

2025 Q2 Review and Q3 Outlook

Executive Summary

- The second quarter of 2025 was one of those quarters that likely confounded investors reading the daily news. Though counterfactual, we think it is likely that if investors were given the major Q2 geopolitical headlines at the end of Q1, they would have lost money despite this clairvoyance.
- Economic, monetary, and geopolitical uncertainty indices all reached thirty-year highs. The US contended with headlines around “Liberation Day” and the ensuing fourth worst two-day percentage loss for stocks in modern history. Civil unrest and political violence continued. Consumer pessimism, inflation expectations, and auto and credit card delinquencies all approached record highs. Outside the US, the war in Ukraine escalated, the war in Gaza continued, the US and Israel attacked Iranian nuclear facilities, and world leaders warned a Chinese attack on Taiwan “could be imminent.”
- Yet despite this barrage of worrisome headlines and heightened uncertainty, investors were rewarded for standing pat and taking risks. We are proceeding with a bit of added caution, but think Q2 is a classic example of why investors should remain unemotional, stick close to long-term targets and avoid the pitfalls of betting jointly on markets and geopolitics.

Currencies, Bonds, and Commodities

The proverbial investor reading Q2’s Wall Street Journal in Q1 likely would have had mixed results in this space. Starting with the US dollar index, which was down 11% through Q2, experiencing its worst year-to-date since 1973, there were certainly various headlines supporting this price movement. “Liberation Day” led to net foreign selling of US assets in April. This occurred even though US interest rates rose sharply in April. Fundamentally, foreign investors generally seek to park more of their savings in the US when interest rates move up and particularly when geopolitical risk rises, but the opposite occurred. Foreign investors seemed more spooked by the potential for higher tariff-induced US inflation and a more politically influenced Federal Reserve. Foreign investors were also particularly concerned with the potential for the “big, beautiful bill” to increase US debt and deficits and tax foreign investors up to 20% for the right to invest in America. The tax ultimately was not enacted, but headlines drove the dollar.

In the bond world, the opposite seemed to occur as bonds turned in small but positive returns despite worrisome headlines. Auto, credit card, and student loan delinquencies approached record highs. Consumer inflation expectations jumped to thirty-year highs as investors feared tariff-induced price increases. The Congressional Budget Office and other non-partisan groups expect the “big, beautiful bill” will push America’s debts and deficits higher still. This is all occurring with the US already issuing record levels of debt and spending over \$3 billion on interest per day. America’s interest expense now eclipses our defense spending. In 1767, Adam Ferguson noted that such a tipping point ultimately led to the demise of many great powers, and this has generally held true since. Indeed, American exceptionalism was often questioned. The term “bond vigilantes” jumped on Google Trends. Headlines noting “Yield Spiking” and “Treasury Auction Goes Badly” caused talking heads to ask, “who will buy all this debt?” Despite all of this, the broad US bond market was up 1.2% in Q2 and up 4% for the year, so much for following headlines here.

Turning to commodities, we’d say again that an investor reading Q2’s news headlines in Q1 would have had mixed results making actual money. Gold’s ~6% gain might well have been predicted with clairvoyancy. Knowing that the dollar weakened, that geopolitical risk would rise and that global conflicts would escalate and erupt all would point an experienced investor to gold. But given these same events, that the US and Israel would bomb Iranian nuclear facilities, who would have bet that oil would be one of the few assets in negative territory for Q2 with a healthy -9% decline. Not us.

US Equities

In US equities, we suppose a clairvoyant investor reading the right kind of contrarian, data-driven Q2 news in Q1 may have fared better than one following the big, geopolitical headlines. The economic, monetary, and geopolitical uncertainty indexes all jumped to thirty-year highs immediately in Q2. President Trump announced his planned tariffs on “Liberation Day” and US stocks quickly lost 10% or over \$6 trillion in value for the fourth worst two-day percentage loss in modern history. Consumer pessimism and inflation expectations jumped immediately toward thirty-year highs. Although Trump later paused these tariffs, they still loom with his announced plans to implement new tariffs on August 1st. Moreover, President Trump deployed 700 Marines and the National Guard to stop “violent, insurrectionist mobs” from “completely obliterating” LA and unsuspecting driverless Waymos. Politically motivated violence continued in the US with an arson attack on the Pennsylvania Governor’s Mansion in April and the assassination of a Minnesota State Representative in June.

An investor focused on these headlines surely would have sold or even shorted US stocks, which instead rose 11% in Q2. How is this possible? Particularly at a time when US stocks were already valued at a near-record level 21X expected earnings heading into Q1 and more dependent and concentrated on just a handful of stocks than ever before? First and most importantly, this handful of stocks or the “Magnificent Seven” delivered and specifically with artificial intelligence (AI). In Q2, the Magnificent Seven announced Q1 earnings that grew 28% year-over-year. While these top names are now more richly valued than the top names during the height of the tech bubble, the Magnificent Seven still see 14% earnings growth in the year ahead.

We got to see Satya Nadella, Microsoft’s CEO, speak earlier this year. He noted that if AI truly reaches artificial general intelligence (AGI) or human-like cognitive abilities, we could see 10% GDP growth. We haven’t seen anything like that since the Industrial Revolution and unlike then, he believes the benefits would be widespread. OpenAI, of which they own a 49% stake, got a 135 or above genius level on the Mensa test and became the fastest company ever to reach 100 million users. Microsoft noted its AI tokens processed jumped 5X year-over-year. Firms like Nestle purchased 25,000 of Microsoft’s AI Copilot licenses and estimate they break even with just 10 minutes of time savings per user per day.

Amazon’s CEO, Andy Jassy, noted AI is a “once-in-a-lifetime technological change” that will drive efficiency. His firm just acquired Bee, an AI bracelet that listens to, transcribes, and summarizes all your conversations. Although Waymos were alit by the mobs in LA, Google reported that driverless trips in California were up 27% in March alone and up 7X year-over-year. In San Francisco, autonomous taxis recently overtook ride shares in terms of market share. Meta’s CEO Mark Zuckerberg noted that “in the not-too distant future” brands will simply send Meta an image of their product and ad budget and AI will do the rest. In Q2, Meta recently invested \$14 billion in Scale AI, a 9-year-old data labeling firm.

We’d be remiss not to mention some of the more negative potential aspects stemming from AI. Amazon’s Jassy openly admits efficiency gains will lead to near-term job cuts. Driving earnings growth for most of these firms is their ability to make more revenue with less overhead. Microsoft just announced 15,000 layoffs, estimating it saved more than \$500 million by using AI in its call centers. For the first time in over thirty-five years, unemployment rates for recent college graduates are consistently higher than the overall unemployment rate. While Nvidia’s CEO Jensen Haung thinks AI is unlikely to cause widespread job losses, Anthropic’s CEO thinks it could eliminate half of entry-level white-collar jobs and increase unemployment to 10-20% in the next one to five years.

More worryingly, Elon Musk, CEO of Tesla and other AI-related firms like xAI, has warned that AI has a 20% chance of wiping out humanity. Ironically, xAI’s chatbot Grok recently began calling itself “MechaHitler” and provided advice on how and when to foment even further political violence in Minnesota. Just before his death, Professor Stephen Hawking famously noted that “AI could be the biggest event in the history of our civilization, but it could also be the last.” In Q2, investors were rewarded for backing AI despite these concerns and other worrying headlines.

International Equities

Geopolitical risk outside of the US also escalated in Q2. In June, civilian casualties in Ukraine reached their highest levels since the war began. Russia intensified its use of long-range missiles and Iranian-made drone swarms against urban areas. In Q2, North Korea confirmed it sent troops to Russia to support the war. Also in June, Ukraine used its own AI-powered drones to autonomously strike deep into Russian territory. President Trump recently asked Ukraine if they could strike Moscow and agreed to indirectly provide Ukraine with the long-range missiles needed to do so.

In Iran, things also escalated quickly. In short order, Iran announced it would open a third uranium-enrichment site. While the International Atomic Energy Agency quickly criticized Iran's program, Russia and China both voted against the measure. Israel retaliated with air strikes. The United States deployed bunker-busting bombs to eliminate nuclear sites. The term "World War III" surged on Google Trends. The conflict between Israel and Gaza continued, with over 100 Palestinians recently killed attempting to access humanitarian aid. Further east, both the longstanding Cambodia-Thailand and nuclear-armed India-Pakistan conflicts flared up. US Defense Secretary Pete Hegseth warned that a Chinese military attack on Taiwan "could be imminent", while French President Emmanuel Macron warned that allowing Russia to take Ukrainian territory may spur China to move on Taiwan.

Again, despite this sharp rise in geopolitical risk and the increased use of the very autonomous weapons that Hawking warned about, international markets jumped 12% in Q2. The pause in tariffs, a much weaker dollar, and much more reasonable starting valuations certainly helped international markets. Additionally, while the early June events and the entanglement of Iran, Russia, North Korea, and China were worrisome, the "axis" did not unite or escalate the situation further for now. Again, though, we doubt an investor with clairvoyant knowledge of the Q2 events above would have bet on international markets.

Alternative Assets

Wrapping up with alternative assets, which are generally managed by professional investors, we'd again say they had mixed results navigating Q2. Directional hedge funds, or those that can long and short stocks and often bet on geopolitics, gained just over 5% for the quarter, generally underperforming global stock markets. These funds often follow risk models that have them cut risk during April's record downdraft, only to add risk back during Q2's record-breaking recovery. We continue to reduce exposure here while relying more on "uncorrelated" funds. We seek funds with steady risk systems who endeavor to make money, come what may, in terms of geopolitics and market movements. We think truly uncorrelated returns are rare, but ever more valuable in a world that has grown more uncertain.

In venture capital and private equity, again, we would say the results were mixed. Rising uncertainty chilled mergers and acquisitions with deal count recently dropping below the COVID level lows. Private market distributions as a share of reported private market values dropped in 2024 to 10%, nearing the lows seen in the Great Financial Crisis. An analysis by State Street recently showed that the Magnificent Seven-heavy, low-fee, liquid S&P 500 index has outpaced private market funds for the last one, three, five, and ten-year periods. Another recent study estimated the annual drag from alternatives before and after fees was from 5 to 8%. With these studies and headlines, are private investments worth it?

While we do think investors need to be very selective in making these long-term commitments, we would note some positive signs. First, despite the rising uncertainty, the IPO exit market appears to be opening. As of this writing, there have been 194 IPOs in the US with over 20 in July alone. These IPOs have also been warmly received with the PitchBook Venture Capital-backed IPO index up 72% in Q2. Driving these IPO returns are companies like CoreWeave in AI and Circle in cryptocurrency. While the Magnificent Seven has a massive size advantage in AI, we've also seen start-ups with just a handful of employees using AI to scale exponentially by providing more focused

tools on smaller data sets, where AI often works best. In sum, we continue to think private investments can work, especially when focused on smaller companies enabled with these new technologies, solving large problems.

Finishing with real estate, again, the headlines were negative, but the returns were positive. Tariffs chilled industrial warehouse sentiment. Rising vacancies dampened multi-family housing starts. Higher mortgage rates and record unaffordability slowed April's home sales to the slowest pace since 2009. Yet again, despite this news flow, listed real estate stocks gained ~5% in Q2 while housing prices reached record highs. On the AI theme, data center construction alone added a record breaking 1% to US GDP growth in Q1. If even more people use their Bee and other AI devices to record and analyze their every word and golf swing, the world will need a lot more energy, power, and data centers.

Conclusion: What is an investor to do?

As always, we think Q2 highlights the need to have a long-term plan and stick to it. We heard many sad stories of investors moving their entire 401(k)s to cash in Q2 at the depths of the market decline, only to miss the record-breaking recovery. Historically, the worst days in the markets are often followed by some of the best days. It is easy to get caught up in the negative geopolitical news which sells ads and miss some of the more positive stories out there. We had the pleasure of attending Berkshire Hathaway's meeting in May again to see Warren Buffett's last meeting taking questions on stage. Paraphrasing a bit, he noted that it is part of the human condition to think that now is the worst or most dangerous time to be alive. While he noted the dangers of AI, nuclear proliferation and US fiscal profligacy, he repeatedly noted that the United States now is still "the best place and the best time to be alive by miles." While we are proceeding with a bit of added caution, we remain close to our long-term targets, on the lookout for opportunities and as unemotional as possible to geopolitical and market volatility.

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