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Navigating An Uncertain Landscape

Various investment classes (stocks, bonds, commodities and currencies) are contending with increased uncertainties. Both deportations and tariffs are pro-inflation and anti-growth. Deportations result in fewer consumers spending and raise the cost of replacing this segment of the labor pool.

U.S. consumers will ultimately pay most tariffs on imports. There is still uncertainty as to what the eventual level the effective tariff rate will be. If the effective tariff rate were to be in a 15%-16% range, it would represent an increase of approximately six and a half times the previous effective rate. This is a substantial and significant increase that will ultimately get passed on in the form of higher prices. This represents a regressive tax increase that was not legislated by Congress. Tariff authority rests with Congress and the Federal Appeals court will decide if the legislature was improperly bypassed. This decision will be appealed to the Supreme Court to resolve the issue. Non-tariff barriers are a major impediment to a trade arrangement. China and the EU, two of our major trade partners, utilize non-tariff barriers. The trade arrangements that are being negotiated are significantly different from previous trade agreements that took much longer periods of time to negotiate. This leaves the door open for misunderstandings. For example, much was made of Japan funding a multi-billion-dollar investment fund whereby the U.S. would receive 90%-95% of the investment returns. However, Japan contends that virtually all of their funding will be in the form of loan or loan guarantees whereby they are paid a market rate of interest. The most that can be said of these trade arrangements is they are the best of a bad deal. They will result in fewer goods at higher prices versus more goods at lower prices previously. It is questionable to what extent domestic manufacturing will increase.

Another uncertainty is to what extent the Federal Reserve's independence in setting monetary policy may be tampered with. The Fed could also have an issue of how to simultaneously address both a weakening labor market and higher inflation in a stagflation environment.

Given the higher uncertainties, this raises the issue of what could go wrong in the investment markets. Areas of concern would include the growth of private credit and private equity. These are often securities from leveraged companies that could see an erosion of their cash flow in an economic slowdown or recession. The relative illiquidity of these instruments could result in significant price corrections. The growth of bitcoin and recent lessening of regulatory oversight

is a concern. More companies are issuing debt and equity to use the proceeds to invest in bitcoin as an asset on their balance sheet. The recent rise of meme stocks that do not trade on fundamentals but rather comments on social media, the increased popularity of single stock ETFs that offer returns of 2x-3x the underlying stock movement. All these areas share the characteristic of investors using increased financial leverage. This has the potential to make corrections more serious.

It would be one thing if markets were at levels to compensate for these uncertainties. However, they are not. The S&P 500 is trading at approximately 23 times forward earnings, which is well above historic norms. The S&P has returned 18% or better in five of the last six years (25% or better four of the last six years). Credit quality spreads are narrow for the corporate BBB sector and high yield debt securities. No one has perfect foresight as to where a negative surprise could occur.