Touchstone Investments®
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2025 Midyear Update

Preparing for What's Possible

Investing in 2025 has meant navigating noise, surprises, and sudden reversals. It's reminded us of the value of staying humble, staying diversified, and looking past the headlines. We don't know where every policy or data point will lead, but by focusing on fundamentals and building portfolios that can weather change, ***investors can stay grounded—while staying in the game.***

Touchstone Asset Allocation Committee

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Key Points

- Lessons from the first half include the importance of diversification, continued economic resilience, and careful evaluation of both short-term impacts and potential longer term consequences of executive actions.
- We favor fixed income for its portfolio ballast and income generation.
- We have shifted toward a more diversified approach to our equity exposure as we see a more even playing field across geographies.

First Half Lessons: Humility and Patience

Markets so far in 2025 have been a masterclass in volatility, driven by policy pivots, trade turbulence, and shifting economic signals. The post-Liberation Day rebound brought a wave of investor optimism, but deeper uncertainties remain. Through it all, several key investment lessons have come into sharper focus:

1. **Don't Underestimate the Resilience of the U.S. Economy**

   Despite a restrictive Fed and repeated recession forecasts, the economy continues to grow. Consumer demand remains sturdy, the labor market is largely balanced, and earnings have broadly exceeded expectations. Investors who stayed grounded in fundamentals and avoided reacting to every negative headline were rewarded for their patience.

2. **Executive Power Is Now a Market Force And It's Unpredictable**

   Perhaps the most underappreciated lesson of the year is just how central the executive branch has become to market dynamics. The Trump administration's use of executive action, most notably the rollout and subsequent pause of Liberation Day tariffs, has created real time policy whiplash. The ability to unilaterally impose or reverse major economic measures has injected significant headline risk into markets.

   But there's a design to the approach, too: the administration appears intent on reshaping trade and industrial policy, but not at the cost of the economy, or the GOP's electoral prospects. Investors must now weigh not only policy content, but also political timing. Markets are being shaped as much by polling calculus as by macro fundamentals.

3. **Diversification Matters Most When Uncertainty Rises**

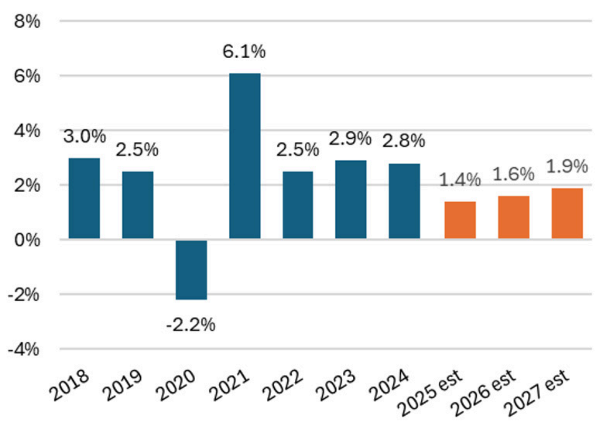
   Leadership has rotated rapidly across regions and sectors. While thematic or concentrated strategies can shine briefly, a diversified approach provided ballast during market dislocations and allowed portfolios to participate in unexpected rebounds. Diversification remains one of the best defenses against an unknowable future.

The Economy: Slower, Not Stalled

Looking ahead to the second half, we expect economic growth to slow, but we don't see a significant risk of recession, absent a major crisis. The U.S. economy still benefits from solid household and corporate balance sheets and moderate job growth, though there is evidence that tighter financial conditions are starting to bite.

Over the medium term, we believe the economy is capable of settling into a central tendency of around 2% real GDP growth. This outlook reflects a blend of factors, slower labor force growth given immigration policy, headwinds from lingering tariffs, and the potential for higher productivity from AI adoption.

U.S. Real GDP Growth



Source: Bloomberg. Forecasts based on Bloomberg survey of economists.

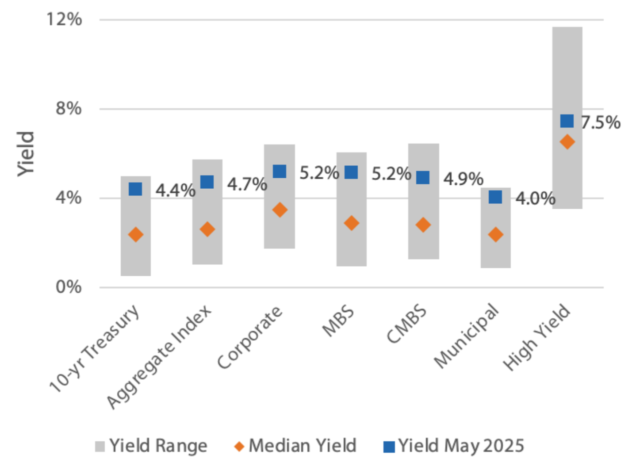
On top of this real growth baseline, we expect the Fed will eventually succeed in guiding inflation back toward its 2% target. But doing so may require keeping interest rates higher for longer than markets have been conditioned to expect.

Fixed Income: Bonds are Back

In a world of higher structural rates, bonds are relevant again. Unlike the previous cycle, where yields offered little cushion, today's fixed income markets provide meaningful income and a reasonable buffer against volatility.

With the Fed unlikely to cut aggressively in the near term, staying invested across quality fixed income sectors offers an attractive balance of income and risk mitigation. Investors no longer have to choose between yield and safety.

10-year Yield Range for Fixed Income Sectors



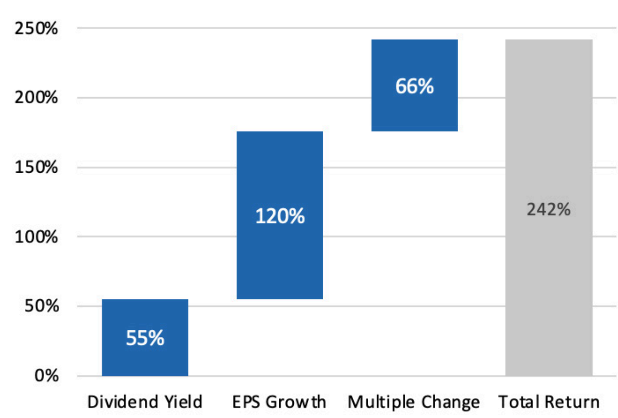
Source: Bloomberg. 10 years monthly data through May 2025.

U.S. Equities: Moderating Returns

We see a more moderate return environment for U.S. equities. Our 4% nominal GDP forecast suggests that revenue growth will be modest. With margins already elevated, there's limited room to boost earnings through operational leverage. Some acceleration in productivity is implied in our estimate due to AI adoption, though we could be underestimating its potential.

Valuations, particularly among large caps, remain rich, trading near dot.com peaks by many measures. The price investors pay continues to be a strong determinant of future returns. Given current high valuations and high profit margins, large cap U.S. equities may deliver more pedestrian returns going forward.

S&P 500 Index Return Composition



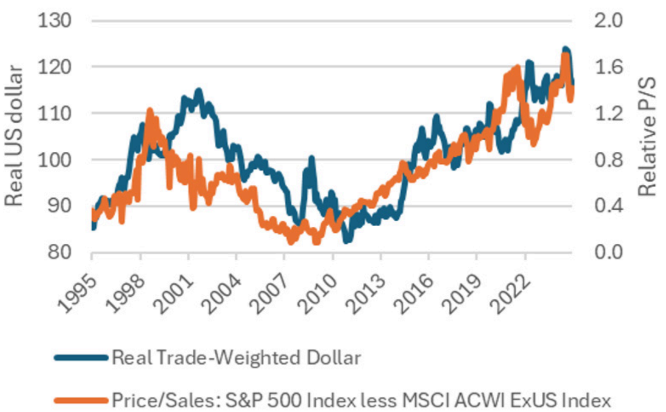
Source: Bloomberg. Cumulative total returns over the last 10 years through May 2025.

There's more nuance in the small and mid cap space. Near-term risks, especially tied to economic sensitivity, remain elevated. But beyond the immediate horizon, lower starting valuations and less optimized profit margins offer a more favorable setup for long-term outperformance.

International Equities: Leveling the Playing Field

Looking backward from the early 2010s through earlier this year, international equities have underperformed in dollar terms, dragged down by a strengthening greenback and falling valuation multiples. However, looking forward, we don't believe those headwinds will be as pronounced.

Valuations: U.S. dollar, U.S. versus International Equities



Source: Bloomberg. 30 years of monthly data through May 2025.

We believe the dollar has peaked due to extended valuations. And the dollar could enter a period of secular decline if the Trump administration introduces policies that dissuade international holdings of U.S. assets. Beyond currency, international markets are trading at a significant discount to U.S. equities. With lower expectations baked into U.S. stocks, the performance bar for international equities has effectively been lowered. We recommend strategic weights to international exposure, both developed and emerging markets, as part of a globally diversified portfolio.

Concluding Thoughts

This year has underscored the value of humility, flexibility, and depth of thinking. Whether it's reevaluating economic durability, diversifying more meaningfully, or anticipating not just what policymakers do, but why they might reverse it, with this backdrop, we believe successful investing requires looking beyond immediate market reactions and economic impacts to consider subsequent, longer-term consequences.

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Word About Risk

Investing in Equities is subject to market volatility and loss. International and Emerging Markets equities also carry the associated risks of economic and political instability, market liquidity, currency volatility and differences in accounting standards. The risks associated with investing in international markets are magnified in Emerging Markets. Fixed Income/ Debt securities can lose their value as interest rates rise and are subject to credit risk which is the risk of deterioration in the financial condition of an issuer and/ or general economic conditions that can cause the issuer to not make timely payments of principal and interest also causing the securities to decline in value and an investor can lose principal.