

Economic & Market Outlook

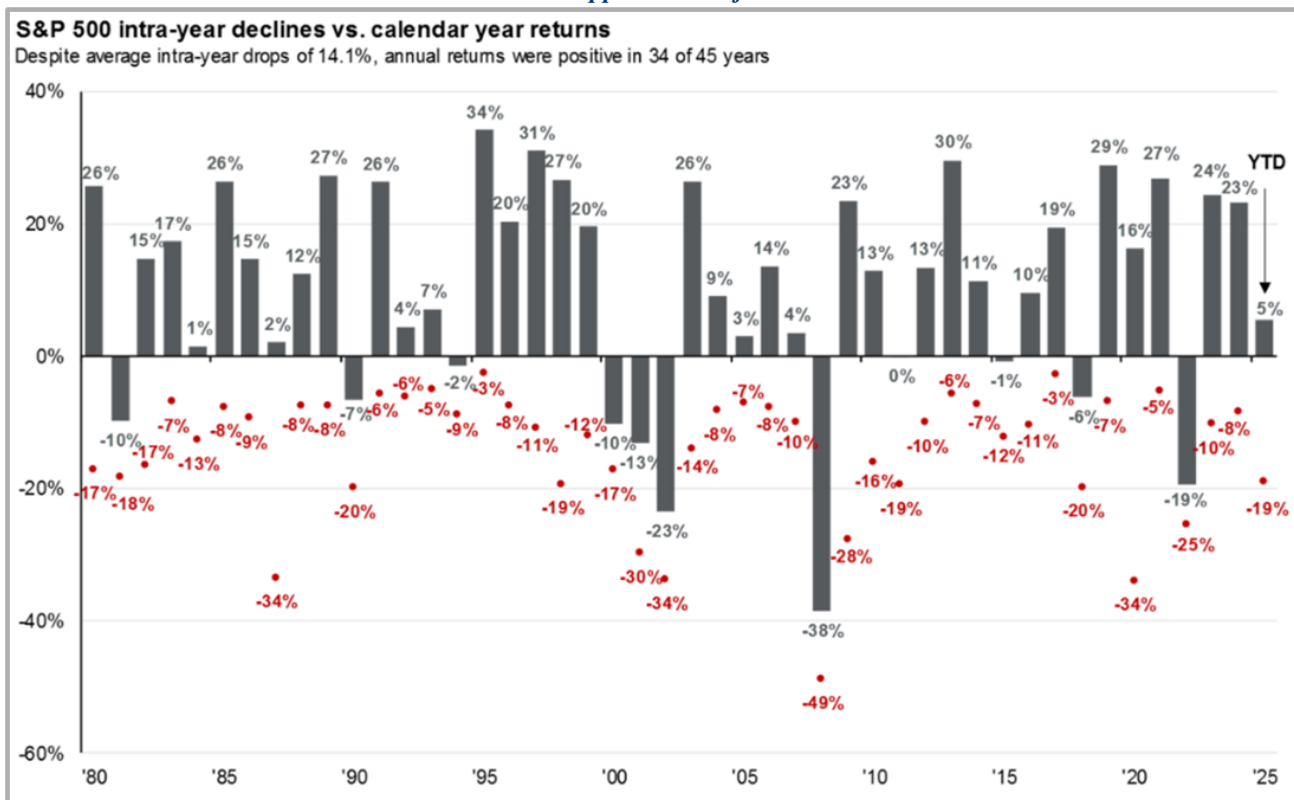
Executive Summary

- ~ The risk-on trade has returned: Equity markets staged a rally exceeding two standard deviations, pushing both equity and credit valuations near all-time highs.
- ~ Markets are dismissing policy and AI risks: Despite aggressive trade rhetoric, markets remain unfazed by tariffs. Talk of fiscal austerity has shifted toward deficit spending, and fears of an AI slowdown have yet to materialize.
- ~ The economy remains delicately balanced: The labor market operates at full employment but is showing signs of strain. Laid-off workers face challenges re-entering the workforce, and wage growth is decelerating.
- ~ The market's indifference to renewed tariff threats surprises us. Many of the newest measures revert to Liberation Day levels, and the full impact of prior tariffs has yet to filter through the economy.
- ~ Broad portfolio diversification has served us well year-to-date and given the market backdrop, we see no reason to deviate from that stance.

Introduction

Our last commentary, written just three months ago, concluded with the reminder: volatility is the successful investor's price of admission. Enduring episodes of uncertainty are required to earn equity-like rates of return. In the last decade alone, the S&P 500 has witnessed a -34% decline in 2020, -25% in 2022, -20% in 2018, and -19% just last quarter, plus countless smaller losses. Yet, stocks have compounded at 13.6% annually, or 258.9% cumulatively. Equity investing is, and always has been, a roller coaster ride.

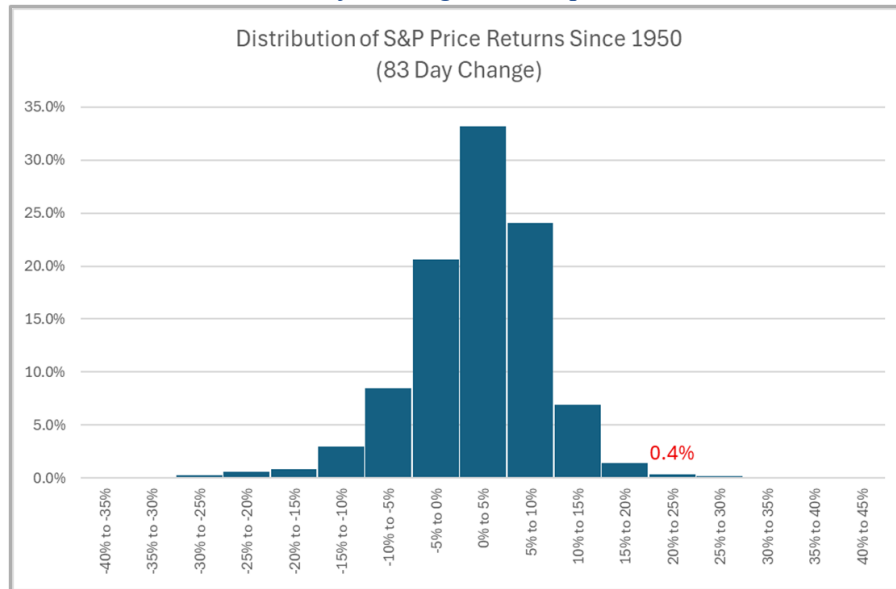
Market Drawdowns Happen More Often Than You Think



JP Morgan

Still, new all-time highs for the S&P 500 feel odd. To recover from a -19% drawdown requires a 23.5% return, which the index delivered, and then some, in less than three months. It's a stunning turn of events, and let's not forget, a war broke out amidst the rally, yet equity markets were unfazed. We ran the numbers: since 1950, bullish moves of this magnitude, over similar timeframes, have occurred in just 0.4% of observations. The stock market hardly ever rips 24.9% in under three months.

A Move of this Magnitude & Speed is Rare

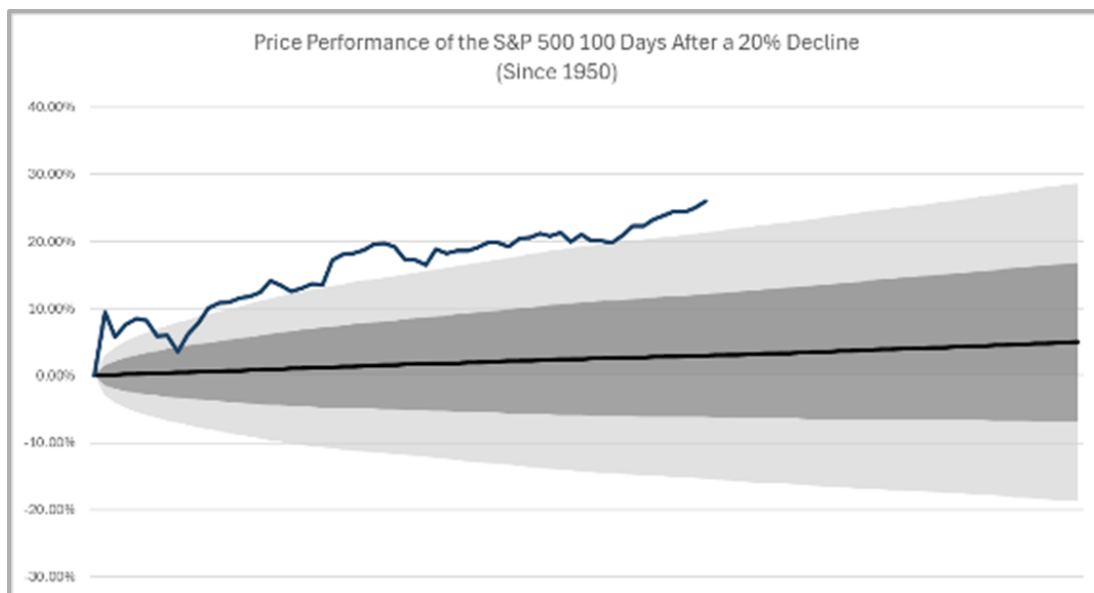


Annandale Capital

You could retort, fairly, that bullish movements of this magnitude are more likely following bear markets. That makes intuitive sense. A looming concern, like tariffs spooks the market, but if the concern is unjustified, exaggerated, or later dismissed, markets can snap back quickly. Think of COVID, Brexit, or the Russian Financial Crisis and the collapse of Long-Term Capital Management.

So, out of curiosity, we examined the S&P 500's price performance following drawdowns of 20% or more, cataloging behavior over the next 100 days. Even after changing the context window, the recent rally represents a more than two standard deviation surprise to the upside. For those not statistically inclined, 95% of observations fall within two standard deviations. The 24.9% rally since President Trump announced a 90-day pause on tariffs sits comfortably outside that range.

Even When Exiting Bear Markets a Move of this Speed & Magnitude is Rare



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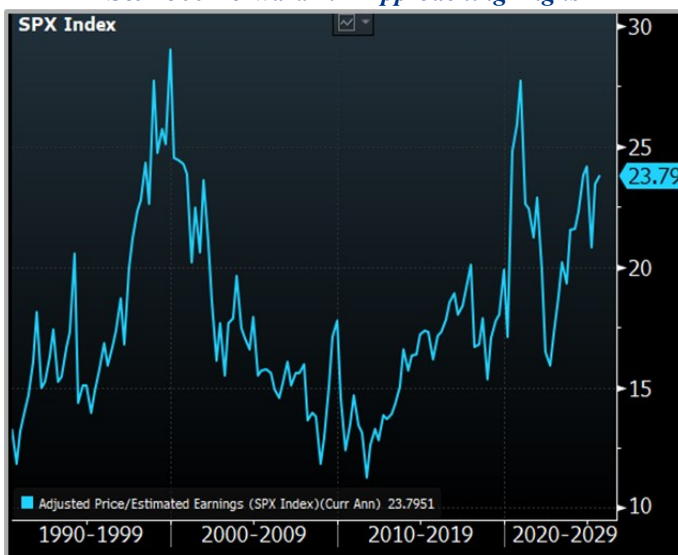
This is what makes financial markets so fascinating: almost anything can happen. They are a puzzle and having a job that lets us study that puzzle is a ton of fun.

If you can't already tell, a rally of this magnitude wasn't on our bingo cards.

Fortunately, the market's push higher has benefited client portfolios. Roughly, 60% of our equity portfolio is invested domestically. The other 40% is spread across developed and emerging ex-U.S. stocks, which has helped us a lot. Year-to-date overseas equities are up 18.3% versus 6.2% for the S&P 500. Ex-U.S. stocks even managed to outperform U.S. stocks during the second quarter. The sudden jump in U.S. stocks, while unexpected, is unequivocally good for results.

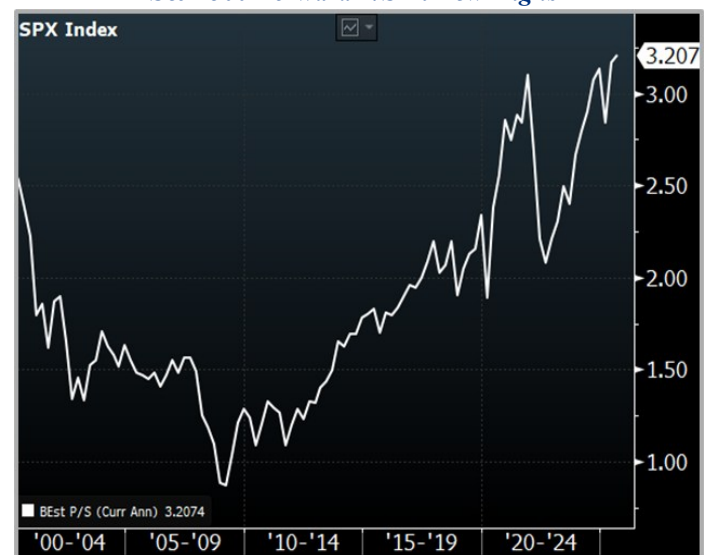
Our surprise isn't that stocks rallied, but the speed and magnitude at which they climbed. Like we said, anything can happen. It's a good reminder that trying to outguess the collective wisdom of the market is a bad idea. Making macro calls is tough; getting the timing right is even more difficult. So, we strive not to do it, and good thing, because the market corrected a lot faster than we would have predicted.

S&P 500 Forward P/E Approaching Highs



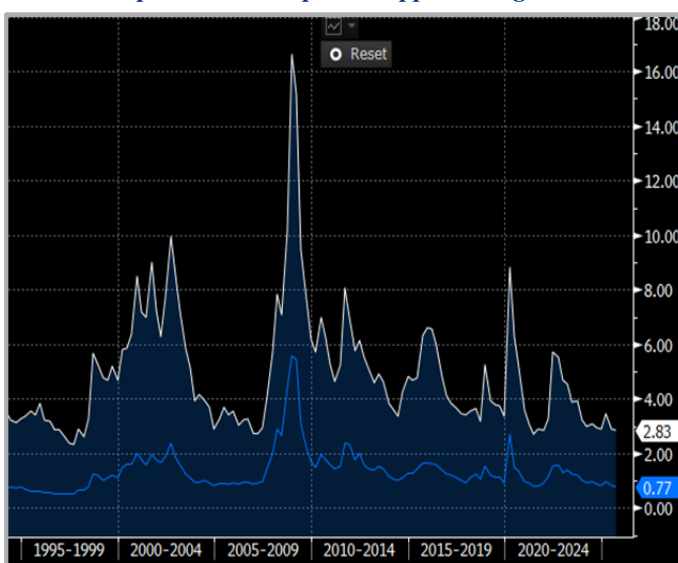
Bloomberg

S&P 500 Forward P/S At New Highs



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Corporate Credit Spreads Approaching Lows



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Implied Volatility Spike Erased



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Stock Market Narratives

So, what happened? Why did the market make a U-turn toward new highs? Why did risk appetites reemerge? We'll get there in a second, but three disclaimers are needed.

1. Financial markets never provide a counterfactual. Would this rally still have occurred had the administration moved forward with the Liberation Day tariffs? We doubt it, but we can't say for sure. Markets and economies are cloaked in mystery largely because we lack counterfactual data.
2. Perceptions can influence fundamentals, which in turn reinforce perceptions. George Soros called this loop "reflexivity," and it's constantly at play in markets.
3. Markets are made up of people - people whose behavior ranges from rational to irrational. We (Annandale) may never be comfortable paying 100x sales for a stock like Palantir, but that doesn't mean the market won't someday value it at an even crazier multiple, like 150x or 200x sales. As we said, almost anything can happen.

We highlighted these disclaimers because the idea that anyone can ascribe a perfect narrative to market behavior, even in hindsight, is preposterous. Still, our desire to understand markets keeps us trying. What follows is our best attempt to distill the market's current set of beliefs, the narrative of the market.

In early 2025, markets were discounting the potential impact of a new administration. Two policy initiatives, trade and fiscal tightening, posed immediate headwinds to the economy amid emerging cracks in the labor market. Valuations were near historic extremes, and the artificial intelligence ("AI") trade fueling mega-cap stocks was showing potential cracks. The tariffs announced on Liberation Day, along with the administration's rhetoric, overwhelmed the market and triggered double-digit equity losses.

Our conjecture is the market's abrupt U-turn and rally to new highs reflected a partial easing, if not outright reversal, of these headwinds. Of course, there is more to the story, but that is the narrative in a nutshell.

Trade Policy Reversals

Let's consider each item in isolation, starting with tariffs.

On Liberation Day, April 2nd 2025, the administration announced a series of tariffs, which if fully enacted would have increased the U.S.'s average effective tariff rate from 3.4% to roughly 25%. Brad Setser, senior fellow at the Council on Foreign Relations, equated the tariffs to a \$90 per barrel jump in the price of oil. Research from JP Morgan noted, "if sustained, this year's ~22% tariff increase would represent the largest U.S. tax hike since 1968." The announced tariff rates shocked the financial markets and business community.

The Path of the Market After Liberation Day



But that's not how the story played out.

Certain products were exempted from the quoted tariff rates later that same day (April 2nd). The following day, the President admitted his willingness to negotiate. On April 9th, in the wake of severe market declines, a ninety-day pause was announced. On April 11th, new tariff exclusions were announced for smartphones, computers, and other electronics. On April 29th, the administration announced measures to soften the impact of tariffs on automobile manufacturers. On May 12th, the US announced a 90-day pause with China, which temporarily lowered their tariffs to 30% from 245%.

There have been random tariff escalations since Liberation Day, but in aggregate, the administration appeared to be pulling back from its original stance. Robert Armstrong, a journalist for the Financial Times, even coined an acronym that gained traction on Wall Street: "TACO" – Trump Always Chickens Out - describing the administration's proclivity to make threats followed by reversals.

To be clear, this isn't a reflection of our view, but we do believe it concisely captures the new narrative of the market, extreme tariff measures, like those published on Liberation Day, are simply too painful for the administration to implement. As a result, markets believe the President's extreme trade threats are just that, threats not policies.

DOGE Spending Cuts vs. the Reality of Washington

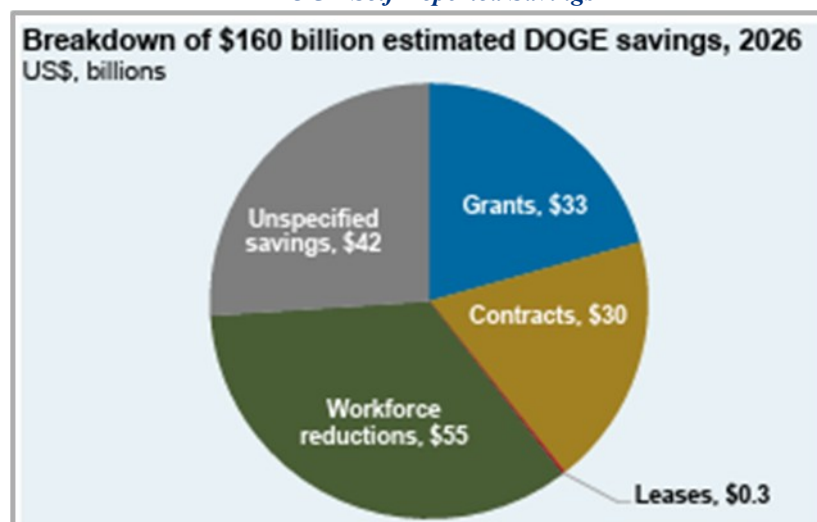
Another shift occurred around fiscal policy.

The Trump administration initially emphasized the need for federal spending cuts, openly acknowledging that such cuts, though painful, were necessary for long-term fiscal sustainability. Political views aside, government spending is a direct infusion into the economy. GDP is defined as consumption plus investment plus government spending plus net exports. Even if the private sector is better equipped to allocate resources, transitioning away from public sector spending creates an uncomfortable adjustment period. The administration understood this and was vocal that such a transition was necessary.

"There's going to be a natural adjustment as we move away from public spending to private spending. The market and the economy have just become hooked." – Secretary Bessent

Through executive order, the administration created the Department of Governmental Efficiency ("DOGE"), aiming for \$2 trillion in annualized budget savings. Ultimately, DOGE's self-reported tally landed closer to \$160 billion. Conservative think tanks, including CATO, AEI, and the Manhattan Institute, estimate actual savings between \$5 billion and \$63 billion. Whichever number you choose, it's clear the cuts were far smaller than initially expected, a relief to financial markets given the contractionary impact deep cuts might have had.

DOGE Self-Reported Savings

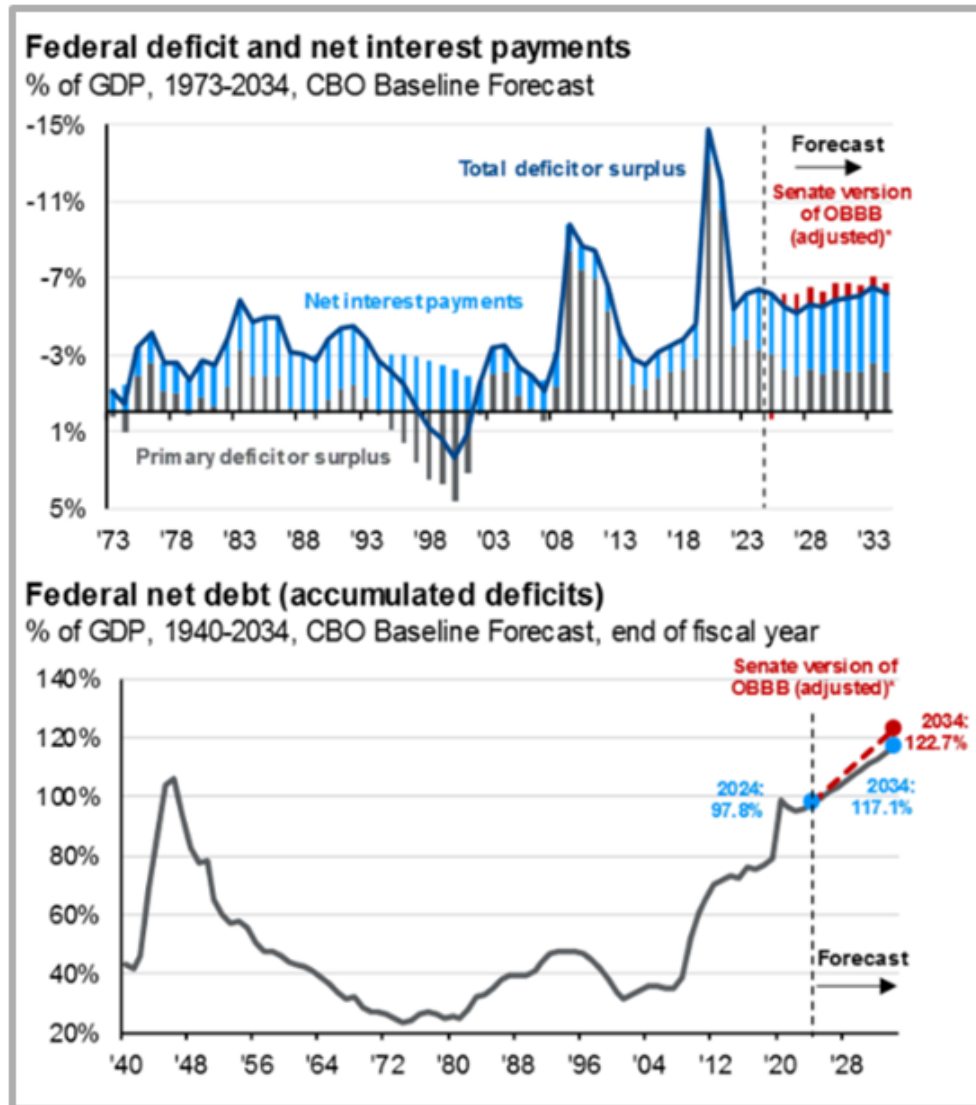


JP Morgan

Then came the Big Beautiful Bill, signed into law on July 4, 2025. It not only permanently extended the 2017 Trump tax cuts but expanded them. The state and local tax (SALT) deduction cap was raised from \$10,000 to \$40,000. Proposed spending cuts faded as the bill moved through Congress. Importantly, the stimulative elements, namely tax cuts, were front-loaded, while the spending cuts were pushed to the back. The CBO estimates the bill will add \$3.3 trillion to the primary (non-interest) deficit. That's a large fiscal impulse.

Remember, public sector deficits equal private sector surpluses, meaning a significant injection of funds is heading towards our economy because of this bill.

CBO Forecast of the Deficit



JP Morgan

100 Trillion Tokens: The Relentless Growth of AI Spending

Next up: AI.

From its January peak, Nvidia dropped 36.9%, and the Magnificent Seven collectively fell 28.5%. Most of that decline occurred before Liberation Day. While the exact catalyst is unclear, the timing aligns with DeepSeek's launch and more importantly, reports that Microsoft was pulling back from data center leases.

The data center business is big and growing fast.

From a capital markets perspective, the ten largest U.S. stocks account for 37.9% of the S&P 500, six of those stocks (Nvidia, Broadcom, Microsoft, Meta, Alphabet, and Amazon), 27.2% of the index, are all-in on AI. The market's true exposure to the AI theme is much larger once you account for the likes of Oracle, Palantir, Coreweave, etc.

From an economics perspective, Nvidia's data center revenue is forecasted to hit \$179 billion this fiscal year and \$229 billion next year. Given that GPUs typically represent about half the cost of a data center, capital spending related to AI could comprise 1.3% to 1.7% of U.S. GDP this year and next. Our math is likely understated, because it doesn't adequately account for competing chips, and the economic impact on adjacent industries, like power and construction. Barron's cited an analyst who estimated total investment in upcoming and under construction data centers at \$750 billion, about 2.7% of GDP.

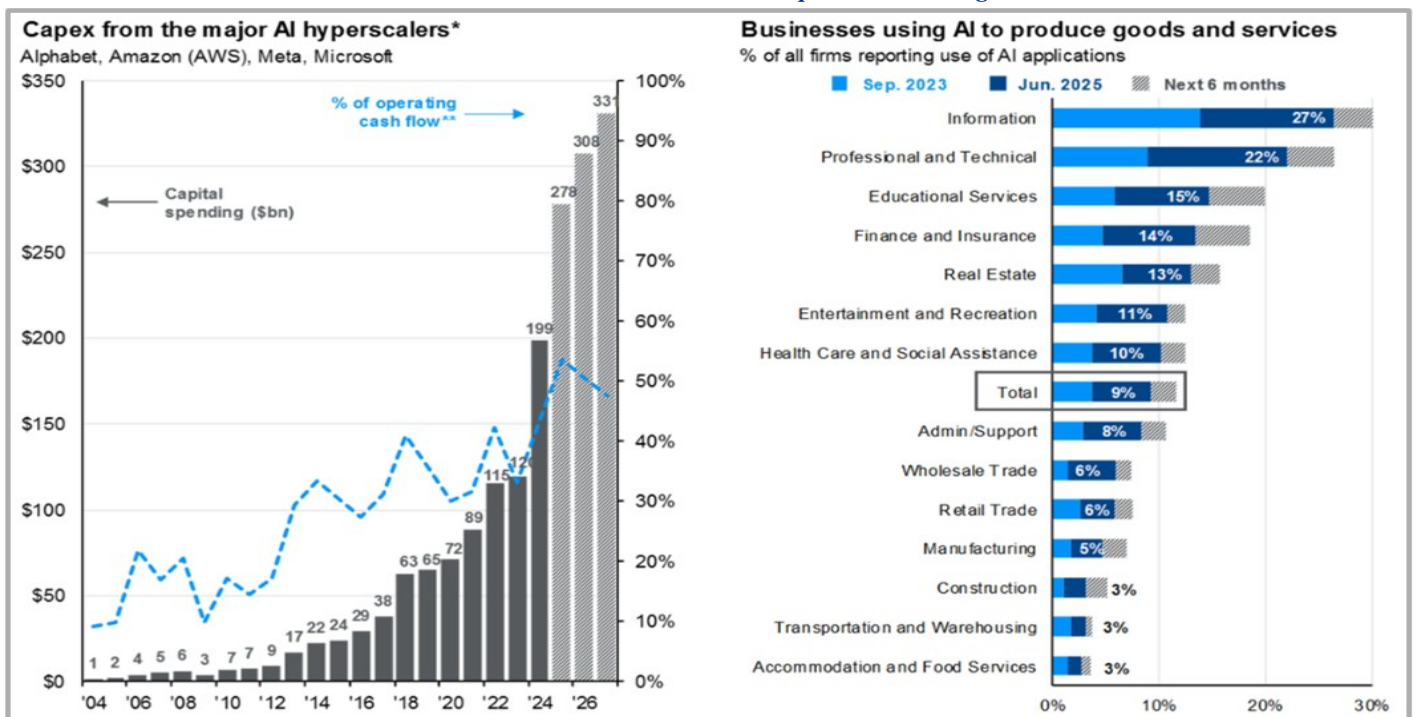
Regardless of the precise number, the point remains: AI is a big bet for both the U.S. economy and financial markets.

The Mysterious Boom in "Structures" is Datacenters



Yardeni

CAPEX Hasn't Slowed Yet & Adoption is Climbing



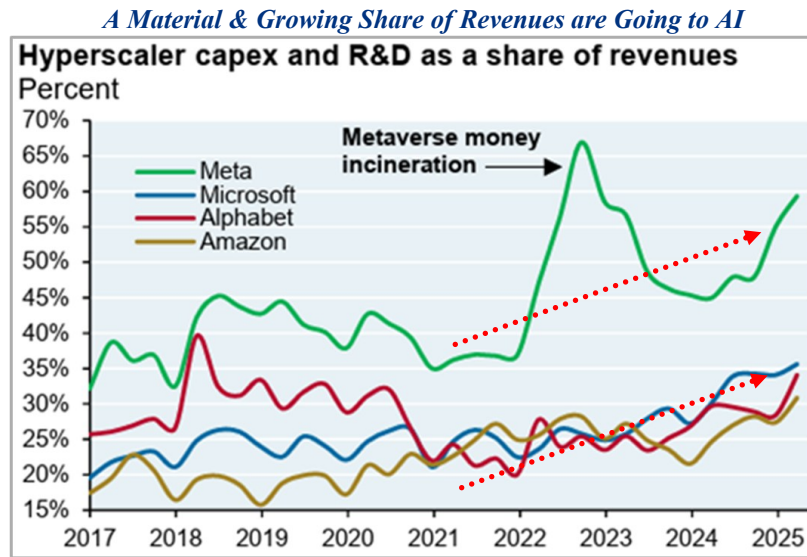
JP Morgan

The market's initial concerns of a data center slowdown quickly faded when the quarterly earnings season arrived. From Microsoft's earnings call:

"While we continue to bring data center capacity online... demand is growing a bit faster. Therefore, we now expect to have some AI capacity constraints beyond June."

Across the hyperscalers, Microsoft, Alphabet, Amazon, and Oracle, revenue growth was strong. Microsoft is the only hyperscaler to break out AI specific revenue, which grew 154% year-over-year to \$3 billion. Microsoft also disclosed token growth. Tokens are the individual units of text fed to a large language model. As we transition from a world of model training to inference, the number of tokens processed will serve as an indication of AI adoption and growth. From the call:

"we processed over 100 trillion tokens this quarter, up 5x year-over-year, including 50 trillion tokens last month alone."

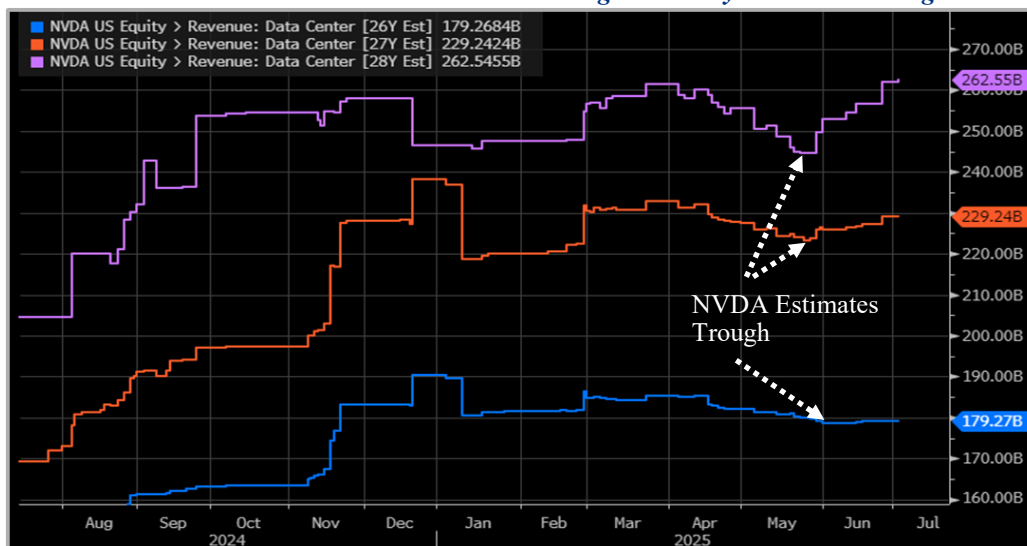


JP Morgan

Spending on AI related ventures has not slowed. If anything, it has accelerated. Meta reportedly offered \$200-300 million compensation packages and invested \$14.8 billion in ScaleAI, just to poach their CEO. Who knew the market for AI talent would mirror that of professional sports?

The level of spending is wild, and it's clear the AI race is still moving at full throttle despite prior concerns.

NVDA Data Center Revenue Estimates Troughed in May and are Climbing



Bloomberg

Financial Conditions & Wealth Effects

Of course, there is more to the story than just a reversal of prior concerns.

Jerome Powell's term expires in less than a year (May 2026). The administration, a vocal critic of Powell, has already lined up potential replacements. The reported front-runners are Kevin Warsh and Kevin Hassett, both seen as advocates for more dovish monetary policy. Powell or not, the market expects rates to fall, with nearly five quarter-point cuts priced in between now and the end of 2026. Two cuts are already priced in before the end of this year. That expectation alone, of easier financial conditions, is enough to loosen financial conditions in the present.

Implied Odds of a Fed Rate Cut

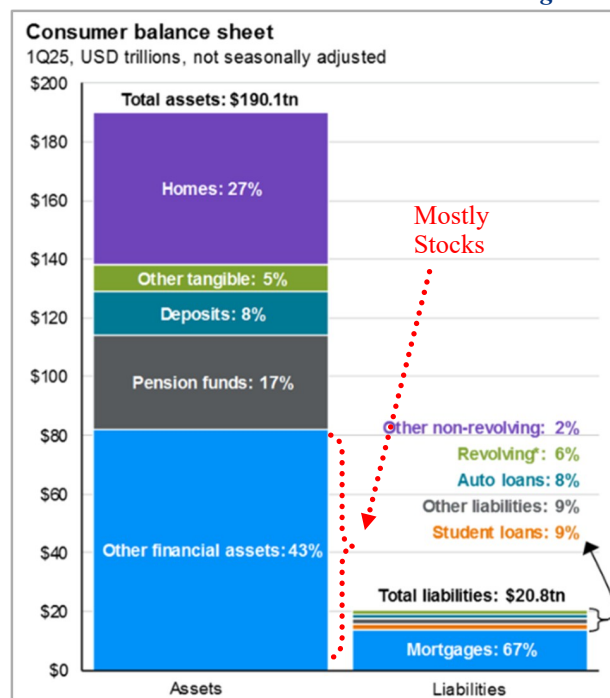
Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate
07/30/2025	-0.067	-6.7%	-0.017	4.313
09/17/2025	-0.743	-67.6%	-0.186	4.143
10/29/2025	-1.347	-60.4%	-0.337	3.993
12/10/2025	-2.061	-71.4%	-0.515	3.814
01/28/2026	-2.487	-42.6%	-0.622	3.708
03/18/2026	-3.025	-53.7%	-0.756	3.573
04/29/2026	-3.327	-30.3%	-0.832	3.498
06/17/2026	-3.841	-51.4%	-0.960	3.369
07/29/2026	-4.157	-31.6%	-1.039	3.290
09/16/2026	-4.488	-33.1%	-1.122	3.207
10/28/2026	-4.597	-10.9%	-1.149	3.180
12/09/2026	-4.724	-12.7%	-1.181	3.148

Bloomberg

Lastly, we'd be remiss if we didn't mention the tremendous wealth effect of higher stock prices. Today, 62% of U.S. adults own stocks. According to the Federal Reserve, direct and indirect equity holdings account for 29.2% of household assets, roughly the highest level on record. For the first time in history, stocks represent a larger share of household assets than real estate.

While equity ownership is concentrated among the top 10% of households, it's worth noting that this group accounts for over half of total U.S. consumption. So even though the wealth effect may not be broadly distributed, it is economically significant. Every upward tick in stock prices meaningfully impacts the group of Americans who spend the most. Consumption accounts for 68.3% of GDP. So long as equity prices rise, the top 10% are unlikely to feel pressure to rein in spending.

Stock Prices Matter More Than Housing



JP Morgan

An Alternate Reality

When you put it all together, the narrative that played out seems quite different from what many expected:

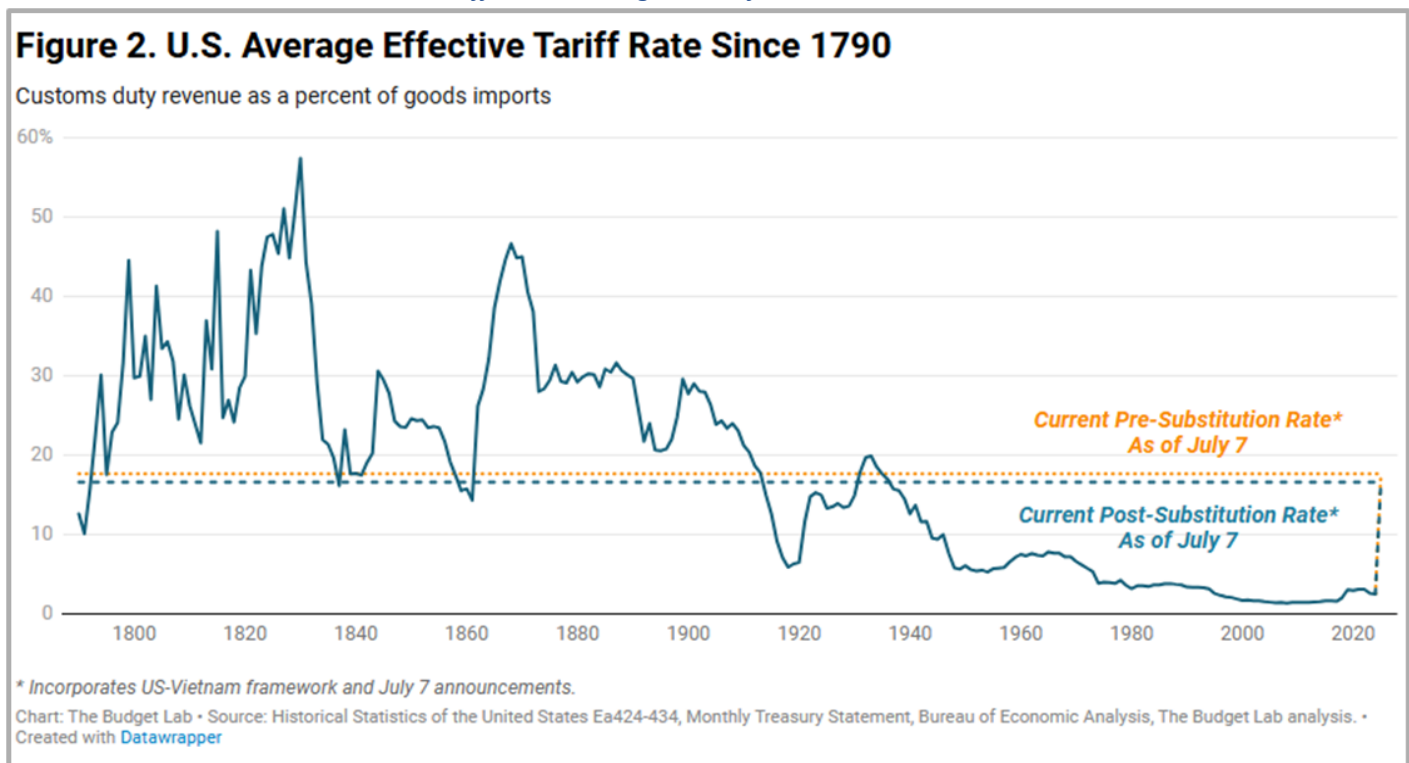
1. Tariffs don't matter and, at worst, are just threats.
2. What spending cuts? Policymakers will always choose to run the economy hot.
3. AI is eating the world, and nothing will stop it.
4. Good things beget good things.

Our natural disposition, perhaps a permanent one, is to be conservative. And there are several aspects of today's market narrative that trouble us, especially the tariff story.

Trade Policy Revisited

We find the market's ambivalence toward trade policy surprising. Yes, the administration backed off its harshest threats, but even the toned-down tariffs are sizeable. In 2024, the effective tariff rate averaged 2–3%. It has already surpassed 9%, and when (or if) the current pause ends, the effective rate could nearly double, taking the U.S. back to tariff levels last seen in 1934.

The Tariff Shock is Large Even After Pauses / Trade Deals



The Budget Lab

The economic impact of the enacted tariffs is not yet well understood by markets. And if St. Louis Federal Reserve President Alberto Musalem is correct, it could be a while before any judgment can be made. As he said:

“It’s going to take time for the tariffs to settle... There’s a scenario where we could be in Q4 this year, or Q1 or Q2 of next year, where tariffs are still working themselves into the economy.”

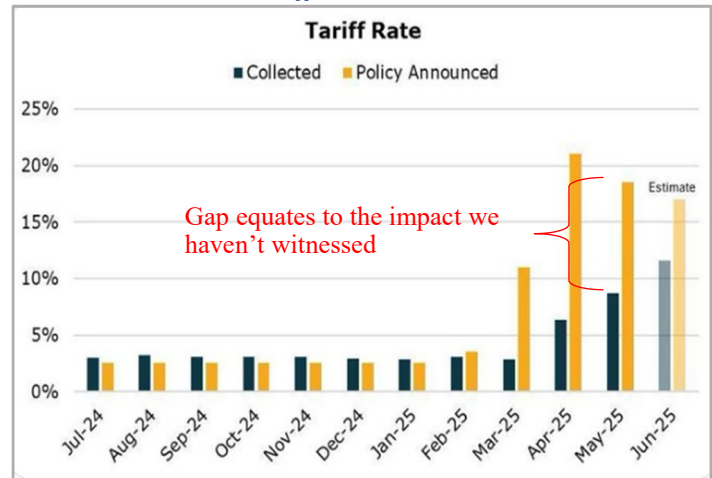
We don't know the precise timing, but there are several reasons to expect a lagged effect. First, U.S. Customs must adapt internally, updating staffing and systems, to enforce the new tariffs. Second, in May, we saw a massive spike in imports (especially pharmaceuticals) as U.S. firms stocked up in advance of implementation.

Front Running Tariffs



Brad Setser

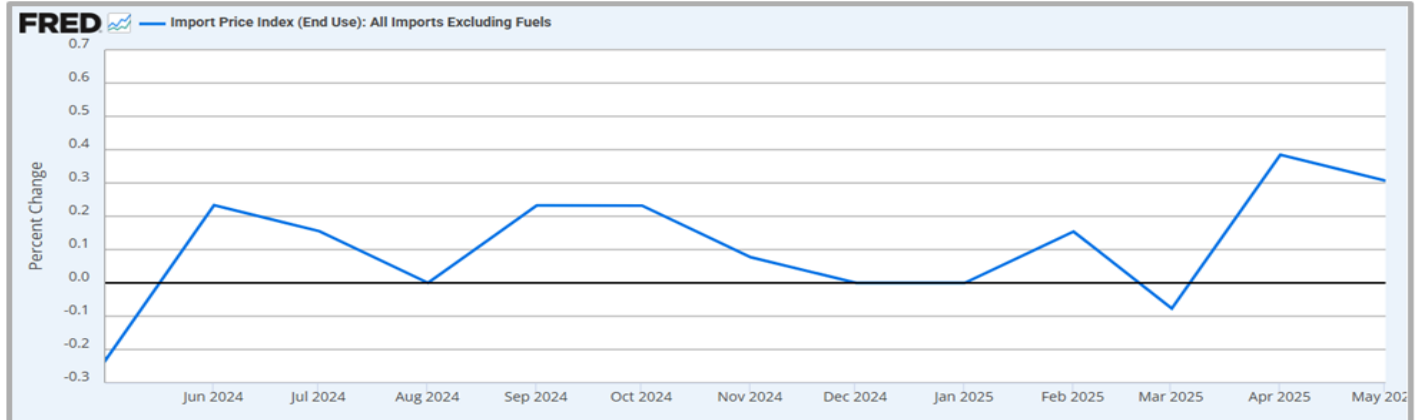
The Full Effect Hasn't Been Felt



Bob Elliott

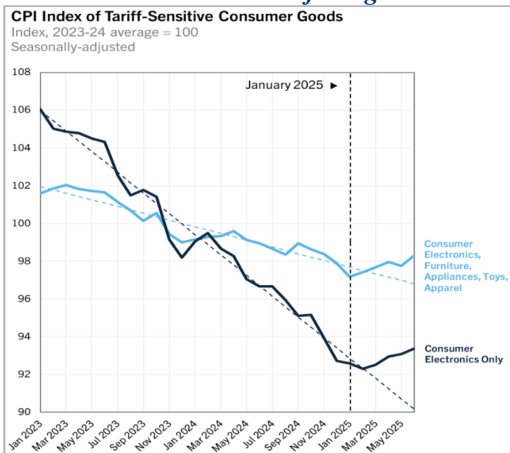
The only notable movement in the data is in goods prices, a small subcomponent of CPI. After a prolonged deflationary stretch, they have edged higher. The same is true for import prices, excluding food and fuels. If producers (exporters) were absorbing the full cost of tariffs, we'd expect import prices to fall by the size of the tariff. That prices are rising suggests costs are being passed on to U.S. corporations or U.S. consumers. It's still early, and the data doesn't paint a clear picture, but it's a trend worth monitoring.

If Exporters Were Eating Costs Import Prices Would be Falling (Negative)



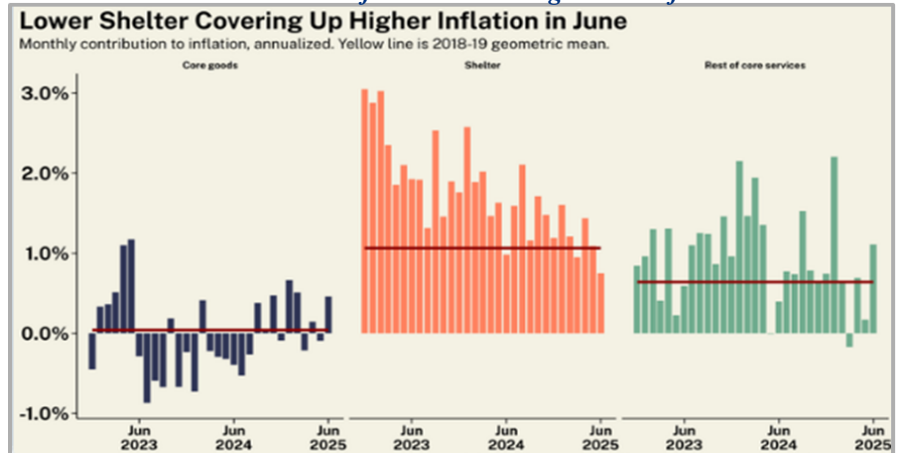
Federal Reserve

Goods Prices Inflating



Ernie Tedeschi

Shelter/Services Deflation is Masking Goods Inflation



BLS, Mike Keneczek

There is also a more unnerving irony in the market's apathy. If the April selloff constrained the administration's willingness to impose tariffs, will a strong market embolden them to try again? Just as there may be a Trump put during market turmoil, is there now a Trump ceiling when things are going great?

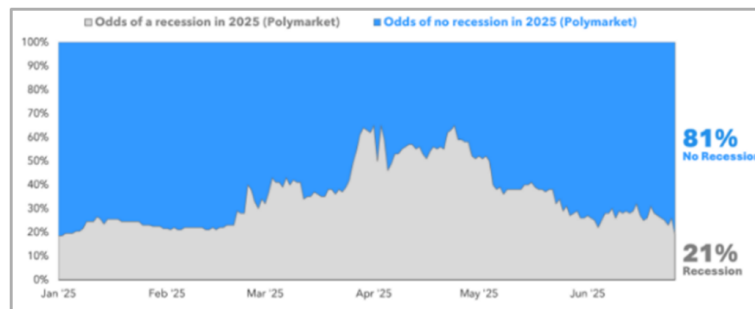
This month alone, we've seen a bevy of new tariff threats, which markets seem inclined to shrug off. On July 8th, "Letter Day," President Trump sent letters to a range of countries, including Japan and South Korea, outlining new tariff rates effective August 1st. The list spanned 22 countries, with tariffs ranging from 25% to 40%. Additionally, the President is threatening a 50% tariff on Brazil - not for trade reasons, but in response to its prosecution of former President Bolsonaro. On July 11th, a 35% tariff was proposed for certain Canadian goods, and the President floated increasing the blanket rate on all trading partners by 5–10%. On July 14th, Mexico was threatened with 30% tariffs on non-USMCA goods, and the EU was told they would receive a 30% tariff if a trade deal couldn't be reached soon. There is a ton we are leaving off, like the 50% copper tariff, but it's hard to keep track of it all. In aggregate, the new tariffs look and feel a lot like those announced on Liberation Day.

We have no idea if these new rates will stick, or if this is simply the TACO trade all over again. The new August 1st implementation date is, in some ways, a slight concession. But as George W. Bush famously said: "Fool me once, shame on you. Fool me twice, shame on me."

The Precariously Balanced Economy

While recession fears may have subsided, it's hard to argue that the economy has received an all-clear signal.

Betting Markets (PolyMarket) Recession Odds



Compound, PolyMarket

The labor market is currently balanced on a knife's edge. On the positive side, the economy is operating at full employment, with the unemployment rate at 4.1%, and initial jobless claims remain within seasonal norms. On the negative side, continuing jobless claims are elevated, and the number of individuals classified as permanently unemployed is rising. Nick Timiraos of The Wall Street Journal described it as a "slow-to-hire, slow-to-fire labor market." This dynamic has undermined workers' bargaining power, leading to slower wage growth. If that trend continues, it could reduce household spending capacity.

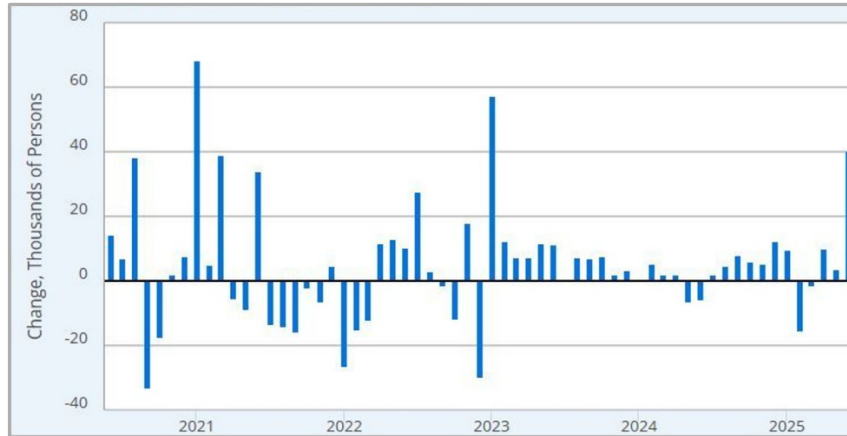
Growing Labor Supply Enables Lower Wage Growth



WSJ, Nick Timiraos

Additionally, we're seeing conflicting signals in the employment data. On July 2nd, the ADP employment report showed a contraction in private payrolls. A day later, the Bureau of Labor Statistics released a report showing that the U.S. economy added 147,000 jobs in June, enough to nudge the unemployment rate down by 0.1%. While discrepancies between these reports are common, outright divergence in direction is less so. A major contributor to the difference was hiring in state and local government. The data suggests the labor market for private sector jobs is considerably weaker than that for public sector jobs.

Change in Payrolls: State Government



Federal Reserve

We wouldn't read too much into the data, either positively or negatively, since it's backward-looking. But we do think it's worth pointing out that while a 2025 recession may have been avoided, the economy remains in a fragile state. When labor markets contract, it sets off a nasty feedback loop: newly unemployed individuals cut spending, which then leads to more job losses.

Wisdom of Crowds

It always feels cliché to write about the wisdom of crowds, but the lesson is a good one. The central premise is a random crowd's collective estimate, of anything, tends to be more accurate than the opinion of an expert. The quintessential example is to ask a crowd how many jellybeans are in a jar. Individual estimates will be all over the map, some way too high and some way too low, but the errors average out.

Financial markets are an aggregation of opinion, some too extreme and others too conservative, but the collective opinion tends to be about right. Tariffs, our economy, and the impact tariffs might have on our economy are probably the most hotly debated topics at present. You could add the state of AI spending to that list. It's hard to imagine having an edge over the market in any of those topics.

There are two caveats though. For the wisdom of crowds to work, an individual's opinion needs to be independently derived. The groupthink or herding of thought that happens at market extremes breaks down the power of collective thinking. Somewhat related to the first point, you also need thought to be decentralized. The group making the estimates needs to draw from their own wisdom and experiences rather than obtaining information from some central authority. To us, this is a lesser concern, but the tribalism that is associated with politics, and in turn policy, plus the prevalence of social media as a means of spreading information, probably impairs the collective.

Conclusion

If there's any wisdom to be gleaned from this admittedly meandering commentary, it's this: don't try to time the markets. Nine times out of ten, the broad markets (stocks, bonds, FX, etc...) are several steps ahead of you. Financial markets aren't reacting to current conditions; they're reacting to what conditions might look like months, quarters, or even years from now. If you try to outguess the market, you will likely get it wrong, impairing your capital and drumming up unnecessary taxes along the way.

Yes, valuations are high, and yes, that concerns us. But moving to cash would require extreme signs of froth, ones we haven't yet seen. Eventually, something negative will happen, and it will hurt. Maybe it's the impact of tariffs. Maybe it's an AI disappointment. Maybe it's something completely unexpected. Odds are the market will sniff it out before you do, and there won't be any single factor you can point out.

As we said at the outset: volatility is the price of admission for successful investors.

The only truly proactive step investors can take is to diversify risks, so that portfolios can withstand a wide range of environments. You don't have to be all-in on the AI trade to earn good, risk-adjusted returns. The market is bigger than just the S&P 500, and we are constantly looking to take advantage of that.

If the aggregate balance sheet of Annandale Capital served as a proxy for the typical client portfolio, you would find that:

- A quarter of our investments are in safe securities, predominantly Treasuries and government-backed mortgage bonds.
- Half of our investments are in equities, 60% of which are U.S. stocks with the balance split between ex-U.S. developed and emerging market companies.
- A quarter of our investments are in private investments, select opportunities, that we think have the potential to deliver equity-like rates of return (or better), but where our underwriting was extremely focused on the downside case.

We never know which aspect of our portfolios will outperform in any given year. Our goal is to build a portfolio of disparate assets at relatively attractive valuations. In a recessionary environment, our safer securities serve as the portfolio's ballast. When commodity shocks occur, private mineral holdings tend to deliver outsized returns. This year, Annandale's equity portfolios are, on average, ahead of the domestic benchmarks, because we hold overseas exposure. We didn't forecast this outcome but felt the diversification benefits made sense given the low valuations abroad. Why not diversify if you are paying relatively little for that benefit? That diversification protected our portfolio during the first quarter tariff shock and has provided a continued tailwind as the US dollar has depreciated in value.

A robust asset allocation is what allows us to sleep well at night. Who knows what next year holds?

We're grateful to serve you and look forward to reporting back next quarter.

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