



The ADVISOR

Focus on Community Banking Issues

Third Quarter 2025

ECONOMIC ENVIRONMENT

Clear Skies Behind the Clouds?

As we cross the halfway point of 2025, the U.S. economy continues to defy earlier recession calls, bolstered by surprising resilience in consumer activity, steady job creation, and optimism in equity markets. However, challenges and uncertainty remain, as inflation is showing early signs of reacceleration and the labor market's strength may be more cosmetic than structural. As policymakers remain on hold and markets anticipate future rate cuts, the path forward is clouded by lingering risks and political volatility.

Inflation is Gaining Steam

Inflation appears to be picking back up, with both survey-based and official data pointing to emerging price pressures. While June's 2.7% annualized CPI is well below the 2022 peak, evolving global trade dynamics and early effects from renewed tariffs threaten to push this trend higher. New 30% tariffs on the EU and Mexico are set to take effect August 1, and threats of "secondary tariffs" on Russia's trade partners suggest additional pricing pressure could be in store (no pun intended). While many companies have been able to delay price increases through inventory stockpiles and front-running, Wells Fargo economists note that these buffers are thinning and create the expectation for rising core goods prices in the second half of 2025. According to

Bloomberg Economics, the tariff effect is passing through to consumers at an increasing rate; they estimate that for every percentage point of tariff shock in June, the CPI rose 0.28% (vs 0.20% in May). This passthrough is most evident in the Core Goods category, which has flipped from deflationary in March to comprising 15.1% of the CPI gain in June.

While we do not expect 2022-like inflation to return, even a modest uptick (particularly if it is politically-driven) poses challenges for the Fed as it weighs the timing of potential rate cuts. Overall, inflation remains within a manageable range for now, but

Features

Economic Environment:

Economy remains stronger than expected, but clouds remain

Fixed Income Strategy:

The Fed remains under intense pressure

Equity Strategy:

Considerations for corporate earnings and the tariff impact

ALM Strategy:

Financial Institutions are successfully weathering the storm

EPG RATE OUTLOOK

July 2025

MARKET RATE	Actual (%) 6/30/2025	Projected (%) 6/30/2026	Yr1 Δ	Projected (%) 6/30/2027	Yr2 Δ
FedFunds	4.50	3.75	-0.75	3.75	0.00
Prime	7.50	6.75	-0.75	6.75	0.00
3mthTsy	4.29	3.90	-0.39	3.80	-0.10
6mthTsy	4.25	3.75	-0.50	3.85	0.10
1yrTsy	3.97	3.75	-0.22	3.90	0.15
2yrTsy	3.72	3.80	0.08	3.95	0.15
3yrTsy	3.69	3.80	0.11	4.00	0.20
5yrTsy	3.80	3.85	0.05	4.05	0.20
10yrTsy	4.23	3.90	-0.33	4.15	0.25
30yrTsy	4.77	4.15	-0.62	4.40	0.25

RATE OUTLOOK DESCRIPTION:

This represents EPG's current view of interest rates. Depending on the actual timing of the ALM meeting, the outlook may be altered and/or updated. For the most accurate current rate outlook, please call EPG, Inc. at (781) 235-2666.





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multiple factors, including rising food and housing costs, lingering tariff effects, and elevated forward-looking price indicators suggest the balance of risks is tilted to the upside.

Labor Market: Strong on the Surface, Soft Underneath

If inflation remains in check, a deterioration in the labor market would be the most likely catalyst for near-term policy adjustments. While monthly nonfarm payroll numbers remain sturdy, the underlying quality of the labor market is questionable. Diving deeper, June's decline in the unemployment rate to 4.12% was driven by a shrinking labor force rather than strong job creation.

Sectors that once powered hiring such as health care and education are now showing signs of deceleration, with education services even shedding jobs due to contract cuts. Wage growth has also moderated, with average hourly earnings rising just 0.2% in June, and total weekly earnings effectively flat due to a shorter work week. These signs point to a labor market that may be stalling, rather than accelerating. As the Fed maintains its cautious stance and tariffs increase input costs, employment trends warrant close monitoring heading into the fall.

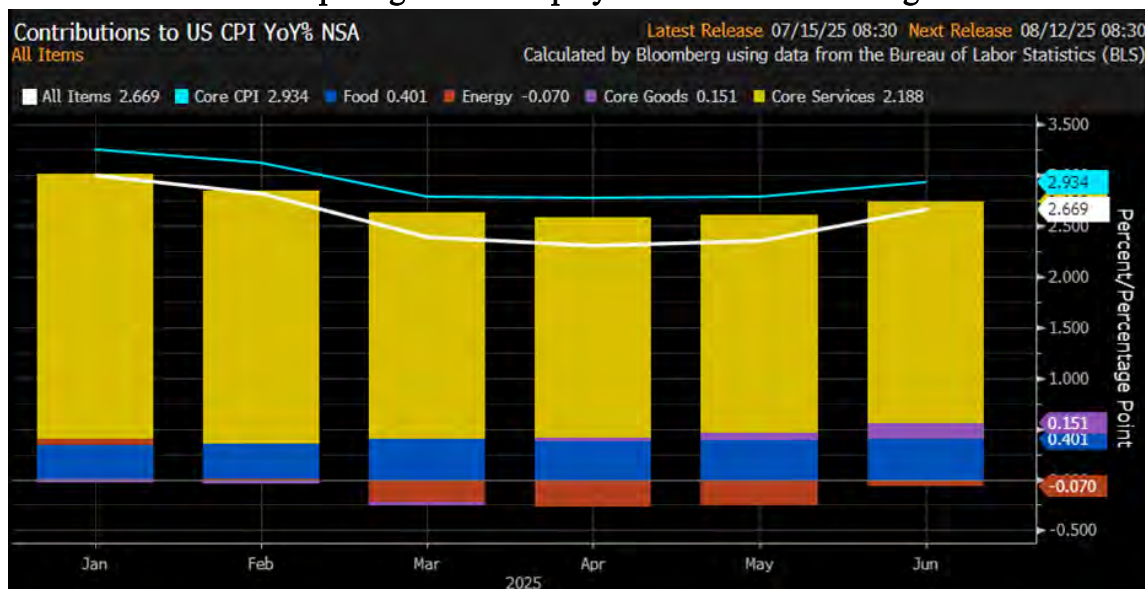
EPG Rate Outlook

So, can the Fed cut rates if the economic backdrop maintains its current momentum? The answer to this has become complicated amid mounting political pressure for the central bank to ease. Recent history shows us that the Fed has been willing to cut to get ahead of a

potential slowdown; we saw this with last September's surprising 50 basis point adjustment that many economists felt was unnecessary at the time. Both the fed funds futures market and the FOMC's most recent Dot Plot project 50 basis points of total cuts this year, but this view becomes more confusing in the context that 7 of 18 voting members are projecting zero cuts this year. Why the split consensus? Based on recent commentary, it is fair to wonder if some voting members are advocating for cuts in hopes of being appointed Chair. The Fed should be immune to political pressure on paper, but Powell's term ends next May regardless of whether he is "fired," creating the very real possibility of a new, likely more dovish Fed Chair at that point.

We continue to project two 25 basis point cuts this year and a

Job Openings Per Unemployed Worker are Shrinking



Source: Bloomberg

ECONOMIC ENVIRONMENT

third midway through 2026, creating a 3.75% terminal rate. We agree with the Fed's official stance that achieving greater clarity on the inflationary effects of tariffs before adjusting policy is important, but slowing employment data could convince the Fed to cut preemptively as it did last fall. Powell emphasizes the need for a "sustained trend," so we may re-adjust our view if economic data continues surprising to the upside or inflation pushes higher. We see lower short-term rates ahead, whether the cuts occur this year or in 2026 under a new central bank regime.

Looking across the yield curve, we believe the upcoming rate cuts should influence continued normalization over the next two years via bull steepening, where the short end falls faster than the long end. If the Fed is cutting into an inflationary environment, the 10 Year could hold steady in the

4.00% – 4.25% trading range while short-term rates fall.

Are Consumers Back, or Did They Never Leave?

Consumer sentiment and spending, which took a hit earlier this year amid escalating trade tensions, have staged a strong comeback. When President Trump initially announced sweeping tariffs in the spring, consumer sentiment plunged as economists warned of price shocks and demand destruction. However, that fall in sentiment never materialized in actual spending data, as evidenced by June's retail sales figures again exceeding forecasts. The University of Michigan's sentiment index has rebounded significantly from its April low point, major banks are reporting improving credit card spending, and earnings from consumer-facing businesses suggest a similar trend.



So, are there any risks to this optimistic spending outlook? Absolutely. Wealthier consumers continue to fuel the strongest areas of spending gains, which makes sense in the context of declining wage growth and slowly weakening labor market conditions. With pandemic-era household savings buffers largely depleted and credit conditions tightening, any future pullback in income or hours worked could ripple quickly through consumer activity. Furthermore, the full inflationary impact of tariffs on consumer goods and retail margins is not yet understood, so we may still see modified consumer behaviors ahead if new trade deals are not reached by the upcoming August deadline. ♦





FIXED INCOME STRATEGY

FIXED INCOME STRATEGY

Tariff Concerns Linger But Investors Question The Fed's Reluctancy to Adjust Policy

Two of the Federal Reserve's strengths over the years have been unity and transparency. Behind the scenes, policy makers may differ in opinions with their individual economic theories and inflation forecasts but in the public eye, the Central Bank is in tandem moving as one. There have been recent cracks and mixed messages regarding Chair Powell and other Fed officials addressing the public with economic and policy insight. At the June FOMC meeting and at the Senate Banking Committee, Chair Powell made it clear that the Fed was in no hurry to modify current policy and cut short-term interest rates. However, within

days, two of his Fed officials suggested that interest rates could move as soon as the July meeting. Federal Reserve Governor Bowman said she was in favor of a cut at the next meeting as long as inflation pressures remain subdued. Governor Chris Waller also suggested a rate cut as soon as July on his thesis that the tariff inflationary impact will be short lived and not hinder the longer-term inflation forecast or the broader economy.

Additionally, President Trump has been aggressively suggesting that Powell act sooner with rate cuts, accusing Powell of moving too slowly to implement policy changes. Trump's ridiculing of Powell's decision to remain patient has investors and analysts questioning the central bank's independence. If investors were to believe the Fed is bending to political pressure, confidence could continue to fall, creating both market uncertainty and volatility.

To complicate things further, the Summary of Economic Projections at the June FOMC meeting made the growing policy concerns compelling among Fed officials. While the median forecast was unchanged, still calling for two interest rate cuts in 2025, policy makers seem to be split on timing and magnitude of policy action for the remainder of the year. Seven see no rate cuts in 2025, while eight officials are calling for two rate cuts. This split among officials adds to the uncertainty of the forward trajectory for monetary policy. Powell's term is up next May and Donald Trump has already suggested potential successors, possibly announcing his decision as soon as this summer. Waller's name has been floated as a potential replacement, and not coincidentally, he is on the short list for advocating a rate cut as soon as July.

Jerome Powell has made it clear that the FOMC acts in an independent manner with their implementation of monetary policy.

Yield Curve 12/31/2024 - 6/30/2025



Source: Bloomberg

Yield Curve Changes Year to Date

Term	12/31/2024	6/30/2025	Change
2 Year	4.24	3.72	-0.52
3 Year	4.27	3.69	-0.58
5 Year	4.38	3.80	-0.58
7 Year	4.48	3.99	-0.49
10 Year	4.57	4.23	-0.34
20 Year	4.86	4.77	-0.09
30 Year	4.78	4.77	-0.01

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However, a combination of the recent political intervention, a split decision among policy makers, and Powell's consistent wait and see approach to tariffs has raised concerns. There are some investors worried that policy makers are being too patient and may fall behind the curve with rate cuts. Inflation has cooled, and although the labor market remains strong, it is showing signs of softening. Investors have raised the question of whether policy makers could eventually crack to political pressure. Markets have even sent warning signals with both the dollar and bond yields dropping on the notion that Trump could announce Powell's successor far sooner than anticipated. The idea of a shadow replacement (most likely dovish) could promote the idea that the policy path may be swayed from a political view rather than economic. If the momentum were to continue, markets may preemptively price in rate cuts, the dollar may continue to soften, and the Fed's reputation for independence may continue to slip. The Fed's job will remain to hold the line and maintain a consistent message to the market, regardless of how soon the next rate cut may or may not happen.

Yield Curve Steeper, Investment Opportunities Remain Accretive

The front end of the yield curve has built in an easing bias, while the longer end remains hesitant to

break the trading range. Longer dated Treasuries continue to remain on the higher side of historical yield levels, a result of weak Treasury auctions impacted by a lack of demand for longer duration Treasuries. This is coupled with the possibility of tariff driven inflation at a time when the current level of inflation is already above the desired target level. As a result, the long end of the yield curve has remained range bound, awaiting more confidence on economic conditions, tariffs and inflation before traders reprice to a new range.

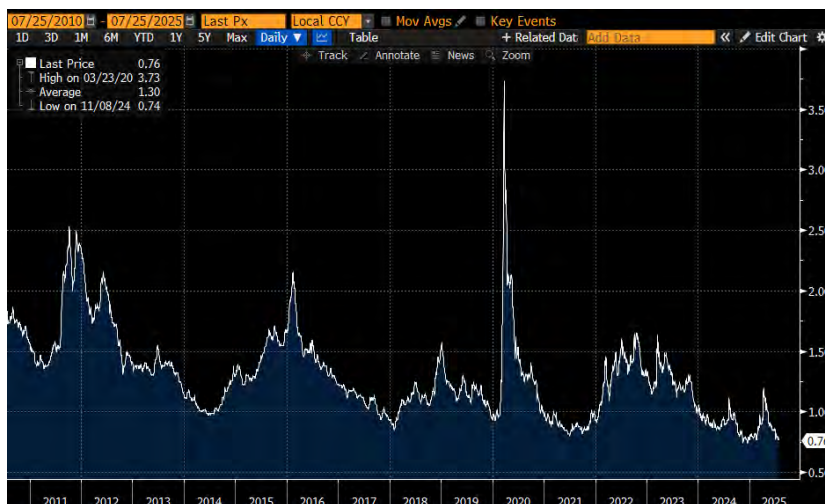
With an increase in interest rate volatility this year, the additional yield associated with taking credit risk in both corporate and municipal investments has somewhat unexpectedly remained in a narrow range. Corporate and Municipal bond spreads continue to remain firm, suggesting limited opportunities to add accretive credit-related products to existing balance sheets. Although call risk can have disad-



vantages, the additional spread in fixed / floating rate MBS and Callable Agencies offer attractive risk adjusted yields above the SOFR rate and traditional bullet like Treasuries.

Monthly portfolio runoff will likely remain on the lighter side unless we see significant weakness in the U.S. economy. This scenario would likely drive cheaper funding costs by lowering and steepening the U.S. Treasury curve, which would then increase prepayment speeds and boost on balance sheet liquidity. Interest rates at current levels create an opportunity to enhance margins with the potential additional benefit of capital appreciation as longer term rates moderate over time. ♦

Historical Spread of Corporate Index



Source: Bloomberg



EQUITY STRATEGY

EQUITY STRATEGY

Equity Investing: Smooth Sailing Ahead?

With continued momentum and impressive gains being registered in the equity markets, investors are increasingly focused on variables that will shape the outlook for corporate earnings and investor sentiment. Several key considerations will be central to how earnings forecasts evolve, how volatility unfolds, and how long-term market trends take shape.

When looking at current and anticipated earnings results being presented, there are several components that analysts and institutional investors will be considering. One ongoing factor is the impact of tariffs, not only on corporate costs but on broader economic dynamics and the reliability of forward-looking earnings forecasts. As with the auto industry, and looking out to the coming quarters, tariff impact on costs associated with product build is and will have a material impact on earnings and visibility in select industries. The key issue is assessing how widespread and significant these impacts will become across industries in the coming quarters.

Interest rates also remain a pivotal driver for equity market behavior, influencing both momentum and volatility. While the Trump administration has called for an immediate and material cut in short term rates by the Fed, this pressure was without underlying rationale or argument. This seems to be changing. Economists and analysts are now weighing whether tariffs will create additional inflationary pressures or if fiscal policies, including the tax plan, will offset these headwinds. Moreover, as trade negotiations progress and agreements are reached, markets may find reassurance that tariff impacts on corporate profitability and forward-looking outlooks will be contained and manageable.

Regardless of the short-term tariff impact, the trajectory of earnings momentum is another critical element. Will the string of positive results translate into a sustainable upward trend, or will signs of slowing growth and downward revisions start to emerge? Given the uncertain outlook across many sectors, analysts will be closely monitoring the tone and direction of corporate guidance, in addition to just the reported results. Downward revisions, or the withdrawal of guidance altogether, could signal shifts in investor sentiment and trigger periods of increased volatility. This is an important consideration when investors determine whether to “buy the dip.”

Earlier in the year, tariffs, Fed policy uncertainty, and the resulting investor caution created a turbulent market environment. However, since April, equities have staged a prolonged recovery, with the S&P 500 hitting record highs. AI-driven efficiencies & implementation, a weaker dollar, and anticipated tax benefits have fueled this investor optimism. Also, analysts believe that in a number of sectors, pent up consumer demand still remains. Interestingly, despite the ongoing friction between the Trump administration and the Fed, the market consensus is pointing towards rate cuts later this year and into 2026.

So, with quarterly results beginning to flow in, which areas of the market are best positioned for strong performance going forward? Technology continues to lead, driven by surging demand for semiconductors, AI-related infrastructure, and cybersecurity solutions. We believe this trend will persist as corporations increasingly integrate AI to automate workflows, enhance customer engagement, and drive operational efficiencies. We also see positivity in Communication Services, which is benefiting from strong digital advertising trends and content-driven revenue growth. Likewise, Financials look to remain sturdy as major players are expected to benefit from stabilizing credit conditions,



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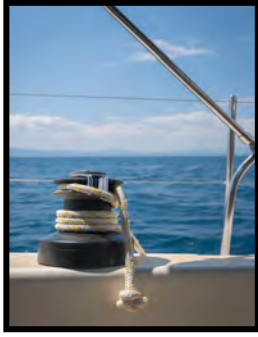
healthy consumer balance sheets, and improving net interest margins.

Broad-based valuation multiples, such as forward-looking P/E ratios, are always an important consideration for investor outlook and activity. With the S&P 500 currently trading at 22.2x next year's earnings, questions about whether valuations are stretched will soon be tested against the backdrop of Q2 and Q3 earnings results.

Controlled inflation, sustained earnings growth, stable to declining interest rates, and robust consumer activity could show that current price levels are justified. However, index-level forward P/E ratios above 22 leave little margin for earnings disappointment, so it will be essential to monitor the influence

of employment trends, Fed policy, new trade deals, and corporate guidance. These elements will determine whether the market's upward trajectory continues smoothly or if volatility becomes a more persistent feature through the remainder of 2025. ♦





ALM STRATEGY

Financial Institutions Seem To Be Handling The Current Uncertainty Well As We Enter Q3

Amid the seemingly constant tariff on / tariff-off environment, financial markets and institutions seem to be faring well despite the barrage of headwinds. In general, bank and credit union financial performance has been steadily improving, driven by increasing margins, still decent loan demand and improving liquidity. In addition, for institutions that need to borrow, there continues to be attractively priced alternatives that can be accessed with modest or moderate levels of option risk. However, how will margins trend moving forward?

A Closer Look at Current Spreads and How They May Change Over the Next 12 Months

For a more 'real-world' example, let's look at the spread on a hypothetical new \$10 million 6.50% CRE transaction funded at current rates, and how that may change 6 months, and then 12 months out. As always, this projection is based on a number of key assumptions that may or may not actually come to pass (such as the loan will not

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prepay within our projection period):

Asset:

- \$10M 5yr CRE deal at 6.50%

Funding:

- \$3 million in 6-month CD Specials at 4.25%
- \$1 million in High Yield MMDA at 3.50%
- \$1 million in 6-month BrokerCD's at 4.40%
- \$1 million in 12-month BrokerCD's at 4.25%
- \$2 million in short term FHLB bullets at 4.54%
- \$2 million in 3YR FHLB Option Advances at 3.50%

Total Weighted Average Cost of Funding: 4.10%

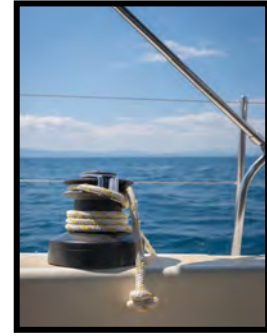
Overall initial spread on the transaction: 2.40%

Although 2.40% may not sound fantastic, it is reasonable given today's operating environment. However, if we look 6 months down the road, and assuming the Fed cuts twice for a total of 50 basis points, the transaction starts to look more appealing. Making some assumptions about how the funding may reprice, driven by declines in the 6-month CDs, High Yield MMDA, 6-month BrokerCD and short term FHLB bullets, the blended cost of funding declines to 3.77%, pushing the spread up to 2.73%.

Moving out 12 months, and assuming another 25 basis points in Fed cuts, all of the funding would have repriced except for the Option Advance, lowering the blended funding cost to 3.54% and raising the spread to 2.96%. At nearly 3%, the projected spread 12 months out looks significantly more attractive than the initial spread of under 2.50%, and although there are a number of assumptions built in, it is reasonable to believe that the spread will increase over time given the current level of interest rates and how they are likely to move over the next year. In addition, the funding mix should be palatable to most institutions, as it includes a mix of sources rather than purely wholesale.

Trying to project more than a year out, and specifically past the appointment of a new Fed chair, is challenging. However, let's give it a shot. The key assumption here is that the new Fed chair will likely come in with a mandate to lower rates, maybe aggressively. It is also probably safe to assume that the candidate would not even be considered if that were not the plan. Based on these parameters, if the Fed were to lower rates by an extra 75 or 100 basis points from our previous example, funding costs would come down quickly, boosting the spread at least initially. However, possibly not too far down the line, the borrower may decide to refinance, even if there is a penalty if rates are low enough. If the Fed were to cut too aggress-

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sively, the market would likely push back, as the back end of the curve could become concerned about inflation. Playing this out, a rise in longer rates after a decline in short rates would lead to a steeper curve, which is an ideal operating environment for financial institutions. This could continue until the Fed sees inflation pop, forcing a change in direction.

How Do We Plan for this Uncertain Future?

If we really believe that short rates could decline sharply in mid-2026, how should we prepare? In a declining rate environment, the risk is that assets prepay more quickly (or are called) and then have to be replaced at lower rates while longer term funding extends at current rates. So, the easy answer is to add longer assets with call protection, while keeping funding short. However, in this hypothetical scenario, longer rates actually climb due to inflation fears (after initially declining as the Fed cuts), so if the curve steepens as short rates fall and longer rates rise, the answer may not be quite as straightforward as simply a falling rate scenario. We need to prepare for a falling rate scenario (short end of the curve) simultaneously with a rising rate scenario (longer end of the curve).

On the funding side, the vast majority of financial institutions are already well positioned by keeping most CD specials short, combined with high yield savings or money market accounts that can be quickly repriced lower. There is only modest demand

currently for longer CDs, in the 15-24 month range, but that could change if depositors start to become concerned about a post-Powell interest rate world. As of now, though, there should be minimal preparation needed on that side of the balance sheet.

The asset side is a little different, as rising longer-term rates could argue for holding off before adding assets. In reality, though, that means a pause on lending, which may not be the best course of action. The most beneficial way to attack this is likely 'business as usual' while holding the line on loan rates that feel too low even as competition remains aggressive. This could be bad news for some of the more attractive (from a borrower perspective) residential rates we have seen lately, such as ARM rates near 5.50% or CRE rates around 6%. With that said, there is no reason at this time to significantly alter your approach to lending, as this hypothetical scenario is around 10 months in the future. ♦



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Jon Rankin
Contributing Author/ Editor

Jason Beshansky
Illustrator

Dave Thomas
Contributing Author

Scott Miller
Contributing Author

Nick Papageorge
Contributing Author

Daniel Dube
Publication Coordinator

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205 Newbury Street, Suite 403, Framingham, MA 01701 • 781•235•2666 or

1•800•535•4544 Fax: 781•235•9688 • www.epgadv.com