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Second Quarter 2025 — The End of U.S. Exceptionalism?

The Debate

Debates calling for the "end of U.S. exceptionalism" or the notion that "America's special run is over" have recently gained some traction. Critics often emphasize some of the following concerns:

- The federal deficit is on the rise. The Congressional Budget Office projects a \$1.9 trillion federal deficit this fiscal year, with U.S. debt expected to surpass 118% of GDP. Without meaningful policy changes, this ratio will likely increase as entitlement spending and government interest expenses grow.
- Questions around economic policy — such as imposing tariffs on both allies and adversaries, provoking threats of retaliation from trade partners, and ongoing culture-war disputes — have contributed to a perception that the U.S. is sliding toward an increasingly isolationist approach.
- The U.S. dollar has weakened relative to other major currencies. At the end of 2024, the dollar's share of official foreign-exchange reserves slipped to 58%, down from the 70% range of the 1990s. Year to date, the U.S. dollar has depreciated 10% against a basket of international currencies and could face further pressure if the Federal Reserve lowers interest rates as expected.
- U.S. growth forecasts are still growing but moderating. The International Monetary Fund now pegs U.S. real-GDP growth at 1.8% for 2025, hardly the roaring premium to other countries we have seen in recent years.

Our Stance

While elements of the aforementioned concerns may be valid, they are hardly conclusive. For instance, despite a projected 1.8% growth rate, U.S. GDP is still expected to outpace every other major advanced economy this year (except China, which benefits from massive government spending). The European Union countries' 2025 GDP forecast is barely 1% and Japan's is even lower. Another significant factor to consider is productivity. U.S. worker productivity increased by over 2.5% in 2024, the best annual performance in years and well above other countries. A surge in artificial intelligence ("AI") startups, cloud automation, and generative-AI tools suggests that this increase in productivity is sustainable, providing the U.S. a pathway to grow faster without stoking inflation. All of this progress is no accident: U.S. companies invested over \$700 billion into research and development in each of 2023 and 2024, dwarfing investments from every other country. Chinese companies followed with the second highest spending, around \$500 billion annually, while Japan came in third, around \$140 billion. Additionally, U.S. companies invested over \$4 trillion in capital expenditures in 2024, with expectations for nearly 5% growth in 2025. This is 25% more than all the European Union countries combined. The "Big Beautiful Bill" is expected to further stimulate U.S. investment by allowing companies to immediately deduct 100% of the costs for qualified equipment, research and development, and new factory construction in the year they are incurred. This provision effectively lowers the after-tax cost of capital, encouraging additional business spending. The U.S. system is rooted in capitalism, where managers are incentivized to innovate and pursue profits. In contrast, while China continues to invest, its approach is characterized as a top-down state-directed model. This top-down approach in Communist China does not always yield the best outcomes, as evidenced by recent challenges such as their real estate crisis and the existence of "ghost" cities.

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The technology sector continues to drive major waves of innovation. Throughout this century, the U.S. has led the world in investment spending, excelling in areas such as networking, desktop internet, mobile internet, cloud computing, and now Artificial Intelligence (“AI”). As a result of these innovations, the profit margins of the S&P 500 Index (“S&P 500”) companies have more than doubled over the past two and a half decades from approximately 6% to 13%. And excitingly, the United States remains at the forefront, investing billions of dollars across hardware and software to unleash transformative changes and enhance productivity. According to International Data Corporation, global enterprise spending on AI software, services, and hardware is expected to reach about \$307 billion in 2025, with more than half of that expenditure originating from the U.S. Mirroring the monumental shifts brought on by other game-changing innovations, we expect AI technology will continue to reshape industries while driving increased profit margins and higher earnings growth. This serves as a favorable set-up for the U.S. to maintain its financial markets leadership, as the technology sector represents up to 35% of the S&P 500, compared to low to mid-teens for major European stock indexes, with the Euro Stoxx Index the highest at 15%.

The U.S. dollar remains the world's dominant currency. Although its share of global reserves has declined, it still accounts for over 58% of all reserve currencies, three times greater than the Euro and fifteen times that of the Yuan. Although the U.S. dollar has declined this year against a trade-weighted currency basket, it has appreciated over the last five and ten years. In times of market stress, U.S. Treasuries remain the safe-haven asset of choice. Additionally, when global capital seeks a long-term home, it still heads to America, which is a top destination for foreign direct investment according to the OECD. The trend in risk capital further supports this narrative—U.S. start-ups attracted over \$200 billion, or 57% of all worldwide venture funding in 2024, fueled by mega-rounds in artificial-intelligence leaders like OpenAI, xAI, and Anthropic. 2025 year-to-date totals are tracking ahead of that pace as funding remains strong, and the U.S. remains a beacon for investment.

Energy security is another key U.S. advantage. Today, the U.S. simultaneously exports more natural gas and more overall petroleum liquids than it imports, a dramatic reversal from the decades-long era of energy dependence. Now, America is the leading oil and natural gas producer, hitting a record crude output of 13.2 million barrels per day in 2024. This compares favorably to the European Union’s 3.3 million barrels per day. Affordable and reliable energy lowers industrial costs domestically and provides U.S. policymakers significant leverage abroad, as Europe discovered when U.S. LNG cargoes replaced Russian supply.

While substantial deficits present real risks, the depth and resilience of the U.S. bond market, which continues to attract funding at reasonable rates, reflect ongoing global confidence in U.S. institutions. Interest expense on government debt could be lowered as interest rates come down. When policy missteps do occur, the U.S. system tends to recover, especially given our democratic framework and our system of checks and balances. More critical for investors, this legal framework is paired with the world’s largest and most transparent bond market, which underpins everything from corporate finance to global reserve holdings.

Tariffs and tough rhetoric may increase costs and create tension with allies, but they have also resulted in higher defense spending abroad, encouraged diversification of supply chains (including moving some closer to home), and sparked new investments in U.S. semiconductor, life science, and clean technology manufacturing. So far this year, the White House has stated upwards of \$5 trillion will be invested in the United States over the next few years. Even if this number is overstated to some degree, we have seen corporate press release pledges of roughly \$2 trillion so far. Despite the cultural

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clashes often highlighted in the media, no other country offers the same combination of open capital markets, strong rule of law, commodity independence, and robust military capabilities.

In summary, we believe that slower growth and political turbulence do not necessarily signal a permanent decline of U.S. exceptionalism. The fundamental attributes that have traditionally made the United States "exceptional" —such as world-class universities, a strong ability to grow and attract talent, leadership in technology, unparalleled innovation, abundant energy resources, robust financial markets, unlimited opportunities for entrepreneurs to start and build a company, and an unmatched security network—remain firmly established and are not going away. In other words, claims about the end of U.S. exceptionalism are, in our opinion, greatly exaggerated.

Staying Selective Amid Heightened Volatility

Investors may not believe the economy is thriving, but they are relieved that the worst-case scenarios anticipated in recent months have not materialized. Trump's tariffs, deportations, and cuts to the federal bureaucracy have bent the economy but have not broken it. The second quarter of 2025 was characterized by extraordinary volatility, as shifting tariff policies and geopolitical developments dominated headlines, resulting in sharp swings across financial markets.

During the week following "Liberation Day", the S&P 500 was down 15% on the year before rebounding significantly on April 8th when many tariffs were paused. This one-day increase of 9.5% marked the fifth-largest S&P 500 move on record. Such movements highlight the market's sensitivity to evolving narratives around tariffs, inflation, monetary policy, and corporate earnings.

Despite these challenges, U.S. equities' resilience demonstrates the U.S. economy's underlying strength and the adaptability of management teams. Beneath the headline figures, there was a notable sector rotation as the "Magnificent Seven" stocks staged a large rally, increasing in the aggregate 19% in the second quarter, outpacing the S&P 500's 10% gain and the Equal Weighted S&P 500 Index's 5% gain. This is a stark contrast to the first quarter when the "Magnificent Seven" stocks fell by 16%, compared to the S&P 500's decline of 4% and the S&P 500 Equal Weight Index's decline of under 1%. By the end of the second quarter, the S&P 500 reached new all-time highs, capping a dizzying 24% rally from the depths of April's tariff-induced sell-off. For the year's first half, the S&P 500 gained 6%, the S&P 500 Equal Weight Index gained 4.5%, and the "Magnificent Seven" rose by 1.5%.

Corporate earnings in the first quarter grew double digits, continuing the solid growth we saw in the fourth quarter of 2024. This earnings growth provided a welcome anchor for the markets. However, estimates for the full year of 2025 have been adjusted, with the market now expecting earnings growth of 10%, down from 12% at the beginning of the year. Tariffs and weaker consumer and capital investment spending are cited as drags on this growth. Companies have highlighted the impact of cost controls and operational efficiency, with many benefiting from productivity gains and technological investment. Nevertheless, management teams were more cautious with their forward guidance, citing uncertainties around consumer demand, input costs, and global supply chain dynamics. During the upcoming earnings calls, we are eager to hear what companies say regarding their business outlooks. Additionally, we anticipate that macro headlines may eventually shift to highlight Trump's pro-business initiatives, such as tax cuts and more significant deregulation, leading to increased lending and investment spending. If enacted, the proposed "Big Beautiful Bill", which extends the tax cuts from 2017 and introduces additional incentives for businesses, is expected to increase GDP by 0.5%.

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At its June 2025 meeting, the Federal Reserve held rates steady. Chairman Powell stated that officials require “greater confidence” that inflation—still slightly above the 2% target—will continue to decline before they consider loosening monetary policy. The market anticipates two rate cuts later this year, but only if incoming data confirms continued disinflation. Consumer behavior is currently characterized by deliberate spending given economic uncertainty and varies by demographics and expenditure cohorts. There is strong demand for value-priced essentials, off-price deals, e-commerce, and travel. However, demand has been inconsistent, or even negative, for mid-tier discretionary goods, major home projects, and even certain restaurant chains. The outlook on the consumer is one of cautious optimism, with consumers adapting to a “new normal” characterized by elevated prices and shifting spending patterns. We will continue to monitor trends in the labor market and consumer behavior, as approximately two-thirds of the U.S. GDP is influenced by consumer activity.

Tariff Paths Will Drive Earnings Outcomes

The direction of tariff policy and its impact on the economy and corporate earnings remain key areas we are closely monitoring. Since Inauguration Day, there have been at least 40 tariff announcements. Tariffs have been the central macro driver of year-to-date volatility. For instance, the U.S. and China continue to impose and negotiate various tariffs on each other. In April, U.S. tariffs on Chinese imports reached as high as 145%, but recent negotiations have led to a reduction, with the highest tariffs now decreasing to 30%. The U.S. is also actively negotiating tariffs with several other countries in an effort to lower our trade deficit. These tariffs will have direct implications for corporate earnings, especially for multinational companies with global supply chains. Higher input costs and disrupted trade flows could pressure profit margins, while increased costs will likely be passed on to customers, potentially dampening demand. Looking ahead, the trajectory of tariff policy will be a critical determinant of economic growth, inflation, and corporate profitability.

We see three potential scenarios regarding tariffs:

- *Prolonged Uncertainty.* In this scenario, we would likely see a continuation of current policies, with a persistent cloud over the economy and an extended state of uncertainty. This situation could result in some degree of economic slowdown. However, we are not yet observing significant data points signaling material weakness in the U.S. economy.
- *Resolution.* In a resolution scenario, we would expect trade deals negotiated over the next couple of months to ease tariffs and positively impact earnings over the remainder of the year. On this path, investors could expect less uncertainty as average tariff rates come down, albeit not quite returning to pre-“Liberation Day” levels. In this environment, we anticipate solid U.S. growth, continued strong employment, and lower interest rates.
- *Escalation.* The most problematic scenario would be marked by an escalation of tariffs. This could increase the risk of recession due to higher costs, inflation, and interest rates, negatively impacting employment, consumer sentiment, and corporate earnings.

Micro Dynamics: Know Your Companies

As we progress through 2025, significant differences are emerging across various industries and companies. The resilience of individual companies will depend on their ability to adapt to rising input costs, shifting trade flows, volatile geopolitics,

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and a potentially weaker consumer base. Our core strategic advantage starts with our patience and capital allocation philosophy, focusing on beyond-privileged and resilient companies (“BP&R”) that can compound value over time. Given that we cannot predict the short-term movement of the market, our investment strategy and process remain biased towards BP&R companies. We define BP&R companies as a combination of quality and growth with a focus on businesses that can earn a return greater than their cost of capital through a cycle. BP&R companies can grow and compound earnings over long periods. We remain unwilling to bet against the skills and ingenuity of the corporate managers who lead our businesses. In our view, corporate managers’ willingness to drive innovation, enhance productivity, allocate capital to the best risk-adjusted return, and compete globally will provide investors with suitable long-term return potential for the risks they bear. Simply put, we believe it pays to bet on optimism, perseverance, entrepreneurship, and science and take a long-term view.

Asset Allocation

We have often stated that “starting points matter,” and today, there remains increasing competition for equities from fixed income, especially on a risk-adjusted return basis. Whether it involves short-dated U.S. Treasuries yielding 4% or shorter-term investment-grade bonds yielding 5%, investors can find reasonable income-earning opportunities. Today’s dynamic backdrop could allow investors to earn more reasonable income for the underlying credit and duration risk. If interested, contact us for more detailed asset allocation conversations, as coupons on a pre-tax basis for specific fixed-income securities may soon be able to compete with stocks on a risk-adjusted return basis.

Near-Term Challenges

Our constructive long-term view on risk assets is not without challenges. Global issues remain front and center and have ripple effects on the U.S. economy. U.S. economic policy uncertainty is high. There is uncertainty over tariffs, government spending cuts, and immigration deportation, to name a few. The U.S. deficit, which represents the gap between government spending and revenue, poses significant challenges as it continues to grow, driven by factors such as increased government expenditures, tax cuts, and rising interest payments on the national debt, potentially impacting economic stability and future fiscal policy decisions. The U.S. now faces \$1.2 trillion in annual interest payments on \$30 trillion of debt, consuming federal budgets and limiting spending flexibility. Conflicts in Ukraine and the Middle East continue. Additionally, Trump has taken a forceful stance against Iran, which could escalate tensions in the region. From a financial market’s perspective, we’d highlight much greater concentration dynamics than historical averages, and a backdrop where the speed of change can tempt investors to try to “guess” tomorrow. Lastly, we believe the most significant risks to the global economy are still unknown today – be they financial or geopolitical.

In closing, we believe that we are operating in a real-world and financial market world where the speed of change is astonishing. Sentiment shifts rapidly from extreme emotions of fear to greed, sometimes even within the same day. Rest assured, we believe this is precisely the backdrop where a disciplined process and diversified portfolios have the potential to prove even more powerful.

Thank you for your continued support.

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The S&P 500 Equal Weight Index (EWI) is the equal-weight version of the widely-used S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight - or 0.2% of the index total at each quarterly rebalance.

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