DISCONNECT?

Israel's sweeping attacks on Iran early on June 13 raised global risks. Markets reacted immediately. Oil prices rose. Money moved into traditional safe assets, including gold and – to some extent – the dollar and US Treasuries. But the risk off mood was not dramatic. By the end of the day, US and global equities were down by 1.2% on the day, but not far off a week earlier. Bond markets still expect the Federal Reserve to be on hold when it meets June 18, and to signal continued caution about rate cuts. Oil prices are up by 8% but against a backdrop of recent price declines and plentiful supply.

This muted initial reaction will change possibly quite swiftly and sharply if hostilities escalate or threaten to spill over, for example to involve the US directly or to risk oil supplies through the Straits of Hormuz. But it is consistent with an eerily quiet tone in markets over recent weeks despite a cloud of uncertainty over policies that will affect the global economy, notably on tariffs and trade.

In a time of rapid policy shifts, investors have been searching for patterns to guide expectations. Many established links – between geopolitical risk and market volatility, between policy changes and economic fundamentals, between growth forecasts and markets, and between different financial markets – seem to be breaking down. The disconnects are disconcerting.

The escalation of hostilities in the Middle East came just ahead of US talks with Iran this weekend aimed at agreement on curtailing Iran's nuclear program. In addition to bombing nuclear facilities and military infrastructure, Israel carried out targeted assassinations of top military and nuclear officials that showed careful planning and deep, real time intelligence. Iran immediately fired back towards Israel.

Before the Israeli attacks, markets– and consumers – appeared to be shrugging off fears that tariffs would curb growth and raise prices. Analysts are in widespread agreement on forecasts, now including from the World Bank, that sharply higher tariffs will slow the global economy.

In turn, those economic forecasts have not – at least not yet – been validated by the data. Inflation reports for May released on June 11 and 12 still show little impact from tariffs. Consumer price inflation slowed to 0.1% month-on-month and came in at 2.4% year-on-year. Perhaps more surprisingly, producer prices were also subdued, suggesting little feed through from tariffs. Meanwhile, the latest jobs report was unremarkable. US unemployment remains contained at 4.2%, although there have been small increases in the jobless rate over recent months. Other signs of softening, as payrolls grew more slowly and more people signed up for unemployment benefits, point to likely increases in unemployment ahead.

In markets, the dollar continued to slide earlier in June, despite higher bond yields. Some see that as evidence that US assets are no longer so desirable. Indeed, European assets have outperformed the US so far this year, with the STOXX Europe up by 20% compared to 2% for the S&P 500. German equities are up 23% year-to-date. The dollar has weakened approximately 10% against the Euro and the Swiss Franc in 2025.

But US equities have recently been catching up. After the sharp bounce back from the April low triggered by President Donald Trump's "Liberation Day" tariff announcements, equities have continued to climb in June. This likely reflects a growing sense that the US will reach trade deals with China and other important trading partners that will keep tariffs far below initial announcements.

RockCreek sees three key macro themes for investors to monitor, with upcoming policy decisions important for each. Tariffs and trade developments remain crucial for earnings and growth. Secondly, interest rates are still restrictive and some easing remains likely later this year – although that will depend on whether tariffs most impact jobs or prices. Finally, the President's "Big Beautiful Bill" will set fiscal policy if passed, as is likely, in the coming weeks.

TARIFFS CAN STILL CAST A CLOUD

The shock from the tariff announcements on April 2 has worn off. Two months after President Trump put most tariffs on hold for 90 days, it is clear that the President does not want to risk crashing markets or the economy by playing tough with US trading partners. His declaration this week that a deal has been reached with China that just awaits President Xi's sign-off is one more sign of his willingness to compromise. Many are surprised that the agreement would allow China to access certain strategic US products it did not have access to before.

But the President's shifting positions, deep seated dislike of trade deficits and willingness to accept – and cause – disruption means a cloud of uncertainty hangs over business decisions. Court challenges to presidential power over trade – which rests with Congress unless delegated to the executive branch – add to uncertainty, although in this case presenting an upside risk. The surprise May 28 decision by the US Court of International Trade (CIT) to strike down many of President Trump's tariffs lifted spirits, although the decision was stayed shortly afterwards.

China has more leverage than most over the US on trade. Apart from the cost to US households – and voters – of high tariffs on the many Chinese-made goods consumed by Americans, China has shown itself willing to cut off supplies of rare earths essential for American tech. It will not hesitate to reinstate the ban, lifted for six months after trade discussions in London, if the US again threatens to ramp up economic hostilities. This is an uneasy truce rather than a settlement.

Markets have nevertheless been cheered by the lowering of the temperature on tariffs. This may be helped by the prospect that the Supreme Court will ultimately disallow the broadest levies, the so-called "reciprocal tariffs" imposed under legislation designed for national security emergencies (IEEPA). The next round of court hearings on this issue is not until the end of July. In the meantime, the Administration is able to leave the reciprocal tariffs in place, with a base rate of 10% across the board. This is sharply higher than the 3% tariff average prevailing just a year ago.

INFLATION AND JOB RISK

The Federal Reserve has held steady in policy and in commentary against the backdrop of rapid-fire decision making by the White House. The data have supported that "steady as she goes" posture. Some hope that the string of good inflation surprises in recent months, as price increases have come in lower than expected, will encourage the Fed to move more quickly to cut rates. President Trump has been calling for a drop of a full percentage point, immediately.

Chair Jerome Powell is likely to ignore that. The

Supreme Court has made clear that the Fed is independent of the White House. Chair Powell will be keen to maintain authority until his term is up, in just under a year, and to deliver inflation on or close to target to his successor. Rumors that the President may name that successor early, to undermine the current Fed, are unlikely to sway the central bank. So the likelihood is that the Fed will be cautious about cutting, unless it sees clear signs of labor market weakening.

Clues to Fed thinking will come next week with the June 18 release of its latest quarterly projections, along with the rate decision.

The Fed's take on growth and the health of the labor market should be watched. One explanation of the lower than expected inflation through May is that the economy is weaker than it seems. Companies may be finding it harder to push through price increases from tariffs. That of course will impact company earnings. This may be partly offset if workers sensing a weaker labor market do not change jobs so frequently and are willing to accept smaller pay rises. But weaker consumption in turn will depress the economy. Look for how Fed Chair Powell talks about balance in the economy. Continued balanced risks would signal a reluctance to cut too soon. Suggestions that the balance of risks is now shifting, towards a slowdown in growth, would indicate openness to cutting rates after the summer

Across the Atlantic, the European Central Bank (ECB) has no such qualms. It has now lowered rates by 200 basis points from their peak and further cuts this year are possible.

FISCAL PRESSURES WORSENING

President Trump's Big Beautiful Bill will swell an already large fiscal deficit. In that, Elon Musk was correct. The nonpartisan Congressional Budget Office (CBO) scored the 10-year price of the bill at some $2.4 trillion, if all the planned tax cuts expire as currently in the legislation. If, as is likely, these cuts are extended, the impact on the deficit would climb to double that, at around $5 trillion.

But as indicated by Musk's retreat from confrontation this week, the President is likely to win out over fiscal hawks. The White House will use its power to browbeat Republicans into getting the bill passed, probably without major changes. It may not happen by July 4, as the President would like, but the White House and its congressional allies would like to get the package approved before House and Senate Republicans go home for the summer – and potentially face unhappy constituents.

Tax cuts, mainly benefiting corporations and the wealthy, are behind the cost of the plan. Spending cuts, most of which will fall on poorer Americans who will find access to health care more difficult and more expensive, are dwarfed by the cost of extending and adding to the 2017 tax cuts of the first Trump Administration. The Treasury cost of borrowing is now an important part of federal spending. Adding to the deficit pushes up the need to borrow to cover both "primary" or non-interest spending and interest payments on the government debt. It can also increase the cost of every dollar of government borrowing, if investors worry. Another potential vicious circle. On Thursday, a highly anticipated Treasury auction of 30 year bonds went off without a hitch – partially easing fears for the time being of a spike in government funding costs.

As discussed below in more detail, foreign investors may be readjusting their appetite for US treasuries.

EQUITIES

Global equities have had an impressive run, broadly gaining about 20% from their April lows. Despite all the uncertainty and conflicting economic data, that rally has pushed the S&P 500 into positive territory year-to-date, up 3%. Japan's major indices are up within the 5% to 10% range. Europe remains the star performer with the STOXX Europe up an impressive 23% in U.S. dollar terms, aided in large part by interest rate cuts and fiscal stimulus measures on top of dollar weakness.

This rally over the past several weeks feels overdone in many respects, but there have been several contributing factors. A resurgence in AI-related stocks has been the biggest boon within the U.S. Since Liberation Day, the NASDAQ has gained 27%, the Mag7 about 31%, the Goldman Sachs TMT AI basket 42%, and AI data center stocks about 50%. Another innovation-backed success story in the past few weeks is Circle Internet Group, which is trading nearly 4x higher than its IPO price. The company’s offering of an alternative payment system in multiple currencies may have particular appeal in the current environment. Retail investors, perhaps anticipating short-lived tariffs, have aggressively bought the dip as substantive progress has indeed been made towards lasting trade deals. Meanwhile, Congress is hashing out the details of its budget reconciliation deal, which appears set to provide some unknown level of fiscal stimulus, while the job market has been holding up better than had been expected by most economists. Finally, higher tariffs have not shown up in the inflation data yet, and the Fed is maintaining flexibility to reduce rates if need be.

That being said, a lot of optimism seems to be priced in now, and it would not be surprising to find that the market has overshot. It's comparatively hard to make a case fundamentally for the earnings growth being baked into current valuations. We're still faced with a messy economic picture. Small-caps have managed to keep pace during this rally, but the Russell 2000 remains about six points behind the S&P 500 for the year. We will need either a big upgrade in growth projections or meaningful Fed easing to close the gap, neither of which is visibly on the horizon. Leading economic indicators have been trending in the wrong direction, with clear deterioration for the low-end paycheck-to-paycheck consumer. Meanwhile, tariffs are almost certainly not returning to pre-trade-war levels, which it stands to reason will eventually show up in inflation readings and consumer pocketbooks. Lastly, population growth is closely intertwined with economic growth, and the clampdown on illegal immigration will prove detrimental if it is not adequately offset by legal immigration, which we have not yet seen.

Given all of this, it feels prudent to lower equity performance expectations over the short- to medium-term from here. The risk/reward opportunity does not look particularly promising from a pure beta perspective. On the other hand, all the crosscurrents and volatility are yielding ample opportunities for hedged strategies from an alpha perspective.

Interestingly, since 1950, average returns for the S&P 500 from May through October have been in the neighborhood of about a 1% to 2% total gain compared to roughly 6% to 7% from November through April. This has been attributed to mid-year economic slowdowns, investors taking summer vacations, and lower trading volumes. It would not be surprising if the old adage "Sell in May and go away, don't come back until St. Leger's Day" proves especially pertinent this year.

FIXED INCOME, COMMODITIES, AND CURRENCIES

The astonishing recovery in equity markets has been accompanied by a weaker U.S. Dollar and higher Treasury yields. This unexpected pairing has caused market participants to wonder what is driving the continued weakness in those markets while equities have recovered. The cause of this is often cited as a shift in demand for U.S. assets over current policy actions. We dig into these drivers below.

US interest rates have risen across the curve since the broader market lows of April. Over this time period the rise has been relatively uniform. Taking a step back and looking at a year-to date basis, rates from 1-10 years are actually lower by varying degrees, while 20- and 30-year rates have backed up notably. Thursday's 30-year bond auction as discussed above further underlining/temporarily tempering the narrative that demand for US Government debt is waning. Fire sales of U.S. assets, including Treasuries, are unlikely, without an unforeseen shock. But there is still conviction that marginal investment dollars, particularly from overseas investors, are more likely to find a home in another part of the world. A reduction of inflows could be material for U.S. government debt given the Treasury's need to issue debt on a constant basis. Another driver of back-end yields could be longer term inflation expectations. Longer term breakeven inflation has actually come in however, further suggesting the real return expected by investors has increased.

What is perhaps most surprising is the dollar's continued weakness despite the back-up in U.S. rates. One would expect a relative rise in US rates, as has occurred vis-à-vis those in major countries, to be accompanied by a stronger dollar. The mechanical effect of tariffs – making imports more expensive – also traditionally leads to currency appreciation. Instead, the dollar has been almost universally weak, falling against all G10 pairs since the beginning of the year with the weakness being exacerbated by the tariff announcements. The most striking example is against the Euro. The EUR has strengthened against the dollar by 5% since the Liberation Day trough in risk assets and is over 10% stronger YTD against the greenback. This is despite the fact the ECB continues to ease its policy rates. Other potentially surprising gainers include the Chinese Yuan and the Mexican Peso, which have strengthened 2% and 10% in 2025. Repatriation concerns have been cited as a potential driver of this weakness. However, it is likely that, as in rates, there is a lack of marginal demand as opposed to a wall of dollar sales and repatriations. There is also another potential force weighing on the dollar: hedging. International investors could simply reduce or even neutralize their dollar overweight while continuing to hold assets they either still find attractive or are unable to sell by selling dollars as a hedge. This would create selling pressure in the currency while not showing up in broad-reaching asset sales. This could be an increasingly attractive option if investors believe the dollar's failure to act as a safe-haven, as it did during the April volatility, is likely to persist in the future.

A commodity, which in this context can be thought of as another currency, worth highlighting is gold. The precious metal is up 30% against the dollar YTD and is trading near an all-time high. We have written multiple times in the past about gold's structural move higher as demand from global central banks increases as they look to diversify their foreign currency reserves. Seemingly the geopolitical dynamics present in 2025 are only exacerbating those moves. Now the ECB has identified gold as the second largest reserve asset in the world.