

# FINANCIAL MARKETS DEEP DIVE

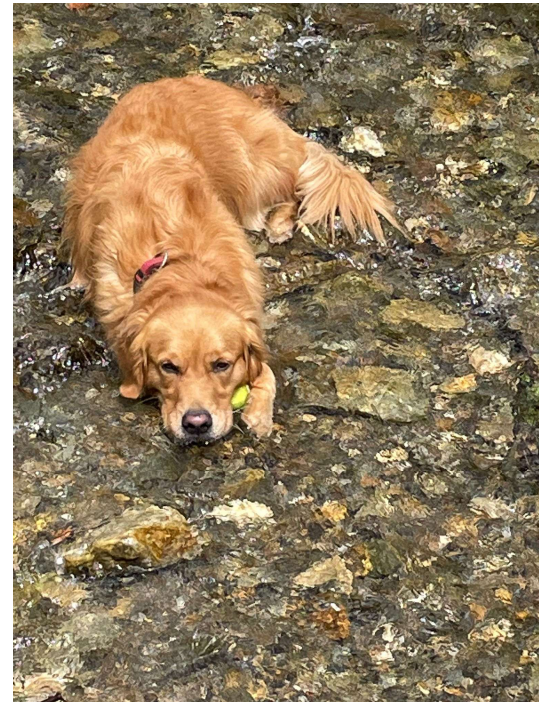
2025/July

*“It is not the strongest of the species that survives, nor the most intelligent, but the one most responsive to change.” –*  
Charles Darwin, Biologist

## ECONOMY: COPING WITH ADVERSITIES

I was walking my dog one morning (named Lupita, a female Golden Retriever – chart to the right) and, I found myself reflecting on how financial markets, and the world as a whole, have become accustomed with both threats of war, and wars themselves. So much so that a debate between Elon Musk and President Trump is seemingly more important than a long-lasting civil war in Africa.

Just to put things into perspective, during the second quarter of the year, we have seen Israel continuing its battle against Hamas and expanding its reach to Iran. We have also witnessed the involvement of the United States, which sent jitters down the back of many of us, for the possible escalation these actions could have provoked – Russia and China are close allies of Iran. In the meantime, Russia continued its special operation in the Ukraine; “special operation” resembles a lot the “transitory phase” Mr. Powell used back in the days, to describe the jump in the inflation rate which, as we all know by now, had very little to do with a temporary phenomenon. And finally, although basically unavailable on the news in any format, we still have ongoing civil wars and conflicts affecting several areas of the globe, such as North Africa, the Middle East (on top of Israel/Palestine), and South America.



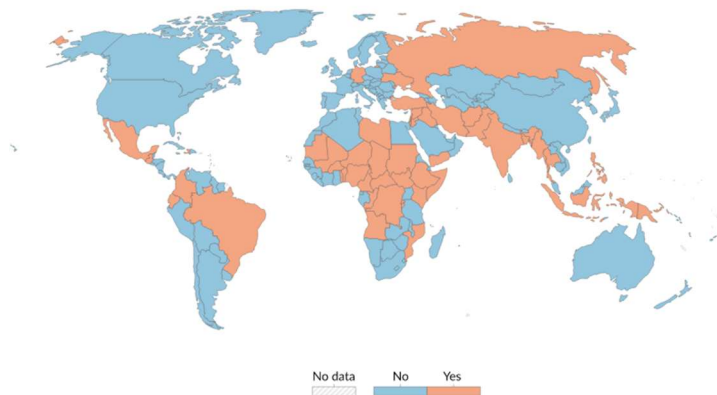
By the time I had approached my house door, I had realized that, somewhat logically, financial markets barely react to these events, especially if they persist through time; why should they? Provided that the economy is not affected, and neither are the companies’ profits, there are no reasons for prices to fall. On the contrary, local wars are positive for the defense industry – *the more, the better*, one could argue. Moreover, human beings – therefore, financial markets too – have a fantastic ability: they adapt. And they do it quickly. Think about how our lives have changed during COVID, in a matter of months. Unbelievable. Or think about those populations living under the constant threat of a military attack; the first missile dropped on the ground causes panic. The second one does too. But as time goes by, people get accustomed to it and live on. And so do financial markets. Again, so long as profits go untouched.

Yet a sense of injustice lingered within me – difficult to articulate in a way that truly conveys what I felt. Still, sharing these few lines with you, even if they diverge from our usual style – my dog certainly does – may serve a purpose: to prompt a moment of reflection for those of us living ordinary, comfortable lives, and to remind us of the immense suffering that persists around the world – suffering that should deepen our awareness and appreciation of how fortunate we truly are.

## Countries where armed conflicts took place, 2024

Included are armed conflicts that caused at least one death in the country that year.

Our World  
in Data



Data source: Uppsala Conflict Data Program (2025); geoBoundaries (2023)  
Note: Current country borders are used across time.

OurWorldinData.org/war-and-peace | CC BY

One reason we can consider ourselves fortunate is that, despite the many challenges humans impose on themselves – often by making poor decisions – the global economy remains resilient. Currently, roughly 80% of the world's countries have positive leading indicators, which point to an optimistic, short-term future. Even Europe and China, which have both suffered from below-potential GDP growth and various, individual challenges, have reasons to be hopeful. In Europe, economic growth is showing signs of recovery, supported by services economies that continue to do very well, especially in the peripheral countries. With inflation at target, the European Central Bank can loosen further the region's monetary conditions, if needed. China, on the other hand, to

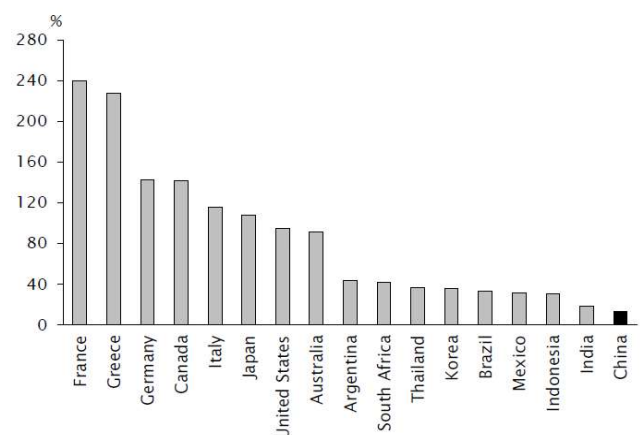
compensate for the shortfall in volumes from the United States, has successfully re-routed its sales to *friendly* countries. Domestic consumption remains tepid, and the central government is well aware that more must be done to stimulate an economy still mired in a balance sheet recession. The 5-year plan that will be announced in October is expected to be shaped around this topic. And despite a huge debt burden, a massive fiscal stimulus is not off the table just yet, given most of the former is held domestically (chart bottom-right) – similar to Japan – which shields the country from severe financial crisis.

Admittedly, the threat of tariffs is a Sword of Damocles for both regions, at least in the short term. But judging by the persistent postponement of the fateful deadline of July the 9<sup>th</sup> – now August the 1<sup>st</sup>, and the myriads of exceptions already granted, President Trump seems to be more inclined in finding trade agreements with his trading partners, rather than slapping tariffs all around. This is good news and should help avoid deep recessions.

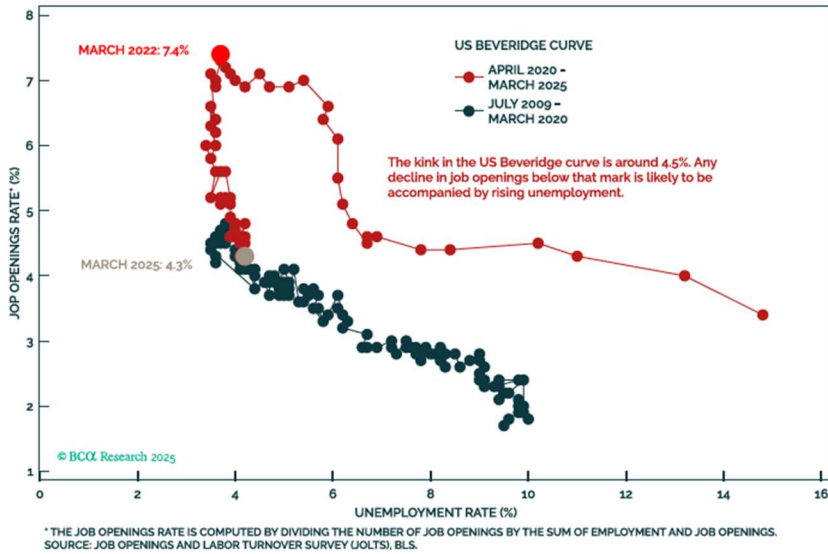
As far as a mild recession goes, despite the optimism prevailing in financial markets, we remain cautious in celebrating before crossing the finish line. From a business perspective, the specter of tariffs has kept investments repressed, especially in the manufacturing sector, which is also suffering from a chronic recession. Luckily enough, the sector has shrunk over the years and now weighs less than 25% of the total output. The remaining 75% comes from the services sector, which is still doing great. On the other hand, spending on artificial intelligence remains buoyant, particularly among Technology and Interactive Media companies, highlighting the good health of businesses and the continuous focus on improving the operating efficiency of their processes.

What keeps us suspicious is the fact that the US economy is being supported by a continuously decreasing share of the population. Overall, US households are in a very strong position; their balance sheets are healthy, with their net worth being close to all-time highs. However, beneath the surface lies a drastically different picture; the top 1% of the population holds 30% of the total US wealth, while the bottom 50<sup>th</sup> percentile holds only 2.5% of the total US wealth. This divergence is mirrored in the distribution of wages, and it shows little signs of reverting. Elevated interest rates are making things worse for the bottom income earners, as the housing market is becoming unaffordable for many, while for others it is eroding their purchasing

**Exhibit 31: Select Economies  
External Debt as a Share of GDP  
2024**



Source: World Bank, International Monetary Fund, Empirical Research Partners Analysis.



power, leaving them with little available to spend. Overall, consumption has remained strong on a 3-month basis – supported by the wealthier share of the population, which is still willing to consume – but the data has started to be more volatile compared to previous quarters. Because consumption represents a major share of GDP growth, it is a key area we will continue to focus on in the quarters to come.

Another source of our unease is the housing market. Notwithstanding rising costs and problematic affordability, the housing market is still resilient and construction employment relatively healthy due to high margins and unfinished construction. The bright spot remains

the Single-Family homes (but it is a bifurcated market between existing and new homes), where demand is still high. Multi-Family homes and Commercial real estate are showing some cracks due to oversupply and subdued demand, respectively. Should interest rates remain elevated, and immigration slow down significantly, our unease may become something more than a simple feeling. Because employment in this sector is a leading indicator for the economy, this is also a factor we will monitor very closely in the months ahead.

Speaking of employment, during the previous several months, headline numbers have been very positive. However, the accompanying revisions have always disappointed and led the total employment to be some 800'000 units lower compared to the second half of 2024. This normalization phase, which started roughly two years ago, has brought the labor market back to the old normal, i.e. a situation on the Beveridge curve (see chart to the left) where falling job openings will push the unemployment higher. A slowing labor market, and the expectation that shelter inflation – a lagging indicator – will push the inflation rate towards the 2% target (net of any temporary effects from tariffs), is persuading FED members into cutting interest rates at least twice during the second half of this year. We doubt such cuts are a game changer, but if accomplished, they will be well perceived at the White House, which has eagerly called for interest rates to be lowered substantially, heedless of what a combination of loosening monetary conditions and a widening fiscal deficit can do to the equilibrium of an economy that is by no means in recession territory just yet.

## FIXED INCOME: NO LONGER A BARGAIN

The change in shape of both the American and the European government bond yield curves during this first half of the year, narrates a very similar story; the steepening of both – albeit to a different extent – tells us that bond investors believe both regions will enjoy a reacceleration of economic growth. The rise in yields (or alternatively, the smaller fall) at the long end of the curve denotes expectations for both higher economic growth, and a higher inflation rate. However, this is where things get tricky because future growth is likely the result of expanding fiscal deficits, both in Europe and in the United States, at a time when unemployment is close to all-time lows, and inflation has just fallen back to target or, has yet to do so. According to different econometric models, the current valuation of the ten-year Treasury yield is fair. However, back in April we have witnessed how bond investors can react if they perceive the line is being crossed; because the risk of this happening is real – an increasing fiscal deficit must be financed through further debt issuance – we currently believe that keeping the duration of the portfolio in the low single digits is the proper stance to adopt for the foreseeable future.

## *What keeps us suspicious is the fact that the US economy is being supported by a continuously decreasing share of the population.*

Turning to credit, our stance remains unchanged compared to our Q1 update. On the one hand, the prospects of continued economic growth (which we deem possible, but not certain) justify an exposure to lower credit (and higher yielding) companies. On the other hand, the valuations of the latter are very unattractive – the risk/reward profile is poor – and the second quarter worsened the situation. For this reason, we see more value in lower-yielding bonds offering higher quality (investment grade issues), both in the United States as well as overseas. An exception to the rule is represented by subordinated debt of financial institutions; as we noted in the past, the financial sector is very well capitalized, and most players have solid balance sheets, making their riskier issues very attractive, when compared to other segments of the market such as high yield or emerging markets bonds. It is indeed true that, in absolute terms, the current valuations of the entire asset class appear relatively unattractive. But so are most of the other asset classes, unsurprisingly.

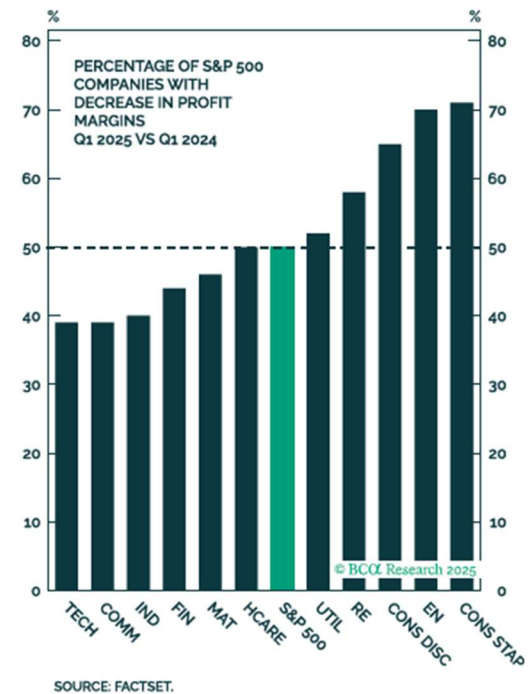
### EQUITY: NEW HIGHS IN THE MAKING

Quality, free cash flow production/margins and growth have been the performance driver since the market bottomed out in April '25 and produced an extremely narrow US market, with 5 stocks contributing c. 80% of total return. It goes without saying that the Magnificent seven remained a major contributor to earnings (EPS) growth although the contribution of the remaining 493 companies is rising. Forward guidance has improved compared to the previous quarter, but multiple companies have pulled out of submitting it, citing trade policy and economic uncertainty. The latter is weighing on earnings revisions for Q2, which has been falling steadily since the beginning of the year. Sectors mostly exposed to tariffs (energy, materials, industrials, and consumer discretionary) bear the brunt of the downgrades. As firms refrain from passing higher costs on to consumers, sector margins have come under pressure. Unsurprisingly, these sectors are cutting back on capital expenditure.

On the other hand, there is a lot of expectation built into the information technology and the communication services sectors. The top line growth has fallen, together with the free cash flow generating capability, as spending on artificial intelligence remains elevated. Yet, stock prices have soared on the back of a significant multiple expansion. Monetizing AI-related investments remains the major challenge for these firms but in the near-term, these two sectors will continue being the driver of EPS growth and margin expansion.

The current level of the S&P 500 Index (6,280) implies an 11% nominal EPS growth rate and a 1.5% real interest rate – both broadly in line with their long-term averages. However, these assumptions do not account for the possibility of a mild recession. Furthermore, they rely on the current valuation multiple (22× next twelve months' earnings) remaining unchanged. In the short term, this is plausible, and as such, the equity market appears to be in equilibrium – neither particularly attractive nor clearly overvalued. Over the longer term, however, with valuations at these elevated levels, equity returns may struggle to significantly outperform those of a relatively unexciting Treasury bond.

Following the outperformance of European equity markets against their US counterparts, many commentators and many investors have begun calling for the end of the US hegemony. We agree that something may have changed on both sides of the Atlantic; there is certainly less confidence and more uncertainty in doing business with US firms, and there is clearly a willingness to spend more by European governments. However, Europe continues to be burdened by regulation, bureaucracy, and fragmentation, leading to productivity levels that lag significantly behind those of the United States.

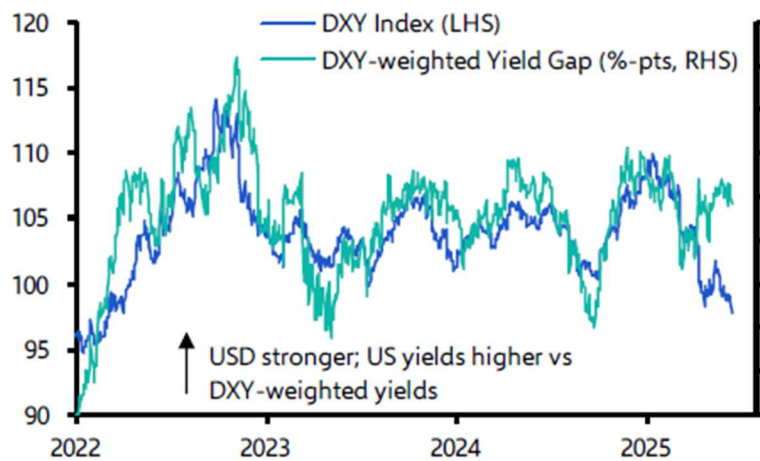




Moreover, although equity valuations in Europe remain significantly lower than in the U.S., they are actually above their long-term average – making a blind, wholesale reallocation toward European equities inadvisable.

## CURRENCIES AND COMMODITIES: USD-WEAKNESS ACCELERATING

Economic issues in China are all reasons that should manifest in a weak commodity market, but stubborn inflation and the threat of tariffs will pressure the opposite way. Specifically, industrial metals may face some headwinds as the Chinese economy is the largest contributor to metals demand. Conversely, waning geopolitical risks will pressure oil prices to the downside, with OPEC+ members very determined to gain market share. Theoretically, a similar faith that should await gold. Yet, the structural factors which have been key drivers of the gold rally should remain alive. In the short-term, with recession risks fading and the USD that may rebound, the gold price may remain downbeat. However, the USD remains overvalued, central banks don't seem to have lost interest in the yellow metal, and the debt burden of major economies continues to rise, all reasons that support a positive view in the long term.



The Big, Beautiful Bill has increased the doubts that the current U.S. administration is willing to reduce the fiscal deficit. Moreover, the renewed threat of tariffs and some not-so-exciting employment data, resulted in long-term Treasury yields rising, and the USD weakening, despite the interest rate differential moving in favor of the greenback (chart to the left). In the near-term, sentiment and positioning appears to have become dollar-negative, which often leads to at least a temporary rebound.

The ECB just cut its main refinancing rate, taking advantage of the inflation rate slightly below target.

The strengthening of the EUR came on the back of an ambivalent communication by President Lagarde, which hinted that a further cut is not yet certain. The resumption of the European economy may act as a boost to the currency, supporting it in the near term. In Switzerland, the annual CPI inflation rate dropped into negative territory. Yields have barely moved as they had fallen already significantly from their peaks in 2022, but the Swiss Franc remained very strong against most currencies, leveraging on other regions' challenges.<sup>1</sup>

<sup>1</sup> Document sources: Capital Economics, BCA, 3Fourteen Research, Creditsight, Empirical, Vontobel, Factset, Refinitiv IBES, Hussman Strategic Advisors, Yardeni, Bloomberg.

# OUR STANCE

Liquidity: Underweight ▼	Bonds: Equal Weight =	Equities: Equal Weight =	Alternatives: Underweight ▼	Commodities: Overweight ▲
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