Two Questions

Weekender

May 10, 2025

Some people grow into their dreams, instead of out of them.

Lois McMaster Bujold

Focus more on your desire than on your doubt, and the dream will take care of itself.

Mark Twain

Laughter is timeless. Imagination has no age. And dreams are forever.

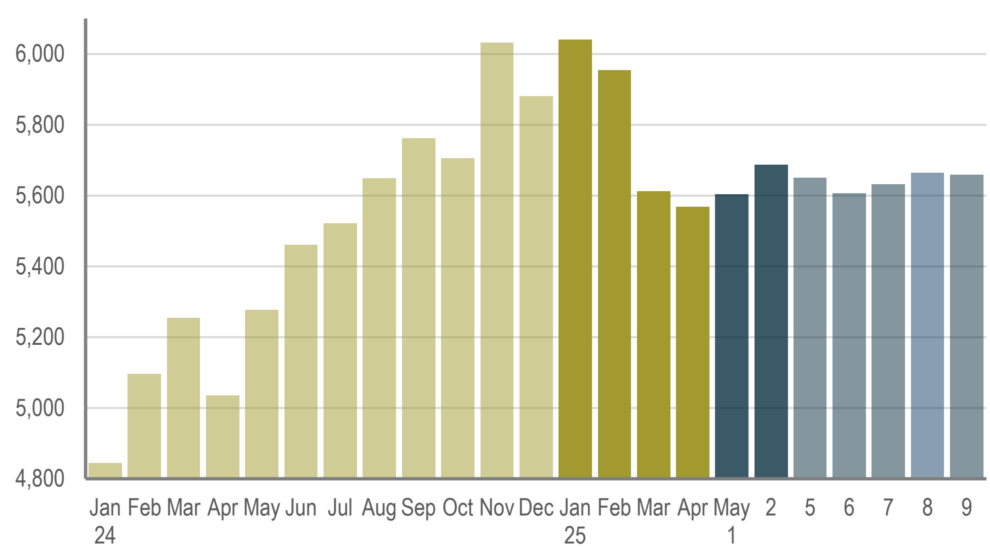
When you believe in a thing, believe in it all the way, implicitly and unquestionable.

You can design and create, and build the most wonderful place in the world.
But it takes people to make the dream a reality.

Walter Elias Disney

Good morning and welcome to the *Weekender* for Saturday, May 10, 2025. As measured by the S&P 500, equity markets were slightly lower by -0.5% on the week. This modest return belies the torrid lift of equities from their tariff bottom on April 8. Equity markets have increased by 13.7% since then, although they remain -7.8% lower than their pre-tariff peak on February 19.

S&P 500 Index Levels
(Source: Bloomberg)



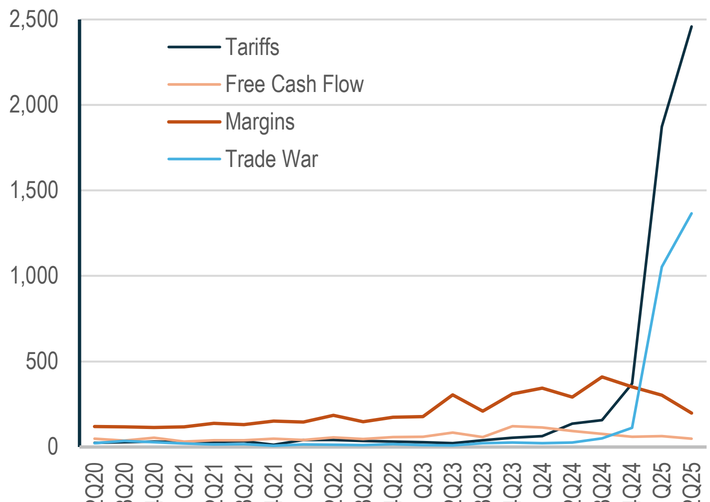
The current rally has been the most unloved since the pandemic lifted. It's been driven by retail investors while the "smart money" remained perched on the sidelines. It's fair to say they have begun wondering if they have waited too long. In this *Weekender,* we will attempt to provide perspective on the financial markets as they are and will likely develop over the next year. Warren Buffett, whom we will discuss a bit more in a moment, considered that financial markets act as a voting mechanism in the short run and a weighing mechanism in the long run.

With approximately 79.8% of US-domiciled companies' financial results reported for the first quarter of 2025, tariffs and trade wars were the primary discussion topics during earnings calls. Artificial Intelligence, the star during previous earnings releases, was nowhere near a starring role. Fundamental elements like margins and free cash flow declined. We believe recent market retracements are primarily a function of tariff voting. As the tariff situation becomes more evident, markets will begin focusing on fundamentals, which we think will be much softer than the market expects.

Earnings Release Terms Mentioned

2Q 2020 - 2Q 2025

(Source: Bloomberg)



Goodbye Mr. Buffett

At the Berkshire Hathaway annual meeting last week, Warren Buffett (94) announced he would be stepping down as the company's chief executive by the end of the year. Buffett's departure is so much more than just the changing of the guard at an investment firm. It's the end of an era. In many ways, Buffett has been at the forefront of modern investment theory and practice for at least a generation. He ignores modern portfolio investment theories based upon statistical analysis in favor of disciplined and deep analysis combined with continued testing of the validity of investment ideas and ideals.

Berkshire Hathaway Stock Price

November 9, 1987 - May 9, 2025

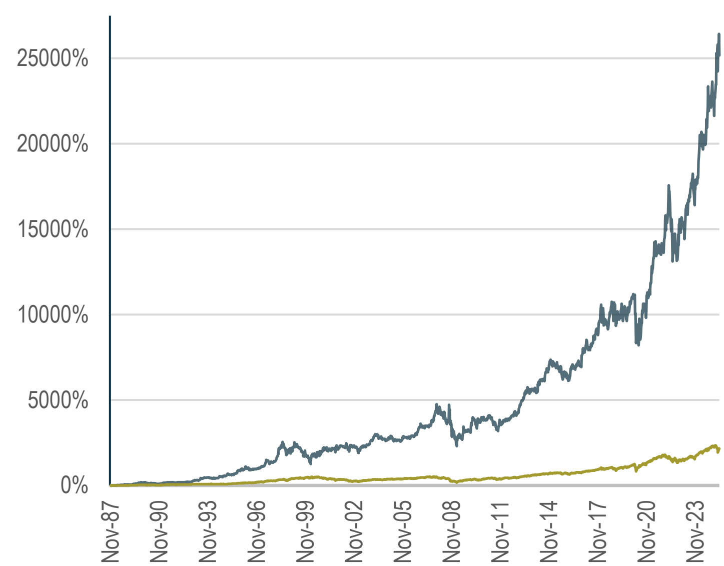
(Source: Bloomberg)

Berkshire's performance has been remarkable. From November 8, 1987, to last Friday, Berkshire Hathaway's total return is 25,178.7% to the S&P 500's 2,160.3%. Buffett proved that active management can

Berkshire Hathaway (Blue) and S&P 500 (Gold) Returns

November 9, 1987 - May 9, 2025

(Source: Bloomberg)



deliver returns far over the broader market. Over the last year, he has been setting up his portfolios for the days ahead. He has been building cash with the expectation of compelling buying opportunities. His stance is defensive and protective, employing many of his cash resources in government bonds. Berkshire Hathaway now holds 5.2% of the US federal treasury's total issuance.

More than a great investor, Warren Buffett was a thoughtful mentor, a consummate gentleman, and a fierce friend. As he bows out of daily operations and communications, an oracle will go silent, and we will all miss our trade's unique avuncular voice and presence.

Smart and Dumb Money

Common parlance among finance professionals bifurcates the investing world into two classes. Smart money identifies investors whose business is to take clients' money and find suitable destinations. Clients are charged a fee for their services, usually a percentage of the assets managed. Savvy money investors agonize over fundamentals, loosely defined as the nature and characteristics of potential targets. Professionals look down on the retail investor whose dumb money is perceived to follow emotional impulses instead of disciplined reasoning. Dumb money is a moniker for the unlearned, unschooled, inexperienced retail investor. Sure to be rolled by the waves and changing tides of the marketplace.

For years, the drumbeat of passive investing has set a tone for the retail investor. Stay invested. Ignore the rise and fall of markets. Returns are maximized by being in the game instead of trying to time when to be in and when to be out of the markets. Lifeless bodies of investors, determined to time markets, line the investing hedgerows to be sure. During the pandemic, another principle was accepted into the retail investor canon. Buy the dips.

Flush with pandemic cash and extra time away from the office, a new retail investor emerged who perceived the investment environment as a video game. If the rules of the engagement could be understood, the villains could be vanquished, and the player would emerge victorious. At this echelon, the costs for losing are minimal since the capital used to play the game was essentially found money - cash provided by the government to assuage the uncertainties of the pandemic.

Investing is certainly a game, in the same way that life is a game. In the game of life, experience is a dear and beloved tutor. But it often blinds the player to a shift in perspective and rules. Throughout an average lifespan, market rules and dynamics are usually thrown aside for an alternative set of constraints. Presciently adjusting to such changing dynamics is critical to long-term investment success.

We have a fiduciary responsibility to serve our clients before anything else. Very literally, every morning, we meet and ask two questions. First, among the positions we hold, if we did not own them today, would we buy them today? If the answer is no, we prepare to exit. Second, given our worldview, where may we be wrong if markets behave contrary to our expectations?

Would We Buy Today?

Our client portfolios are fully deployed in relevant fixed income, quality equity, and income sleeves. Fixed income provides strong yield, diversification, and meaningful capital appreciation as market rates begin to fall over the next few quarters. We deployed our quality equity positions a few months ago when equity markets were softer. Our rationale was that we wanted our quality portfolios fully deployed before meaningful economic softness prompted investors to lean in that direction.

Our income allocations combine income funds and direct exposure to quality high-yielding equities. Each of these sleeves is fully allocated and deployed in our client accounts. We believe they are doing as intended and as hoped.

Our equity growth sleeves have not been deployed yet. Instead, capital allocated to them is earning approximately 4.2% in cash. We are not market timers. However, we have been and continue to anticipate a period of economic softness ahead, during which equity markets will broadly fall and growth stocks will fall hard. We believe this softness will provide better entry points than the present environment.

Where Could We Be Wrong?

While we do not believe any manager is a consistently effective market timer, we have purposely delayed deployment of our high-growth equity sleeve, anticipating that a drawdown in equity markets may provide a better entry point. While we wait, client cash is earning a respectable 4.2% annually. The question to be answered here is whether a durable rally in equities is underway, in which case we should deploy our growth equity sleeve, or whether better buying opportunities may lie ahead. A candid and rough presentation of the issues underlying this question is critical. The answer lies in addressing the relative state of five underlying factors: 1. Valuation, 2. Consumer, 3. Inflation and Interest Rates, 4. Tariffs and 5. Earnings.

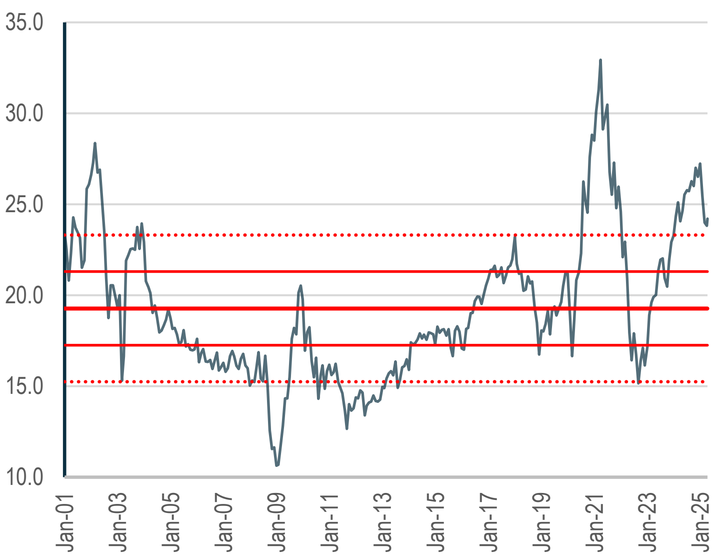
Valuation

Valuation of the S&P 500 using price-to-earnings multiples suggests that equities are significantly overvalued. The bold red line in the graph below shows the average PE ratio over the period. The thinner solid red line above and below the average line represents half a standard deviation above and below the average. The dotted line is a full standard deviation. Equity markets are meaningfully overvalued, even more so if corporate earnings expectations continue to soften.

S&P 500 PE Ratio

January 2001 - May 9, 2025

(Source: Bloomberg)



Given its relative overvaluation, we do not believe purchasing "the market" broadly is prudent. However, we find names that manifest attractive valuations and strong fundamentals within the market. Stocks selected to be part of our growth sleeve are below their average valuation and have stronger-than-market earnings growth expectations.

Consumer

The strength of the US consumer is critical to any equity investment justification. Consumer strength is predicated on their willingness and ability to spend. Willingness is a function of labor market health and real wage growth. Defying almost all expectations, the US labor market remains robust. Indeed, some softness is beginning to show, but nothing that would give pause. Real wage growth continues to be positive, signaling consumers are becoming "wage" wealthier.

As most economic cycles turn south, consumers tend to spend voraciously until they are forced to stop, which usually comes with a break in the labor market. The labor market is not broken, with only a few cracks. At the same time, stress and strain are beginning to show up on consumer balance sheets. Last week, the federal government announced that student loan amnesty was over and that payments must resume or be placed in collections.

Consumer ability to spend is showing cracks. Pandemic-era largesse is primarily gone. Savings are trending back to normal. Consumer credit is at levels that signal danger ahead. Consumer probability of missing minimum credit card payments continues to

Probability of Missing Minimum Payments

January 2014 - April, 2025

(Source: Bloomberg)

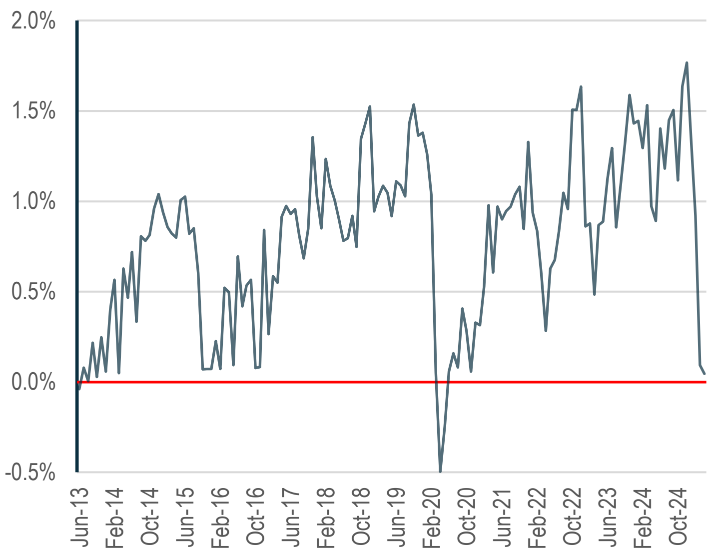
rise. As does the level of delinquency on auto loans. Now that student loans are on the repayment block again, this number will likely increase, leading to a drop in spending.

The Federal Reserve categorizes consumers into percentiles. Consumers in one percentile live in different worlds from others. At the lower end, consumers in the twenty-fifth percentile are falling apart—they are over-indebted, earning a relatively low wage, and finding it increasingly difficult to find service employment. Prospects of wage growth over the next year among this group do not signify growth.

Expected Wage Growth in 25th Percentile

January 2014 - April, 2025

(Source: Bloomberg)



We believe the US consumer is about to enter a period of retrenchment, and we expect them to slowly reduce spending, first on interest-sensitive items and then on discretionary items. By the end of this year, we expect spending cutbacks to increase across most product and service categories.

Inflation and Interest Rates

Important inflation data will be released over the next two weeks. Previous data incorporated periods preceding Trump's tariffs, when inflation came toward the Federal Reserve's 2.0% target. In March, data suggested inflation was falling and the economy was softening. This was the perfect milieu for lower interest rates, fueling fixed and equity markets. Then came the tariffs.

Tariffs are inherently inflationary. The Federal Reserve and most market participants hope the administration's announced tariffs will precipitate a one-time price increase that will not cascade into sustainable inflation. But hope isn't a valid investment strategy. We will need to wait and see.

Tariffs

Beginning the first week of April, a torrent of tariff threats covered financial markets in fog, making it impossible for companies and investors to see the way forward. Over the weekend, the Trump administration announced progress on potential trade agreements. Aside from Japan and South Korea, very little progress has been made. Even so, minimal progress seems to be sufficient to move markets.

Assuming positive outcomes with most significant trading partners, the 10.0% blanket tariff imposed on every nation will still result. We believe that this alone is sufficient to slow the US consumer. Financial markets may look past a period of tariff confusion to a time, about a year from now, when things have normalized. Consequently, we do not believe our long-term investment strategy should depend on the relative success or failure of the administration's tariff strategy.

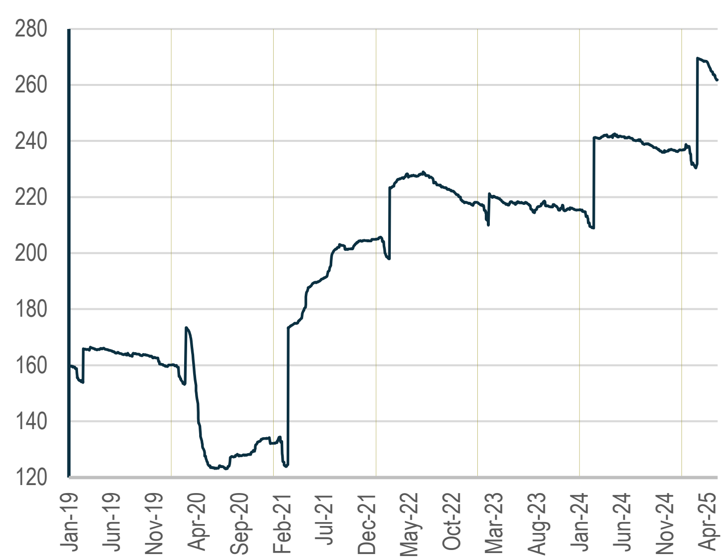
Earnings

Earnings estimates usually trend lower as the year progresses. However, we believe a perfect storm is

S&P 500 Earnings Expectations

January 2, 2019 - May 9, 2025

(Source: Bloomberg)



forming that will push corporate earnings into recession territory. Softer consumer demand will put a crimp on unit sales. Tariff-related stockouts will further reduce unit sales, while higher product costs related to tariffs will compress corporate margins. Tariff fog and uncertainty push many capital projects off by a year or more. We expect earnings to be significantly lower than what analysts and economists expect.

Conclusion

We do not believe recent tariff news announcements broadly provide an "all clear" for financial markets or investors. Markets will likely move into another period of volatility, resulting in the fulfillment of our views described above. We also believe it is time to begin deploying our equity growth sleeve. While we cannot hit tops and bottoms, our forty target companies are well-positioned to take advantage of the environment we increasingly believe will unfold as we outlined.

This unusual *Weekender* is designed to outline our expectations and provide a cautionary guide for tempering them over the coming months.

That's it for this *Weekender*. Have a wonderful week.