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Market Overview

May delivered a continuation of the sharp rebound off the April 8th lows. Despite persistent headlines about tariffs, deficits, and the Fed, investor sentiment improved meaningfully, driven largely by strong corporate earnings. International equities have outpaced U.S. markets, while small caps again lagged. Credit spreads remained tight, and the broader market appears increasingly comfortable with a soft-landing narrative.

Earnings Season: Better Than Expected

Earnings stole the spotlight in May. After expectations for just 8% year-over-year growth in Q1, actual results came in at 14%, well ahead of historical averages. Strong results were driven by large-cap tech names, particularly the so-called Mag 7, where six of the seven beat on both revenue and earnings. The continued CapEx boom in AI-related infrastructure helped drive upside surprises and supported a broader rally. Even outside of large-cap tech, commentary from bellwether companies reflected stable demand and improving margins, thanks in part to disciplined buybacks and capital allocation.

High Yield Surprises to the Upside

One of the more surprising developments was the strength in high yield bonds. Year to date, high yield returned nearly 2.8%, outperforming investment-grade credit and the Bloomberg Aggregate Index. This came despite macro volatility and rising long-end yields. The explanation? Tight credit spreads. Nearly half the high-yield index trades at an option-adjusted spread of just 200 basis points or less, levels usually associated with stable economic conditions. Much of the riskiest debt exited the index post-2020, and many remaining issuers locked in long-term, low-cost debt, further insulating the space.

Public Debt and the Growth Mandate

The fiscal backdrop remains front and center. Treasury Secretary Scott Bessent emphasized the need to grow nominal GDP at or above 6.5% to stabilize the debt-to-GDP ratio. With $38 trillion in outstanding treasuries and rising interest expense, the government must keep the economy running hot to maintain fiscal stability. For investors, this reinforces the case against long-term bonds and in favor of risk assets. History shows extended periods of negative real returns for bonds when inflation-driven growth is prioritized, a playbook we may be re-entering.

Fed Policy and Tariff Noise

The Fed remains caught between sticky inflation and political pressure. The recent federal court ruling blocking certain Trump-era tariff mechanisms could accelerate the Fed’s willingness to cut

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rates, assuming tariff-driven inflation expectations recede. However, expectations are that the Trump team will seek alternate avenues to reinstate tariffs under different statutes, including those that allow temporary hikes with Congressional review. The situation adds uncertainty but does not fundamentally alter the Fed's cautious stance for now.

The Tail Environment and Market Behavior

May's rally highlighted an increasingly tail-driven market. Since 1950, only four calendar years have ended with S&P 500 returns between 7% and 9%. Extremes dominate. Already this decade has delivered three separate 20% drawdowns—2020, 2022, and again in early 2025. The faster the drop, the faster the recovery, especially in a world where policy responses are increasingly aggressive. Investors must be positioned not just for volatility, but to participate meaningfully in both left- and right-tail scenarios.

Looking Ahead: Summer Slowdown or More Volatility?

As earnings season winds down and the calendar turns to summer, the market could drift back to macro headlines including tariffs, deficits, and the Fed. While the period from April to September is historically weaker, the current environment could buck that trend. The underlying strength of corporate earnings, consumer demand, and the structural push for nominal growth all suggest a constructive backdrop. But with policy risk elevated and volatility always possible, staying nimble remains critical.

Final Thoughts

Despite a noisy backdrop, May reinforced a few key themes: strong earnings matter and growth remains the government's primary tool for managing debt. For investors, the message is clear. Focus on resilience, stay active, and be prepared for both ends of the return spectrum. Tails aren't rare anymore. They're the norm.

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