Wespath

Investment Services Driven by Your Mission

A Message from Chief Investment Officer
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The second quarter of 2025 will be remembered for one of the most extraordinary disconnects between news headlines and portfolio outcomes in recent market history.

An investor who checked their portfolio on April 1 and then again on July 1 might conclude Q2 was a relatively uneventful, low-volatility period. They would be quite mistaken. As we know, Q2 2025 was anything but quiet. Markets absorbed a whirlwind of geopolitical shocks, trade policy shifts and fiscal debates. Though there were significant market declines within the quarter, overall it delivered relatively positive results.

At Wespath, we continue to navigate this complexity with a focus on resilience and progress. Our approach, grounded in purposeful diversification and long-term thinking, has helped our clients weather volatility while positioning for opportunity. And we're not standing still.

We recently implemented a benchmark change in our Fixed Income Fund, a move that enhances transparency and strengthens accountability to our investors. This change reflects our ongoing commitment to refining our processes and ensuring our strategies remain aligned with best practices and investor expectations.

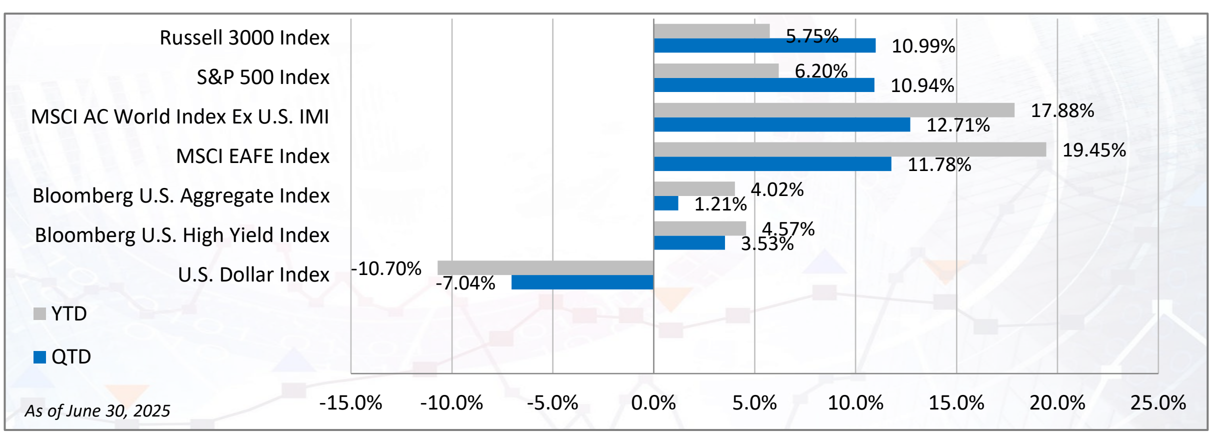
Looking ahead, we're excited to share that we plan to launch a new International Equity Index Fund in Fall 2025. This offering will expand the options available to our clients and provide additional flexibility for those seeking global diversification. We'll share more details soon, but it's another step in our broader effort to grow and adapt alongside the organizations we serve.

The themes of this quarter underscore the importance of thoughtful stewardship. At Wespath, we remain committed to helping our investors navigate these challenges with clarity and confidence. Thank you for reading this quarter's letter!

[1] *This letter is intended for institutional investor audiences. Wespath Benefits and Investments ("Wespath") is a general agency of The United Methodist Church, a 501(c)(3) tax-exempt organization. Wespath administers benefit plans and together with its subsidiaries, UMC Benefit Board, Inc. ("UMCBB") and Wespath Institutional Investments, LLC ("WII"), invests (or provides back-office services for) assets on behalf of benefit plan participants and beneficiaries, plan sponsors and other institutions controlled by, associated with or related to The United Methodist Church. The P Series funds are managed by UMCBB, and the I Series funds are managed by WII. As part of the Wespath organization, the WII and UMCBB utilize certain shared personnel, including investment professionals. The shared personnel relationship is governed by the terms of a Dual Employee Agreement entered into by and among Wespath, WII and UMCBB.*

Key Takeaways from Q2

- **GDP:** Economic momentum has proven surprisingly resilient despite policy headwinds. J.P. Morgan's outlook shows solid business cycle momentum continuing through the first half of 2025, with Q3 annualized real GDP growth estimated at 1.0%. However, the impact of tariffs has lowered full-year GDP growth forecasts from 2.0% to 1.3%.
- **Inflation:** Core PCE inflation, which fell from 5.6% in 2022 to 2.5% as recently as April, is expected to reverse course due to tariff pass-through effects. Projections suggest annualized core PCE inflation could reach 4.6% in Q3 before moderating, ending the year at an uncomfortable 3.4%.
- **Trade Policy:** The administration's "reciprocal tariff strategy" created extraordinary market volatility, with the S&P 500 falling 12% over just a few trading days in April. However, subsequent de-escalation efforts, including reducing U.S.-China tariffs from 145% to 30% (and China's reciprocal reduction from 125% to 10%), helped stabilize markets. Current tariff collections are on pace to raise $255 billion annually—less than 1% of GDP.
- **The Fed:** The latest FOMC meeting largely met expectations, with the Federal Reserve (Fed) maintaining its forecast of 50 basis points of cuts in 2025 and projecting only one cut in 2026. Chair Powell emphasized the Fed's continued wait-and-see approach, noting that policy uncertainty remains elevated.
- **Stocks:** The S&P 500 gained 10.9% in Q2, bringing year-to-date returns to 6.2%. International equities outperformed, with the MSCI ACWI ex-U.S. IMI gaining 12.7% in Q2 and 17.9% year-to-date. The rotation into international stocks—particularly European markets, where many countries are up over 20% in dollar terms—began in mid-February, possibly catalyzed by the DeepSeek AI breakthrough that challenged U.S. technology dominance.
- **Bonds:** Bond markets experienced volatility during the tariff announcement period, with high-yield credit spreads widening to nearly 500 basis points over Treasuries, up from 355 basis points. But spreads ended the quarter back below 300 basis points.



Beyond the Headlines

The Paradox of Headlines vs. Returns

Q2 2025 exemplified the growing disconnect between news cycle intensity and portfolio outcomes. There were many market-moving headlines: “Liberation Day” tariff bombshells, Supreme Court challenges to trade authority, dramatic U.S.-China negotiation reversals, and ultimately, direct military strikes on Iranian nuclear facilities. In any previous era, such events may have produced sustained market disruption. Instead, markets demonstrated a remarkable capacity to absorb extraordinary policy uncertainty.

The Limits of Fiscal Discipline

Another interesting theme from the quarter was the U.S. government’s increasing indebtedness. Consider this sobering reality: interest on federal debt now totals $1 trillion annually—one-fifth of all government receipts. The recent budget bill projects deficits based on a 3.6% interest rate assumption, yet the entire Treasury curve yields between 4% and 5%, meaning that any new government debt will pay higher rates than that 3.6% assumption. Each percentage point increase in rates on the debt adds $360 billion to annual interest costs, pushing the country further into a fiscal spiral.

Efforts to rein in spending have proven largely ineffective. Despite a reform-minded administration and the high-profile DOGE initiative, touted to cut $1–$2 trillion in waste, the actual savings amounted to just $175 billion, using generous accounting assumptions (with only $9.4 billion actually submitted to Congress for rescission). Meanwhile, the “One Big Beautiful Bill” spending package is expected to increase annual deficits by $200–$500 billion over the next decade, raising doubts about the feasibility of meaningful fiscal discipline without external pressure.

This dynamic suggests that if there is little Congressional appetite to make the hard decisions required for a balanced budget, perhaps only bond market discipline can force action. While recent fiscal expansion, as seen after the Global Financial Crisis and COVID stimulus periods, has largely driven asset prices higher, a shift in bond market sentiment could turn the tide. For instance, if bond investors come to believe that the only way the U.S. can afford the interest payments on its debt is to inflate its way out of its debt load, perhaps by printing more money, those investors will require a higher yield on Treasury debt to compensate. Higher yields mean even higher interest payments and a potentially negative cycle that could require the U.S. to cut spending and raise revenues, hurting economic growth and stock prices.

Beyond the Headlines

The Great Rotation: America's Relative Decline or Healthy Rebalancing?

The quarter's most significant structural shift was the dramatic outperformance of international markets over U.S. equities. Through June, the MSCI ACWI ex-U.S. IMI has outperformed the S&P 500 by 11.7% year-to-date—a remarkable reversal after years of American market dominance.

During several days in April, we witnessed the rare occurrence of simultaneous declines in U.S. stocks, Treasuries and the dollar. This "Sell America" dynamic sparked reflection about fiscal sustainability and dollar hegemony, but it could also be reasonably interpreted as healthy mean reversion rather than widespread American decline.

Historical perspective is instructive: over the decade ending 2024, the S&P 500 gained 242% compared to the MSCI ACWI ex-U.S. gain of 69%, while the Dollar Index rose 20%. By late 2024, the S&P 500's 10-point P/E premium over international peers (24x vs. 14x) had become excessive. This gap has narrowed slightly, but comparisons to long-term averages are still compelling. U.S. stocks are still trading at a premium to their 20-year average P/E of 16x; while there's no guarantee that U.S. P/E ratios will snap back to their long-term averages, investors can certainly observe that there may still be an interesting valuation case for international equities.

The dollar, still 16% overvalued relative to purchasing power parity and 20-year averages, has begun working off some excess. We view the Q2 rotation as the beginning of a longer-term rebalancing rather than a sign of American decline (also read: A Pause in U.S. Exceptionalism: Shifting Dynamics in Global Markets).

Wespath's Upcoming International Equity Index Fund for Institutional Investors

We are pleased to announce the upcoming launch of the International Equity Index Fund in the I Series, currently slated for Fall 2025!

The new fund will provide another option for investors seeking global diversification within their equity holdings. The International Equity Index Fund – I Series (IEIF-I) will be benchmarked to the MSCI World ex-U.S. Index, which broadly covers developed markets outside the U.S. Look out for more information on IEIF-I soon!

Looking ahead

Themes for the Second Half of 2025

As we enter the second half of 2025, several key themes will likely dominate market narratives and investment outcomes:

Geopolitical Recalibration: The quarter's final act—U.S. bombing of Iranian nuclear sites on June 21—represents a dramatic escalation in Middle East engagement. This shift from diplomatic to military solutions introduces entirely new risk factors that could significantly impact energy markets, inflation trajectories and global stability.

Trade Policy Evolution: While tariff-related volatility appears to have stabilized around a framework of 10% rates for most countries and 30% for China, ongoing legal challenges and potential Supreme Court involvement could reignite uncertainty.

Inflation Trajectory: The critical question for the second half is whether tariff-induced inflation pressures prove transitory or more persistent. With core PCE potentially reaching 4.6% in Q3, the Fed faces a challenging balancing act between supporting economic growth and maintaining price stability. Survey measures of inflation expectations have risen, though a softening labor market may limit near-term risks.

International Opportunities: European markets present compelling opportunities with cheaper valuations and increased fiscal spending commitments. Germany's infrastructure and defense spending plans, combined with local government budget flexibility, could provide meaningful economic stimulus. China's commitment to meeting its 5% growth target through stimulus measures offers potential upside despite ongoing trade tensions.

Fiscal Reckoning: The federal government's fiscal trajectory appears unsustainable, with debt service consuming an ever-increasing share of receipts. While timing remains uncertain, the bond market may eventually force discipline that Congress appears unable to self-impose. This dynamic could create both risks and opportunities across asset classes.

As we've emphasized throughout this turbulent period, successful navigation of these crosscurrents requires maintaining perspective while implementing thoughtful diversification. The quarter's events reinforced that while corrections are uncomfortable and often dramatic, they represent normal market function rather than fundamental breakdown. Our focus remains on optimizing risk-adjusted returns through disciplined portfolio management, recognizing that today's challenges will eventually create tomorrow's opportunities.

The path forward is unlikely to be smooth, but history suggests that patient, diversified investors who maintain composure during volatile periods are best positioned to benefit from the inevitable recovery and growth that follows.