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## North Forty Two & Co. 2025 Mid-Year Update: Managing Capital Prudently through Geopolitical Disturbance

Entering the year, the theme of our 2025 Investment Outlook was “Navigating Policy Change Amidst Fully Valued Markets.” In the six months since, there has been no shortage of seismic changes in policy from the incoming administration, particularly around trade agreements, budgetary considerations, and executive fiats. The resultant volatility in financial markets and the impact on asset prices and client portfolios was certainly anticipated in this space and has, by and large, been successfully navigated through prudent portfolio management. In this commentary, we will soberly address the central geopolitical and legislative concerns that influence markets, command our attention, and keep us up at night in the hope that our clients can rest more easily.

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At first blush, for those who wisely ignore the day-to-day noise and outsource investment management, broad-based equity markets in the first half of the calendar year may have appeared somewhat serene, with generally middling performance. Under the surface was considerable tumult. Although the intra-period volatility was foreseeable, the sheer magnitude of market movements was quite striking and largely centered around one contentious macroeconomic issue — tariffs. Following the announcement of Liberation Day tariff intentions on April 2, when new levies on imports of a minimum 10% baseline were introduced — plus additional, stacked tariffs of up to 50% on certain partners — the stock market experienced its worst three-day period in nearly forty years, dating back to Black Monday in October of 1987. The S&P 500, a measure of US large company stocks, experienced a swift 19% drawdown, and both bond prices and the dollar suffered materially (with the dollar yet to recover).

Equities rebounded relatively quickly as the administration announced a somewhat chaotic 90-day pause on the implementation of most global tariffs. The frenetic tariff on/tariff off dynamic toyed with asset prices for months, and at present, it appears capital market participants are ignoring some of the saber-rattling rhetoric and bombastic headlines and expecting more reasonable, yet still hugely impactful, effective US tariff rates of nearly 18%. That is a six-fold increase from norms and the highest rate in nearly a century.

Conventional wisdom regarding tariffs suggests a direct, obvious, upward pressure on prices for consumers and a subsequent drag on economic growth. But this is not yet reflected in mixed measures of inflation, at least as of this writing, likely due to the fluidity of announced tariff levels and a flushing out of excess inventories. And there are pushbacks on that commonly held position of tariffs being both inflationary and an impetus to economic growth, due in part to the century that has passed since our last tariff-heavy global trade position, and in part to our consumption patterns, where spending among the wealthy minority is more than offsetting the changing habits of the less fortunate majority. Inflation measures appear more opaque than usual at present, but sentiment leans toward higher prices as tariffs work their way through the supply chain and the mixed “hard data” of housing,

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household, labor, and retail data converge with the “soft data” of consumer surveys and CEO confidence. As a result, many market participants are in a wait and see posture while the tariff puzzle sorts itself out.

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While the tariff dialogue tends to dominate day-to-day conversations in financial media, we would next like to shift focus to the subjects that dominate our current analysis and keep us restless: (1) our financial health, with rising debt levels, the specter of easy monetary policy on the horizon, and the threat of higher bond yields, and (2) stretched equity valuations domestically. Let us address them separately and then explore their relationship.

First, with respect to our financial health, we offer an even-handed assessment through our traditionally apolitical lens. The United States now has a \$36 trillion national debt, and our annual bill simply to service that existing debt will exceed \$1 trillion in 2026. That interest expense alone equals 3.2% of the annual economic output of the United States, or for comparison, as much as total spending on either defense or Medicare. The One Big Beautiful Bill Act (OBBBA) is anticipated to add \$3.3 trillion in federal debt over the next decade, not including interest costs on that figure. Annual deficits are expected to reach 7% of GDP through 2034, or over twice the stated goal of the Treasury Secretary, whose plan anticipates 3% GDP growth and 3% federal deficits.

Within the OBBBA, there are large shifts in priorities for spending and tax revenue. On the spending side, defense and border security expenditures will rise significantly, and more than \$100 billion in funding for immigration enforcement was introduced. Countermeasures to help finance these initiatives include adjustments to Medicaid enrollment and spending, funding cuts for food stamps (SNAP), and the rolling back of clean energy incentives and regulations.

On the revenue side, the legislation generally makes the Tax Cuts and Jobs Act tax brackets permanent, enhances the deduction for seniors (allowing them to keep more of their Social Security benefits), increases the state and local tax deduction cap, and offers relief on tips for certain workers. All these adjustments reduce federal tax receipts, making the net effect of the Act additive to the debt and deficits.

There is no fiscal conservatism in the federal government; the song remains the same, as our nation continues on an unsustainable trajectory irrespective of which party controls the purse strings. And the global financial marketplace is beginning to recognize the dire nature of our fiscal position. While our dollar remains the world's reserve currency, the greenback suffered its worst first half since 1973, losing 11% of its value against the world's six most traded currencies.

The decline reflects skepticism not only about our rising public debt levels, but also about the prospects of an aggressively easy money policy being jawboned from Washington and resisted by the current decision makers on the Federal Reserve. The administration is not shy in trying to oust Fed Chairman Jerome Powell in favor of a more accommodative leader who, along with his or her governors, would embrace sizeable interest rate cuts principally to offer relief to our debt interest cost but also to stimulate the type of growth needed to remedy our budgetary ailments. The Fed has a long-standing dual mandate of maximum employment and stable prices that guides its policy discussions; employment has been somewhat resilient with lower levels of both hiring and layoffs,

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but inflation remains sticky and is challenged by upward pressure from, yes, a heavy-handed tariff scheme. Again, the anticipated impacts of the tariff regime have yet to flow through and be reflected in a notable step up in inflation. But the decline in the dollar reflects the global marketplace's lack of faith in the austerity of the US government in addressing decades of financial imbalances.

In terms of bond yields, around the globe, long bond yields are rising as investors await a higher premium for lending money to financing sovereign activities. Few countries are immune from this condition. In the US, yields for 30-year Treasury bonds have pushed above 5%, the highest level since 2007, in part because of the tax and spending bill that worked its way through Congress. To better finance our current policies, the government is hoping for relief from the Federal Reserve. The math behind the administration's pressure on the Fed is to orchestrate at least a 1% reduction in lending rates — from a lower range of 4.25% to 3.25% — on short term obligations, whether warranted by economic conditions or not, to realize net savings on cumulative government borrowing costs and bend the debt service curve.

The risk in cutting rates too much (the President has even floated cutting rates down to 1%) is tied to abundant levels of liquidity and the potential further deleterious impact on the attractiveness of longer-dated bonds. If inflation fails to moderate or rises, because of the future pricing impact of tariffs (currently estimated at a 1.9% increase), rising commodity inputs, or a welcome surge in consumer demand for goods and services, the purchasing power for bond owners will continue to be compromised, and secondary bond market prices will face even greater headwinds.

Related to the anticipation of future loose monetary policy is a notable phenomenon that has borne out in 2025. Reflecting concerns about economic policy uncertainty and a weakening dollar is the rise in value for the safe haven of gold and, to a more misunderstood extent, bitcoin. Gold gained 26% in the first half, and bitcoin rose 15%, far outpacing traditional asset classes. Capital is flowing to alternative assets that preserve pricing power and hedge against further deterioration in both the value of the dollar and in our nation's financial position.

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Secondly, on to equity valuations, a constant concern for us as investment managers. Broadly, stock prices remain quite stretched and have yet to relent. The price-to-forward earnings ratio for equities sits at 22 times, versus the thirty-year average of seventeen times, suggesting that multiple expansion will be challenged and lofty forecasts for earnings growth, in the face of a higher tariff backdrop, must be met. For context, when stocks trade at these levels, forward one-year and five-year total returns are close to zero — a stark contrast to the average annual stock market return of around 10%. Expectations should be managed accordingly.

On a more granular level, one of the principal reasons for the richness of the index on balance is the sheer size of the "Magnificent 7" large-cap names — Nvidia, Microsoft, Apple, Amazon, Alphabet (Google), Meta, and Tesla. From 2022-2024, those seven names that represented 40% of the market capitalization were responsible for nearly 60% of overall total return (both positive and negative), overshadowing the far more modest contribution of the other 493 or so companies in the index that comprised the other 60% of total value.

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The tide appears to be shifting somewhat, a welcome development that offers some opportunity. In 2025, the share of returns coming from the Magnificent 7 is a far more reasonable 21%. Stock market breadth is expanding, and styles outside of large-cap growth are suggesting more attractive opportunities outside of the most widely held companies and outside of market cap-weighted indexes. But domestically, no sector or style is cheap relative to historical averages, presenting a high bar for outsized investment return.

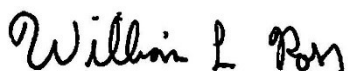
Here is where our two concerns of too accommodative monetary policy and hefty stock valuations intersect. Virtually all asset prices are extremely elevated, fueled by that prospect of less restrictive monetary policy and a lower cost of capital. Stocks, credit, housing, and alternatives like gold and bitcoin are at all-time highs, as one might expect when the domestic money supply is at an all-time high. Lowering interest rates, as the administration is keen to do largely to address the debt service dilemma, will continue to boost asset prices but also blow more oxygen on the flames of inflation. If the pendulum swings too far, the hard-fought battle over the past several years will be jeopardized. Our hope is that cooler heads prevail; that the thoughtful relative austerity of the current, independent Fed board remains in place despite intense, unprecedented political pressure to give monetary doves the reins of the domestic economy.

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To close, understanding these fiscal imbalances and extended valuations for financial assets, we offer some perspective on portfolio positioning. When pondering underlying market assumptions, or what we might expect from future returns over the near-term, we are currently anchored to a 4/5/6 framework where cash equivalents offer around 4% returns, bonds yield 5%, and stocks may produce a 6% return. While narrow in range of returns, those buckets each carry wildly distinct levels of risk. For instance, a key consideration is how much exposure to stocks, and incremental potential return, is called for given the impact of a sustained 30% drawdown in equity prices? Or how much duration risk in bonds is prudent given an outlook for higher yields and lower prices for longer maturity bonds? Or, given inflation trends, how much should cash levels be trimmed? Generally, we are reducing overweight positions in client portfolios in each of these areas where they exist and rebalancing them to reflect this view on future market risk and return assumptions. We continue to add to diversified, global exposures that are more reasonably valued. With shifting sands, this prudent approach to preserving hard-earned client capital gives us comfort.

We continue to be honored by your trust.

Best,



Founder & Chief Investment Officer  
North Forty Two & Co.



President  
North Forty Two & Co.