Think Strategically

Eight Issues to Position Portfolios for the Second Half of 2025 and One Theme: Stay Invested

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Despite Trade and Geopolitical Uncertainty, Fundamental Data Continues to Deliver

Over the past three years, the U.S. consumer has served as the primary engine of economic momentum—driving domestic demand and acting as a stabilizing force globally. Even amid the highest inflation in a generation, a cycle of rapid rate hikes, and persistent external shocks, household consumption has remained resilient. In our view, inflation has been beaten. The Fed must begin to lower rates in June 2025, but it's not something the Fed will do, at least not now.

The most recent data offers optimism as the May Consumer Price Index (CPI) revealed a softer-than-expected inflation print:

- **Headline CPI** rose just **0.1% month-over-month** and **2.35% year-over-year**, falling **2.08% below Inflation Nowcasting**
- **Core CPI** increased by **0.1% month-over-month** and **2.77% annually**, also **2.41% under consensus estimates.**
- **Down 74.06% from its high in June 2022 of 9.06%.**

US Consumer Price Index & US Core Consumer Price Index

Notably, **core services inflation**, a bellwether for policy direction, climbed by a modest **0.2%** in May, marking an annual pace of **3.6%**—its lowest since 2021. Meanwhile, **core goods prices remained flat**, rising only **0.3% year-over-year**, indicating that recent tariff actions have yet to feed through to consumer costs meaningfully. This muted price transmission suggests that many firms may be absorbing tariff-related expenses in the short term, betting on the eventual resolution of trade frictions.

Although inflation appears to be cooling and the Federal Reserve signals a tilt toward easing later this year, **subtle signs of consumer fatigue are emerging**. This nuance introduces complexity into an otherwise resilient narrative, signaling that the U.S. consumer—while still strong—is not invulnerable.

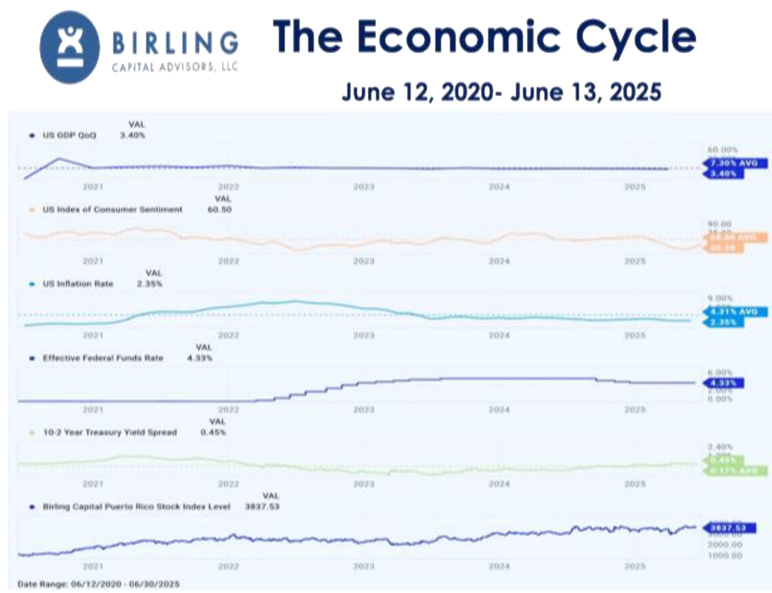
We break down the current state of U.S. consumer spending through **Eight critical issues** and provide the **Portfolio Positioning** and **The Final Word** for investors and policymakers navigating this evolving landscape.

Issue 1: Consumer Sentiment vs. Economic Strength

Despite a sluggish first quarter largely weighed down by an inventory build-up, the U.S. economy appears poised to accelerate in Q2 2025, potentially surpassing 3% annualized GDP growth. This momentum is supported by steady household consumption, currently forecast at 1.7% annually, underscoring the resilience of the American consumer even amid mixed sentiment data. While consumer confidence remains subdued, it has begun to stabilize, and actual spending remains firm, likely bolstered by contained inflation and a still-solid labor market.

Key Statistics:

- University of Michigan Consumer Sentiment rebounded to 60.5 in June from 52.2 in May—a 16% monthly increase—marking the first rise in five months.
- Despite this improvement, sentiment remains about 11% below June 2024 levels, and inflation eased from 9.06% in June 2022 to 2.35% in May 2025, a 74.06% decrease.
- Contrast this with the ongoing GDP growth, as the Fed's GDPNow for the second quarter of 2025 was updated on June 9 to 3.80%, unchanged from the previous value of 3.80%. Low unemployment remains at 4.20%, highlighting the familiar gap between optimism and reality.



Issue 2: Inflation — Moderate Cooling, but Essentials Still Pricey

Inflation pressures have steadily receded in 2025. Updated May figures for both the Consumer Price Index (CPI) and Producer Price Index (PPI) came in below expectations, with CPI rising 2.4% year-over-year and PPI up 2.6%. These figures represent a significant decline from the inflation peaks of 2022, when the CPI and PPI reached 9% and 18%, respectively. With inflation now aligning more closely with the Federal Reserve's 2% target, pricing pressures appear well-contained for the time being. Notably, the anticipated inflationary impact of new tariffs has yet to materialize, likely due to proactive inventory accumulation and supply-chain planning. However, should current trade negotiations falter, upward pressure on goods prices could emerge in the coming quarters.

Key Statistics:

- May CPI rose just 0.2% MoM, with headline year-over-year inflation at 2.35% and core CPI (ex-food and energy) at 2.78%.
- Food at home rose 0.3% MoM, bringing annual grocery inflation to 2.2%, while food away from home climbed 3.8% YoY.
- Shelter was a major culprit: rent and owners' equivalent rent increased 3.9% YoY, contributing 0.3% of monthly CPI.
- Energy prices eased — gasoline dropped 12% YoY, though utility gas rose 15.3% YoY, and electricity was up 4.5%.
- Firms are still pushing price increases on essentials, keeping inflation stubborn at the household level despite broad moderation.
- Bottom line: Inflation is moderating, but consumers continue facing persistent price pressures in food, rent, and utilities.

Issue 3: Housing & Labor Market Pressures

Housing:

- Existing home sales stand at 4.00 M annualized (April), down 2% YoY.
- Housing starts held around 1.36 M (April), 1.7% below April 2024 levels.
- Data shows a shift to a buyer's market:
    - Only 28% of homes sold above asking.
    - Median discount of ~7% between list and sale.
- Builders' project housing starts are expected to decline by another ~2.7% in 2025, resulting in a structural supply deficit.
- Mortgage rates remain elevated near 6.8%, dampening affordability and keeping listings low.

Labor:

The employment landscape, though showing signs of moderation, continues to defy expectations of a major slowdown. The unemployment rate hovers near 4.2%, comfortably below the long-term average of 5.5%. Hiring has cooled, but layoffs remain historically low as employers retain talent in a competitive market. More importantly, wage growth—currently at approximately 3.9%—is outpacing inflation, providing positive real income gains that support consumption and bolster economic confidence.

- Unemployment holds steady at around 4.20%, while job openings, quits, and switch rates decline — indicating softening but not collapsing conditions.
- Consumer sentiment on jobs appears geographically rational: people remain employed but cautious about future prospects.
- Bottom Line: Housing is cooling into a buyer's market, squeezed by high rates; the labor market remains strong but shows signs of plateauing.

Issue 4: Spending — Still Growing, but Slowing

- April retail sales rose just 0.1% MoM, up 4.7% YoY.
- Core retail sales (excluding autos, gas, building materials, and food services) fell 0.2% MoM.
- Same-store sales improved by 4.9% YoY in May, signaling selective strength.
- Personal consumption (PCE) increased 0.2% in April, up from a minimal 0.1%, driven mainly by essentials.
- The personal savings rate sits near post-pandemic lows (~4%), indicating consumers are dipping into credit or assets to sustain spending.
- Bottom Line: Real spending growth is slowing. Consumers are prioritizing essentials, and core discretionary purchases are showing signs of fatigue.

Issue 5: Wealth Effect — Soaring but Uneven

- Household net worth dropped to $169.3 T in Q1 2025, down from $170.9 T due to equity and real estate declines.
- The top 10% hold ~67% of wealth, with the top 1% owning around 31%.
- Homeowners' median net worth (~$430K) is $10K), reflecting stark inequity.
- Boomers remain the wealthiest cohort, controlling over half of U.S. household wealth.
- Young and low-income households experience minimal gains, which limits broader consumption and exacerbates the risks of wealth concentration.
- Bottom Line: Asset-driven wealth gains continue but are heavily concentrated. The broader base sees little benefit, constraining retail momentum.

Issue 6: Trade Policy: Tariffs in Transition a key uncertainty. Two events are in focus:

- **China-U.S. Trade Framework:** U.S. and Chinese officials have recently agreed on a tentative trade structure. Tariffs on Chinese exports to the U.S. are expected to decline from 145% to 55%, reflecting a mix of reciprocal tariffs (10%), fentanyl-related penalties (20%), and legacy tariffs (25%). Meanwhile, Chinese tariffs on U.S. goods remain at 10%. Non-tariff barriers are also under review: China has reinstated six-month rare-earth export licenses for U.S. manufacturers, while the U.S. is loosening restrictions on Chinese aerospace components.
- **July 9 Deadline for Broader Tariff Pause:** The 90-day tariff pause for non-Chinese trading partners is nearing its expiration. Treasury Secretary Bessent suggested the pause could be extended for partners showing "good faith" in negotiations. Nonetheless, tariff levels remain elevated at roughly 10%, and further increases are possible should talks stall.

While headline tariffs may not reach the extremes laid out in the April 2 announcements, we still anticipate a substantial rise from the ~2% average at the start of the year, particularly on Chinese goods and select sectors. The resulting cost increases could weigh on both inflation and consumption. Still, given the service-heavy nature of the U.S. economy—where services account for roughly 70% of GDP—the broader impact on growth may be somewhat muted.

Issue 7: Outlook & Market Implications

- Atlanta Fed GDPNow estimates 3.8% growth for Q2 2025 — down from 4.6%, indicating modest deceleration.
- The Fed is expected to pause in June, holding rates steady to ease at least twice later in the year.
- Markets price in 1–2 rate cuts by late 2025, possibly starting in September.
- Equities remain strong, led by AI-centric megacaps, but market gains are narrow — opening vulnerability to rotation or correction.
- Cyclical sectors, such as consumer discretionary, industrials, and semiconductors, may benefit from continued growth and eventual easing.
- Risks include persistent core inflation, slower housing and labor tallies, and geopolitical developments.
- Bottom Line:

Issue 8: Positioning Portfolios for the Second Half of 2025

Resilient economic fundamentals characterized the first half of 2025 despite investors navigating persistent uncertainty stemming from ongoing trade negotiations, tax policy shifts, and geopolitical tensions. Equity markets delivered solid gains; however, as we look ahead, short-term volatility may resurface as markets adjust to developments in tariffs, fiscal legislation, and global conflicts.

Looking forward to the second half of 2025 and into early 2026, the investment landscape is expected to become more constructive. The Federal Reserve could pivot toward rate cuts, and there is likely greater visibility on regulatory and tax frameworks. These evolving conditions could set the stage for a renewed cycle of corporate earnings growth.

Market pullbacks may offer timely entry points for long-term investors. Maintaining a disciplined focus on high-quality assets, utilizing volatility to strategically build positions strategically, and emphasizing diversification remains critical. Additionally, we advocate for exposure to a broader range of sector leadership rather than concentrating on a few outperformers.

Birling Capital's Consensus view of markets as we move into the second half of 2025.

1. Equity Market Cap Exposure: Balanced Tilt Toward Large and Mid Caps

- **Large-Cap Stocks (Core Holding):** Favor high-quality large-cap companies with strong balance sheets, pricing power, and global exposure, particularly in the U.S. and developed markets. These provide resilience during periods of volatility and are well-positioned to benefit from potential Federal Reserve rate cuts.
- **Mid-Cap Stocks (Selective Overweight):** Mid-caps may outperform as earnings visibility improves and M&A activity picks up. They offer an attractive blend of growth and stability, particularly in industries such as industrials, technology, and healthcare.
- **Small-Cap Stocks (Neutral to Cautious):** Maintain select exposure but remain cautious. Small caps remain vulnerable to elevated interest costs and inflation-sensitive inputs. Consider tilting toward quality names with stable cash flow.

2. Equity Sector Allocation: Emphasize Quality, Diversification, and Cyclical Recovery

- **Overweight:**
    - Technology: Focus on AI, cloud infrastructure, and cybersecurity. These subsectors continue to drive structural growth and margin expansion.
    - Financials: Beneficiaries of a steepening yield curve, but closely monitor credit quality and consumer balance sheets.
    - Health Care: A defensive growth play amid demographic trends and innovation in biotech and health services.
- **Neutral:**
    - Industrials: Positioned to benefit from onshoring trends, infrastructure investment, and improving global PMIs.
    - Consumer Discretionary: Position selectively in companies with strong brand power and pricing resilience.
- **Underweight:**
    - Utilities and Real Estate: Rate-sensitive sectors may lag if inflation proves sticky. Exposure should be limited unless targeting dividend income.
    - Energy: Watch for margin compression and policy headwinds despite elevated global demand.

3. Investment Grade Bonds: Extend Duration Gradually, Favor High Quality

- **Duration Positioning:**
    - Begin gradually extending duration in anticipation of potential Fed rate cuts in late 2025 or early 2026.
    - Lock in yields as monetary policy pivots, especially in intermediate-term bonds.
- **Credit Quality:**
    - Maintain a bias toward A- and AA-rated corporate bonds and U.S. Treasuries to preserve capital and provide stability during equity market volatility.
    - Minimize exposure to lower investment-grade or BBB paper until credit spreads stabilize.
- **Municipal Bonds:**
    - Remain attractive for tax-sensitive investors, especially in high-income brackets. Consider laddered strategies for liquidity and reinvestment flexibility.

4. Dollar Cost Averaging (DCA): A Tool for Uncertain Terrain

- Use DCA to deploy capital into equities and bonds over the coming months, especially during market pullbacks.
- DCA is particularly effective in this environment of elevated geopolitical risk and shifting macro signals, helping mitigate timing risk and behavioral biases.
- Combine DCA with tactical rebalancing to maintain discipline as volatility presents entry points.

The Final Word: Stay Defensive, Be Opportunistic

In the second half of 2025, investors should strike a balance between defensive positioning and selective offense. Favor high-quality assets across both equities and fixed income, extend bond duration gradually, and prepare to capitalize on opportunities as policy and macro clarity emerge. A disciplined DCA approach will help navigate near-term uncertainty while staying focused on long-term return potential.

John Templeton maintained, ***"Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria".***

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