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Better-than-hoped-for GDP growth in Q2, along with a Fed rate cut, pushed the stock market to new highs in July. The S&P 500 gained +1.3%, for a total return of +20.2% by month's end. But the shakier underlying data that gave rise to the rate cut, along with sluggish and uneven corporate earnings growth, created undercurrents of concern that burst out into the open at the start of August, when President Trump sent markets tumbling with his announcement of new broad-ranging tariffs against China. It would be wise to expect a bumpy road ahead—but also wise to remember that the prospective returns to equity risk, compared to historically low bond yields, remain remarkably high.

The U.S. economy grew +2.1% in the second quarter—a slowdown, but not as slow as many had feared. The two drivers of that growth were consumption and a solid rebound in government spending in the wake of the previous quarter's federal shutdown. Consumption grew by +4.3% in Q2, its strongest pace for a year and a half, and a strong bounce back from a sluggish +1.1% in Q1. After struggling a bit in recent months, consumer confidence (as measured by the Conference Board) recovered in July to just shy of its 18-year high in October. The University of Michigan's gauge of consumer sentiment also stands near cycle highs, up slightly from a year ago. Consumer confidence and willingness to spend have been bolstered by continued jobs and wage growth, amid relatively low inflation. The U.S. economy added a respectable +164,000 jobs in July, and initial jobless claims remain near 50-year lows, with no real sign of picking up. Personal income growth was revised upwards to an impressive +4.9%, compared to a year ago. That boosted the personal savings rate to 8.1%, suggesting that households have some insulation from economic shocks.

Besides consumption and government spending, however, the rest was negative in Q2. Exports fell by -5.2% while imports were flat, widening the trade deficit. Perhaps daunted by trade tensions, business investment fell by -0.6%, its first quarterly decline in over three years. Businesses also pared back on inventories, shaving nearly a point off GDP growth, in response to rising inventory-to-sales ratios. Durable goods orders in Q2 were down -2.1% from a year ago, though orders for core capital goods were still up a modest +1.2%. The ISM Manufacturing Index fell to 51.2 in July, its lowest level since 2016. With new orders flat, manufacturers dug into back orders to keep up production. (The slowdown in U.S. manufacturing matches similar purchasing manager surveys in Europe, Japan, and China, which are all in outright contraction). The ISM Non-Manufacturing Index, which reflects a much broader portion of the U.S. economy, fell -1.4 points in July to just 53.7, its lowest reading since August 2016. Many of the businesses surveyed cite trade tensions among their concerns.

Even otherwise confident consumers remain cautious towards large purchases such as homes and automobiles. Residential investment fell -1.5% in Q2, its sixth straight quarterly decline in a row. New housing permits—often a leading indicator of where the housing sector is heading—

were down -4.5% in Q2, from a year ago. It's possible that lower mortgage rates, in anticipation of further Fed rate cuts, could help revive flagging demand in this sector.

The Fed cut interest rates at the end of July for the first time since it started raising them from near-zero in December 2015. Low inflation rates—the PCE price index is up just +1.4% from a year ago—give the Fed room to cut further, as expected. Though it initially looked like the Fed's rate cut might turn the yield curve's slope positive again, President Trump's announcement of new tariffs on China the following day drove 10-year Treasury yields down below 1.7%, approaching the historic all-time lows they hit in July 2016. That deepened the yield curve's inversion, a sign that bodes poorly for growth expectations.

The new tariffs on China—10% on virtually all imports that aren't already tariffed at 25%, scheduled to take effect in September—are exactly what U.S. companies across multiple sectors have worried and warned about for nearly a year now. Though their direct impact may be limited, the prospect of further escalation hangs like a cloud over business confidence. If China continues to try to blunt the tariffs by allowing its currency, the yuan, to depreciate, a stronger dollar could create significant headwinds to U.S. growth, as it did in 2015. Reactions to headlines aside, the stock market is likely to feel the impact of rising trade tensions in the form of downgraded company earnings projections for the second half of the year.

Corporate earnings for Q2 are already sluggish and uneven. With 71% of firms reporting, operating earnings per share (EPS) are expected to be up +2.1% from a year ago, but actually only four sectors—financial, health care, IT, and real estate—are showing positive growth from a year ago; seven out of 11 are down. It's worth noting that in Q1, out of +4.0% EPS growth, year-on-year, the majority (+2.3%) came from a reduction in outstanding shares, due to buybacks. This means company-level earnings growth, in Q2, may be weaker than it looks.

Given these uncertainties, U.S. share prices may look daunting even at a 12-month trailing P/E ratio of 19.1x operating earnings, which is far from excessive by historical terms. But they look better compared to U.S. Treasuries at an implied P/E ratio of 60x, returning little more than inflation, or the nearly \$15 trillion in bonds around the world selling at negative yields. Safe harbors are expensive, and likely to prove costly over the longer term, even if the economy could stumble in the meantime. With an equity risk premium at 5.6%—before the latest dip in share prices and bond yields—the prospective rewards to riding out the storm, as opposed to running for cover at any price, are too high for an investor who can endure a few bumps along the way to ignore.

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