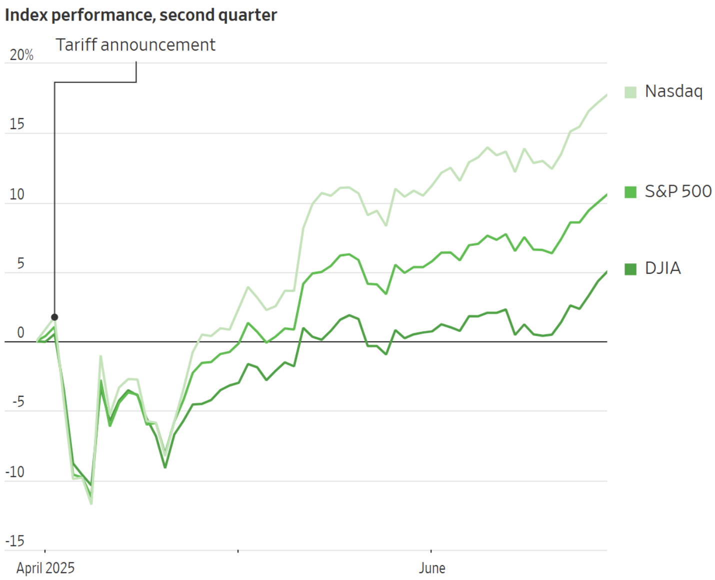
Round Trip

"Headline Driven Markets Suck."– **Walter Deemer**

The stock market entered the second quarter down about 8% from all-time highs and then on April 2nd (Liberation Day), the Trump Administration announced an unprecedented level of tariffs on countries around the world, triggering a sharp market selloff. As investors questioned the administration's strategy, markets fell into a 4-day free fall and eventually ended down nearly 20% from the highs set in February. Then, on April 9th, the administration announced a 90 day pause on the tariffs and markets began a massive rally. This pause on tariffs has now been dubbed the TACO trade (Trump Always Chickens Out) and markets rallied about 15% into quarter end and have now hit all-time highs at this writing. Despite the chaos, the S&P 500 ended the first half up 5.5% on the year.



Although bonds were flat to slightly down for the quarter, they are still up nearly 2.5% (*Barclays Aggregate Index*) on the year as interest rates have stayed relatively calm despite the overall stock volatility.

Foreign markets continued to perform well and are now up 18% on the year (*MSCI EAFE*). Approximately half of this return can be attributed to the US Dollar weakness. The other major source of outperformance relates to the Defense Sector in Europe as many countries in NATO are now going to invest a larger portion of their GDPs. This is the largest outperformance of international stocks versus US stocks since 1993.

Below we discuss the 2nd quarter and current market conditions and the positives and potential risks for the balance of the year.

Q2

In our last newsletter, we spent a lot of time on the Tariffs, and we ended by saying "this too shall pass." If every correction ended as quickly as this one, investing would certainly be easy. The resilience of the market despite the tariffs and the geopolitical tensions is truly amazing. Fears of rising inflation from the tariffs and increased oil prices from the Iran conflict have failed to materialize thus far. Overall sentiment has begun to normalize as investors are now feeling more upbeat heading into the second half of the year. So, what is going under the hood?

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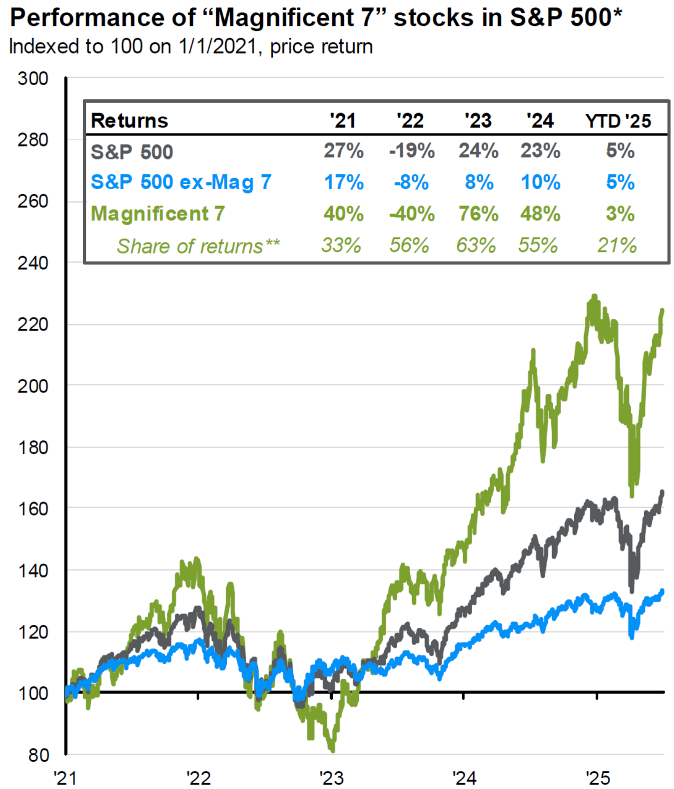
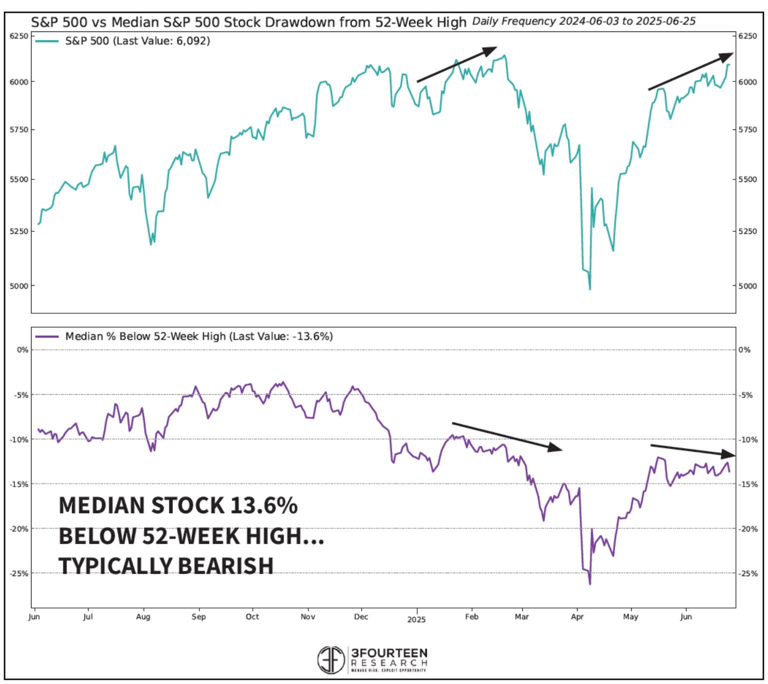
The driver of returns over the past couple of years has been the Magnificent 7 and the AI boom. As can be seen from this chart, these stocks have dominated and carried the overall market with them since 2023, representing over half of the overall returns. There have been many concerns regarding this concentration, so it is quite encouraging to see the rest of the market catching up this year. Within the Mag 7 in 2025, there has been a wide dispersion in performance with Meta, Microsoft and Nvidia continuing to perform well, while Tesla and Apple have declined around 20% on the year.

While overall stock valuations remain elevated, most of this is coming from the top 10 stocks, which carry a P/E multiple of 29x, while the remaining 490 stocks of the S&P 500 have a multiple of around 21x.



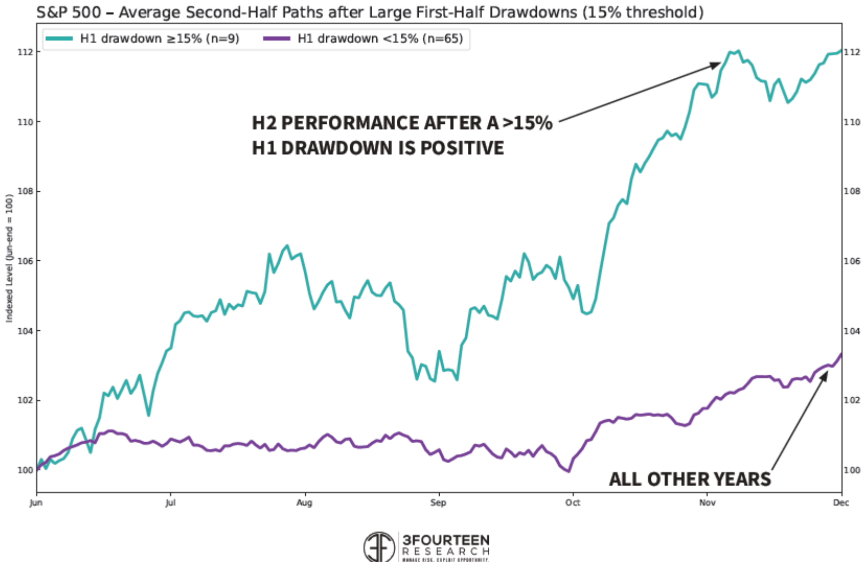
Returns	'21	'22	'23	'24	YTD '25
S&P 500	27%	-19%	24%	23%	5%
S&P 500 ex-Mag 7	17%	-8%	8%	10%	5%
Magnificent 7	40%	-40%	76%	48%	3%
*Share of returns***	*33%*	*56%*	*63%*	*55%*	*21%*

Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.



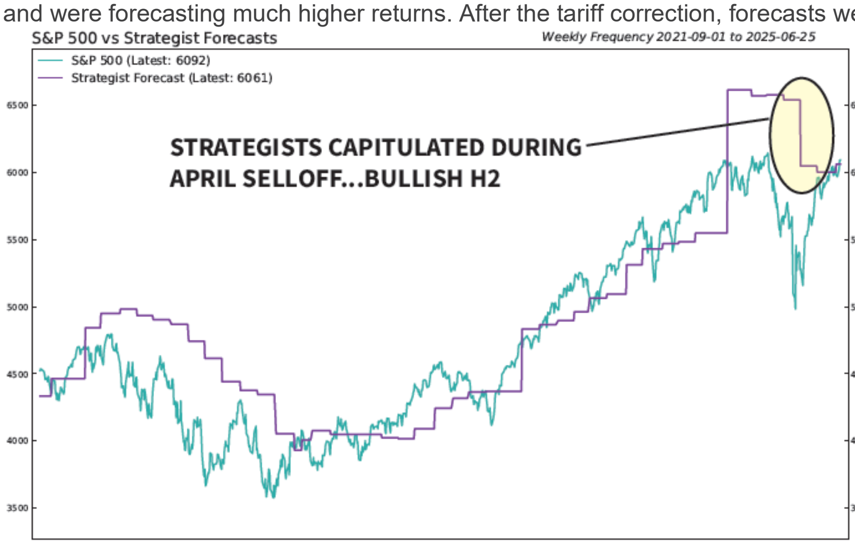
Another way to think about the valuation difference is shown on the chart to the left. While the overall market is back to all-time highs, the median stock in the S&P 500 is still 13.6% below its highs of the past year. Although the breadth could be viewed as weak, we believe this is shaping up for a reversion to the mean move for the average stock, which could carry the other 490 stocks higher into year end. Ultimately, this would lead to a much stronger overall market with far more companies participating.

2nd Half Outlook (Positives)



Since World War II, there have been 9 instances when the market has corrected by more than 15% in the first half of the year. History says that these instances typically experience strong performance in the back half of the year (*chart right*). Seven of the nine years experienced positive 2nd half performance and six of those years had gains greater than 15% in the second half. Although this is a small data set, it is indicative that we could be setting up for strong performance into year end.

Generally, in investing, it pays to go against the crowd. We have discussed strategist forecasts in the past, but it has proven to be a pretty good indicator. These forecasts are provided by the largest banks and investment firms in the US. At the end of 2024, strategist expectations had finally caught up with the market and were forecasting much higher returns. After the tariff correction, forecasts were reset by 10% and they are now at the same level as current market prices. Historically when strategist forecasts are <5% above current prices, this has translated to outperformance for the S&P 500. So, we have another good back drop heading into year end.



Ultimately, earnings drive stock returns and earnings estimates have just reached all-time highs. Although 2025 expectations have been reduced for earnings to grow by 9%, 2026 & 2027 earnings are forecast to grow by 14% and 12%, respectively. As can be seen from the chart below, when earnings per share forecasts are at all-time highs, the market tends to significantly outperform. Most importantly drawdowns tend to be much lower than the average market.

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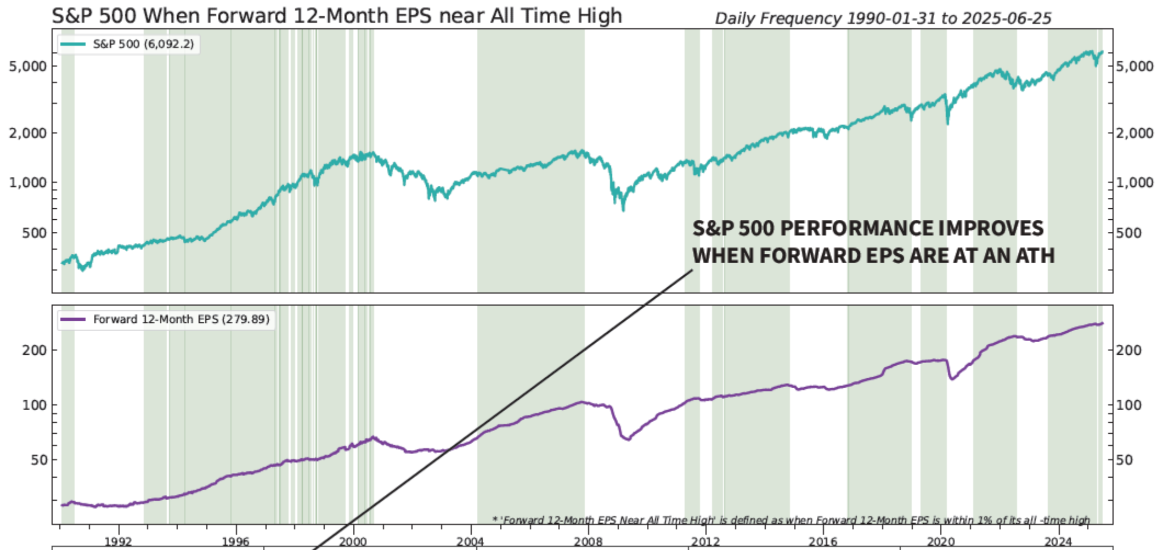
Based on the volatility in the 1st half, strategists declines in forecasts and earnings projections back to the highs, one can be quite bullish in the moment. However, there are always risks lingering.



Mode*	CAGR	Max Drawdown	Sharpe Ratio	Percent of Time
Forward 12-Month EPS ATH	12.3%	-23.6%	0.90	55.5%
Forward 12-Month EPS Not ATH	4.3%	-71.2%	0.30	44.5%
Buy and Hold	8.7%	-56.8%	0.55	100.0%

3FOURTEEN RESEARCH

2nd Half Outlook (Risks)

We believe there are two big risks heading into year end, tariffs and foreign investors. Perhaps the biggest risk at the moment is a **Fed mistake**. Many on Wall Street and even President Trump are saying that the Fed is already late in lowering rates. Although the Fed lowered rates by a total of 1% in 2024, they have been on pause since December. The 10-year Treasury is higher than it was in September when the rate cuts started and most borrowing costs have not declined, which is putting pressure on the consumer. Mortgage rates recently went above 7% again and there is a mountain of commercial real estate loans coming due in the next couple of years.

As a reminder, the Fed has two mandates, to moderate inflation and to strive for full employment. Inflation continues to decline and should be on a downward spiral for the next few months. Employment continues to slow down along with a number of leading indicators for the economy, thus this seems like a good time to start cutting rates again. However, we still have the tariff wildcard sitting out there. Deadlines were just pushed back to August, and some trade talks seem to have stalled. In the end, if we have good trade negotiations and actual deals, the Tariff risk could decline dramatically. However, if it takes more time and the ultimate tariffs end up closer to that white board from April 2nd, then we run the risk of hot inflation and a Fed with its hands tied on lowering rates and possibly having to raise rates. In the end, we lean towards the camp where tariff risks subside, and the Fed starts lowering in the fall.

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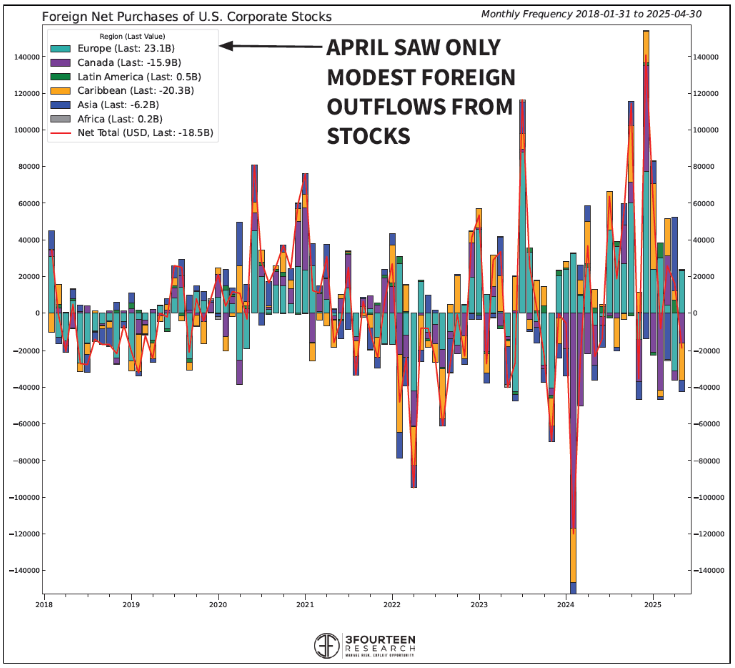
Our second major risk relates to **Foreign Investors**. When the market chaos was in full swing in April, there was tremendous fear that the dollar would lose its status as the world's reserve currency, and this would force foreign investors out of US stocks and US Treasuries. It was widely reported that the magnitude and swiftness of the declines was due to foreign selling pressure, which at the time had its largest weighting to US stocks in history. The April data is now available and according to this chart, the month showed only very modest outflows. Notably, when combining Europe and Asia, they were net buyers of US stocks for the month. Although the risk is still there, this was not the driver of markets in the decline, which is a relief. The data on US Treasuries paints a similar picture with Europe and Asia also being net buyers of Treasuries. However, Canada was a large seller reversing many of its purchases from earlier in the year.



Although there are many other risks, we believe the Fed and Foreign investors are at the top as we head into year end. It would be very typical to see some volatility in August and September, especially after having such a large move in a short period. If the Fed is able to lower rates, the dominoes could be falling into place to see a strong economy and stock market. Stay tuned.

Resources

What We Are Reading:

Two Long but great presentations on the Future of AI:

1. Update on Benedict Evans Presentation from Last Year: AI Eats the World
2. Coatue's Mid-Year Update: 2025 East Meets West Presentation

Conclusion

Thank you for taking the time to read this letter. As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall plan or risk tolerance. This is a great time of year to set up a review meeting.

Sincerely,

Canal Capital Management

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