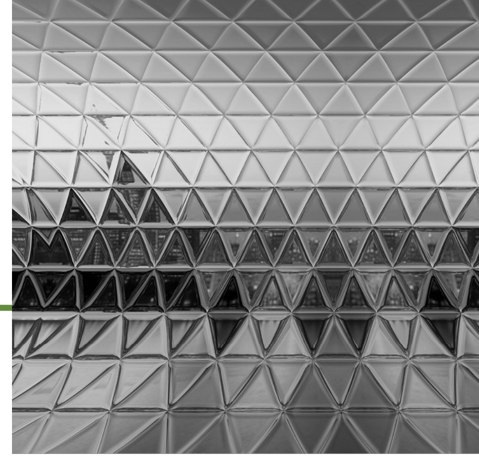
MARKET SIGHTLINES



Our Second Half Outlook: Animal Spirits Are Proving to Be a Driving Force in 2025

By Michael O'Keeffe, *Chief Investment Officer*

Investors started the year with some optimism, with equity market forecasts projecting strong returns for the year. Our forecast was a little more subdued, with an S&P 500 target of 6,200, which would translate to a full-year return of 6.7%. In April, the S&P 500 fell below 5,000 on tariff worries [and softer Animal Spirits], and some questioned our (and others') year-end target as overly optimistic. But now, with a market recovery that has surprised most, the S&P 500 has risen above our 6,200 target, raising even more questions about the future. In this week's Sight|Lines, we provide an outlook for the second half of 2025, considering geopolitics, government policy, inflation, Federal Reserve (Fed) policy, economic growth, and company earnings.

THE TAKEAWAY: THE ECONOMY AND MARKETS ARE PROVING RESILIENT, BUT RISKS REMAIN

Market participants may have overreacted to D.C. policy shifts and geopolitical tensions, but bouts of volatility are still likely in the second half. In summary:

- Military conflict shook investors, and worries about further tensions remain.
- Unpredictable policy shifts have complicated economic and market forecasting, also making it a challenging environment for company leaders to offer earnings guidance.
- Tariffs remain a key concern, raising worries about inflation and the broader economic impact, but the prospect of negotiated trade deals offers reassurance.
- The "One Big Beautiful Bill" (OBBB) was enacted, with near-term stimulative elements like tax cuts, but longer-term potential headwinds from the continued deficit and growing federal debt.
- We see U.S. economic growth in the lower part of our forecasted range this year of 1.5%-2.5%, consistent with the consensus forecast of 1.5%.
- Recent inflation is closer to the Fed target, and despite some worries about tariff impacts, we and other investors expect one to two quarter-point Fed cuts later this year.
- Earnings are forecasted to grow 9.0% in 2025, a positive figure contributing to optimism and higher market levels; we see continued, muted growth, with some downside risk.

IN-DEPTH: THE ECONOMY AND MARKETS ARE PROVING RESILIENT IN 2025, BUT RISKS REMAIN FOR SLOWER ECONOMIC GROWTH AND MARKET VOLATILITY

Investors and market experts may have overreacted to D.C. policy shifts and geopolitical tensions, but the stage remains set for bouts of volatility through the balance of the year. Going deeper:

- Understandably, investors find military conflict unsettling:
  - While worries remain, our base case assumes fragile peace with Israel and Iran, and continued U.S. diplomatic efforts with Russia and Ukraine.
- Unpredictable policy shifts have made it challenging to forecast future results:
  - The expected inflation and economic impacts estimated from tariffs may have been overdone.
  - Some company leaders withdrew forward guidance or issued wider ranges.
- Tariffs remain in focus, with worries about potential inflation and economic impact:
  - We believe the administration remains committed to negotiating trade deals, with extensions likely serving that objective.
- The OBBB was enacted, creating tailwinds and headwinds:
  - Tailwinds include lower tax rates, bigger State and Local Tax deductions, and larger inheritance exemptions.
  - Headwinds are longer term, driven much by a continued deficit and growing federal debt.
- We remain modestly optimistic about U.S. economic growth in 2025:
  - New trade deals and stimulative elements of the OBBB are positive and remove uncertainty.
  - In line with the consensus, we see growth in the lower end of our forecasted 1.5%-2.5% range.
- We see improved inflation eventually leading to one to two quarter-point Fed cuts later this year:
  - CPI and PPI have averaged an annualized rate of 1.4% and 0.0% over the last four months.
  - We believe the tariff impacts will be muted, giving the Fed room to cut rates.
- A modestly strong economy and continued earnings growth will be supportive of equity market levels:
  - Earnings are forecasted to grow 9.0% in 2025, supportive of higher market levels.
  - Through 2025, we see continued, muted growth, with a soft target of 6,500 for the S&P 500.
  - That said, downside risks from weakened Animal Spirits due to geopolitical tensions, more erratic policy shifts, and unexpected economic or earnings weakness outweigh upside risks from things like the stimulative elements of the OBBB.

CONCLUSION

While investors started the year optimistic, tariff worries and geopolitical tensions drove markets lower, with the S&P 500 falling below 5,000 in April. Optimism faded, but then markets recovered, with investors seeming to shake off the worries about tariffs and war. Then the S&P 500 closed above our 2025 target of 6,200 on June 30. As we look forward, we see an environment that is proving resilient, and we expect some Fed cuts, modestly positive economic growth, company earnings holding up, and the potential for still positive equity returns going forward. That said, geopolitical tensions, more erratic policy shifts, and unexpected economic or earnings weakness may drive more negative Animal Spirits, which can create downside risks for the economy and markets.

Michael P. O'Keeffe, CFA
Chief Investment Officer
michael.okeeffe@stifel.com
www.stifelinsights.com

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