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First Quarter 2025- DJT Returns to D.C.

The current investment landscape is proving to be both dynamic and uncertain. Confidence levels are currently low among consumers, business leaders, and investors. At the beginning of the year, most investors anticipated that the Trump 2.0 agenda would introduce a combination of incentives and restrictions, ultimately resulting in a net positive economic impact. However, the market is currently grappling with the initial implementation of these stricter policies, leading to ongoing economic concerns related to tariff uncertainties, immigration restrictions, and the impact of the Department of Government Efficiency ("DOGE"). Trump's "America First" agenda has heightened tensions with allies and rivals as all parties grapple with the economic and political fallout from increased global tariffs. Despite these challenges, we remain optimistic about the future and will continue to focus on separating the signal from the noise as the year progresses. The United States remains the most attractive region in the world, offering unparalleled opportunities for growth and investment. We anticipate that headlines may eventually shift to highlight Trump's pro-business initiatives, such as tax cuts and more significant deregulation, leading to increased lending and investment spending. If enacted, the proposed tax package, which extends the cuts from 2017 and introduces additional incentives for businesses, is expected to increase GDP by 0.5% . The Trump administration's goal is to balance the budget by cutting waste and leveraging tariffs to generate added revenue. This plan aims to alleviate the tax burden on middle and lower-income Americans, with the potential to eliminate income tax for Americans earning less than $150,000. This is our best guess of Trump's strategic and economic vision. Implementation, of course, is much easier said than done.

During the first quarter, we witnessed various macroeconomic shifts, micro-level disruptions, and political developments impacting the economy and the markets. This letter aims to summarize these events and evaluate their implications as we progress through the year.

Macro Environment: Rising Volatility due to Fiscal Policy

During the first quarter, the S&P 500 Index ("S&P 500") entered correction territory, dropping 10% from its late 2024 highs. This decline was fueled by concerns over tariff policy and a slump in consumer and business sentiment. Additionally, the Nasdaq Composite experienced a 14% peak-to-trough decline, indicating a pullback in tech-heavy growth stocks as expectations for higher interest rates persisted. At one point in March, even the Equal-Weighted S&P 500 index recorded a drop of over 9% from its 2024 highs.

The macroeconomic landscape of 2025 has been characterized by a significant increase in volatility compared to the more stable conditions of 2023 and 2024. The CBOE Volatility Index (the "VIX"), a key measure of market uncertainty, has averaged in the mid-to-high twenties year-to-date, rising from the mid-teens in previous years. However, as we concluded the quarter, the VIX returned to the low twenties. Thirty-nine percent of trading days in the first quarter have seen the S&P 500 move up or down 1%, significantly higher than the long-term average of twenty percent (based on data since 2000). This shift is attributed to a combination of factors: policy uncertainty driven by the Trump administration, global trade and geopolitical tensions, and a cooling domestic economy. We expect macro volatility to persist as trade policies evolve and the Federal Reserve navigates uneven growth.

The Federal Reserve (the "Fed") has maintained its wait-and-see posture on interest rates while increasing its forecast on inflation and revising its outlook lower for growth and employment this year. The market currently anticipates two rate cuts later in the year. Though moderated from 2022 peaks, inflation remains sticky at around 3%, above the Fed's 2% target. U.S. GDP has grown satisfactorily despite various challenges, with growth expected at 1.1% in Q1 and 1.7% for the entire year. The University of Michigan's Consumer Sentiment Index dropped by 11% in March, the largest decline since 2020, reflecting concerns about inflation, job insecurity, and economic uncertainty. The manufacturing sector continued its slow growth trajectory as factory output and inventories adjusted to potential new tariffs. Job growth has slowed slightly but remains steady, and unemployment remains historically low, around 4%. Despite the cooling

pace, wage growth of 4.1% reflects continued labor market resilience amid shifting economic conditions. The U.S. housing market continues to bounce along the bottom, with housing starts down 6% YTD as mortgage rates remain high and affordability is stretched.

Corporate earnings currently paint a mixed picture. First quarter S&P 500 earnings growth is tracking around 6%, below the 11% growth we saw in the fourth quarter of 2024. Tariffs and weaker consumer and capital investment spending are cited as drags on this growth. However, corporate earnings are expected to re-accelerate and grow over 10% for the entire year, driven by healthy business activity and improving profitability.

Micro Dynamics: Know Your Companies

As we progress through 2025, significant differences are emerging across various industries and companies. The resilience of individual companies will depend on their ability to adapt to rising input costs, shifting trade flows, and a potentially weaker consumer base. We remain unwilling to bet against the skills and ingenuity of the corporate managers who lead our businesses. In our view, corporate managers' willingness to drive innovation, enhance productivity, allocate capital to the best risk-adjusted return, and compete globally will provide investors with suitable long-term return potential for the risks they bear. Simply put, we believe it pays to bet on optimism, perseverance, entrepreneurship, and science and take a long-term view. Here are some key areas on our radar that we are monitoring closely.

<u>Tariffs</u>

Companies across various industries are grappling with the impact of tariffs, especially the multiple tariffs imposed by the U.S. on imports from Mexico, Canada, and China – three countries that are top exporters and importers for the U.S. Best Buy Co. Inc. stated, "International trade is critically important to our business and industry. The consumer electronics supply chain is highly global, technical, and complex. China and Mexico remain the number one and two sources for our products, respectively". While businesses have generally adapted their supply chains over the past few years, most additional changes cannot happen overnight. Many companies are diversifying production across different countries, but predicting which locations will stay favorable in the long run is challenging. As apparel retailer American Eagle stated, "… nobody knows what tariffs are going to be put on where, when, or what…so where are we shifting to?"

Depending on the implementation of various tariffs, the automotive industry could face challenges as cars manufactured in the U.S. may cross the Canadian and Mexican border up to five times. If all these tariffs are enacted, it is estimated that car prices could rise by $4,000 to $10,000 to offset these additional costs. The agricultural sector has also been significantly affected. Tyson Foods reported a 12% decline in pork exports to China due to retaliatory tariffs, while U.S. farmers have expressed concerns about reduced demand for key crops like soybeans and corn.

The consensus among many firms is that while tariffs may provide long-term domestic advantages as they bring production back to the U.S. and strengthen the middle class, they create short-term uncertainty and disrupt global supply chains. Many companies believe they can raise prices to offset any tariff headwinds, but we think this may be challenging for some. Thus, companies continue to explore strategies such as nearshoring and diversifying supplier bases to mitigate these risks. We believe many of our holdings manage these challenges proactively rather than reactively. Thanks to their large scale and strong market positions, they can effectively absorb tariff pressure or pass on at least some of the costs. Owning companies with brand, scale, and operational advantages is critical to handle this turbulence. While "Liberation Day" is April 2nd, we expect tariff discussions and negotiations to extend into the foreseeable future with governments, businesses, and investors alike seeking greater clarity on the "rules of the road".

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Consumer

The state of the consumer in 2025 is marked by cautious spending amid persistent inflation and economic uncertainty. We have observed value-oriented customers trading down to less expensive options. We will continue to monitor consumer trends, as approximately two-thirds of the U.S. GDP is influenced by consumer activity.

Retailers and consumer-facing companies are reporting mixed signals. For instance, Procter & Gamble highlighted that consumers increasingly traded to private-label brands in categories like household goods and personal care, reflecting heightened price sensitivity. Similarly, Coca-Cola reported a 3% decline in volume sales in North America as consumers opted for cheaper alternatives. While some brands face challenges due to this cautious spending, others benefit from resilient demand among affluent consumers. Luxury brands like LVMH reported strong sales growth of 12%, driven by high-income buyers who remain insulated from broader economic pressures.

Additionally, companies like Amazon Inc. have noted a shift in consumer behavior. Discretionary spending on electronics and home goods is slowing, while essentials such as groceries and household staples are steadily growing. Walmart Inc. echoed this trend, reporting a 6% increase in grocery sales but a 4% decline in apparel and electronics sales. The travel and hospitality sectors have also experienced bifurcated trends: Delta Airlines reported strong demand for premium travel, with business-class bookings up 15%, while economy-class bookings have stagnated.

Companies are focusing on promotional strategies, loyalty programs, and value-driven offerings to retain customers. For example, Target Corp. has ramped up its discounting efforts, while Costco Wholesale Co. has seen increased membership renewals as consumers seek bulk-buying savings. Currently, U.S. consumers are focused on convenience and value above all else. While changing economic conditions can shift spending patterns, people generally gravitate towards retailers that meet these two needs – which aligns with our retail holdings.

Artificial Intelligence

The adoption of artificial intelligence (“AI”) is accelerating across industries, with companies leveraging it to enhance efficiency, improve customer experiences, and drive innovation. Across the board, companies emphasize AI as a transformative tool aligned with broader trends like automation and personalization. Many are increasing investments to stay competitive in this rapidly evolving landscape. For example, Microsoft Corp. has integrated generative AI into its Office 365 suite, enabling features like AI-driven content creation and real-time data analysis, which are highlighted as key growth drivers. Similarly, Salesforce Inc. has introduced Einstein GPT, an AI-powered tool that helps businesses generate personalized marketing content, which has already seen a 20% adoption rate among its enterprise clients.

AI is also transforming operational efficiency in the retail sector. Walmart Inc. is optimizing inventory management and reducing waste, with its CEO noting that AI-driven forecasting has improved supply chain efficiency by 15%. Kroger Inc., similarly, has implemented AI in grocery stores, using machine learning to predict demand for perishable items, resulting in a 10% reduction in food waste.

In the healthcare sector, AI is reshaping drug discovery and clinical trials as AI-powered research platforms have reduced the time required to identify promising drug candidates by 30%. Pharmaceutical companies are leveraging predictive analytics to identify ideal patient populations for clinical trials, shortening trial durations by six months. AI is also driving innovation in creative industries. Netflix Inc. leverages machine learning to enhance content personalization and improve viewer engagement. At the same time, the Walt Disney Co. uses AI to optimize visual effects in its films, cutting production timelines by 25%.

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AI innovation is simply the latest catalyst driving transformative changes aimed at productivity enhancement. Mirroring the monumental shifts brought on by other game-changing innovations, AI may or could propel productivity gains, thereby liberating humans to engage in more stimulating and complex endeavors instead of routine tasks that typically lead to higher employee turnover. In the future, we expect AI technology to continue to drive profit margin improvement and earnings growth as AI ramps up and increasingly impacts our lives.

Department of Government Efficiency

DOGE was established to ensure that public resources are used effectively and efficiently. By streamlining processes, reducing waste, and improving service delivery, the department aims to enhance the overall performance of government operations. DOGE has and will continue to create significant ripple effects across various sectors. Its actions have included organizing mass layoffs of federal workers and cutting funding in certain government areas. As DOGE consolidates agencies, digitizes public services, and reallocates resources, unintended consequences are emerging, particularly for industries reliant on government funding or contracts.

DOGE's cost-cutting measures are raising concerns across many industries. Defense companies face scrutiny as Pentagon spending comes under review, and Accenture PLC has reported a slowdown in government work related to its federal service division. Hospitals and providers reliant on Medicare and Medicaid could face cash flow challenges due to temporary disruptions in claims processing caused by DOGE's digitization efforts. Finally, pharmaceutical companies could be pressured by aggressive drug price negotiations, creating uncertainty around pricing policies and research budgets.

While DOGE's reforms aim to improve efficiency, they create challenges for many industries. For investors, monitoring these developments and identifying companies that adapt effectively will be key to managing risks and uncovering opportunities in this evolving landscape.

Investment Approach

We see 2025 as a year of selective opportunities amid heightened risks. In volatile periods, it is essential to remember that headlines happen, and market fluctuations are a natural part of the economic cycle. Our core strategic advantage starts with our patience and capital allocation philosophy, focusing on beyond-privileged and resilient companies ("BP&R") that can compound value over time. Given we cannot predict the short-term movement of the market, our investment strategy and process remain biased towards BP&R companies. We define BP&R companies as a combination of quality and growth with a focus on businesses that can earn a return greater than their cost of capital through a cycle. BP&R companies can grow and compound earnings over long periods. In our opinion, owning these companies is the best recipe for earning attractive equity returns through various cycles. During periods of market imbalances, patience gets tested in both directions, whether it is the desire to make more when money-making seems easy or the desire to lose less when everything appears hard. Our mindset is to remain balanced and reasonable optimists and trust our companies and time horizons. We believe that quality plus time is a magical combination for investing success. That said, we also stand ready to use volatility and market drawdowns as an opportunity to further "upgrade" the quality of our portfolios should that opportunity arise.

We continue to be reasonable optimists based on the following:

- We operate in a thriving democracy capable of implementing corrective policies.
- Capitalism, as practiced in the United States, represents a winning formula for sustained economic growth.
- Innovation will continue to propel the economy forward.
- The U.S. offers unparalleled opportunities for entrepreneurs to prosper by starting and building a company.
- We are self-sufficient in oil, export natural gas, and have abundant land for wind and solar generation.
- The U.S. will remain in a low to moderate inflation environment.

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Asset Allocation

We have often stated that "starting points matter," and today, there is increasing competition for equities from fixed income, especially on a risk-adjusted return basis. Whether it involves short-dated U.S. Treasuries yielding 4% or shorter-term investment-grade bonds yielding 5%, investors can find reasonable income-earning opportunities. Today's dynamic backdrop could allow investors to earn more reasonable income for the underlying credit and duration risk. If interested, contact us for more detailed asset allocation conversations, as coupons on a pre-tax basis for specific fixed-income securities may soon be able to compete with stocks on a risk-adjusted return basis.

Near Term Challenges

Our constructive long-term view on risk assets is not without challenges. Global issues remain front and center and have ripple effects on the U.S. economy. U.S. economic policy uncertainty has spiked to its highest level since the pandemic and is well above Trump's first term. There is uncertainty over tariffs, government spending cuts, and immigration deportation, to name a few. The U.S. deficit, which represents the gap between government spending and revenue, poses significant challenges as it continues to grow, driven by factors such as increased government expenditures, tax cuts, and rising interest payments on the national debt, potentially impacting economic stability and future fiscal policy decisions. The U.S. now faces $1.2 trillion in annual interest payments on $30 trillion of debt, consuming federal budgets and limiting spending flexibility. Conflicts in the Ukraine and the Middle East continue. Additionally, Trump has taken a forceful stance against the Houthis as it relates to the Red Sea, which could escalate tensions with Iran and North Korea. Moreover, we believe the most significant risks to the global economy are still unknown today – be they financial or geopolitical.

In closing, we believe that we are operating in a real-world and financial market world where the speed of change is astonishing. Sentiment shifts rapidly from extreme emotions of fear to greed, sometimes even within the same day. Rest assured, we believe this is precisely the backdrop where a disciplined process and diversified portfolios will prove even more powerful.

Thank you for your continued support.

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The S&P 500 Equal Weight Index (EWI) is the equal-weight version of the widely-used S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight - or 0.2% of the index total at each quarterly rebalance.

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