



2Q2025

*"I am an old man and have known a great many troubles, but most of them never happened."*  
- Mark Twain

Sometimes I wish I were a bear. Not an investor negative on the market, but an actual four-legged, furry-coated bear. To have the luxury of stepping away from the realities of day-to-day life and hibernating away in solitude for an undetermined period would be refreshing. Imagine if we had entered our collective lair at the end of the first quarter of this year, slumbering away for ninety days, only to emerge to find markets at all-time highs and investors fattened with ballooning balance sheets. It would appear in the initial survey that all is well in the world and investors are embracing what the future has in store for them.

But let's review what transpired as the grizzly dreamed of the next great salmon run. Two days into the slumber the world witnessed the unveiling of plans to alter the order of global trade. Punitive tariffs by the world's largest economy were enlisted with the goal of realigning an ever more uneven balance of trade. These actions incited the single largest two-day selloff in markets since the early days of the global pandemic. China responded with reciprocal tariffs shortly after. In mid-May, Moody's, ever late to the party, joined Standard and Poor's and Fitch in downgrading the US's credit rating on concerns about the indebtedness of the US government and its inability to manage fiscal deficits. In mid-June, Israel launched an attack on Iran and their nuclear ambitions in the Middle East, pulling the US into the fray with its own military response on Iran's nuclear assets. The Ukraine/Russian conflict escalated with further destruction within that region. In May and June, the US Federal Reserve maintained restrictive interest rates despite global central banks easing conditions in response to economic stress relating to the newfound global trade barriers. Finally, at the end of June, the US Congress was on the verge of approving the Trump administration's signature "tax-cut" bill, the OBBBA, One Big Beautiful Bill Act. The Congressional Budget Office estimates the legislation will add \$3-5 trillion to the budget deficit over ten years depending on the permanency of the tax cuts.

Despite the concerning events above, the S&P 500 witnessed a 25% surge in price terms from its early April lows to the end of June. Retail investors embraced the buy-the-dip mentality with retail inflows into US equities exceeding \$70 billion year-to-date. Much of the buying occurred in volatile single stock names either in crypto-related or AI-linked businesses. Retail-focused providers like Vanguard have seen their inflows into US-focused ETF's jump to 37%, up from 27% a year earlier. The demand from retail buyers is having a draw-in effect on the more cautious institutional investor. Professional investors have been more circumspect of the negative geo-political headlines and have been late to the market's rally. They are now being forced back into the market for fear of missing even greater returns. The idea of a euphoric bubble is beginning to have merit.

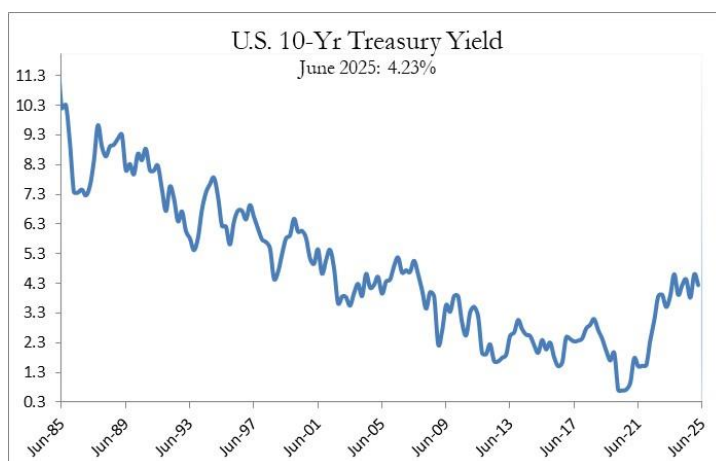
Both macro and market related data have proven ineffective in predicting the recent surge. Over the past 12 months, the correlation of weekly changes in the Bloomberg US Economic Surprise Index and the S&P 500 have been almost exactly zero. While this relationship has generally been positive for most of the period since the 2008 crash, it has been negative for much of the period since 2023. The indication here is that using macro-economic data to try and predict the direction of equity markets has been a futile endeavor in recent years.

One would logically think that corporate earnings should matter most when attempting to predict the direction of equity prices. At the start of the year, Wall Street analysts expected profits at S&P 500 companies to rise nearly 13% according to Bloomberg data. Less than six months later, the figure is down to 7.1% growth. Wall Street is expecting second-quarter year-over-year profit growth to be the weakest in two years at 2.8%. Yet the market remains at new highs. The stunning recovery in the S&P 500 during the 2<sup>nd</sup> quarter has added over \$10 trillion in value to US stocks. Just two months prior the index was teetering on the verge of a bear market decline. Investors have amped up their appetite for risk assets and appear to be looking past the obvious

obstacles and focusing more on the Administration's only plausible solution to our spending & debt challenges - inflating our way to prosperity.

Investors seem to embrace the notion that government spending will see limited restraint and ballooning debt balances will remain nothing more than a talking point in skeptics' letters to clients. The machine continues to roll forward on the expectations that the Trump administration will bully the Federal Reserve to cut rates sooner rather than later despite Powell's sensible concern that tariffs and trade restrictions will drive prices higher. So where do the risks lie and what could be the indicator of trouble on the horizon?

The bond market will likely be the final arbiter between trouble or future gains in equities and the economy. We have emerged over the past several years from a historically low period of interest rates. Today's levels match a period similar to the years shortly before the Great Financial Crisis. Over a much longer period, today's cost of debt should not be considered restrictive in comparison. The critical difference from prior periods, however, is the size of the nation's debt burden, both now and in the years that lie ahead of us.



Most take for granted the US's position as the leading global economy where the USD is considered the reserve currency and the US Treasury's promise to repay their debts is without question. Consider, however, that the US's interest bill on its sovereign debt as a percentage of its tax revenue is the fourth highest globally, sitting behind only India, Brazil, and Mexico. Our government currently spends over 17.5% of its tax revenue on interest payments. Approximately 22% of these payments are made to foreign holders who own approximately \$7.6 trillion of our debt. Money that likely isn't recirculated into our economy. The Congressional Budget Office estimates that by 2035 almost one dollar in four of tax income will go to interest. Does our nation's interest expense at 4%, 5%, or 6% of GDP really matter to the average investor? The analytical answer is it depends! Unfortunately, our nation's leaders are not fiscally prudent. They may be forced to change under much less favorable conditions if borrowers' revolt. Our focus remains on the bond market as an indicator of trouble ahead. Should we experience a sudden rise in longer-dated bond yields it is likely to have a meaningfully negative impact on equity markets and the economy more broadly.

Within the portfolio, our Strategic Value holdings returned 9.5% at the composite level during the first half of the year versus a total return of 6.0% for our Russell 1000 Value benchmark and 6.2% for the technology heavy S&P 500 index. Stock selection was the primary driver of out-performance despite our conservative positioning. I added to existing positions (CPRI, LYB, & PFE) during the market's decline in April as well as several new positions throughout the quarter where my fair value estimates outweigh the risk of further market weakness. At the end of the quarter, the portfolio had a free-cash flow yield approximately 3x the S&P 500, an earnings yield of nearly 9%, and a P/E valuation approximately half that of the S&P's 23.3x current year estimates. We own businesses with quality balance sheets and the ability to consistently generate cash flow over a cycle.

As always, I appreciate your confidence and remain committed to a disciplined approach to investing in long-term value. Please reach out if I can be of any assistance or if you'd like to discuss markets in more detail.

Drew  
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