Markets & Investing: Sifting Through the Headlines

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Welcome to 2025! Is your head spinning yet? It feels like several years have passed since the end of 2024. Investors are currently grappling with the economic and market implications of the recent US election, the future of Artificial Intelligence (AI), and trade tensions. These issues have heightened investor anxiety recently and are likely to demand a great deal of our attention for the foreseeable future. Let's take a moment to put some structure around the noise and discuss portfolio positioning.

US Economy on Firm Ground

Let's start with some good news! The US economy is on a solid footing coming into 2025. Businesses and consumers alike have done a fantastic job locking in low-interest rate debt prior to 2022's interest rate spike. This has allowed the US economy to not only avoid recession, but also continue to grow at a rate that is the envy of many, if not all, major economic peers. The US has also made meaningful strides in taming inflation. The Fed has responded with three recent rate cuts totaling 1%. Earnings growth of the S&P 500 has been tremendous since the nadir of the pandemic-driven recession. Earnings expectations for the S&P 500 for 2025 remain robust and indicate broader participation across sectors beyond Technology. Credit spreads, the excess premium corporate bond investors require over the reference rate of US Treasuries, indicate calm conditions and strong credit worthiness. The US consumer continues to spend briskly with sentiment bolstered by a good job market, appreciation in home values, as well as their retirement plan and brokerage accounts. US corporate balance sheets remain strong, business capital expenditures remain robust, and the environment for mergers and acquisitions appears to be on a firmer footing than recent years.

Cutting Through the Noise

So why all the consternation? Why do we feel so much anxiety? Let's talk about some of the issues getting under our skin. In the US, we have a new administration quickly driving an ambitious agenda, we have

sharp elbowed bluster on trade with our friends and foes alike, and we have news from China that their AI capabilities purportedly may rival those of the US and at a much lower cost. We also have hot and cold conflicts in many parts of the world that are exacting a tremendous human toll. That is a lot to digest.

Political Uncertainty

Recently, the new administration in the US has made headlines regarding trade, the sustainability of Federal debt and deficits, deregulation, and income taxes. Rationally, many investors are pondering how the new administration's policies may impact the economy, inflation, and capital markets. Today, we view trade threats as an opening salvo to gain negotiating leverage on a variety of issues beyond trade including immigration, defense, and the curtailment of illicit activities. Already, we have seen hawkish trade threats transform quickly into more dovish, potentially productive discussions. The transition from "hawkish to dovish" posturing may establish the pattern for future trade negotiations where the headlines are severe, but the reality is less so. Hopefully, new mutually beneficial trade agreements will be realized that encourage healthy international commerce rather than punitive "tit-for-tat" actions that would impede economic growth, lessen productivity, and fuel inflationary pressures. It is reasonable to assume that some of the price increases from tariffs on imports will likely be shouldered by end consumers, thereby pressuring inflation higher. However, increased prices from tariffs are likely to be one-time events rather than a force fueling inflation persistently higher into future periods. Federal spending has also been an area of intense focus as the newly established Department of Government Efficiency (DOGE) has begun auditing, disclosing, and eliminating Federal spending perceived as wasteful. This is not the first administration in history to take a hard look at Federal spending. Prior administrations (notably Truman and Clinton) also endeavored to broadly audit and rationalize Federal spending. While DOGE's impact remains to be seen, the sustainability of the US debt and deficits is questionable, at best and may, if left unchecked at some point in the future, threaten the US dollar's reserve currency status, stoke inflation to unhealthy levels, and send borrowing costs higher, compounding our debt and deficit issues. No doubt spending decisions and tradeoffs will be challenging and viewed as positive or negative depending on your perspective. In the coming months, we anticipate the new administration will put forward policy focused on lessening regulatory burdens for businesses and continuation of lower personal and corporate income taxes. These policies should generally be supportive of stronger economic growth, but many will require legislation. While Republicans currently have control of the House and Senate, the majority in the House is very slim and its constituents have their own ideas and opinions. The US has enjoyed and benefitted from government checks and balances for nearly 250 years. We should find a certain level of comfort that these guardrails remain solidly in place. The new administration is highly attuned to how capital markets react to its activities. Activities that may exert downward pressure on equities, cause turmoil in credit markets, or cause interest rates to move higher could

be pivoted away from quickly. Let's agree that we will experience a steady stream of noise from Washington D.C. We will remain vigilant on developments and do our best to separate bluster from substance.

New Players in the AI Space

Now that we have the political situation sorted out (sarcasm intentional), let's turn our attention to the other easy-to-understand hot topic of Artificial Intelligence ("AI"). Recently, DeepSeek (a Chinese AI software company) released its "DeepSeek-R1" application which, to the surprise of many, has capabilities that, on the surface, appear to be on par with leading US AI models. Additionally, DeepSeek asserted that its technology was built for a fraction of the cost of US AI models, runs on non-cutting edge microchips and requires less energy to perform. The news on DeepSeek caused investors to quickly rethink their AI-related investments. Has Silicon Valley lost its competitive edge? Will the torrid pace of capital spending on AI investments be significantly curtailed? Did the US's AI lead significantly narrow? Investors are right to ask these questions as AI spending and AI's promise have been significant pillars of the US equity market's bull market and relative outperformance against international markets. While there are many reasons to be skeptical about DeepSeek's true development cost, its ability to stay on or ahead of the fast-moving AI technology frontier, and concern about how it may use user data, the most important insight from DeepSeek may be that the dawn of quality, widely available and low-cost AI tools may be upon us. The implications are profound as useful, low-cost AI tools will likely accelerate AI investment from current levels and serve as a catalyst for widespread adoption of AI by consumers and businesses. Recent earnings reports from several Mag 7 companies[1] indicate a strong commitment to sustain AI capital expenditures at high levels. Improvements of AI capabilities at lower costs is not surprising since disruptive technologies throughout time have followed a similar pattern. To whom does AI's potential value accrue to? Beyond the direct most observable beneficiaries related to AI infrastructure investments, AI productivity gains will likely boost broad economic growth and benefit a wide swath of consumers and businesses across industries and sectors. We believe AI tools are poised to drive meaningful advancements in science and technology. What will AI's impact be to labor? AI will likely destroy jobs, create new jobs, but more importantly fundamentally change the way we work and drive substantial labor productivity gains. So, perhaps we say, "change is the only constant BUT the rate of change constantly accelerates"?

Investment Outlook

Despite the noisy, fast-paced environment, we advise clients to remain committed to their strategic asset allocations that are aligned appropriately with their unique long-term goals and consistent with their willingness and ability to assume risk. We recognize a more balanced investment landscape as fixed income instruments currently offer much higher yields than in recent years. However,

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1 Microsoft, Amazon, Meta, Apple, Alphabet, Nvidia & Tesla

we continue to believe equities will provide higher long-term returns more than inflation, cash investments, and bonds. Harvesting the equity risk premium will require acceptance of greater portfolio volatility and, of course, the experience of an occasional drawdown. We continue to rebalance client portfolios periodically following a "trim high, add low" process.

The US economy, by many measures, remains on a firm footing supporting an outlook for solid 2025 earnings for the S&P 500. The US also enjoys many fundamental strengths including well developed laws, deep and well-organized capital markets, an extremely productive labor force, abundant natural resources, the best universities in the world, and a culture centered on innovation and entrepreneurship. These strengths will likely sustain a healthy bid for US assets as the US remains the venue of choice for capital allocators globally. As noted before, we anticipate a continuation of AI capital expenditures and accelerating adoption of new AI tools which will likely be supportive of economic growth. This will likely provide a favorable backdrop for US companies across a broad array of industries and sectors. For these reasons, US equities remain the centerpiece of our equity allocation. Are US equities overvalued following a strong run? The US bull market has been well supported by fundamentals as the growth of earnings and free cash flow of the S&P 500 has been tremendous. Much of this success has been driven by Mag 7 companies which now represent a significant percentage of the S&P 500. The significant weighting of the Mag 7 names skews the S&P 500's valuation metrics to the higher end of its historical ranges. While we maintain healthy exposure to Mag 7 names and believe they deserve premium valuations given their outstanding financial results and strong growth profiles, we find value in a more broadly diversified US equity allocation and emphasize investment opportunities in high-quality companies with less demanding valuations. We continue to maintain a reasonable allocation to International Developed equities as many valuation metrics are at historical lows relative to the US and believe they will provide diversification benefits. There are signs of life in International Developed equities as they have outperformed US equities so far in 2025. We do not maintain an allocation to Emerging Markets as we remain wary of unfavorable trends, particularly in China, which is currently grappling with a significant credit-fueled real estate correction and faces problematic long-term demographic trends, severely limiting the Country's economic growth potential. We believe our equity positioning offers an improved risk/reward profile and downside protection relative to the S&P 500.

We remain in a higher yield environment than in years past, which means forward return estimates for bonds are improved. As noted above, credit spreads indicate corporate issuers remain in strong financial shape. We continue to maintain an intermediate duration orientation for bond allocations and believe this remains an effective control for reinvestment and interest rate risk. More importantly, bonds should provide a ballast to equity market volatility and provide a consistent stream of recurring income. We recommend investors with full equity

allocations and unnecessarily high cash and short-term bond allocations consider extending duration to lock in higher yields currently available. We are encouraged that inflation pressures have significantly moderated and should continue the path lower. However, we expect that it will be challenging to meet the Fed's target rate of 2% given the outlook for continued economic growth. As such, Fed rate cuts may be slower than consensus market expectations. Central bank policy outside of the US may deviate from the Fed given less robust economic outlooks.

We hope this article informs you on topics receiving a great deal of attention and provides color on our thinking and how it manifests itself in Truxton portfolios. Do your best not to let the headlines of the day increase your anxiety and derail your well-laid plans that are built to stand the test of time. Please reach out with any questions. We appreciate your partnership and look forward to what the future holds.▪