July 21, 2025

Three months ago, the market was reeling in the wake of President Trump's new tariff regime. By June 30, however, the S&P 500 had closed at an all-time high. What changed? The most-cited reason was that the market decided that Mr. Trump was using his initial high tariffs simply as a cudgel to force trading partners to reduce their own tariff regimes. We, and many others, thought that a recession was likely to occur due to those ultra-high tariffs and the uncertainty introduced by pauses and restarts. Since then, however, the market has come to believe that the tariffs we ultimately will live with won't resemble those originally announced. Recession risk calculations have come down accordingly.

Another plausible reason for the market recovery (and the lowering of recession risk) is the recently passed tax and budget bill (the so-called BBB). The headlines are pointing out the resulting increase in the federal budget deficit going forward and the associated rise in interest costs (all true). But what they're not talking about is how stimulative the bill is. Whenever the federal government runs big deficits, it is pumping a lot more cash into the economy than it's collecting in taxes. This gives the economy a boost, even though the long-run effects may lead to elevated inflation and higher interest rates.

So, here we are, just a little more than halfway through 2025, and the market has already had a recession scare and a recovery from it. Those were events that very few people, by my observation, saw coming on January 1. What will the second half bring? The future is similarly murky. Is this uncommon? Not at all. As I've often pointed out, even though we may use the language of forecasting, we are not clairvoyant. We who think hard about the future direction of the economy and the financial markets are not seers, but odds-makers. We weigh the relative probabilities of the various potential outcomes and go with the most likely. But we are living in a world where even the probabilities of less likely outcomes are not insignificant. One must be prepared for surprises, even though they're really not surprising anymore.

Last quarter's letter included a thought that bears repeating: *Since the future is hard to know, and since economic variables are so complex, it is exceedingly difficult to know what the outcome of an economic policy change will be.* That sentence reminded me of the chaos theory concept known as *the butterfly effect*. (Note: this is not about the 2004 Ashton Kutcher movie of the same name, which purported to illustrate this concept, but got it wrong.) The idea was hatched by meteorologist Edward Lorenz about 60 years ago. Simply stated, *in a complex non-linear system, minute initial changes can result in very large and* ***unpredictable*** *consequences later*. The illustration is that of a butterfly beating its wings in Brazil which, through an unpredictable sequence of events, produces a damaging thunderstorm in the central US. The concept has become a useful tool in the analysis of complex systems and is also a helpful offset to the human tendency to overly simplify difficult problems.

The difficulty of predicting market behavior is not just the difficulty of predicting human behavior, which is challenging enough, but the complexity of the system. Financial markets are complex non-linear systems such as what the butterfly effect envisions. This means that small inputs can have outsized effects that are inherently unpredictable. So, what's an investor to do?

Investment portfolios need to be constructed in such a way as to take advantage of potentially different favorable scenarios and to defend against potentially adverse scenarios. This means not every stock in an equity portfolio is there to do the same thing. One stock may be there to hold up well in a recession, while another may be there to prosper in an economic expansion. They're both in the portfolio because a wise portfolio manager knows that he cannot predict the future. Both types of stocks probably won't outperform at the same time, but that's the point. The portfolio manager wants *something* doing well in virtually any environment.

Similarly, wise asset managers include multiple asset classes in their asset allocations precisely because they cannot predict the future. There may be some high-grade bonds in case a recession breaks out and some high-quality stocks in case it doesn't. Some good foreign company stocks could be added in case non-US growth accelerates and/or the dollar depreciates, and perhaps some gold will be included if the long bull market in the dollar runs out of gas and goes the other way.

The aforementioned probabilities determine relative weightings and adjustments to those weights, but a properly diversified portfolio is designed to produce good returns (good, not the best possible) in many kinds of positive environments and produce good downside risk protection (good, not the best possible) in negative environments. It may not be the most exciting way to invest, but it gets the job done in an uncertain and unpredictable world. One just never knows what the breezes from those butterfly wings are going to do.

We appreciate your confidence in us.

Gratefully,

Mark A. Keller, CFA
CEO and Chief Investment Officer