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WEALTH MANAGEMENT

Investor Letter
Second Quarter 2025

The global economy and human initiative are remarkably resilient and adaptable to changing circumstances. While there are no guarantees in financial markets, our view is that this will once again be demonstrated when the current crisis subsides. (Western Pacific First Quarter 2025 Investor Letter)

The S&P 500 Total Return Index rose 10.9% in the second quarter of 2025 while the NASDAQ Composite rose 17.8%. The Barclays Aggregate Bond Index rose 1.2%. More than in most quarters, however, the headline numbers fail to capture the underlying drama that took place during a very busy three months for financial markets.

The second quarter of 2025 will be remembered as one of the more interesting and volatile periods in recent financial history. As we wrote in our last letter, the quarter began with the announcement by the U.S. of significantly higher than expected tariffs on virtually all US trading partners. The announcement led to widespread forecasts of a global recession (or worse) and caused an 11% drop in the stock market over the next two weeks. This drop, which followed a market decline which began in mid-February, brought the total fall in the stock market to nearly 20%.

Following the steep market drop, the tariffs were suspended for 90 days to give the U.S. time to work out trade deals with its trading partners. Around this time, the Federal Reserve Bank also clarified that it did not have plans to raise rates due to inflation concerns. First quarter earnings came in above expectations, and several economic data points reduced fears the economy was headed for recession. Markets recovered strongly on all this positive news, and over the next two months gained back all the ground they had lost in early April.

The selloff in early April was not unprecedented but ranked with some of the larger short-term stock market drops. A similar decline took place in 2020 during the Covid scare, and in 2018 when investors feared a global recession. Both of these declines were followed by "V" shaped rallies, as was the recovery in April.

Each time there is a steep drop in the stock market there is a narrative to accompany it. In 2018 the story was that a recession was coming and that the Fed was too slow to lower interest rates. (There was no recession.) In 2020 there were understandable concerns about the ability of the economy to function during the pandemic. (There was a brief recession in the first quarter of 2020.) In 2025 it appeared to many experts that the US was putting in place a tariff regime that would threaten global trade.

As of the beginning of the third quarter, the expectations of a tariff-led slowdown have not come to pass. Economic growth has continued to be strong, job creation has been higher than forecast, and (surprisingly) inflation has remained under control. It is worth looking at each of these data points to better understand the situation.

Economic growth better than forecasts. With tariffs in place (albeit not the highest ones discussed in April), why hasn't the economy slowed? One answer is that the US economy is roughly 80% services now, and the tariffs apply primarily to goods. This was made clear in May when the jobs number was released and showed strong job creation in the service sector including health care and financial services.

Job growth remains strong. Strong job growth may also be related to a healthy service sector. In the months since tariffs were announced, service sector job growth continues to be above expectations. On July 3rd it was reported that non-farm payrolls continue to grow at a faster pace than expected by most economists. The primary areas of job growth were healthcare, professional and business services and hospitality.

Inflation lower than expected. This data point one may be the most surprising. Since tariffs were introduced in April, inflation has continued to moderate. The explanation is once again related to the service sector. Inflation in the service sector which has been stubbornly high since the covid crisis, has started to moderate. This has (so far) offset price increases caused by tariffs. Another factor, suggested by a group of economists known as monetarists, could be that the money supply has grown at a slower rate in recent years. Monetarists believe that inflation is primarily caused by the Fed injecting too much money into the economy, so with money supply growing at a slower rate as the Fed withdraws the liquidity it created during Covid, inflation should continue to come down.

It is possible that economists overestimated the impact the tariffs will ultimately have on the global economy. First, the size of global trade, while significant and extremely important, is probably less than generally thought. Consider for example that U. S. imports from China, at roughly $400 billion last year, are only 1.8% of the U. S. economy. Total imports from all countries are roughly 15% of US GDP. Second, the ability of US companies to react to tariffs was underestimated. For example, on Apple's first quarter conference call on May 1, 2025, CEO Tim Cook described how the company was changing its manufacturing of iPhones so that as many of the iPhones sent to the US as possible came from India rather than from China, since India has lower tariffs. In the longer run, Apple has also committed to manufacturing more in the U.S. which will of course not be subject to tariffs.

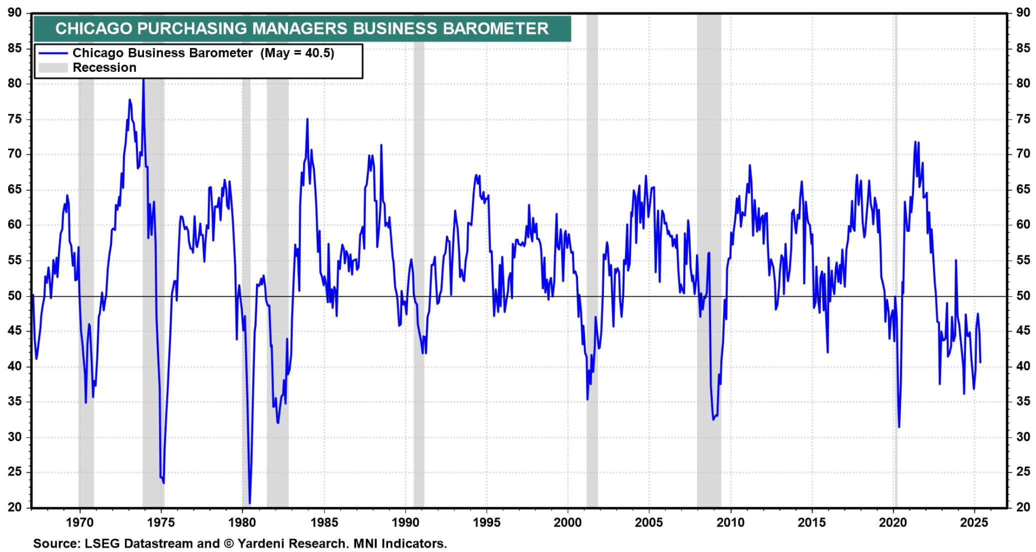
It is now mid-July and the 90-day period to reach new tariffs agreements has ended. Unfortunately, only a handful of countries have reached tariff agreements with the US. Our expectation is that the negotiations will continue over the summer and that some sort of agreements will be worked out with the US's major trading partners. In the meantime, there is likely to be higher than usual volatility as financial markets react to every new development.

In mid-April, the stock market briefly reached a very attractive level of valuation, one which was approximately the same as at the market low in 2022. The ferocious rally since has put the market back at a slightly overvalued level, making it vulnerable in our view to a correction at some point this year.

Sentiment Remains Weak Despite Economic Resilience

One of the tools economists use to forecast the economy is the sentiment survey. Sentiment surveys involve asking people (sometimes regular people, sometimes CEOs or company purchasing managers) how they feel about the economy, what they foresee for the next year, and their overall concerns. Historically these surveys have provided a window into future economic activity. Economists use them along with actual economic data in making their forecasts.

Not surprisingly sentiment surveys turned very negative early in the year with all the news about the tariffs. So far at least, the surveys have proven to be wrong. Interestingly, this appears to be part of a larger trend. Several recent articles point out that in recent years, sentiment surveys have become less useful than in the past. Specifically, sentiment indicators have been much more negative than the actual so-called "hard" data. Consider the following chart of the Chicago Purchasing Managers Index:



As you can see, in the past, almost every downturn in the survey has coincided with a recession (the grey areas on the chart.) In the current period, however, the survey has been negative for over a year, and there has been no recession. Explanations for this phenomenon range from the difficulty of getting people to respond to surveys in today's world, to the possible political bias of some respondents, to the potential for negative "group think" caused by too much exposure to financial media which tends to focus on negative stories. We don't know which of these is correct, but for now at least, it is better to look at actual economic numbers than at surveys which are proving to be increasingly unreliable.

Thank you as always for being a client. Please feel free to reach out to Roger or me if you would like to discuss your portfolio.

Best regards,

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