INTELLIGENT INVESTMENT

Second Quarter 2025

S&P 500 - YTD 5.50%[3] *MSCI INTERNATIONAL - YTD 6.23%*[3]

"Every breath you take… And every move you make
Every bond you break, every step you take
I'll be watchin' you "[1]…

If I could describe the markets over these last three months with one word it would simply be "historic". From tariff liberation day, to the 2nd fastest 20% market pullback ever, a full scale 12-day war in the Middle East, multiple tariff related fits and starts followed by an equally historic "V shaped" recovery just to name a few. What are the markets to make of this and what should they be on the lookout for?

The volatility witnessed over the spring has investors now "every single day, every word you say, they'll be watchin'"[1]. We began 2025 on a high note, only to close out the first quarter with the S&P 500 down (-4.59%) clearly related to pressures surrounding tariffs. Markets rapidly went from bad to much worse when President Trump transformed from one of the markets biggest proponents to the "King of Pain"[1] with his tariff announcements a.k.a. "liberation day" on April 2nd. Equities "Driven to Tears"[1] quickly contracted and suffered its fifth-worst two-day decline in history erasing $6.6 trillion in wealth. However, this tailspin made an about face when a "Message in a Bottle"[1] appeared sending markets "Walking on the Moon"[1] gaining almost 10% in a single day!

What was this "Canary in a Coalmine"[1] causing markets to whipsaw back then recover to all-time highs in less than 3 months? The April 9th pressure relieving post on Truth Social: "I have authorized a 90-day PAUSE, and a substantially lowered reciprocal tariffs during this period, of 10 percent, also effective immediately. Thank you for your attention to this matter!"[2] With markets already "Wrapped Around Your Finger"[1] The S&P 500 exploded a whopping 9.52%[4] that same day. This snap back was due in large part to recession probabilities went from around 75% to around 35% effectively in an instant. Recession fears stemming from the secondary effects of inflation and consumer spending imposed upon by tariffs.

ARPG has always been somewhat skeptical of not only the full scope implementation of tariffs but their inflationary effects as well. The market appears to be joining our skepticism with a follow through rally to new all-time highs on June 27th. We wrote back in January "Although this has proved to be a robust subject of debate ARPG believes the issue of tariffs to be a relatively simple equation consisting of no more than a tax on imported products. This "tax" will most certainly not increase demand on tariffed products domestically and thus is not likely inflationary to the domestic economy."[3] Being tariff-based inflation has yet to show in any of the hard data it appears we are no longer "So Lonely"[1] as several others are beginning to come around to these counterintuitive effects of tariffs as well. From CEPR, "Although the current perspective is to see tariffs as inflationary: they raise import prices, reduce supply, and increase costs. But this view misses the softening of demand surrounding tariffs. When implemented large-scale tariffs could have the opposite effect as they can depress earnings expectations, erode asset valuations, trigger financial deleveraging and tighten credit conditions. In this environment, the net effect is financially disinflationary or even deflationary. Not due to tariffs lowering prices, but because they reduce aggregate demand."[5]

Are we seeing any tariff-imposed inflation or rather is demand beginning to wane and slow economic growth? Inflation has yet to show in any material way, the Federal Reserves preferred measure of inflation core PCE for March, April and May annualize to a mere 1.8%. Along with these low inflation numbers, May's consumer spending and income showed signs of weakening. Spending fell (-0.1%) for the month, compared with the estimate for an increase of 0.1%. Personal income declined quite drastically (-0.4%), against the forecast for a gain of 0.3%[6].

This reduction of aggregate demand is becoming most evident in the housing market. As the Federal Reserve has maintained stubbornly restrictive policy rates due to the perceived uncertainty surrounding tariffs. The housing market, once a juggernaut is very quickly becoming a buyers' market as home inventories are rising across the country. Housing inventories are up 21% over the last 12 months ending in May to a record $698 billion dollars' worth of homes for sale. Furthermore, sales of existing homes fell 0.7% in May from a year earlier, according to data from the National Association of Realtors.[7]

Restrictive interest rates are having negative effects not just on the housing market but across the broader economy as well. Q1 GDP final revision came in (-0.5%) down from the initially reported (-0.2%)[4]. Although we can attribute the first quarters contraction to a high number of imported products shipped in ahead of potential tariffs the Federal Reserve found it necessary to reduce 2025 and 2026 GDP from 1.7% and 1.8% to 1.4% and 1.6% respectively[4]. The labor market remains strong but is showing signs of cooling as job creation has contracted materially. May saw job growth of 139,000 new jobs along with March and April collectively revised down by 95,000 jobs. The three-month new job average of 144,000 is down from 249,000 one-year ago[4]. The Fed is well aware of this as they have adjusted their 2025 estimate of unemployment up to 4.5% from the 4.4% March estimate[4]. Clearly consumer spending, personal income as well as the housing and the labor markets are all cooling quickly, although the economy is strong and in a good place now these restrictive rates could change that if the Fed doesn't pivot away from their current restrictive policy stance.

Although parts of the economy might be cooling due to uncertainty one thing we are certain about the weather isn't cooling at all… it's hot out there! The not so "Invisible Sun"[1] seems to shine extra bright in June and July. In any season or market, the best investors always focus on the long term and ARPG will continue to practice our approach to value investing, "Intelligent Investment is Investment on Value, buying high quality companies in low quality times". This is what we believe sets ARPG apart from the rest. As always, we thank you for your confidence and are humbled by your trust. Please feel free to contact us at any time.

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Sincerely,
Matthew D. Dahl
Chief Investment Officer

1. The Police
2. Truth Social
3. ARPG / Stockcharts.com
4. Factset
5. CEPR
6. Bureau of Economic Analysis
7. National Association of Realtors