



## “Artificial Perception” Market Commentary – August 2025

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**The advance estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 3.0% in the second quarter of 2025.** This is much larger than -0.5% in 2025 Q1. The components of the 2025 Q2 GDP number are: consumer spending +0.98 percentage point, investment -3.09 percentage points, net exports +4.99 percentage points, and government spending +0.08 percentage point. The sum of these numbers equals +2.96%. As expected, the net exports value swung wildly in the opposite direction of 2025 Q1, likely an unsustainable one-time side effect of the global tariff negotiations. Investment was weighed down by the volatile inventories category, which caused GDP to be lower by 3.17 percentage points (unsustainable). Assuming net exports and inventories did not contribute to GDP in Q2, GDP growth would have been only +1.1%. Uncertainty over tariffs seems to have caused caution for businesses and consumers.

**On July 30, the Federal Open Market Committee (FOMC) maintained its target range for the federal funds rate at 4.25% to 4.5%.** The FOMC statement said that “growth of economic activity moderated in the first half of the year”, “the unemployment rate remains low”, and “inflation remains somewhat elevated”. Fed Chair Jerome Powell is locked into a political standoff with President Trump where the President is pressuring Powell to lower the federal funds rate. The Fed risks committing a policy error by stubbornly keeping interest rates high, as lower interest rates would help offset tariff negotiation uncertainty about economic growth. The inverted yield curve indicates that the bond market believes the Fed is too tight. The 3-year Treasury note yields 3.89%, suggesting that the federal funds rate should be about 0.75% lower than 4.375%. Meanwhile, the Fed’s balance sheet had \$6.658 trillion in assets on July 23, down only \$4 billion from June 25 (much less than the Fed’s monthly reduction target of \$40 billion). Why has this cooled? The next FOMC decision on monetary policy is scheduled for September 17.

**Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market.** The Standard & Poor’s forecast for S&P 500 operating earnings per share (EPS) through June 30, 2026 is \$279.12, which implies a price-to-earnings (P/E) ratio of 22.7 with the S&P 500 at 6,339. The earnings yield (E/P) of 4.40% represents fair value relative to the 10-year U.S. Treasury note yield of 4.37%. The yield spread has shrunk to only 0.03%. Seven of the nine largest companies in the S&P 500 make up \$19.2 trillion of the \$56.3 trillion index market capitalization with a weighted P/E of 36.6. If 34.0% of the index has a P/E of 36.6, then 66.0% of the index has a P/E of 15.5 for the overall P/E to be 22.7. A P/E of 15.5 is an E/P of 6.43%, which is attractively priced compared to the 10-year Treasury note yield of 4.37% (a yield spread of 2.06%).

**While the S&P 500 closed at an all-time high of 6,390 on July 28, a correction seems imminent.** Breadth has been deteriorating over the past week or two. Plus, volume on the declines on July 29, 30, and 31 has been increasingly higher (which market technicians call “distribution days”). These are signs that the bulls may be taking a breather. There should be ample support for a normal correction around 6,100 (February 2025 high and 50-day moving average) and 5,900 (200-day moving average).

**The “theory of reflexivity”, made famous by billionaire investor George Soros, helps explain the infatuation that market participants have with mega-cap technology stocks these days.** The theory argues that investors, biased by imperfect knowledge, buy based on distorted perceptions of fundamentals, creating a self-reinforcing feedback loop where buying creates more buying. The situation continues until perception becomes so stretched from reality that prices suddenly crash. Artificial intelligence (“AI”) is the concept distorting perception today. Investors are allocating their scarce capital lopsidedly to a handful of giant companies in the AI space, either through index investing or active decisions based on fear of missing out. This “artificial perception” will continue until, from out of nowhere, it snaps. Such investors will likely be taught the age-old lesson that this time is *not* different.