

2025: SEMI-ANNUAL MARKET UPDATE

SUMMARY

Global equity markets experienced whiplash during the quarter, dropping through April 8th as the U.S. government shocked the world with dramatic proposals to tariff all its trading partners. Stocks then recovered abruptly to end the first half in positive territory, as a pause in tariff implementation to allow for negotiations relieved investors (figure 1). Despite calls by the administration for lower interest rates, the risk of tariff-induced inflation kept the Fed sidelined.

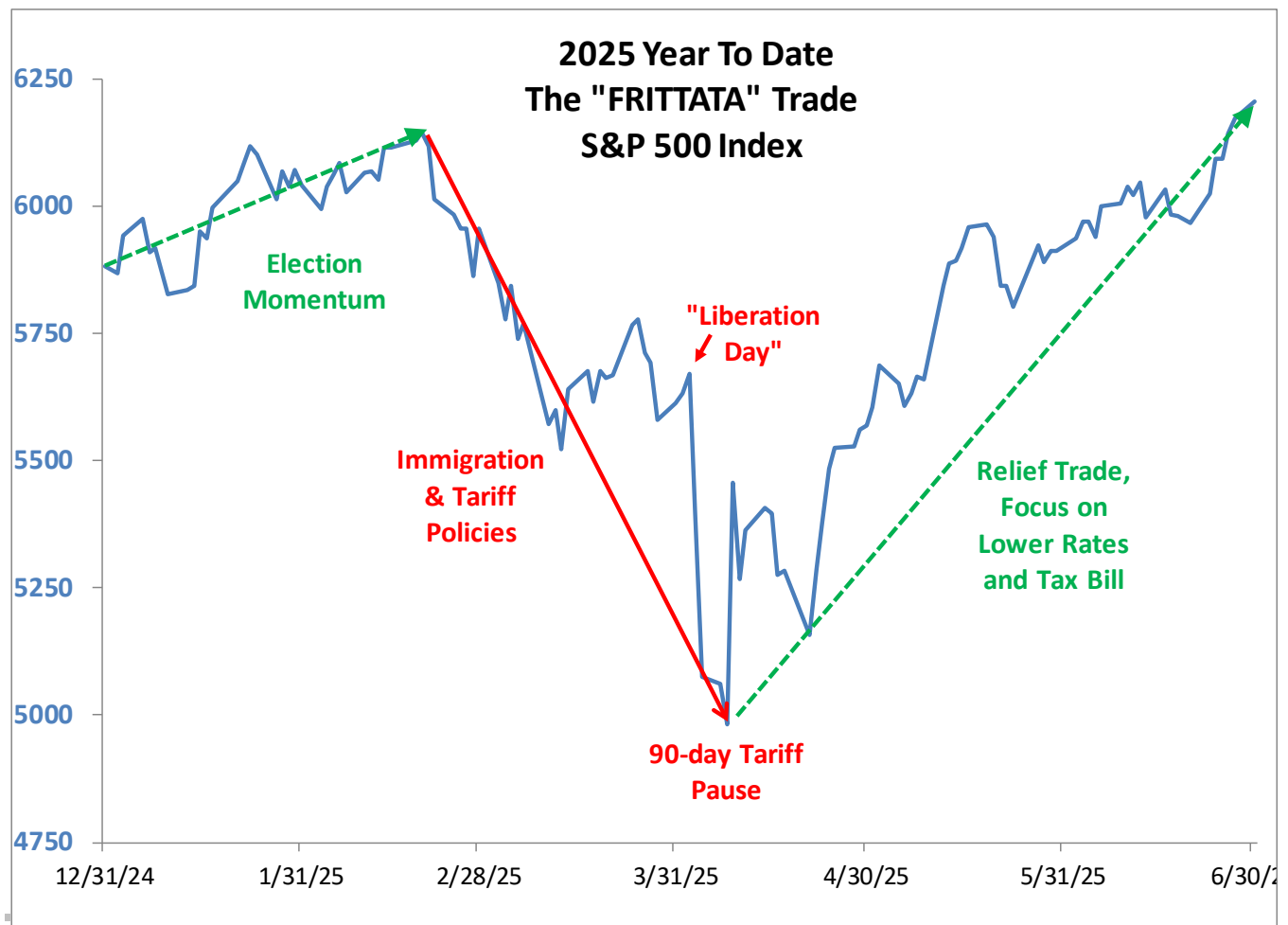
In the first half of 2023, global equities rose +10.0% and U.S. fixed income +4.0% while broad commodities gained +5.5% on sharp gains in precious metals. Volatility briefly spiked in April but returned to subdued levels, and the U.S. Dollar fell steadily against foreign currencies.

THE "FRITTATA" TRADE

The Art of the Deal: *"Frequently Raise International Tariffs Then Alter Them Afterwards."*



The new Republican administration wasted no time implementing its agenda following Inauguration Day. An initial focus on deportations and cuts in



government programs (led by Elon Musk and DOGE – the new Department of Government Efficiency) led markets lower on sudden concerns around fiscal restraint and a hit to growth.

Attention then quickly shifted to trade policy on April 2nd, dubbed “Liberation Day,” as the government announced the most sweeping tariff hike since the Smoot-Hawley Tariff Act of 1930. Details included a 10% baseline tariff on all imported goods, plus sectoral tariffs on steel, aluminum, autos and anticipated tariffs on copper, lumber, semi-conductors and pharmaceuticals, as well as higher tariffs on countries with large trade deficits with the U.S. (notably China, the EU, and Japan). April estimates pegged the new effective tariff rate at 28% vs. 2.4% in January. The magnitude of the announcement shocked markets, leading to a 12% decline in the S&P500 from April 2nd to April 8th, and a worrying jump in U.S. bond yields (the yield on the U.S. 10-year bond rose by +0.3% to 4.3% between April 4th and April 8th). On April 8th, the government took the pragmatic approach of announcing a 90-day pause on new tariffs to allow the U.S. to reach trade deals with its partners.

The pause walked markets back from the abyss and triggered a rally as the more far-reaching implementation of tariff policy was shelved in favor of a progressive approach.

With trade negotiations on track and markets relieved, the administration shifted its focus to its last objective, tax policy, in the form of a comprehensive bill addressing tax cuts, defense spending, immigration enforcement as well as cuts to Medicaid and renewable energy tax credits. The House passed its version in May, and the Senate voted on its version in July, with the “One Big Beautiful Bill Act” (OBBBA) signed into law on July 4th.

The Congressional Budget Office estimates that the OBBBA will add \$3.4 trillion to the primary deficit through 2034, cementing the case for further fiscal stimulus. With fears of fiscal restraint off the table, investors plowed back into U.S. equities.

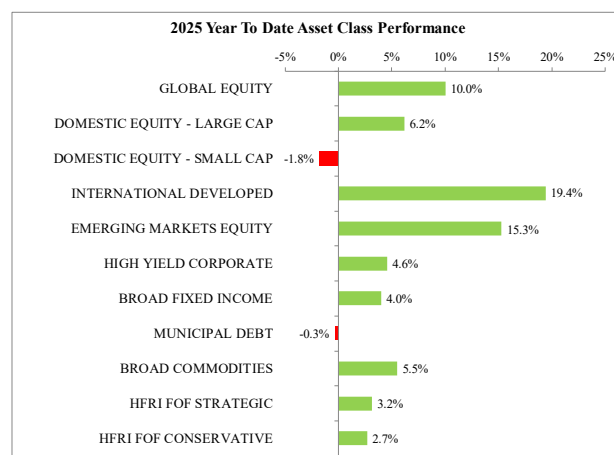


The Soufflé: an egg-based dish that puffs up when baked due to the expansion of air incorporated into the egg whites.

The VIX volatility index started the year at 17, then expanded like a Soufflé through April 8th, peaking at 52 before deflating back to 17 by the end of second quarter. The yield on the benchmark 10-year U.S. Treasury note dropped from 4.6% at year-end 2024 to 4.0% by April 4th, before rebounding to 4.2% by the end of the second half. The U.S. Dollar fell steadily throughout the period, depreciating by -10.7% vs. a basket of foreign currencies (DXY index), while Gold rallied by +25.8% through June.

Most of the major asset classes gained for the first half, except for smaller capitalization domestic stocks and municipal bonds. Defensive investments including fixed income and hedge funds lagged large cap equities (figure 2).

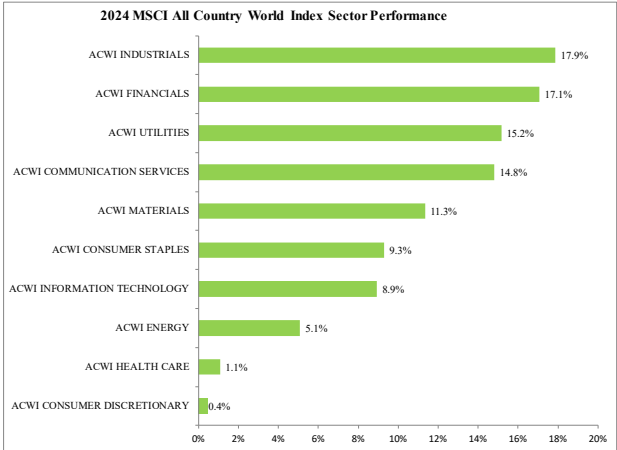
(Figure 2)



Source: Bloomberg

Year-to-date, all equity sectors are positive, led by sectors expected to benefit from new trade policies (chiefly Industrials). Health Care and Consumer Discretionary lagged on expectations of a negative impact from trade policy (figure 3).

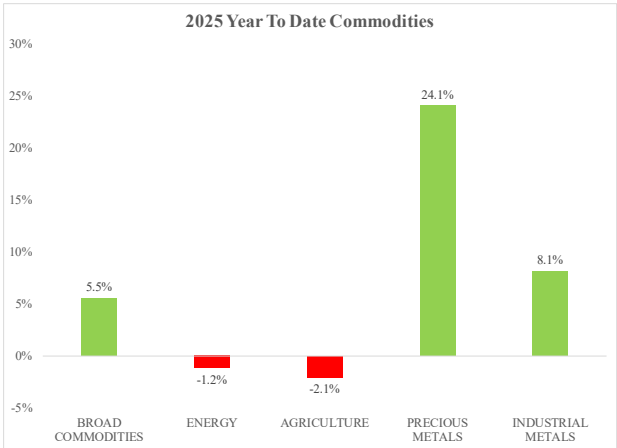
(Figure 3)



Source: Bloomberg

The U.S. Dollar was the main casualty of new trade policies, benefiting Gold and other precious metals. Copper rose in U.S. markets but declined abroad on distortions introduced by new tariffs policies (figure 4).

(Figure 4)



Source: Bloomberg

In this volatile environment, equity-oriented directional hedge fund strategies fared well, while defensive absolute return strategies lagged.

Hedge Funds		YTD Return	
HFRI EQUITY HEDGE	6.0%	Directional	
HFRI EVENT DRIVEN	4.6%		
HFRI RELATIVE VALUE	3.4%	Absolute Return	
HFRI MACRO	0.1%		

FISCAL DIET

The year so far has been dominated by macro-economic volatility induced by the chaotic implementation of new government policies. With the dust settling around tax and trade policies, it is time to assess their likely impact on the U.S. economy.



The Turducken: a chicken stuffed inside a duck that's then stuffed inside a turkey.

Like a Turducken, OBBBA stuffs a lot of priorities into a single package, including over 90 initiatives. In aggregate, the tax bill is expected to increase the primary deficit by \$3.4 trillion over the next ten years (or \$4.1 trillion including interest on the new debt that will be needed to fund it). See figure 5.

(Figure 5)

Deficit Increasing Provisions		-\$5,883 billion
+ Extend & Expand TCJA Individual Provisions		-\$3,886 billion
+ Revive TCJA Business Provisions		-\$772 billion
+ New Individual Tax Cuts		-\$418 billion
+ New Business Tax Cuts		-\$285 billion
+ Immigration & Border Spending		-\$176 billion
+ Defense Spending		-\$173 billion
+ Other Spending		-\$173 billion
Deficit Reducing Provisions		\$2,489 billion
+ Health Care Provisions		\$1,102 billion
+ Repeal & Reform IRA Credits		\$540 billion
+ Other Revenue Increases & Tax Credit Reductions		\$197 billion
+ Education Reforms		\$295 billion
+ Other Offsetting Receipts		\$149 billion
+ SNAP, Agriculture, & Other Savings		\$206 billion
PRIMARY DEFICIT EFFECT		-\$3,394 billion
Interest		-\$717 billion
TOTAL DEFICIT EFFECT		-\$4,112 billion

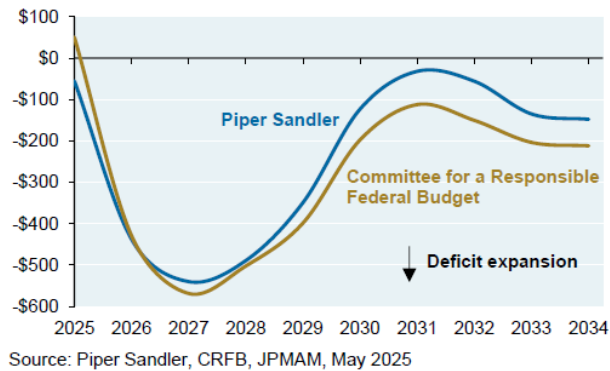
* If Permanent* figures for these provisions were calculated as a group
Note: figures may not sum due to rounding

Source: Committee for a Responsible Federal Budget

The impact of the tax bill will be front-loaded, with tax cuts in place as soon as 2026, but spending cuts delayed until 2028 and the next presidential election (figure 6).

(Figure 6)

Estimated impact of reconciliation bill on CBO baseline deficit, US\$, billions



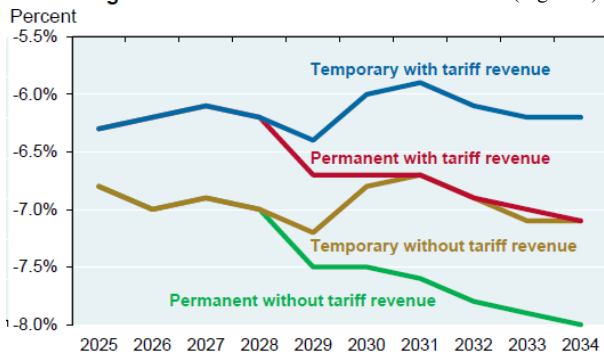
Source: JP Morgan

Some of the new tax provisions are temporary, including the increased SALT cap (through 2029), or the tax cuts on tips and overtime (through 2028). Assuming all provisions are made permanent, the primary deficit would increase to \$4.7 trillion over ten years (\$5.5 trillion with interest on the new debt).

However, new tariff revenue should alleviate the deficit. As of July 30th, the Yale Budget Lab estimates that tariffs would raise \$2.3 trillion over ten years (including dynamic reductions, i.e. substitution or lower output overall).

Depending on the exact scenario, the budget deficit should remain in a 6-8% deficit range over the next ten years (figure 7).

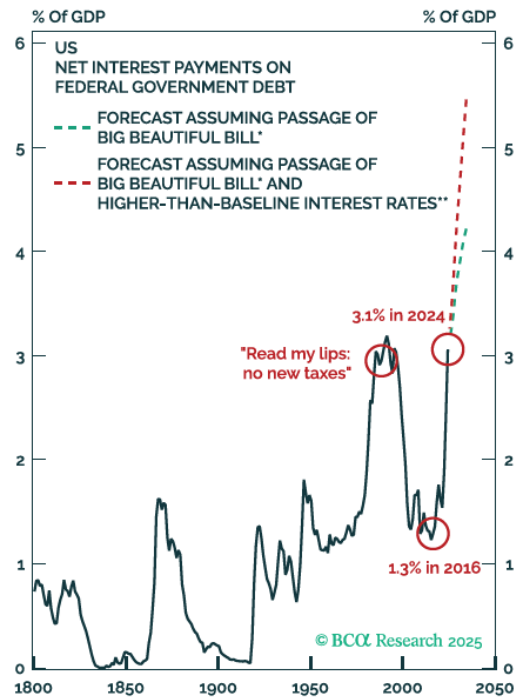
Total budget deficit to GDP (Figure 7)



Source: JP Morgan

Unfortunately, a deficit of about 3% is required to keep the debt level from rising relative to GDP. Accordingly, the debt to GDP ratio is expected to rise from about 100% today, to 120-130% over ten years (depending on the tariff/tax scenario). The Congressional Budget Office foresees interest payments on the federal debt rising from 3.1% of GDP to over 4% in that period (figure 8).

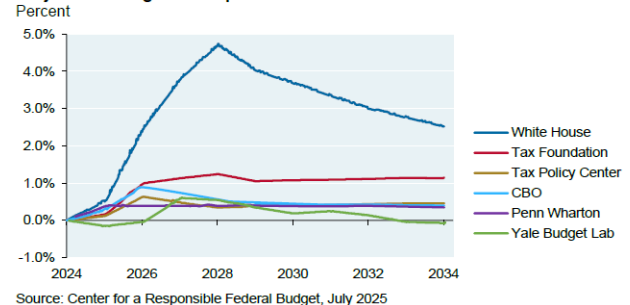
(Figure 8)



Source: BCA Research, CBO

Given renewed fiscal stimulus, GDP growth should receive a boost from the OBBBA. The median forecast is about +0.5% (although the White House Council of Economic Advisers stands out with more optimistic projections, see figure 9). Current GDP growth year-over-year is 2.0% through June 2025.

Projected GDP growth impact of OBBBA (Figure 9)



Source: JP Morgan

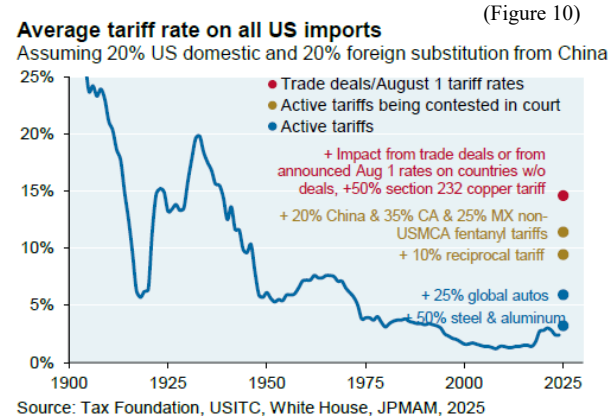
TRADE REGIMEN

Besides fiscal policy, the other major development this year is the new direction of trade policy.



Haggis: a traditional Scottish dish, made by stuffing a sheep's stomach with a mixture of sheep's pluck (heart, liver, and lungs). Enjoyed by locals but unappetizing to most foreigners.

While tariffs are still being negotiated, deals have been announced with the UK, Japan, Korea and the EU. A picture is starting to emerge, with the new effective tariff rate settling around 15% (figure 10).



Source: JP Morgan

While an effective tariff rate of 15% is much less than what was feared on Liberation Day, this is still six times the prevailing rate at the beginning of the year and a level not seen since the 1930's. A meaningful impact on the U.S. economy should be expected.

Tariffs are a tax on the importer and end consumer. Until now, importers have mostly absorbed the costs of new tariffs, pending clarity on trade negotiations, in order to preserve sales and market

share. As trade deals get implemented, cost increases will start to pass through to the end consumers, depending on the availability of local substitutes.

Consumers face particularly high increases in clothing and textile prices in the short-run: 40% for leather products (shoes and hand bags), 38% for apparel, and 19% for textiles. After substitution and global supply shifts in the long-run, prices remain 19%, 17%, and 10% higher, respectively. Prices increase by 9.4% in the long-run for motor vehicles (figure 11).

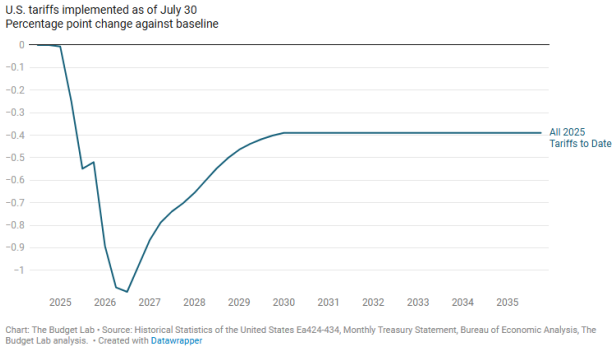
(Figure 11)

name	Short Run	Long-Run
Leather products	39.7	18.8
Metals nec	39.2	17.8
Wearing apparel	37.5	17.2
Crops nec	33.6	14.9
Electrical equipment	26.6	12.9
Textiles	19.2	10.3
Computer, electronic and optical	18.7	7.8
Ferrous metals	18.0	10.6
Mineral products nec	14.2	7.3
Machinery and equipment nec	13.9	8.6
Motor vehicles and parts	12.3	9.4
Metal products	11.2	6.9

Source: Yale Budget Lab

In aggregate, tariffs are expected to lower GDP growth by -0.5% in 2025 and 2026, with the long-run effect settling at -0.4% hit to GDP (figure 12), effectively offsetting the expected boost from the tax stimulus.

(Figure 12)



Source: Yale Budget Lab

Tariffs will lead to reallocation across sectors, with manufacturing expected to expand by 2%, while construction, mining and agriculture are expected to contract by 3.6%, 1.3% and 0.8% respectively.

More importantly, the risk of long-run goods inflation has kept the Fed on hold until now.

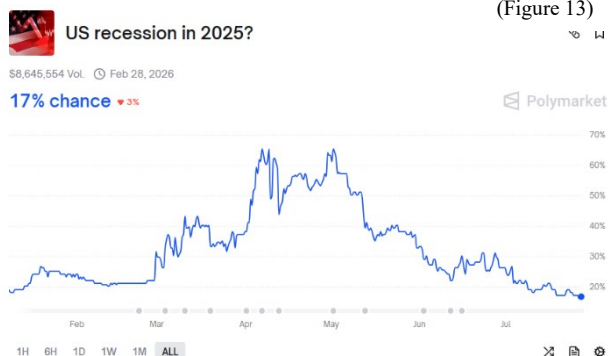
IRRESISTIBLE DESSERT

With tax and trade policies apparently offsetting each other, it seems like the “macro-economic storm” has passed for now, allowing investors to indulge in their favorite slice of the market.



Devil's food cake is a moist chocolate layer cake. Hard to deny the appeal but maybe a bit rich...

The odds of a recession shot up above 60% in the wake of the Liberation Day announcement but have since declined to 17% according to Polymarket (figure 13), reflecting resilient economic statistics and a more benign outlook on tariffs.



Source: Polymarket

This allowed investors to resume risk-taking in the equity markets. However, market performance remains concentrated in U.S. large cap growth stocks (figure 14).

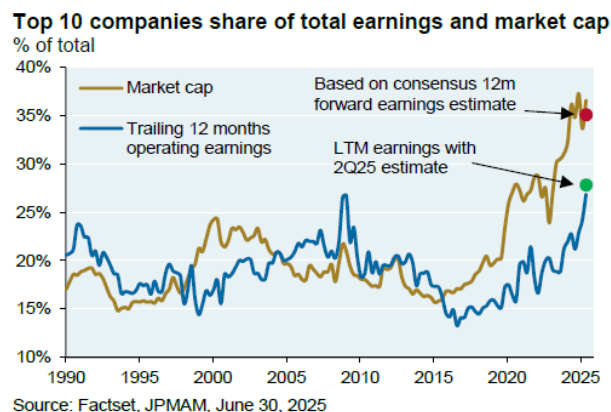
(Figure 14)

YTD Return	Growth	Value
S&P500	8.9%	3.3%
Russell 2000	-0.5%	-3.2%

Source: Bloomberg

Of course, U.S. large cap growth stocks are dominated by a handful of technology companies. The top 10 stocks in the S&P 500 represent about 35% of the market capitalization of the index, and nine of them are technology companies (the exception is Berkshire Hathaway). See figure 14.

(Figure 14)



Source: JP Morgan

It is easy to understand the appeal of these companies as they have experienced a nearly uninterrupted 15-year increase in market value. Not only did their earnings prove resilient during the Covid crisis, but they were unaffected by the rise in interest rates and bank failures in 2022. And since November 2022 and the advent of ChatGPT, excitement surrounding artificial intelligence has propelled technology stocks further, with most of the benefit assigned to large cap hyperscalers, which are busily investing in data centers to handle the surging demand. In the end, a series of fortunate coincidences has made the sector an irresistible treat to market participants.

However, something is different about this investment cycle. What had made technology companies so successful in the past was their asset-lite characteristics and the fact that low capital expenditures helped guarantee high margins. Today's top four tech leaders have reportedly spent \$155bn in AI capex year-to-date. That is more than the \$130bn that the U.S. government has spent on education, training, employment and social services¹.

¹ Fiscaldata.treasury.gov

Historical examples of sectors providing a critical service to the economy but unable to reap profits from it because of the required capital intensity include railroads, airlines, or more recently, the energy industry (fracking technology).

Consider what happens when Nvidia sells chips to Google. Nvidia gets to record the sales as earnings, but Google can capitalize its spending and record only a fraction of the purchase price as depreciation, flattering earnings.

As shown in the table below (figure 15), Google produced \$19.7bn of net income in 2016, and \$25.8bn in free cash flow. Stock-based compensation was \$6.7bn, leaving \$19.1bn in economic profit. Net income and economic profit were roughly in line. Fast forward to 2024 and the era of high AI capex, and net income has grown to \$98.5bn but free cash flow is now lower than net income at \$72.8bn. Factor \$22.8bn in stock-based compensation and economic profit is only \$50bn, or about half as much as earnings. Accounting profits make the company look more profitable than it really is.

(Figure 15)

GOOG US Equity			
in \$ billion	2016	2024	
Net income (1)	\$ 19.7	\$ 98.5	
Free Cash Flow (2)	\$ 25.8	\$ 72.8	
Stock-based compensation (3)	\$ 6.7	\$ 22.8	
Economic Profit (2)-(3) = (4)	\$ 19.1	\$ 50.0	
Enterprise Value (5)	\$ 457.8	\$ 2,241.6	
FCF/EV (2) / (5)	5.6%	3.2%	
Economic Profit/EV: (4) / (5)	4.2%	2.2%	

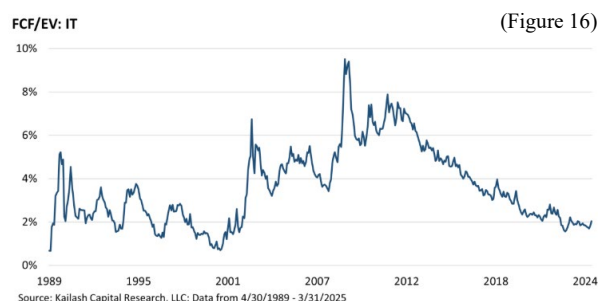
Source: Bloomberg

The free cash flow yield (free cash flow relative to enterprise value, which includes the value of the company's debt) has in fact declined from 5.6% in 2016 to 3.2% today.

The open question is whether capex will decline in coming years, allowing profitability to increase. However, if each new generation of chip triggers an arms race among peers to purchase new computing power to keep up, it is hard to envision capex slowing anytime soon.

The issue is not confined to a single company. In fact, the FCF/EV ratio has declined for all

technology companies from a peak of almost 10% in 2009 to about 2% today (figure 16).



Source: Kailash Concepts

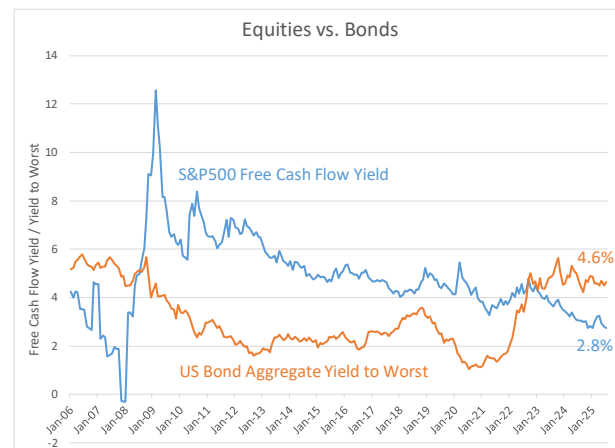
Just like chocolate cake, indulging in “high-quality” technology stocks is enjoyable in moderation, but the large helpings of sector concentration that are dished out by indices are likely to deliver indigestion at some point in the future.

EAT SOME VEGETABLES



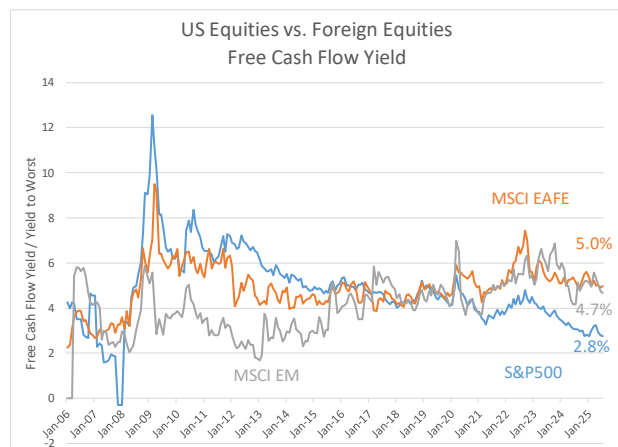
U.S. bonds now offer a meaningful premium over equities. The last time bond yields exceeded equity FCF yield was in 2008 (figure 17).

(Figure 17)



Source: Bloomberg

Since 2020, international equities have also enjoyed a meaningful FCF yield advantage over U.S. equities (figure 18). (Figure 18)

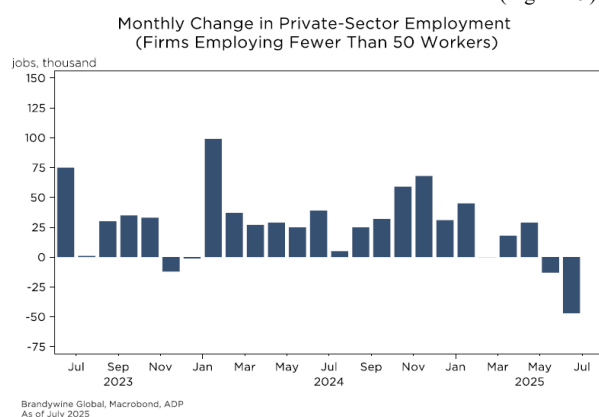


Source: Bloomberg

U.S. equities trade at elevated valuations, propelled by momentum based on hopes for positive macro-economic tailwinds. But as we have discussed, the contradictory effects of tariffs and tax stimulus will likely offset each other, leaving underlying economic fundamentals to reassert themselves.

While the U.S. labor market has shown remarkable resiliency to date, allowing the Fed to focus on inflation risk, some cracks are starting to show. As shown in figure 19, smaller firms laid off workers in May/June, hinting at financial stress in the broader economy.

(Figure 19)



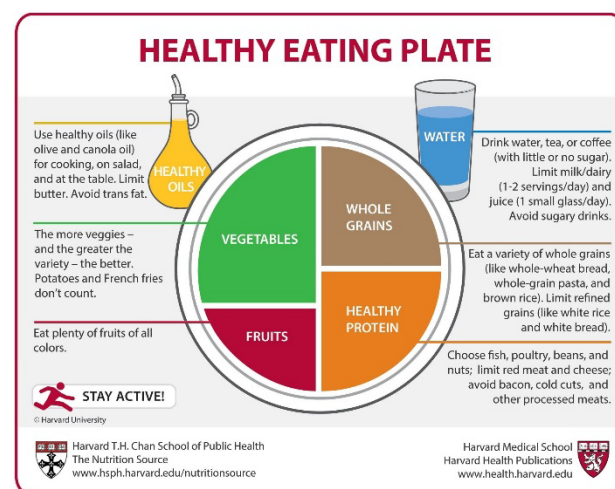
Source: Brandywine Global

Ultimately, confirmation of a weakening U.S. labor market would be the signal for the Fed to act and lower rates. Diversification into bonds and foreign holdings might be beneficial when that time comes.

A BALANCED DIET

Between valuation signals and uncertain economic conditions, diversifying portfolios beyond the U.S. large cap growth equities that have recently driven the market remains a compelling proposition.

So far this year, international diversification has helped our equity and directional hedge fund portfolios outperform. But hedging strategies, such as bonds and absolute return hedge funds, lagged as economic worries were eventually washed away by tariff relief and tax cut euphoria.



A healthy diet involves getting nutrients from multiple food groups, and portfolios behave in much the same way.

We intend to persevere with portfolios designed to weather the bad times and participate in the good times by harnessing the power of diversification.

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