ClearBridge
A Franklin Templeton Company

AOR Update: Clarity Coming Into View

August 1, 2025

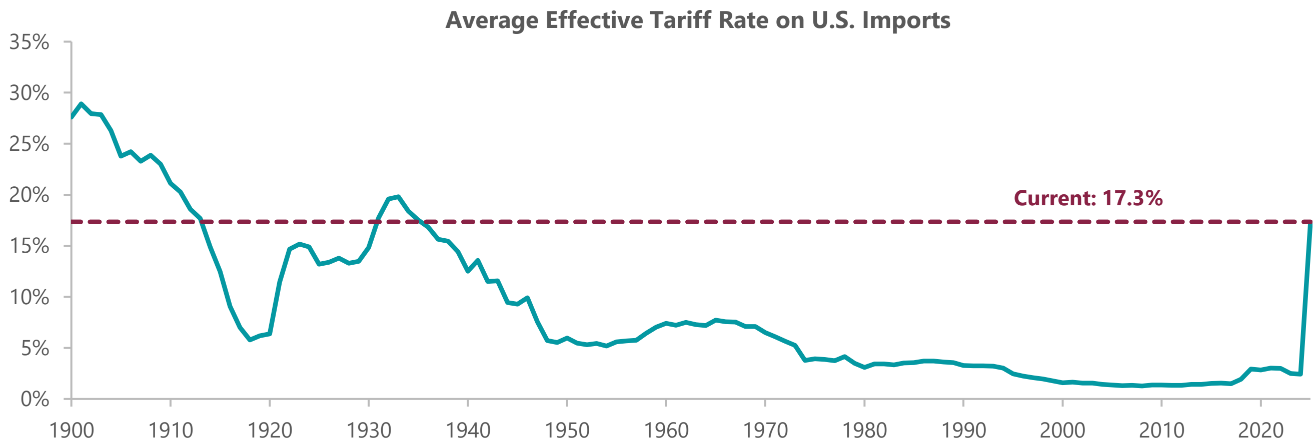
Key Takeaways

- With clarity on tariffs emerging, a major source of uncertainty for businesses, consumers and financial markets is waning. Combined with a tax and fiscal boost from the One Big Beautiful Bill Act, corporate animal spirits are poised to pick up.
- A further slowdown in the labor market and elevated equity valuations are the biggest near-term risks, but we believe that both can be successfully navigated by investors in the months to come.
- A soft patch and/or a market pullback could present a buying opportunity for long-term investors as we believe the economy and corporate profits are likely to accelerate over the next 12 months.

Progress on Trade Deals a Win for Corporate America

Over the past several weeks, the Trump administration has announced a series of trade deals along with updated tariff rates for many countries that have not yet signed agreements. Deals have been made with key trade partners such as the European Union, Japan, the United Kingdom and Vietnam, while tariff “truces” are in place for China and Mexico. The average effective tariff rate is 17%, a modest pickup from where it stood in late June, but still lower than mid-July estimates.

Exhibit 1: Tariff Headwind



Data as of Aug. 1, 2025. Source: Yale Budget Lab.

More importantly, a “new normal” for trade appears to be emerging with tariff rates ranging from 10% to 25%, higher duties on trans-shipped products (i.e., re-exports), quotas for key products and investment/financing agreements. On balance, the trade landscape looks similar to our midyear expectations and thus our view remains that higher tariffs will slow U.S. economic growth and raise inflation but not cause a recession. This is supported by the ClearBridge Recession Risk Dashboard, which remains in overall “green” expansionary territory and did not have any signal changes this month.

Exhibit 2: U.S. Recession Dashboard

		July 31, 2025	June 30	March 31	December 31
Consumer	Housing Permits	⬆	⬆	⬆	⬆
	Job Sentiment	✖	✖	✖	✖
	Jobless Claims	⬆	⬆	⬆	⬆
	Retail Sales	⬆	⬆	⬆	⬆
	Wage Growth	⬆	⬆	⬆	⬆
Business Activity	Commodities	⬆	⬆	⬆	⬆
	ISM New Orders	✖	✖	✖	●
	Profit Margins	●	●	⬆	⬆
	Truck Shipments	⬆	⬆	●	●
Financial	Credit Spreads	⬆	⬆	⬆	⬆
	Money Supply	⬆	⬆	⬆	●
	Yield Curve	●	●	✖	●
	Overall Signal	⬆	⬆	⬆	⬆

⬆ Expansion ● Caution ✖ Recession

Data as of July 31, 2025. Sources: BLS, Federal Reserve, Census Bureau, ISM, BEA, American Chemistry Council, American Trucking Association, Conference Board, Bloomberg, CME, FactSet and Macrobond. The ClearBridge Recession Risk Dashboard was created in January 2016. References to the signals it would have sent in the years prior to January 2016 are based on how the underlying data was reflected in the component indicators at the time.

With clarity on tariffs coming into focus, one of the major sources of uncertainty that has weighed on businesses, consumers and financial markets is waning. Combined with tax incentives and a fiscal boost from the One Big Beautiful Bill Act (OBBBA), corporate animal spirits are poised to pick up this fall as business leaders can now execute hiring and capex decisions that had been put on hold for lack of visibility. In fact, several M&A transactions have been announced in just the past two weeks, including a merger between railroads Union Pacific and Norfolk Southern and a tie-up between regional banks Synovus Financial and Pinnacle Financial.

This backdrop is consistent with the views we laid out last month that the economy could experience a second-half tariff-induced soft patch before reaccelerating into 2026 with Fed cuts, fiscal stimulus and corporate animal spirits as catalysts.

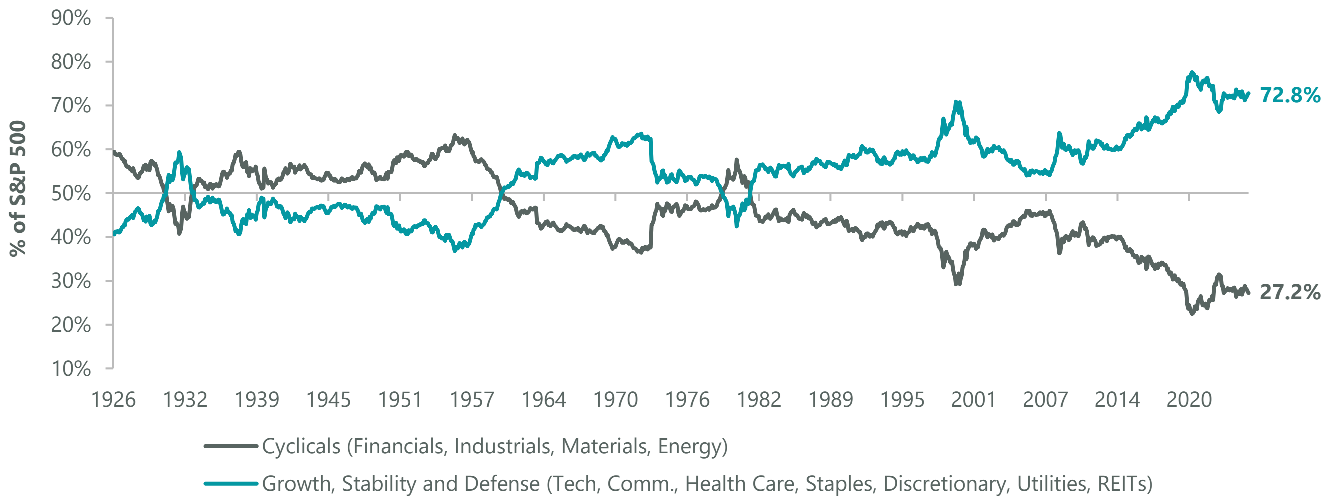
The two biggest risks that lie ahead are a further slowdown in the labor market and elevated equity valuations. The first of these was discussed last month, but Friday’s +73,000 jobs report caught many (including us) by surprise. Although we had previously stated that job creation below 100,000 per month could be the “new normal” given DOGE-related layoffs, an aging population and reduced immigration flow, we did not expect the labor market to slow to this degree so soon.

Even more strikingly, the -258,000 revisions to May and June bring the three-month average to a paltry +35,000 trend pace, meaning there is little buffer for future disappointments. With job creation at stall speed and tariff headwinds ahead, a negative payroll print in the coming months is a strong possibility, which may conjure up recession fears.

While this may be cause for near-term volatility, the July jobs report wasn't all doom and gloom. The release showed steady wage gains and a pickup in average weekly hours, both of which should help support spending. Aggregate weekly payrolls — a good proxy for aggregate labor income — rose by 5.3% year over year, tying the best reading since March 2024. Put differently, a slowing labor market is a normal late-cycle dynamic, but it doesn't look recessionary at this juncture.

The other primary risk comes from elevated equity valuations, with the S&P 500 Index trading at 22.1x expected next-12-month (NTM) earnings. Valuation is a famously poor timing tool, however, and there are several structural reasons why current valuations look historically expensive, including the composition of the market itself. Higher-P/E sectors such as information technology make up a larger share of the benchmark today, while groups that typically trade at lower multiples such as energy are a smaller weight; this pushes the overall market multiple higher. Another key driver of higher multiples is superior fundamentals today compared to the past, with the index sporting higher operating margins, better revenue growth, stronger free cash flow generation and lower leverage.

Exhibit 3: Index Composition Supports Higher P/Es



As of July 31, 2025. Sources: Piper Sandler, FactSet, S&P.

While these shifts cannot fully explain higher valuations, it's rare to see multiple contraction in an environment of elevated earnings growth and recent rate cuts, as is the case today. Although valuations are "stretched" compared to history, there are many reasons to believe equities can remain expensive in the years to come. That said, the resurgence of "meme stocks" over the past few weeks and concerns on the labor front suggest that the risk-reward may be skewed unfavorably in the near term. Should a pullback emerge, we believe long-term investors would be rewarded by deploying dry powder into weakness given our expectation that the economy (and by extension corporate profits) are likely to accelerate over the next 12 months.

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