

July 10th, 2025

Summer Quarterly Commentary

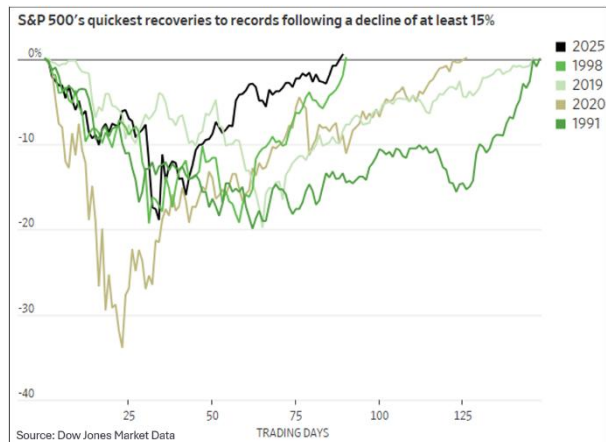


"The most hidden way, hence the preferred and common way, for government policy makers to deal with having too much debt is to lower both real interest rates and real currency rates."

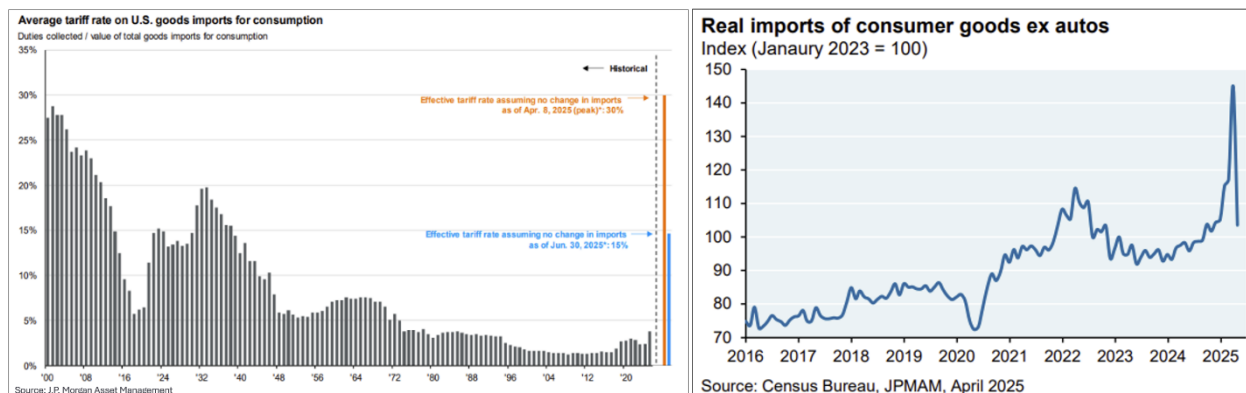
Ray Dalio

Hedge Fund Manager, Author, and Philanthropist
1949

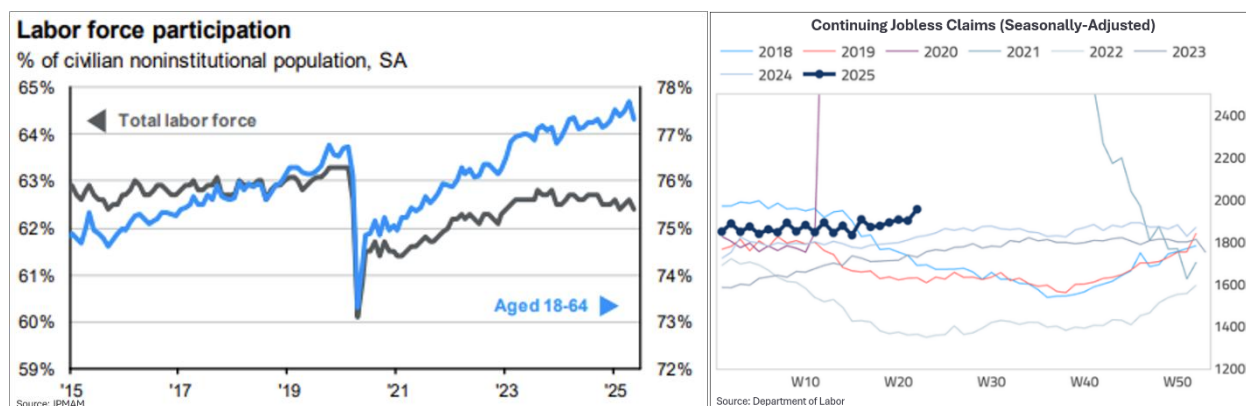
After it peaked February 19th, the stock market went on a wild ride, plunging 20% on the heels of sweeping "Liberation Day" tariff threats before recovering at a record pace to new highs this past quarter.



So far, the damage from tariffs hasn't been as bad as feared, eased by a 90-day holiday for the most punishing "reciprocal tariffs." This past quarter, public companies reported a surprisingly positive outlook, with only 15% cutting forward earnings guidance (25% raised while 57% held steady). Accelerating imports to front-run tariffs helped protect recent corporate profits... something which cannot be repeated.

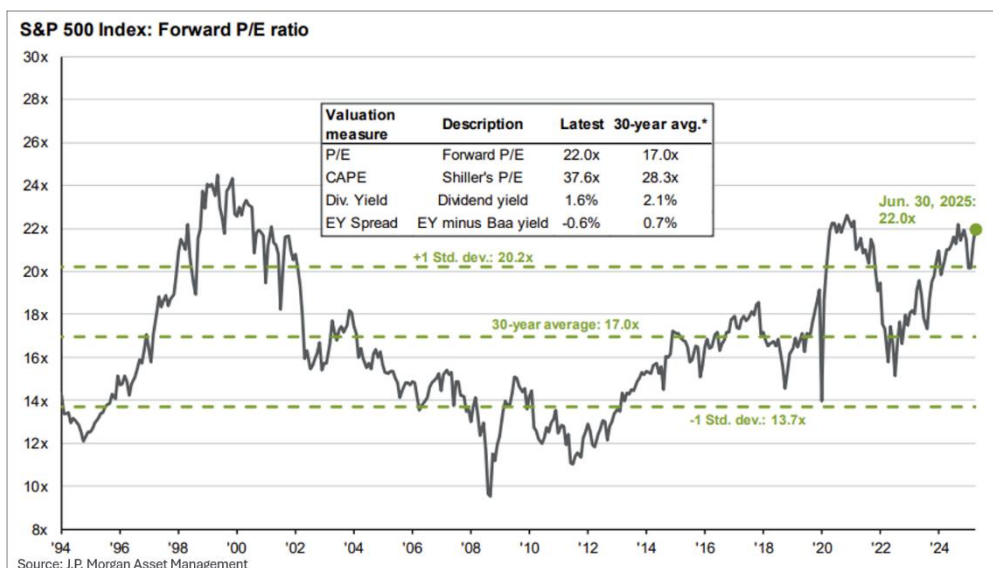


U.S. banks initially slashed post-tariff earnings estimates, but have reversed course and now expect nine percent earnings growth for the year – a healthy clip. Add in mild inflation reports, some good geopolitical news, a job market that is hanging in there, and the passage of Trump's Big Beautiful Bill (BBB) enshrining tax cuts, and you have a recipe for the current all-time market highs.

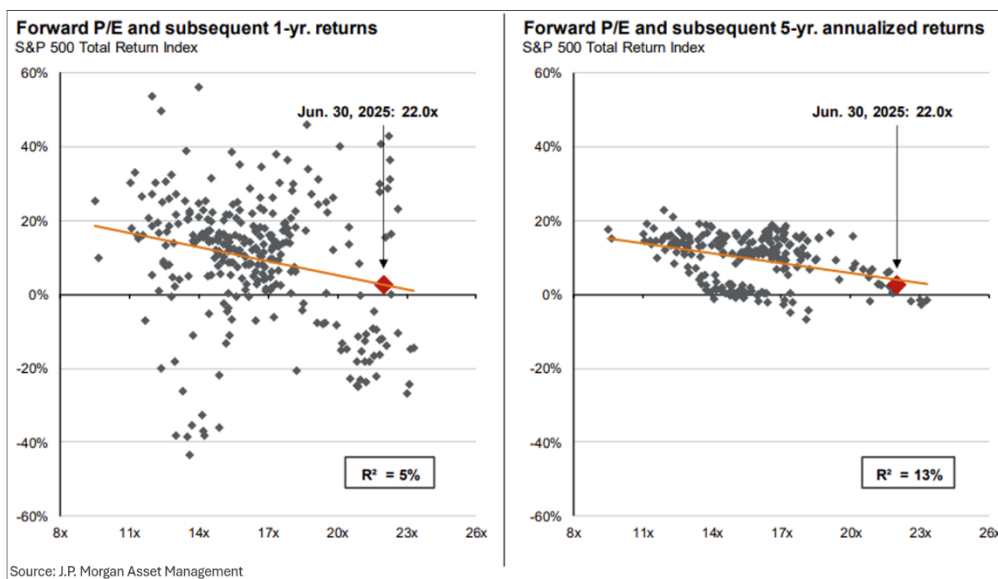


Markets apparently expect the good times to keep rolling. Despite renewed threats of big tariffs in recent days, the market doesn't seem to believe they'll be implemented because of what's being called the TACO (Trump Always Chickens Out) phenomenon.

Thus, the market has returned to being as expensive as it was at the beginning of this year, when we first argued for pulling money from the stock market in favor of private lending. The market crash didn't last, but we're still glad to have avoided all the drama.



Today's elevated valuation (22 times forward earnings) once again suggests lackluster forward returns over the next five years.¹ After the recent market resurgence, we are happy to continue parking a portion of what would normally be equity exposure in our favorite higher-yielding private lending funds.

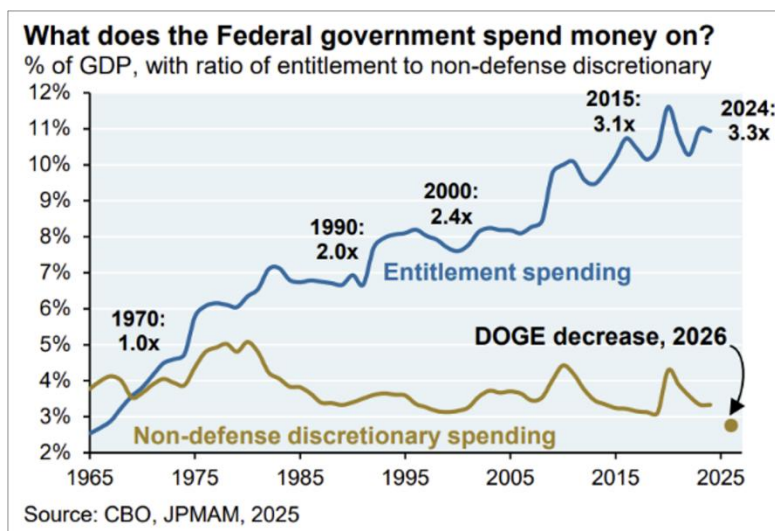


Stocks tend to focus more on the year immediately ahead and may be signaling "all is well." The bond market meanwhile indicates all may not be well in the longer term. The Federal Reserve has been cutting short-term rates and 10-year yields have relaxed. However, longer-term 30-year yields have bucked the trend and are creeping up.

¹ Stock market valuation has little bearing on short-term returns. Historically, however, what you pay very much affects longer-term investment results, as the accompanying chart demonstrates.



The rise in long-term interest rates isn't exactly surprising: the U.S. government's budget outlook is bad, and the BBB just made it worse. To be clear, budget deficits are not a problem solely caused by Republicans. The main drivers are entitlements (such as Medicare, Medicaid, and Social Security), which largely have origins in the Democratic party. With that said, the Republican refusal to set taxes at a level closer to expenditures exacerbates the issue.



The non-partisan Congressional Budget Office scores the new bill as adding \$3.4 trillion in federal debt over the next 10 years, and \$4 trillion if interest on the new debt is included in the figure. This compares to the pre-BBB baseline of \$5 trillion in annual revenue, \$7 trillion in annual expenditures, and an existing stock of about \$30 trillion in debt. It appears we are locked into budget deficits of 6-7% of GDP for the foreseeable future.

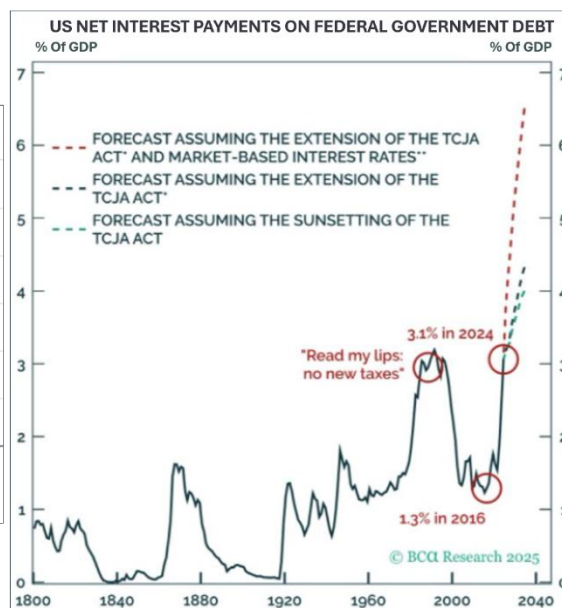
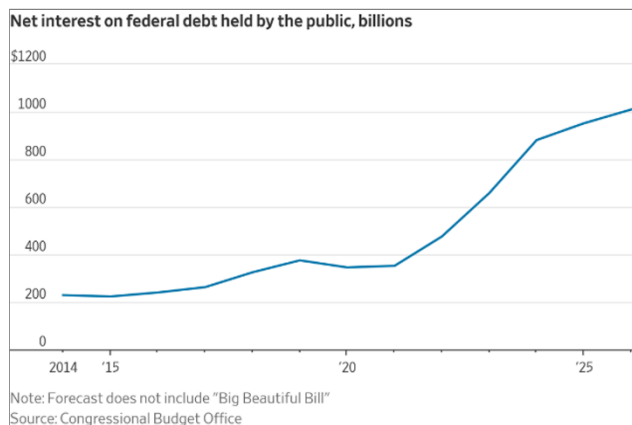
The One, Big, Beautiful Bill vs. Current Law

Provision	Current Law	One, Big, Beautiful Bill
Individual Rates	2017 preferential tax rates (highest at 37%); set to expire 2025	Made permanent
Pass-Thru (199A) Deduction	Deduction of up to 20% of Qualified Business Income (QBI)	Made permanent at 20% (not 23%, as proposed in the House)
Estate Tax Exemption	\$12.9MM exemption for single/\$25.8MM for married filers	\$15MM for single/\$30MM for married filers; made permanent
SALT	\$10K SALT deduction; expires 2025	\$40K SALT for <\$500K income, w/phase-out at \$600K; reverts in 2029
Standard deduction	\$15,000 (single) \$30,000 (married)	\$16,000 (single) \$32,000 (married)
Child Tax Credit	\$2K/child, set to expire in 2025; refundable up to \$1.4K/child	Increase to \$2.2K/child; made permanent; refundable up to \$1.4K/child
No Taxes on Tips	Taxed as ordinary income	Deduction up to \$25K for incomes <\$150K; expires end of 2028
No Taxes on Overtime	Taxed as ordinary income	Deduction up to \$25K for incomes <\$150K; expires end of 2028
Tax Deduction for Seniors	\$1.6K deduction for ages 65+	Additional \$6K deduction for ages 65+ through 2028
No Taxes on Auto Loan Interest	N/A	Up to \$10K deduction for "made in USA" cars through 2028
Remittances	N/A	1% tax surcharge
Endowment Tax	Top rate of 1.4%	Top rate of 8%
Bonus Depreciation	40% bonus depreciation	100% bonus depreciation from Jan. 19, 2025; made permanent
R&D	5-year amortization for domestic R&D	Full expensing restored; made permanent
Expensing for structures	N/A	100% for manufacturing structures starting Jan. 19, 2025
Not in bill	N/A	Section 899 ("revenge tax"); PTET elimination

Source: Bloomberg, EY, Senate Finance Committee; As of July 2025

All else equal, large deficits put upward pressure on interest rates. This has straightforward negative implications for bonds and indirect negative implications for stocks, as higher interest rates act like stronger gravity on most all financial assets.

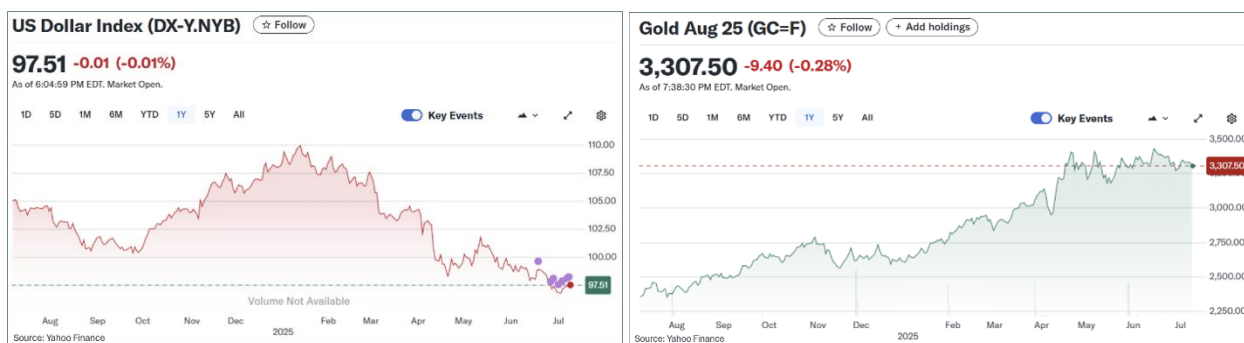
The direct effect of an expanded supply of debt from budget problems is higher interest rates which pressure existing bond values. However, in the real world, even with more debt issued it doesn't necessarily mean we will see rising rates. Whether or not that happens depends on the actions of the Federal Reserve.



Lately we've been listening to Ray Dalio, the famous macro investor quoted at the start of this letter, and his thoughts on what he calls the Big Debt Cycle.² When federal deficits and the supply of debt expand, policymakers can reverse course by raising taxes and cutting spending. To Dalio, it isn't surprising that this doesn't happen because this is painful to voters and the economy in the short term – and thus unpopular and politically difficult.

If central bankers do nothing amid rising debt, interest rates naturally increase which then causes pain in the real economy, as perhaps is beginning to happen now. However, according to Dalio, faced with this quandary and with politicians unwilling to cut spending, central bankers tend to ease the pain of the higher interest rates by printing money and buying bonds, keeping bond prices elevated and interest rates depressed (and eventually causing inflation). Either path (higher interest rates or lower rates via inflationary money printing) is bad for bond returns in the longer run. At least to Mr. Dalio, it is obvious from history which path central bankers choose... money printing and the avoidance of short-term pain.

What does this process look like? The signs are: rising long-term interest rates, a declining currency (especially relative to gold), and the central government shortening the maturities of its debt offerings. The first two signs are clearly evident. On the third, the shortening term of U.S. Treasury bond issuance started under the Obama administration and has continued with subsequent administrations.



As the cycle advances further, governments can be expected to try and implement strict capital controls and exert extraordinary pressure on creditors to buy – and not sell – debt. While we have yet to see capital controls, a small step towards "extraordinary pressure" to buy bonds can be seen in the contemplated changes to banks' Supplementary Leverage Ratios. As a result, banks may soon be allowed to buy U.S. government bonds without having a charge against their capital ratios, making them easier to buy.

²<https://www.linkedin.com/pulse/most-important-principle-keep-mind-when-thinking-large-ray-dalio-nozze/?trackingId=fVGf1XCPQN6vU4CS8S4ZiA%3D%3D>

The main takeaway is that, in this environment, which we fully expect to continue and worsen, cash and bonds are bad assets to own. At the moment, cash in your brokerage account is not too bad, as it yields above four percent. However, that is expected to change when the Federal Reserve continues lowering short-term interest rates in coming months.

Because bonds still have a place in portfolios to protect savings from the volatile swings that exist in the stock market, here are some of the things we are doing to protect client assets allocated to fixed income:

- We are going shorter-term in our bond holdings. Shorter maturities protect investor principal from rising long term rates (which are bad for bond prices) and, when compared to longer-term bonds, can be reset to rising interest rates more quickly.
- We have re-allocated some of our corporate bond exposure to newly issued mortgage bonds, which offer higher coupon payments with less duration (meaning less benefit from lower interest rates along with less pain from higher ones).
- We've allocated money to private lending funds. These funds benefit much more from rising interest rates vs most publicly traded bonds. Private loans are often paid back in a year or less, thus, if interest rates or inflation rise, our chosen funds can adjust loan rates more quickly.
- We are actively considering adding gold, inflation-protected treasuries (TIPS), and even bitcoin to fixed income portfolios.³

Within our equity portfolios, we've been buying more foreign stocks. Stocks with earnings in foreign currencies benefit when the domestic currency declines. While other countries are also subject to many of the same pressures from the "Big Debt Cycle," our reserve currency status allows us to push things further. European countries are at least supposed to restrict their budget deficits to 3% of GDP (currently 3.2% across the EU, although several countries plan more military spending in the wake of Russian aggression in Ukraine). Foreign stocks are also typically cheaper vs U.S. companies.

These are good things to talk about with your financial advisor, and we'll be bringing them up in our client conversations this year.

A quick note on Japan, which is often brought up as an example of a country with substantially higher debt to GDP levels than the U.S., but where long-term rates have been subdued. The Japanese experience, in fact, embodies the typical debt cycle playbook. Japan's central bankers didn't let rates rise, but rather printed money to buy bonds and push

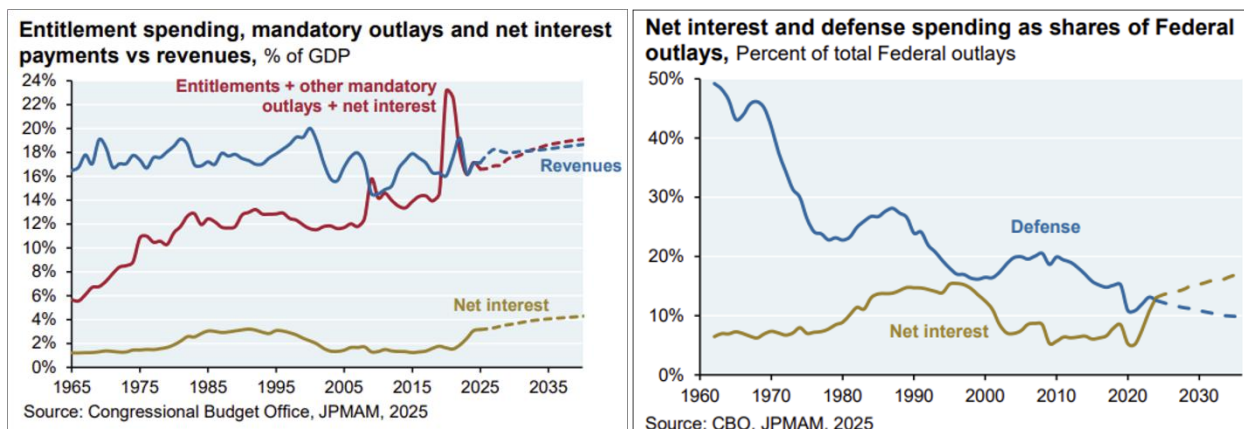
³ Until recently, it was not even possible for us to buy Bitcoin in client portfolios.

yields down. Bond returns have suffered there. Since 2013, Japanese bonds returned 45% less than U.S. dollar debt.

Some will likely note that reckless government spending has been a problem for a long time and there hasn't been a disaster yet. However, the situation is reaching a point where things in the future might be different. Dalio, for one, now says a turning point might be reached in perhaps three years, give or take a few - a prognostication that could be accelerated by shocks to the system.

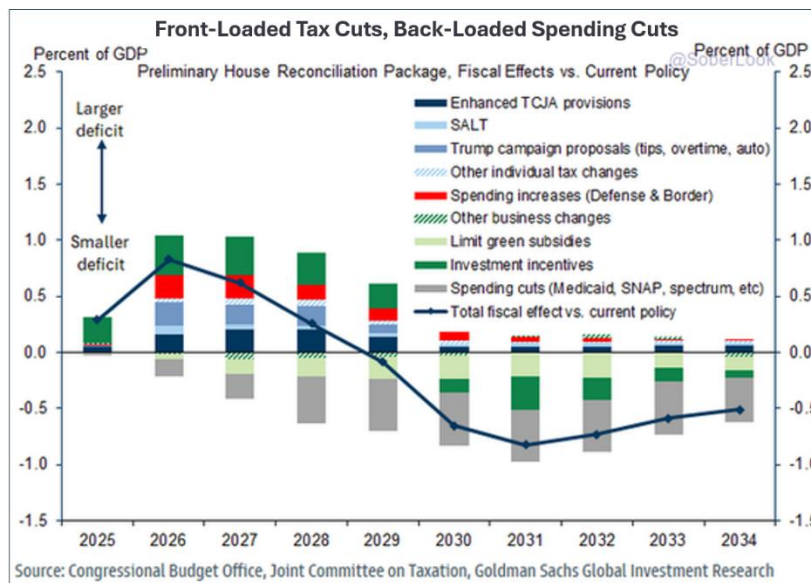
A recent report from the Trustees for Social Security and Medicare indicates that the programs will be jointly insolvent by 2034, with benefits needing to be cut by 23% and 11% (!) respectively to balance the books at that time. JP Morgan observes that a "fiscal day of reckoning," when entitlements and interest on the federal debt exceed revenues, is coming in the early 2030s. Already this year we passed another unfortunate milestone where interest on the existing federal debt surpassed defense spending.

In investing, at least for stocks, something happening five years from now might as well be never. However, we now judge this problem as close enough to do something about it, at least with regard to bonds.



Remember, just like with a person or household, government borrowing for consumption means more consumption now, less consumption later. (Borrowing can also finance productive activity which can pay for itself. However, considering the U.S. is cutting things like NIH research while Social Security and Medicare spending increase automatically, we surmise that on the whole we are borrowing for consumption.)

For now, the increased spending is stimulative to the economy, and we remind readers that deficits are currently a large 6-7% of GDP. The BBB is also frontloaded in its deficit spending, meaning most of the positive effects for the economy (and stocks) will last past 2028, so for the time being the economy should continue to be strong.



Despite the negative tone of this letter, it's important not to spin ourselves into a doom loop over the situation. Foreigners, who now hold approximately 33% of the Treasury market, are the ones most at risk. Our country has substantial real wealth (property, productive companies, and all the things we enjoy in our daily lives), and under almost any scenario that real wealth will continue to grow. Debt is just paper.

However, most people measure their wealth in paper because "real" things are too hard to count. "Real wealth" consists of goods, services, and productive capacity. You might call how people measure their wealth in dollar terms "psychic wealth" or "nominal wealth." In the past we've called this the "illusion of prosperity." We believe this measure can be misleading. In aggregate, as this all plays out over the next 2-15 years, some may find out they aren't as wealthy as they believed. Today's paper wealth may not translate into as many future goods and services as expected.

Our worrying about this does serve a productive purpose. It is done in an effort to remain effective stewards of your wealth, protecting it from such future "adjustments." We appreciate the continued trust you place in us.

Sincerely,

John Prichard

John G. Prichard

Kurt Beimfohr

Kurt Beimfohr

Miles E. Yourman

Miles E. Yourman

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