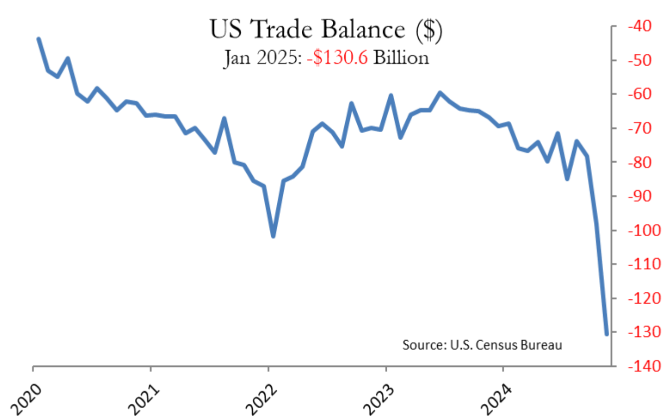
1Q2025

"Don't Know What You Got (Till It's Gone)"
Cinderella, 1988

The quote above seems very apropos for our current environment. This isn't from the fair maiden in the land of Disney, but rather from the iron maiden in the land of heavy metal hair bands. The popular tune among rockers of that time bemoaned the loss of some fair lass who likely grew tired of all the empty hair spray cans. Today, however, it applies to investors who are becoming painfully aware of the shifting structural supports that have propped up markets for the past many years.

We have just witnessed an historic two-day selloff in markets on the heels of the "Liberation Day" so keenly promoted by the Trump administration. A 48-hour period where the administration deployed its tariff strategy on countries around the globe and the US's largest trading partner responded with its own level of reciprocal trade barriers. Are we on the cusp of a global trade war? Is a stark decline in global commerce and growth ahead of us? Or will countries agree to eliminate their pre-existing trade barriers and level the restrictions on the flow of goods? These are the multi-trillion-dollar questions. No doubt, it's a bold move by the administration and a serious game of chicken. Investors seem to be taking a sell first approach. The weakness in markets is sure to have knock-off effects we have yet to witness as funding costs rise and levered investors begin to do the math.



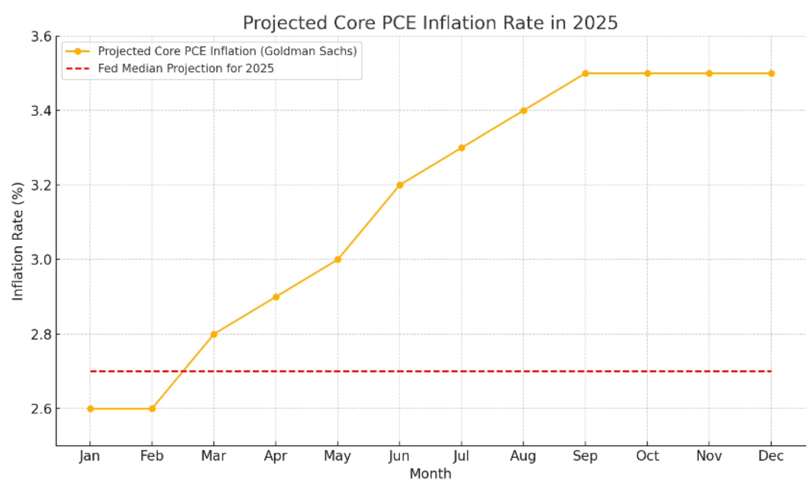
Consider the following. The U.S. monthly trade deficit in goods and services has tripled from $43 billion in March 2020 to $131 billion in January 2025. In 2024, the full-year US trade deficit in goods alone reached a record $1.2 Trillion. A significant imbalance on a trajectory that needs fixing. The solution, however, has resulted in the worst week for global and U.S. equities since the Covid lockdown collapse. The S&P 500 lost $5.4 trillion in value during April 3rd and 4th. The ill named Magnificent 7 lost a combined $1.7 trillion in market cap. Commodity prices are in free fall and global distressed debt levels are spiking. Unlike Covid, this is a recipe of our own making. Our response to the virus driven decline was a massive stimulative rescue package. We shouldn't expect anything similar this time around nor can we afford it.

Is it a matter of implementation, timing, structure, or all of the above? The Trump administration's quick moving policy shifts have been formidable since taking office. They seem aware, and perhaps correctly, that they have a short window of time for getting objectives launched prior to the mid-term elections. At the helm of the nation's purse strings is Scott Bessent, the country's 79th Treasury Secretary. Bessent is a former macro hedge fund manager and protégé of Stanley Druckenmiller. He has a keen sense for the financial nuances of markets and differs from his predecessor, Janet Yellen, and her world of academia. As for the newly imposed tariffs, Bessent has commented that the administration's focus is to benefit "Main Street" over "Wall Street". His focus is on small businesses and the consumer in rebalancing the economy rather than on policies benefiting large companies (think Mag 7). Bessent has referenced President Reagan's first term as a historical analogy in several conversations regarding equity markets. During the first two years of Reagan's initial term, as he implemented more restrictive trade policies, the S&P 500 declined -25%. This was followed by a 195% increase in the years that followed. This seems to be the roadmap the administration is following. Reagan, however, used a much more managed approach targeting specific industries or structuring voluntary export agreements (VERs) with specific trade partners like Japan on auto imports. The Trump administration has chosen, instead, to cast one giant tariff net at every country with an unfair trade advantage. The administration promises a smoother road ahead, but we likely have miles and miles of potholes to navigate before reaching the expressway's on-ramp.

So where does the current tariff turmoil lead us? As is usually the case, there are many possible outcomes. In my view the best possible result would be a willingness by a few of our significant trade partners (the European Union, Japan, and Mexico) to renegotiate current trade barriers to levels that are much less restrictive to US inflows. The hope is that this willingness to negotiate occurs sooner rather than later. Investors and the Trump administration need some signal that the tariff policy is leading towards a more free and open trade system. The U.S. economy is the heart of the global trade network and most of its economic partners rely on that system working effectively to circulate activity and finances around the globe. A coordinated rebellion by trade partners would be devasting and senseless. The Trump administration seems to be relying on the sanity of our partners and their willingness to perhaps make their economies a bit more open, profit a bit less, but keep the systems up and functioning.

The future impact domestically is currently being debated. Inflation is still unresolved and a cooling economy under the new trade restrictions have many debating the timing and severity of a recession or stagflation as well as the impact on future prices. The inflationary pressures are mounting. Tariffs include a blanket 10% duty on all imports, additional country-specific tariffs, and a steep 34% tariff on Chinese goods. These measures will raise the cost of goods and services, but for how long and by how much. Tariffs are a tax hike on U.S. households and businesses. According to JPMorgan, the proposed cumulative rise in U.S. tariff rates this year would be the largest tax increase since the Revenue Act of 1968 which preceded the 1969-1970 recession.

U.S. inflation swaps anticipate a short-term spike in consumer prices, with the one-year inflation swap rate reaching 3.07%, reflecting expectations of higher inflation. However, longer-term swaps indicate a decrease, suggesting that while immediate price increases are expected, tariffs could slow economic activity, potentially leading to lower overall inflation and increasing recession risks. Goldman Sachs economists have adjusted their forecasts, now predicting three interest rate cuts by the Federal Reserve this year, up from their previous forecast of two, due to increased risks from the tariffs. They also project that tariffs could drive up costs for producers and consumers, potentially pushing core PCE inflation to 3.5% year-over-year by the end of 2025. The Federal Reserve's March projections indicate a median PCE inflation rate of 2.7% for 2025, with core PCE inflation projected at 2.8%, reflecting concerns about rising price pressures. Fed Chair Powell finds himself in the unenviable position of having to monitor rising prices and a potentially cooling economy. He is leaving rates unchanged at the moment but may be forced to choose between propping up economic activity by lowering rates or tamping down prices by holding firm or becoming more hawkish. We just hope he doesn't choose to start using the term "transitory" again!



The one item that seems the most difficult to quantify and is absent from the Trump administrations calculus is the idea of demand destruction as a result of all the turmoil and uncertainty Mergers and acquisitions activity will slow significantly, funding costs will rise, and borrowers will be less incented to take risks. IPO and expansion activity will be paused as c-suites await more clarity. Consumers will curtail spending and businesses will reduce staffing and pause hiring. Economists estimate that the tariffs could reduce GDP growth by 0.3% to 0.4% in 2025. J.P. Morgan revised its real GDP growth forecast down to 1.6% for the year, a 0.3% reduction, citing heightened trade policy uncertainty and the effects of tariffs and retaliatory measures. The U.S. GDP balance in 2025 is estimated at $28.2 trillion, so the impact could be between $85-$112 billion in the current year.

At the portfolio level, our Strategic Value investments finished the first quarter up 0.7% at the composite level versus the Russell 1000 Value Index up 2.1% on a total return basis. By comparison, the S&P 500 returned -4.3% and the Nasdaq declined-10.3%. Unfortunately, all of these figures are now recent history following the declines in the first week of April. To highlight the severity of the move in markets the comparison below details the selloff's impact on our holdings and the broader indices.

	3/31/2025	4/4/2025
Hourglass Strategic Value	0.70%	-8.70%
Russell 1000 Value	2.13%	-7.48%
S&P 500	-4.28%	-13.43%
NASDAQ	-10.26%	-19.13%

Volatility and downward moving markets are never the preferred course, but a correction in market multiples and valuations is long overdue. As I've stated for many quarters, the securities priced for perfection and endless growth are not the places we choose to invest. We certainly are not immune to the downdraft, but as markets move lower, we encounter more opportunities to buy into meaningful businesses at very reasonable prices. I've held a meaningful overweight to cash investments these last few years as values have stretched. We are entering a period where those funds can be put to good use. Our list of compelling investment ideas is expanding. Importantly, the underlying economy, for now, remains robust. Manufacturing is rebounding, services remain high and job growth is expanding. We remain hopeful a resolution to the trade debate resolves itself in a timely manner.

As always, I appreciate your confidence and remain committed to a disciplined approach to investing in long-term value. Please reach out if I can be of any assistance or you'd like to discuss markets.

Drew
Hourglass Capital, LLC