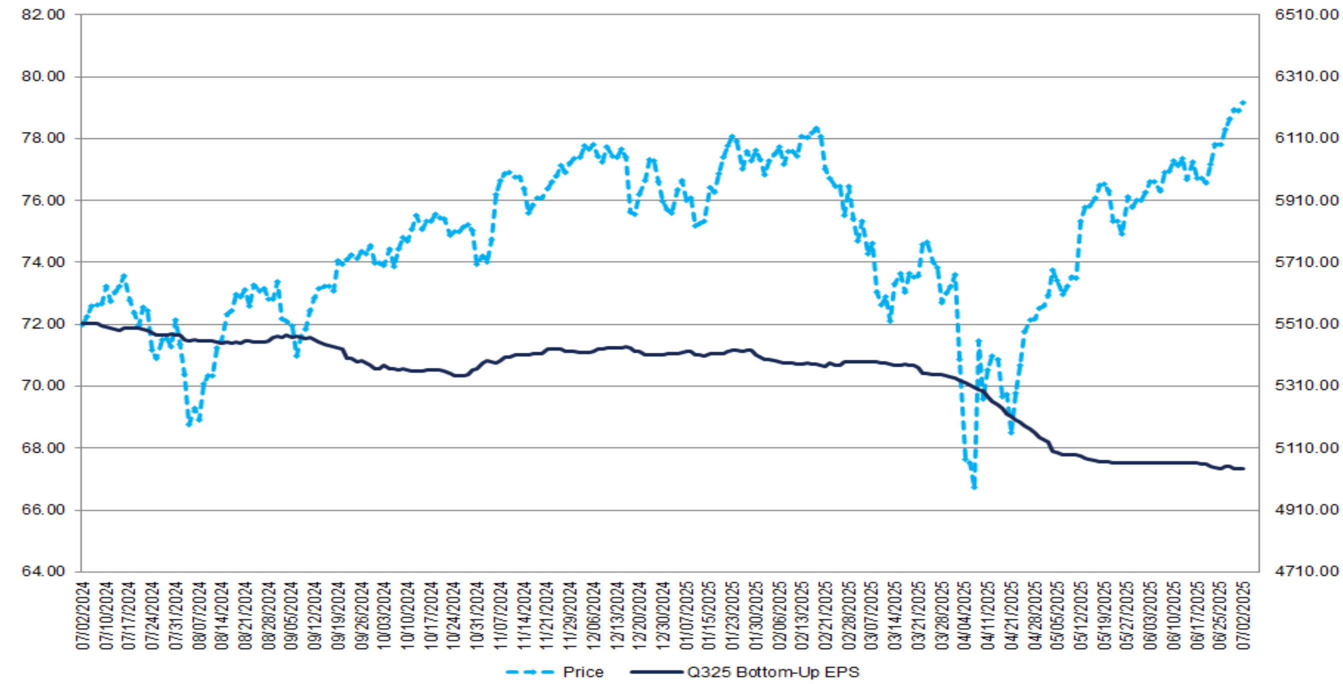
Despite the market's strong performance, a notable shift occurred beneath the surface. At the start of Q2, analysts expected robust earnings growth of around 9% year over year. However, as the quarter progressed, rising tariff pressures, particularly on globally sourced goods, began to erode those expectations. As a result, the latest FactSet consensus now forecasts a more modest 5% year-over-year earnings growth rate.

While top-line revenue remains relatively resilient, companies increasingly feel the pinch on margins. Elevated input costs and renewed supply chain constraints are squeezing profitability, especially for multinationals with large international footprints. Still, lower expectations may create an opportunity for upside surprises, as markets have historically rewarded companies that exceed a modest bar.

As we transition into the second half of 2025, the OBBB could be a meaningful catalyst for market rotation and sector diversification. If implemented effectively, the bill may offer structural support to various industries, particularly those aligned with domestic investment, infrastructure, and innovation. We are witnessing some of these effects as analysts issue earnings growth estimates for the second half of 2025. These estimates are coming at ~11% relative to a decline of 4% in the first half of the year, equivalent to roughly 23% and -9% on a half-over-half annualized basis, respectively.

We see compelling opportunities in areas that combine value, defensiveness, and long-term structural growth. Financials stand to benefit from improving credit conditions and still-attractive valuations. Utilities and Real Estate

**S&P 500 Q23 Bottom-Up EPS: 1-Year**




Source: FactSet

offer defensiveness in a choppy market, with Real Estate especially poised to rebound if interest rates ease. Industrials and Materials, particularly US-based manufacturers, could enjoy a renewed tailwind from a stabilized tariff policy.

Meanwhile, Healthcare, despite facing recent headwinds, may reaccelerate as AI boosts the prospect of increases in productivity and innovation across care, delivery, diagnostics, and research.

APPROPRIATIONS COULD DELIVER VALUE

The second quarter of 2025 highlighted how quickly market sentiment can rebound when policy support aligns with investor positioning. While headwinds from persistent but waning inflation, cost pressures, and narrow equity leadership remain, the groundwork is laid for broader participation and new growth drivers.

Discussing the overall impact of appropriation bills in the context of both bond and stock returns may appear somewhat contradictory. That's intentional—macroeconomic data that supports corporate earnings growth may also weigh on debt market performance. In this evolving landscape, staying flexible, diversified, and focused on long-term objectives remains the most effective strategy.

By Daniel Zeigler, CFP®, CMFC®; Christopher Zabel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# MARKET OUTLOOK

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