

# WHEN THE PUNCH BOWL LEAKS: Markets in a New Fiscal First World



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In our quarterly letters, our aim to highlight themes and developments that we believe merit closer attention — some widely recognized, others more easily overlooked. We fully expect that readers may disagree with some of the viewpoints, as forecasting is inherently fraught with peril, potentially more in today's environment. Our goal is not to be definitive, but to offer perspective and stimulate thoughtful discussion among our intellectually curious clients and friends of the firm.

In this letter, we delve into topics that may signal important shifts in the investment landscape:

1. We examine the defining characteristics of the past couple of decades and ask whether that era is changing, and if so, what signals might indicate a new regime.
2. We analyze the unusual behavior of the U.S. dollar and explore what underlying signals it may be sending.
3. We examine whether hyper-scaling represents a genuinely superior business model, or merely a capital-intensive strategy that falls short of the market dominance achieved by prior generations of U.S. tech leaders' end markets.
4. We assess the growing evidence of an economic slowdown and join the bond market in asking, by how much?
5. Finally, we present a set of unique positioning ideas aligned with our approach to wealth preservation and diversification.



# Regime Changes Are Rare, But Have We Entered One?

The U.S. equity market has surged to record highs, driven by AI-led mega cap momentum investing, passive flow mechanics, and a sentiment shift from fear to FOMO. Yet under the surface, investors are hedging, and gold has emerged as one of the top-performing major assets again this year. The dollar is now front-page news, having fallen 10% year-to-date, a record move to start the year, coming off the worst six-month performance in over 50 years.

It has been an extraordinary first half, marked by one of the sharpest drawdowns and recoveries in recent memory, ultimately leaving the S&P 500 near its long-run average. But the story behind that recovery is far more complex. We believe it may mark the beginning of a regime shift, widely speculated but rarely observed, which occurs perhaps once every couple of decades. We explore what the market may be signaling and whether we are entering a new environment or simply witnessing a pause in the long-standing regime.

To frame the discussion:

- The prevailing trend has featured 15 years of persistent U.S. economic and market outperformance relative to the rest of the world.
- U.S. earnings and economic data have been exceptional (as detailed in prior letters here).
- The U.S. dollar has reached valuation extremes not seen since the Plaza Accord.
- Interest rates have been on a downward trajectory for more than three decades, peaking under Volcker and steadily declining since then in both nominal and real terms.

We should begin by listening to what “Mr. or Ms. Market” has to say. Typically, during large and sudden market moves, the market may be searching for—or testing—a new regime. The

recent episode—with one of the most significant drawdowns and fastest recoveries in history—offers an ideal moment to examine what is working and what those moves might imply.

Shown below are the 15-year annualized returns through the end of 2024, alongside year-to-date returns across select global markets. The takeaways are clear:

1. U.S. returns have been exceptional—the best 15-year stretch on record outside the run-up to 1929.
2. Diversifying into other assets over this period was, in most cases, a mistake.
3. Gold performed well, but so did the dollar.

|               | 2010-2024 Annualized Return | H1 2025 Return |
|---------------|-----------------------------|----------------|
| NASDAQ        | 18.7%                       | 8.4%           |
| S&P 500       | 13.9%                       | 6.2%           |
| Euro 600      | 8.4%                        | 9.4%           |
| Gold          | 6.0%                        | 25.9%          |
| ACWI Ex. U.S. | 4.7%                        | 17.9%          |
| U.S. Dollar   | 2.2%                        | -10.7%         |

Source: Bloomberg

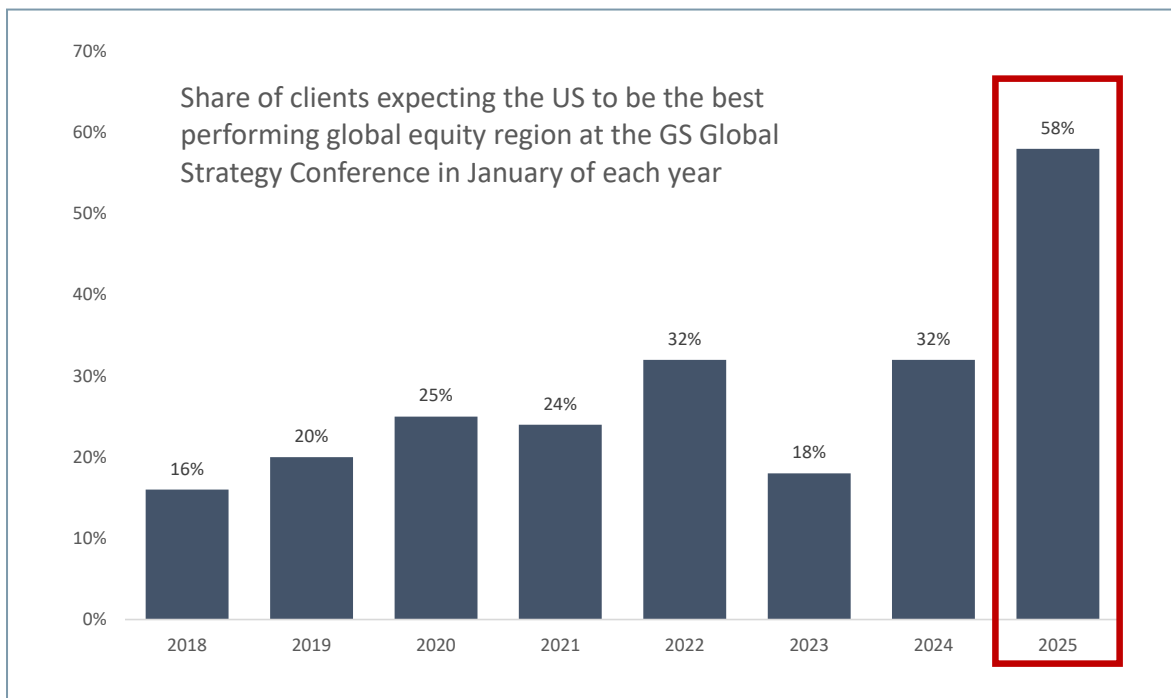


The twin deficit increases during the first Trump administration and the Biden administration, along with U.S. exceptionalism, helped form this chart below, which saw investors chasing

performance and foreign central banks and investors recycling “assets” in U.S. markets, as well as illustrated another way through client surveys in January of this year.



Source: EPFR Global, Natixis



Source: Goldman Sachs Global Investment Research

If we are indeed entering into a new regime, several key dynamics would likely shift:

1. The U.S. dollar would weaken, or at the very least, begin behaving more like a countercyclical asset than a perennial haven, acting more like a choice to investors.
2. Market leadership, particularly from technology and the S&P 500, would fade, giving way to new sectors or geographies.
3. U.S. earnings and economic data would begin to underperform, or at a minimum, lose their relative advantage vis-à-vis the rest of the world.

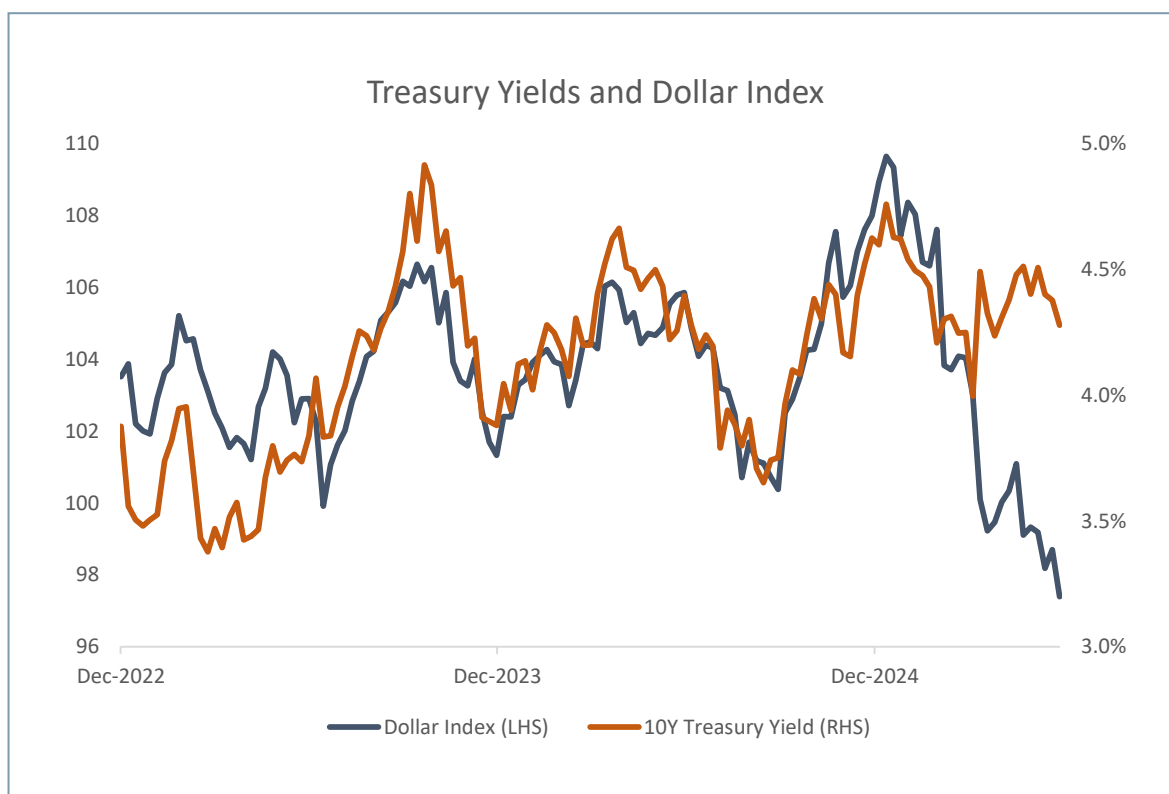
After a decade of extraordinary performance with an appreciating currency, it is not a surprise that investors and central banks flooded into U.S. assets. The dollar enjoyed a strong run for decades—until now.

The chart below illustrates the performance of the U.S. dollar, which has closely tracked 10-year

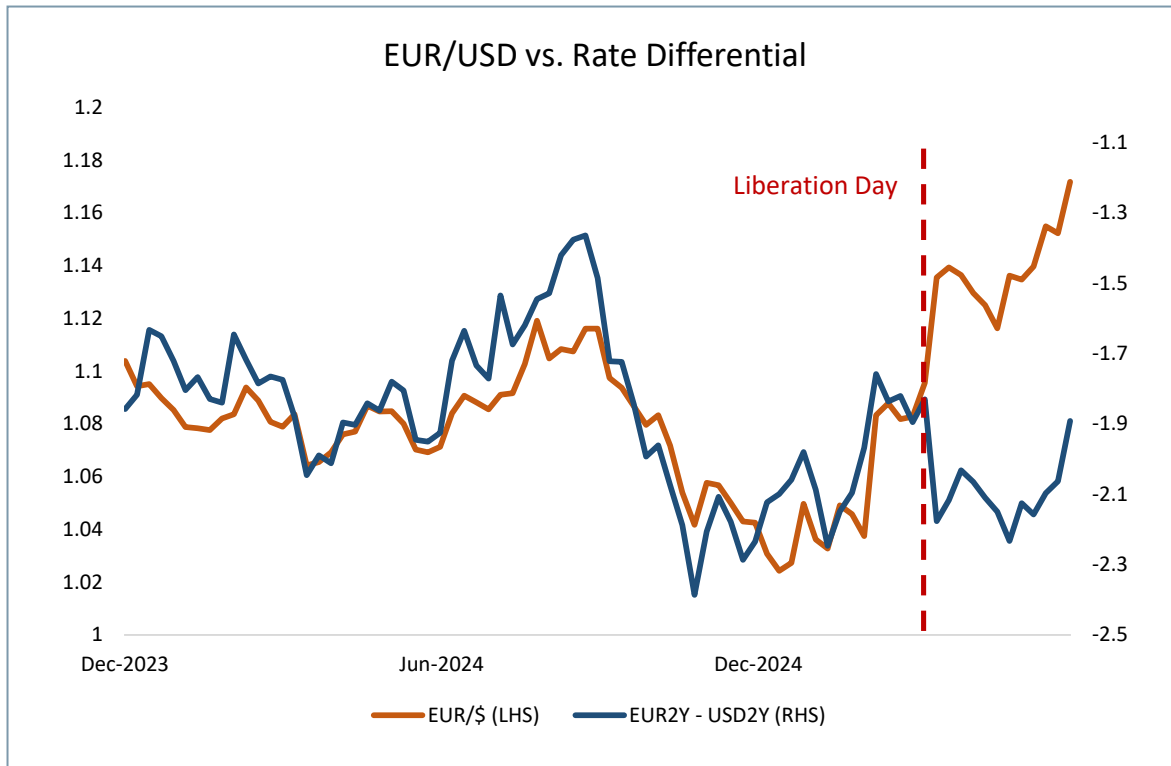
U.S. Treasury yields in recent years and, in some cases, over periods spanning decades. To further simplify the view and emphasize our main points, we excluded other variables.

What emerges is a clear inflection: something has shifted. We believe this marks the beginning of stronger efforts to rebalance global trade flows, likely through currency manipulation rather than tariffs. Gold, which tends to respond more directly to currency debasement and geopolitical risk, began outperforming real rates over three years ago.

We discussed Scott Bessent's views on the balance of payments in our last letter. While multiple factors influence both interest rates and the U.S. dollar, we believe recent moves are best explained by foreign currency markets anticipating stronger foreign currencies and fixed income investors demanding better yield compensation for investing in U.S. Treasuries.

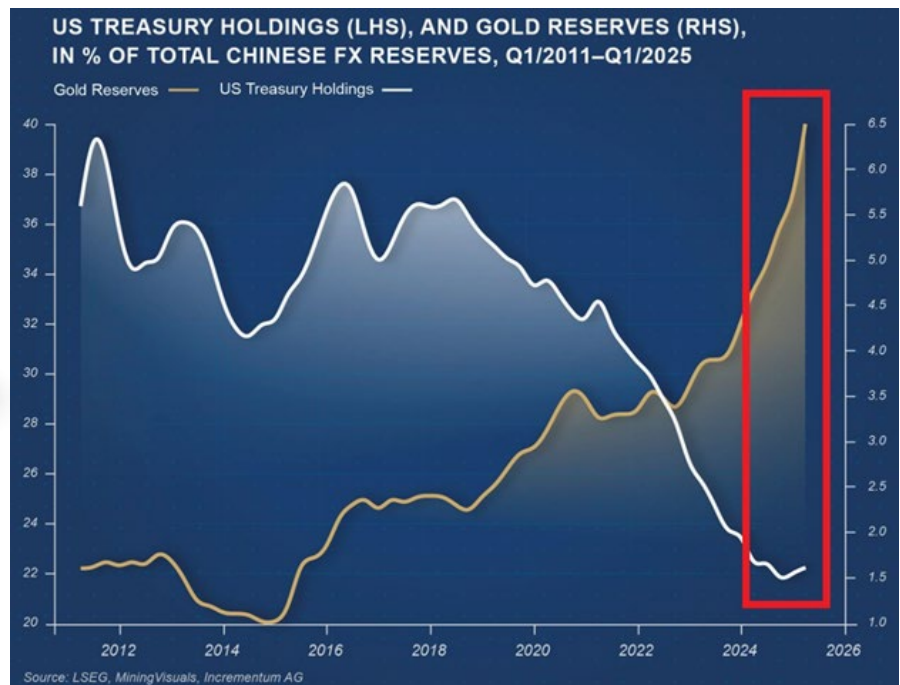


Source: Bloomberg



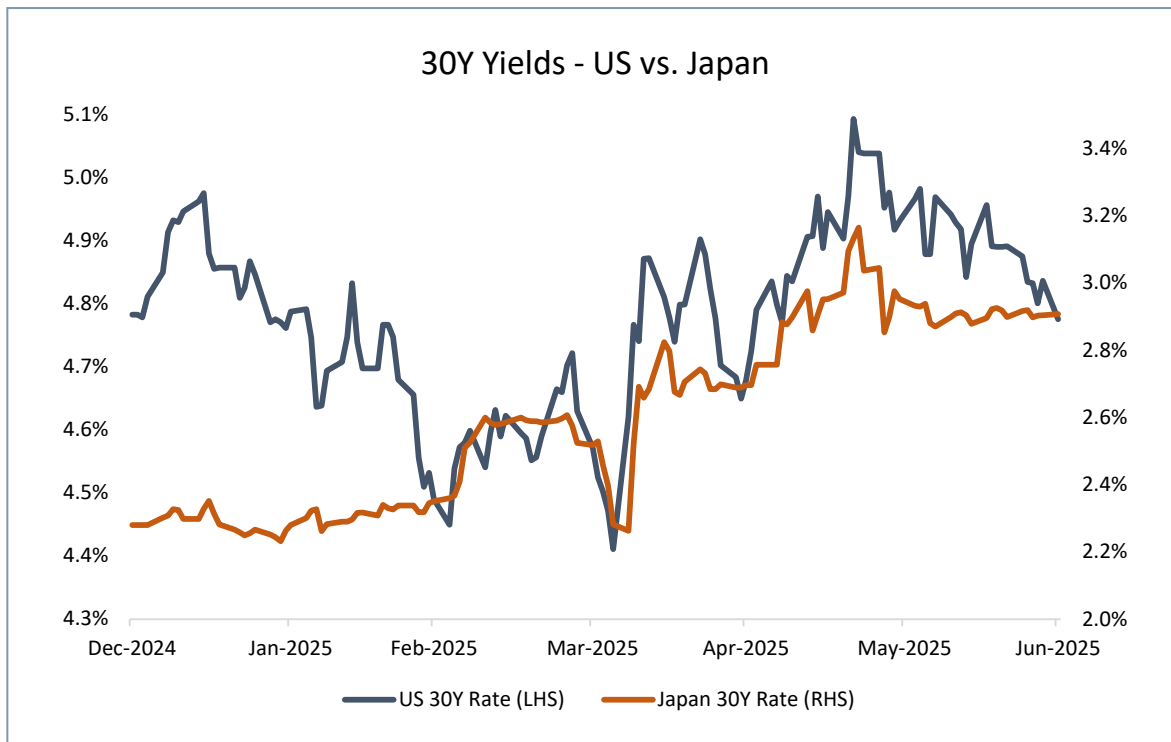
There has been extensive press speculation that the Chinese are responsible for the rise in the term premium on U.S. bonds, with claims that they were “selling” in retaliation for the trade war. However, we

believe that part of the story is inaccurate. Our most significant trading partner has been quietly shifting assets away from dollars and into gold for several years (we highlighted gold’s appeal last year in our letter [here](#)); if anything, they have most likely been buying our Treasuries lately, to stabilize their currency at low levels to support external trade.



Still, someone clearly sold more than usual, and the data points to investors and insurance companies, particularly those based in Japan. Japanese rates have increased sharply across the curve, while U.S. rates are about flat, creating relative demand for yen assets. The yield levels are at a point that insurance firms might find attractive.

Flow data and public commentary from industry executives suggest that the largest net sellers of U.S. Treasuries have been Japanese and Taiwanese institutions. At the same time, China has remained a steady seller over the past several years. Shown below are 30-year rates; Japan's rates are near a 40-year high and have increased 80 basis points, while U.S. rates are about flat.



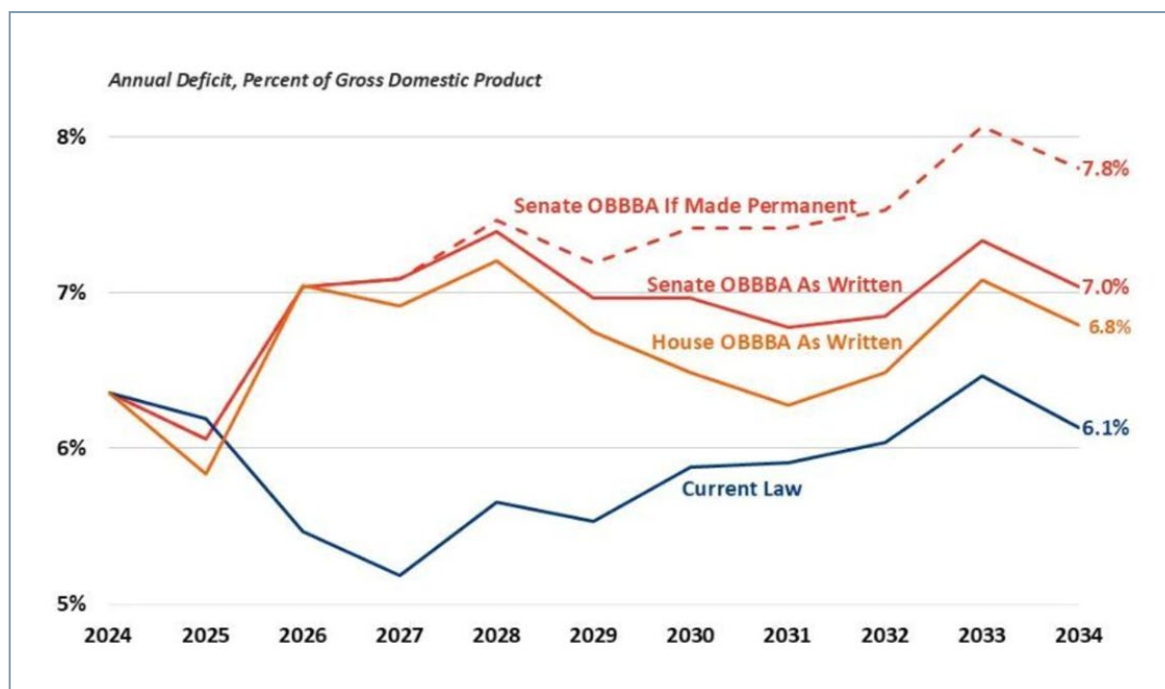
Source: Bloomberg

# Was DOGE DOA?

We suspect the market and participants quickly discounted the failure of the DOGE-led efforts to rein in federal spending. The chart below underscores the “Christmas tree” nature of the One Big Beautiful Bill Act, reflecting a wide array of add-ons and concessions for interest groups. To emphasize, we are not making a political judgment, but objectively analyzing the facts—i.e., it is simply unusual for a wealthy nation to run persistent peacetime or non-recessionary deficits.

Some may recall that in the late 1990s tech boom, the U.S. briefly achieved a budget surplus. In contrast, today’s environment, with record-high markets, empirically low unemployment, and strong capital gains prints, makes the continued rise in government spending as a share of GDP particularly striking (and worrisome), especially with nominal growth well above 2%.

The fiscal outlook remains troubling as well. Notably, through the Senate reconciliation process, the federal deficit is projected to increase by \$1 trillion over 10 years. The deficit is expected to rise from approximately \$230,000 per U.S. family/household to around \$430,000 over the next decade.



Source: Goldman Sachs and CBOE



While we have not had a full-blown Liz Truss moment in U.S. bond markets, there are enough “puts and takes” to question the durability of the trade that has defined the past few decades, in an environment where the Federal Reserve could implement yield curve control whenever markets wobbled. From our perspective, market behavior this year suggests we have shifted from central bank dependence to a regime that is increasingly fiscal-dependent. That may explain the strength in gold and bank equities on the year-to-date, which is quite unusual based on the trading pattern of the past decade, where generally U.S. tech has been a leader and bank stocks globally typically a loser.

Bulls of the recently passed OBBBA—argued that the CBO, which scores these bills, was too pessimistic on nominal growth and that stronger growth will prove these ratios to be aggressive. We hope the bulls are right, but we are skeptical for two reasons: first, CBO forecasts are generally too low, not too high; and second, there is the common-sense view embodied in the Armey Curve—that increased government spending generally crowds out private investment and drives inflation over time, and this is especially true when spending exceeds rational levels.

At its core, the Armey Curve reflects the idea that:

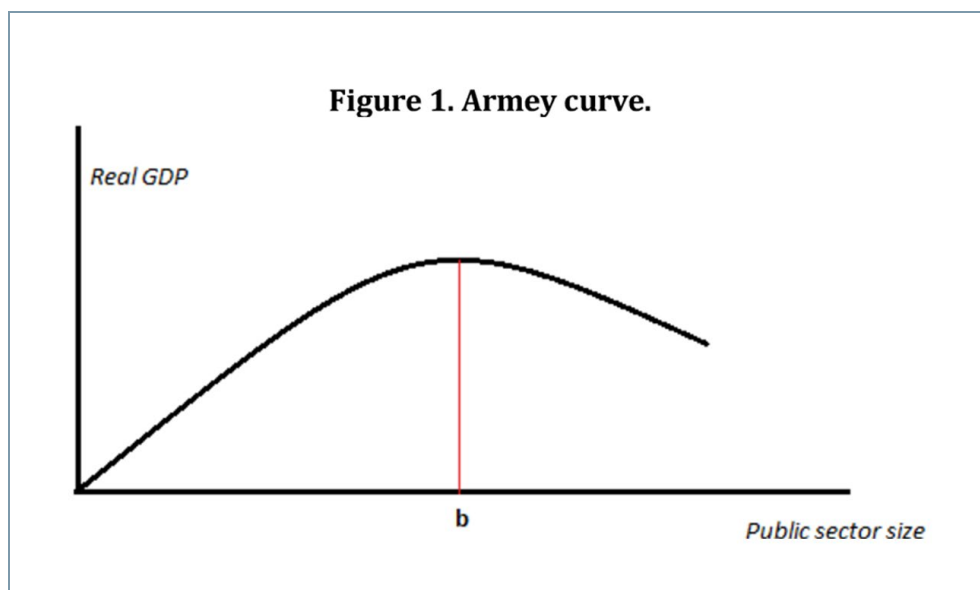
- Government spending is not free—it must be paid for now (via taxes) or later (via debt, future taxes, or inflation).
- When spending outpaces productive output, it crowds out private capital, creates malinvestment and misaligned incentives, and reduces long-term economic dynamism.

The theory holds that as spending increases:

1. Interest rates rise as the government competes with the private sector for capital, but this has been less true as until a few years ago money was almost free in “carry” currencies like the yen.
2. Private investment falls due to higher capital costs and uncertainty over future taxes or inflation.
3. Productivity stalls because government spending is often less efficient than private investment.
4. Inflation risks grow, eroding real returns for savers and investors.



We are already seeing elements of this today, as private sector job growth over the last 12 months (after recent payroll adjustments) has been far lower than the government sector growth. The chart below helps put it into perspective. While the precise values may be debated, at today's level, with federal and state spending totaling roughly 40% of GDP, we are nearing (or past) the tipping point.



Source: Published in *Advances in Social Sciences Research Journal* 2019

The Armey Curve reminds us that more is not always better. We have likely passed the point where government spending supports growth, and we are now in the zone where it quietly erodes it. There have been a few academic studies by G7 countries on emerging economies. Generally, the studies found that in developing economies, the optimal level was mid-teens and in established countries no higher than 30% was the theoretical answer from economists, based on historical data.

In conclusion, we are skeptical that aggressive fiscal spending leads to sustained and stable growth—and by certain measures, the bond markets appear to reflect similar skepticism.

Optimal government size and economic growth in Spain—evidences through the Armey Curve (1980–2016).

# What Is The Market Trying To Tell Us?

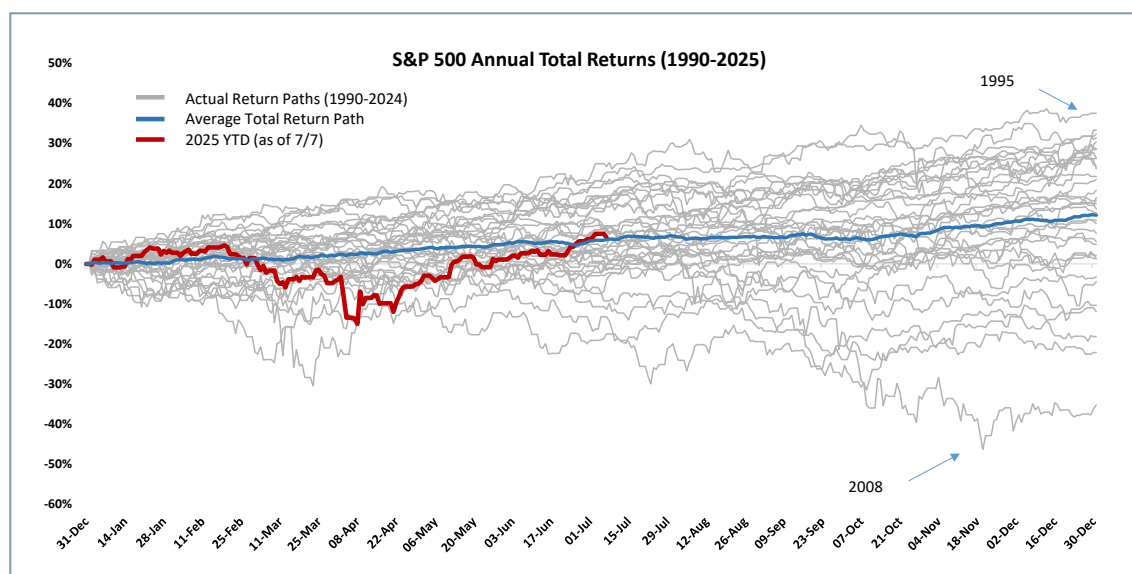
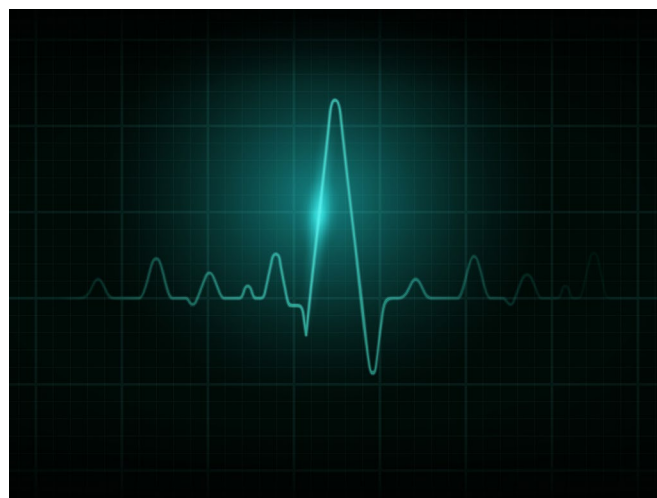
As long-time market watchers, we are always on the lookout for the signal in the noise. The most potent time for a potential “regime” change or shift is always after market volatility. We have had one of the best litmus tests year-to-date, with a significant drawdown followed by a sharp recovery. The chart below illustrates the unusual nature of the sharp drawdown earlier this year—one of the worst in the past 25 years—and the subsequent rebound to what now appears to be a relatively normal year.

In our view, this is an ideal environment for identifying winners and losers, especially if we are in the midst of a regime change. Shown below is how unusual the 15% drawdown was that occurred during Trump’s tariff announcement of “Liberation Day”, and how typical the year appears now, with returns at the long run average.

We think the takeaway from this is not the drop and pop, but rather the signal underneath, and what has changed. As we highlighted above, the QQQ and SPYs have been relative winners consistently for 15 years, while the dollar has been strong for decades, and the bond market has generally been counter-cyclical (or at least declined)

during periods of stress. Since Liberation Day, the dollar has not been a safe haven, with generally strong U.S. equity markets, but not as well as other assets year to date. Complicating the analysis is that the OBBBA is extremely cyclical and positive in the short run, with bonus depreciation deductions

approaching 100%, at the expense of increased, longer-term fiscal deficits.



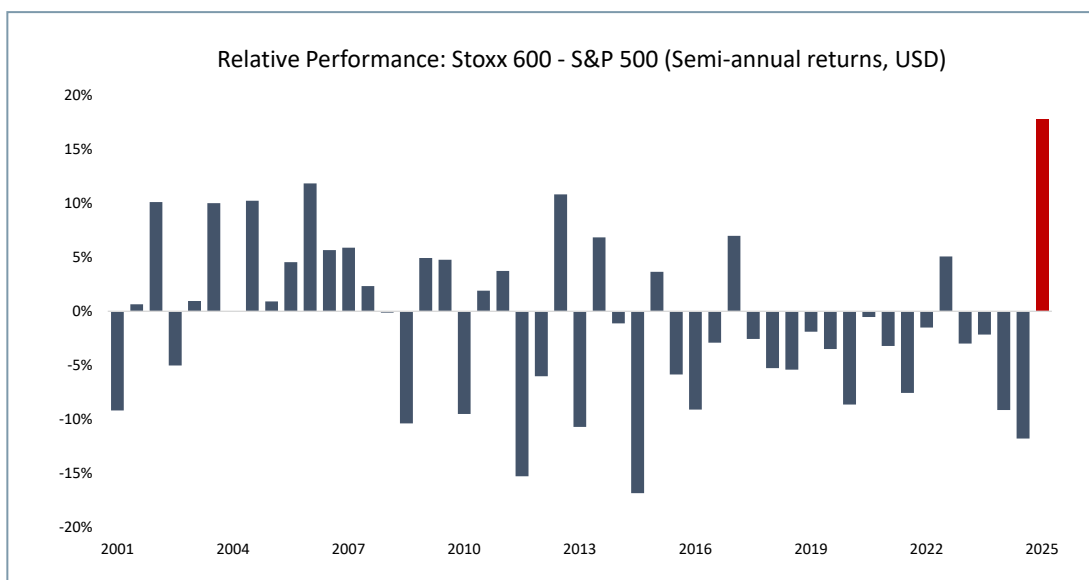
Source: Bloomberg

# None Of These Were True Year-To-Date, So What Happened And Why?

Interestingly, when we look at the winners year-to-date, through the first week of July, it bears no resemblance to the last 15 years. Gold miners—a play on fiscal dominance—have run a staggering 50%. Bitcoin, a similar play, is up 17%, and has hit several all-time highs in July. Banks globally are outperforming their local markets materially in most markets, and most emerging markets are performing well, both in credit and equity. Banks have not performed well in decades, especially so universally. This potentially signals the end of central bank dominance and enormous yield curve control, and a move toward higher nominal and fiscal growth—e.g., fiscal dominance. As an example, the European Bank Index in Euros is up 49%. A steeper curve and fiscal lead growth are helpful to spread more profitable bank lending.



After nearly two decades, the European market is outperforming the U.S. market—and the margin of outperformance is not modest. While short-term fluctuations are expected, the chart below clearly highlights the extended period of European underperformance, until 2025.



Source: Bloomberg

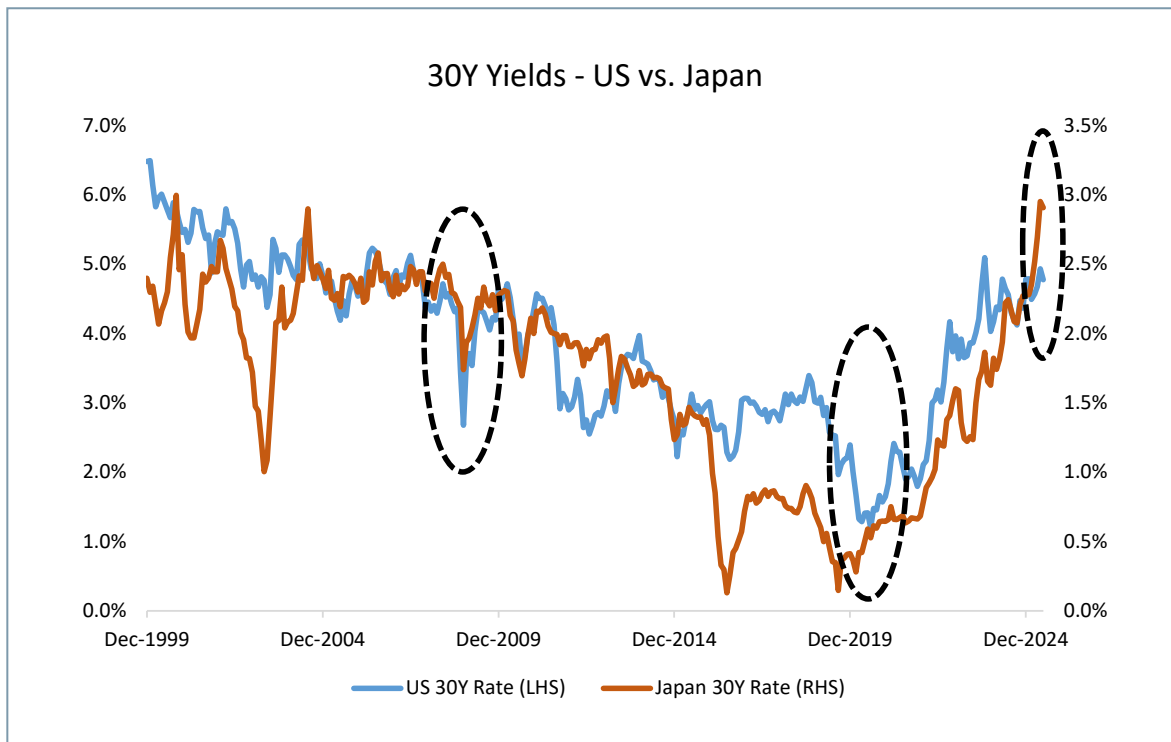


Regarding bonds or rates, something has changed: the yen, which has been the funding currency of choice for many years, and the dollar, the reserve currency, have both experienced considerable moves. This is unlike what we have seen in this regime over the past 20 years where interest rates have always come to the rescue.

Notably, despite the massive rout in equities during the first quarter of this year, Japanese and

U.S. rates drifted higher rather than materially lower. It seems that something might be changing, and while we cannot be certain we are in a new regime, we are at the very least, curious.

Shown below are long duration rates in Japan and the U.S.—you will notice that in the large drawdown in 2008 and during COVID, rates went significantly lower not higher, unlike the 2025 drawdown.



Source: Bloomberg

# What Is The Market Trying To “Guess?”

The clearest measure of U.S. market dominance was the outperformance of EPS relative to the rest of the world. As highlighted last quarter, since 2009 U.S. companies compounded earnings per share at a rate of approximately 5% higher than their European counterparts.



In the prior 30 years, there was no such earnings exceptionalism—earnings growth was comparable, and so were market returns. In essence, the era of U.S. earnings outperformance began around 2009.

The question we have, since the U.S. market started underperforming this year, is whether there has been any evidence that earnings or the domestic economy are beginning to struggle

DISPLAY 6: RELATIVE US VS. EUROPEAN EQUITY PERFORMANCE AND RELATIVE EPS GROWTH



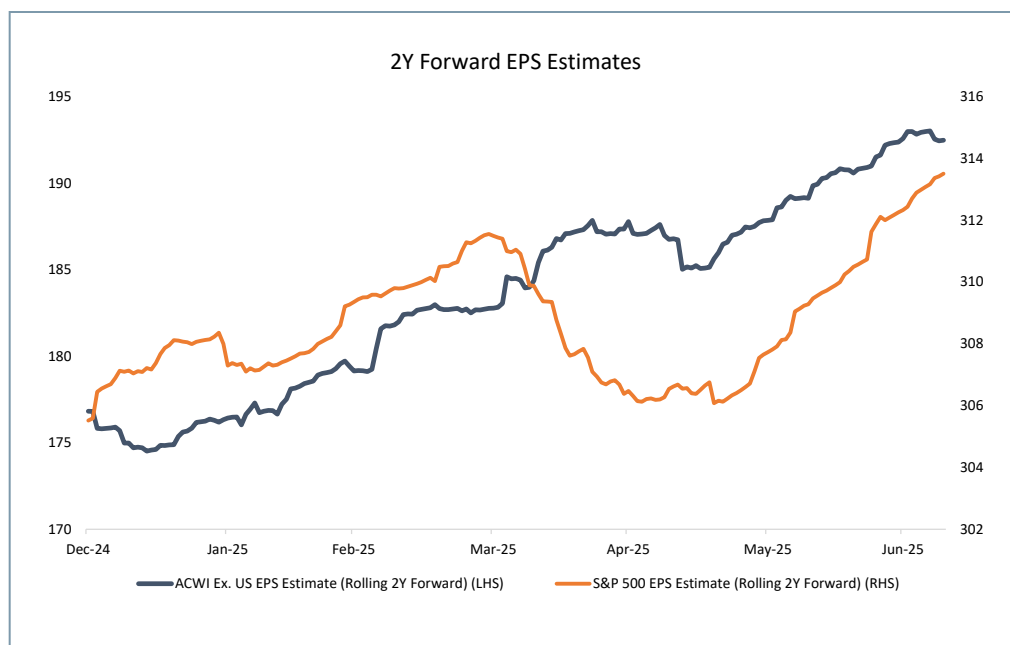
Past performance does not guarantee future results.

As of February 28, 2025

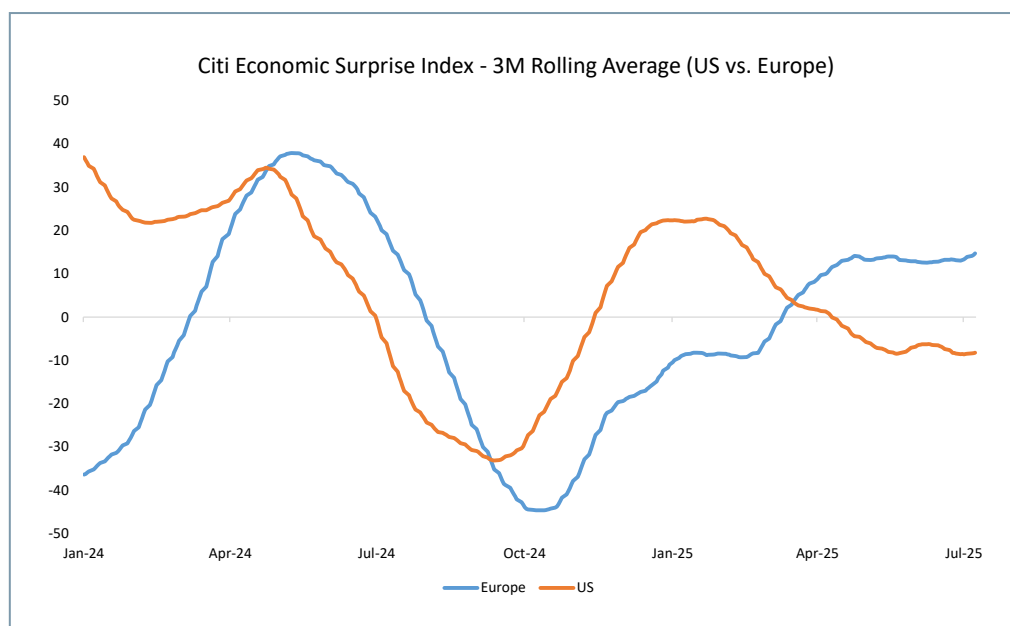
Source: LSEG Datastream and AB

relative to the rest of the world (ROW). Shown (right) are FY2 EPS forecasts for the S&P 500 vs. ACWI Ex. U.S., as a more diversified proxy. One can see a subtle change in economic surprise and maybe the same in fiscal year two estimates, that are slightly favoring the rest of the world over the U.S. If EPS are to turn, it likely comes from a failure of the large tech leaders, who have been a large part of the earnings moves in the U.S.

Another rapidly changing data point is the economic surprise, which measures the fluctuations in economic forecasts. Simply, when economists are more positively surprised—here Europe shows a slight advantage, year to date, which is unusual.



Source: Bloomberg



Source: Bloomberg

A reasonable view on shorter-term data is that at least over the last six months, economic and earnings data slightly favors the rest of the world.

# Regime Watch, Not Regime Change?

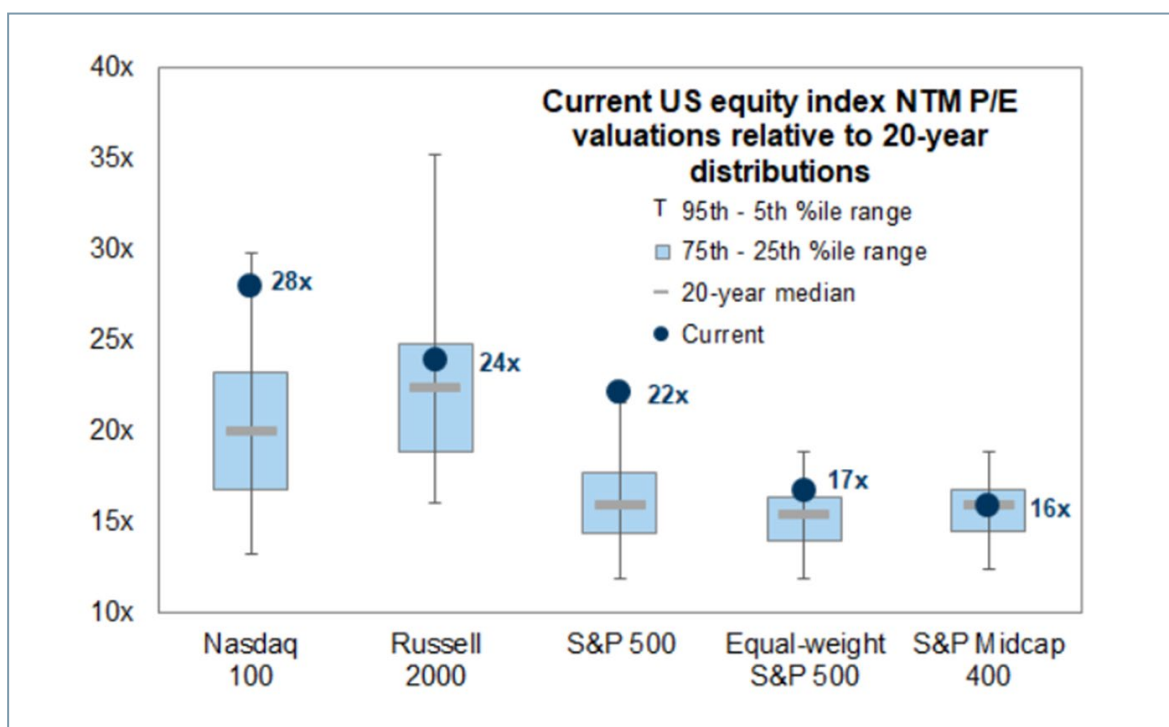
Taken together, the regime of lower and lower long-end real rates appears to have come to an end. U.S. stock markets now lag some other indices, short run fundamentals are slightly lagging the globe and this year, our currency is off to its worst start on record. This combination suggests we may be exiting the regime of the last 15 years and entering one defined by greater fiscal dominance, reduced central bank influence, and a broader opportunity to diversify into non-U.S. assets—many of which still trade at a discount to the ROW.





# U.S. Markets A Closer View

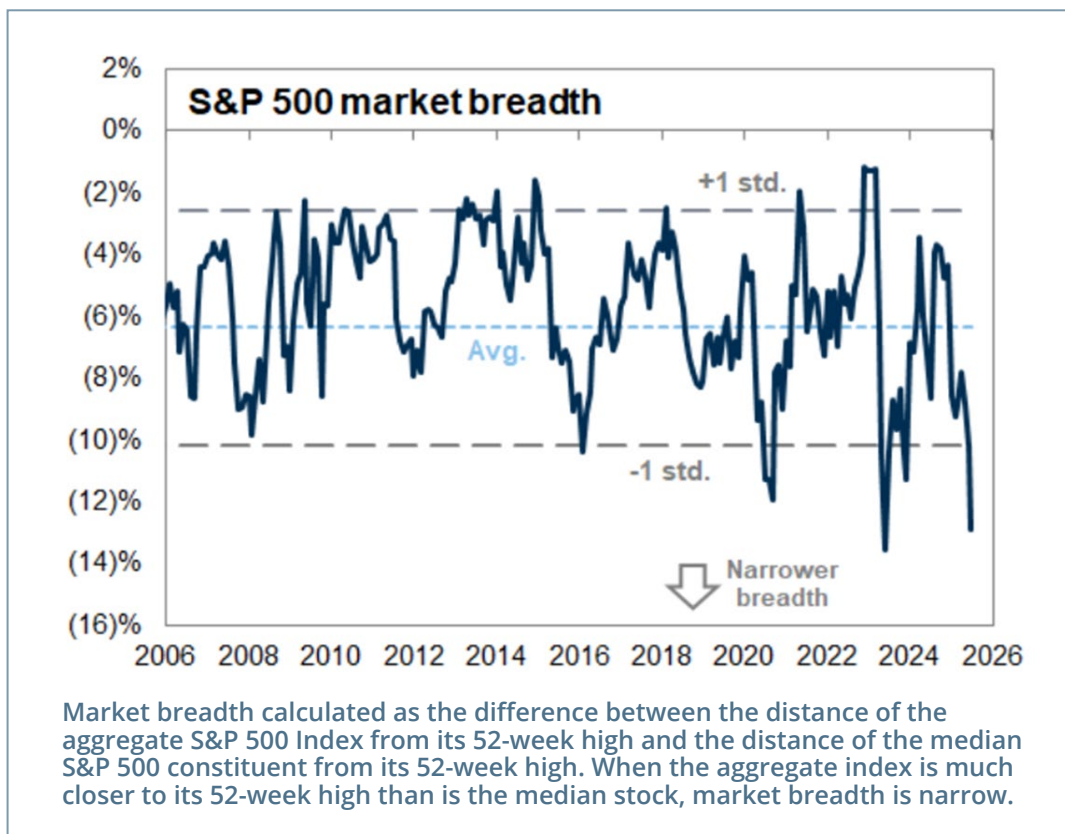
With the “drop and pop” year to date, the market is back on a typical trend. Earnings estimates have generally been immune to tariff pressures, and with the passing of the One Big Beautiful Bill Act we have some clarity, particularly on capital spending depreciation, which is pro-growth in the short run. The U.S. market has effectively discounted this with cyclical sectors like industrials and semiconductors leading in performance. The valuations shown below are near the top end of their range over the last 20 years; however, the return on capital or return on equity is considerably higher than in decades past, meaning valuations are not as comparable to prior periods if these returns hold.



Source: Compustat, FactSet, IBES, Goldman Sachs Global Investment Research

Market breadth remains anemic, reflecting the outsized performance of a handful of very large-cap tech companies that have led the market for years. While there has been

a modest resurgence in small-cap stocks in recent weeks, suggesting that breadth could improve, the trend remains very narrow.



Source: Goldman Sachs Global Investment Research

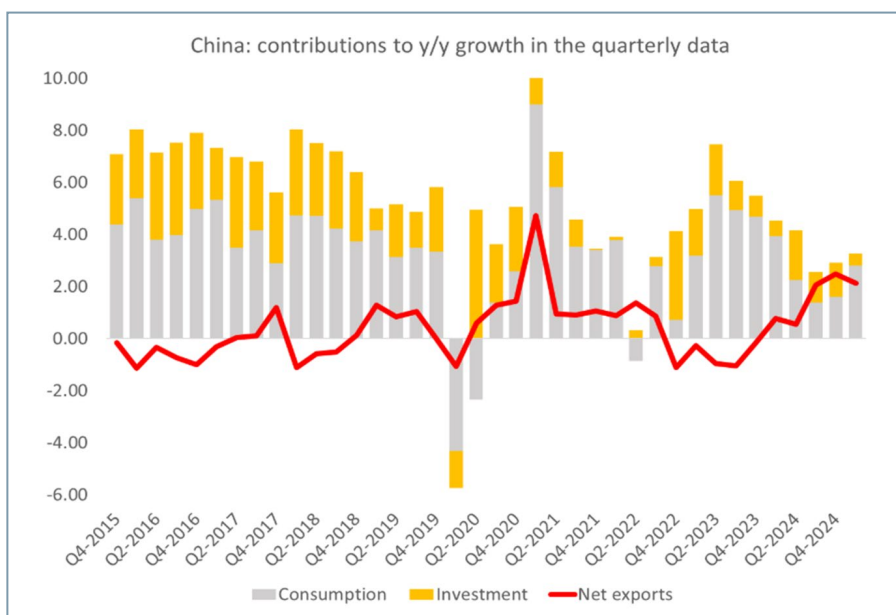
With sentiment near extremes, breadth still weak, and valuations stretched, it seems more likely we will see an average finish to the year rather than a repeat of last year's spectacular gains.

# China Has Not Given Up Its Sword

While we may be entering a new regime globally, the current regime in which China exports aggressively and consumes less than most developing economies continues unabated. We discussed this at length last quarter, but the key point remains without a rebalancing between the U.S. and China, the idea of a meaningful “grand bargain” is not on the table.

We believe the chart below summarizes China's intentions: to continue growing net exports. What is staggering is that despite nearly eight years of rising tariffs, China's economy continues to export more than it imports. Viewed in relation to domestic consumption, this trend appears to be accelerating. While Chinese officials have paid lip service to boosting consumption, so far, they show little sign of flinching under the burden of high tariffs. Transshipments, where a high-tariff country ships goods to a low-tariff country, have become increasingly evident over the past few years, as countries like Vietnam have seen a fivefold increase in exports. The takeaway is that the ultimate landing spot for tariffs will be more of an equal value than the punitive tariffs announced so far.

A notable example of China's continued dominance in manufactured goods is the Chinese electric vehicle (EV) manufacturer, BYD. The stock market has taken notice, as their vehicles generally offer better technology than their rivals and EVs at half the price of domestic competitors. Some of these advantages stem from sound



Source: Estimates World Economic Forum

sales. According to sell-side forecasts, its return on capital is higher than that of its global peers. This is not about losing money—it is about manufacturing dominance. Shown below is the strong performance in BYD year to date, along with the impressive increase in earnings per share.



Can't everyone get along? If we are exiting the relative ease of Bretton Woods II—where everyone borrowed from the U.S. because we had excess to lend and our rates were lower on a real basis—and entering a more delicate environment, it should not surprise anyone that opinions are diverging. Few examples are starker than the apparent disagreement over the Fed's role between President Trump and Fed Chair Powell.

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We do not have strong views on who is right. But the drama and constant stream of quotes feels more like a reality show than the expression of sound, stable governance.

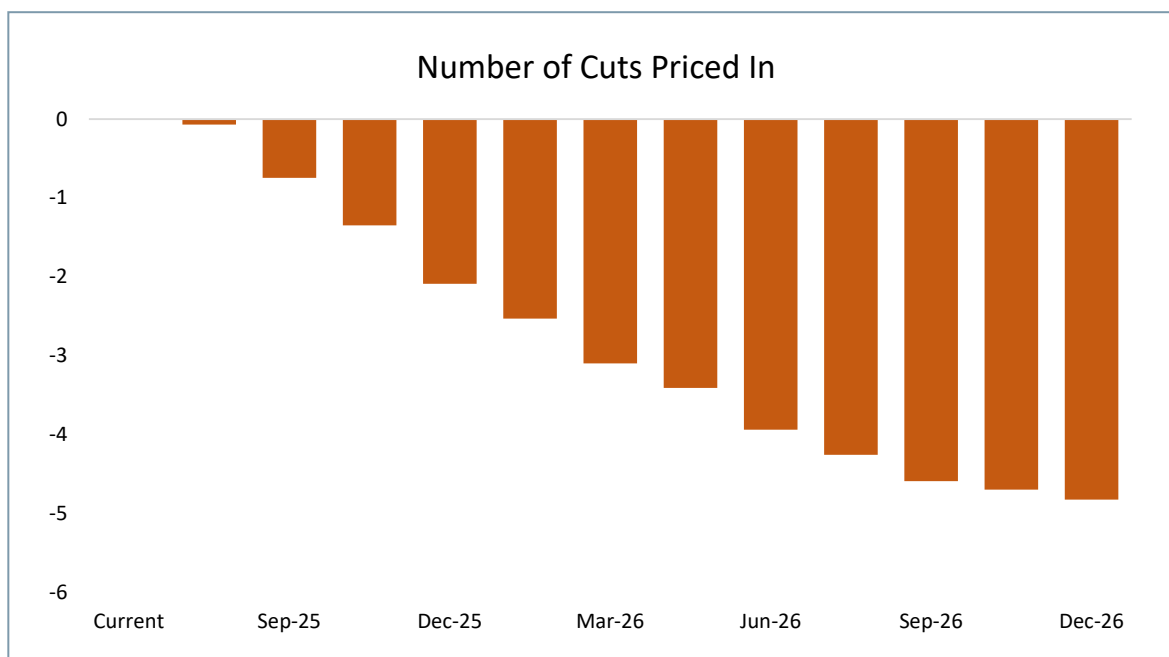
What we can say is that market forecasters have already priced in 100 basis points of rate cuts over the next 18 months. That feels about right for a market hovering near all-time highs but showing some cracks in economic indicators.

What the recent tiff highlights is that central bankers were never as independent as many believed. There is a well-known story from the 1960s: then-Chairman Bill Martin famously said the Fed's job was to "take away the punch bowl just as the party gets going." But that was not always what presidents wanted or needed. During the Vietnam War, with inflation heating up, President Lyndon Johnson reportedly summoned Martin to his Texas ranch and said, "Boys are dying in Vietnam, and Bill doesn't

care." Only a few years later, President Nixon faced the same tension with Martin and replaced him with a more dovish Fed chair, Arthur Burns, who, looking back, was far too slow to tighten policy amid rising inflation.

The takeaway is this: if we are entering a new regime, we should expect more of these skirmishes. If Fed governors have historically struggled to get along with presidents during peacetime and low inflation, how will they navigate a global reset of currency and capital flows?

Simply put, diminishing Fed independence implies a dovish outlook. An early Fed chair nomination, particularly under political pressure, increases the odds of a pivot in monetary policy. At that point, the personality of the nominee may matter less than their willingness to carry out the policy agenda dictated from above.



Source: Bloomberg

# The Dollar's Role In A Fiscal-Dominant World

Finally, we have seen countless stories predicting the end of the dollar as the world's reserve currency. Bitcoin bulls point to its robust performance. Gold bulls cite its rise since 1998, when yield curve control quietly began, and its 2,000-year track record in global commerce.

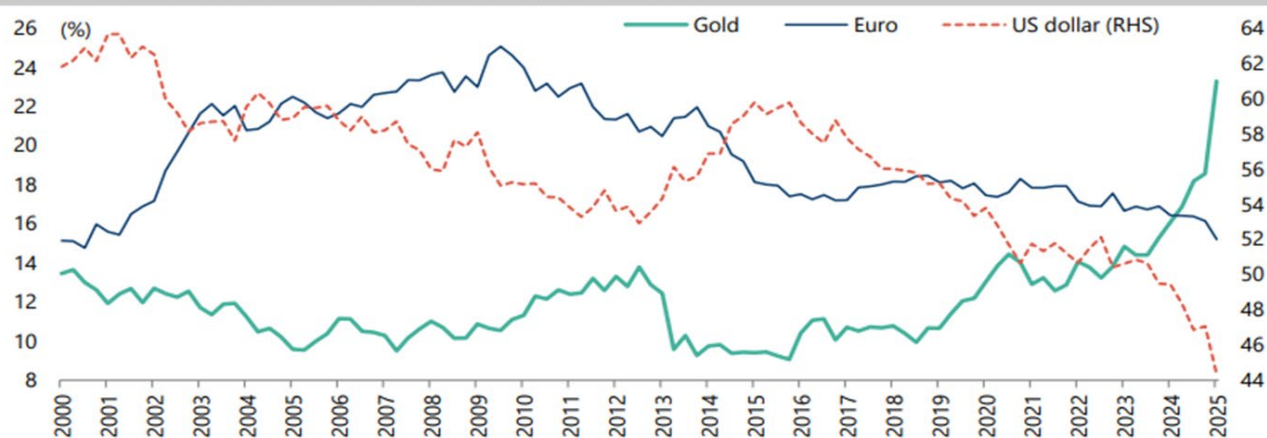
We believe these arguments are misplaced. The U.S. remains the largest and most liquid currency system in the world. The reserve currency narrative is often overstated. Put differently, with our enormous twin deficits, we have been supplying massive quantities of dollars to the rest of the world, either in exchange for goods or to fund our fiscal largesse. Any meaningful attempt to reduce these deficits would naturally reduce reinvestment demand for dollars and exert downward pressure on the currency.

If we are indeed entering a fiscally dominant world, policies like the Supplementary Leverage Ratio (SLR) relief—which allows U.S. banks to hold more Treasuries with less capital—are not just likely, but increasingly certain.

The chart below, while based on several assumptions, offers the best available estimate of global central bank reserves. Over the past decade, both the euro and the dollar have gradually lost share to gold (and possibly Bitcoin).



**Exhibit 20: Share of world official foreign reserves (including gold)**



Source: Bloomberg

The story of the dollar is complex, but the main point is this: the dollar, driven by fund flows, carry trades, and trade imbalances, is at an extreme price level that is not supported by traditional valuation measures, such as purchasing power parity. Instead, it has become the flow of choice for most investors, both consciously and unconsciously. “

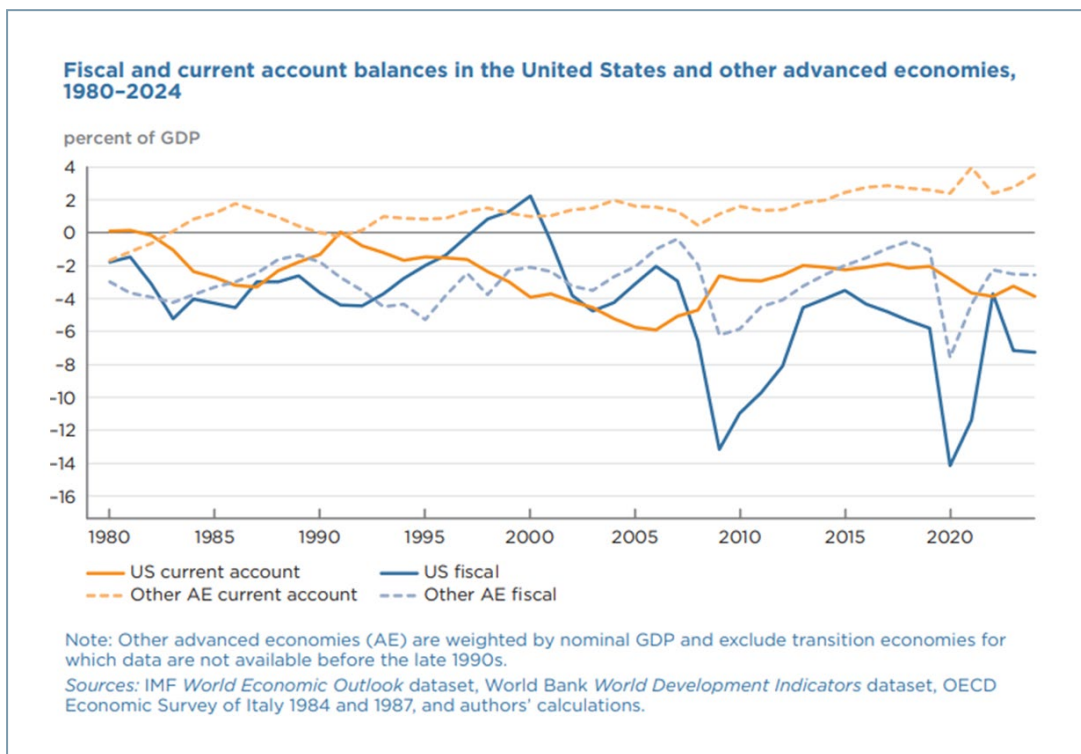
That is why its year-to-date underperformance is so noteworthy. It aligns with the early stages of efforts to rebalance global trade, which will likely reduce demand for dollars as the U.S. twin deficits begin to shrink.

Only two times has the dollar experienced a worse drop than the start of this year, both ending in sharp changes in the economic outlook. In 1973, with the Fed too dovish, the dollar fell sharply, eventually leading to record rates of inflation, and in 1986, the market began to discount a major change in rates over the next few decades.

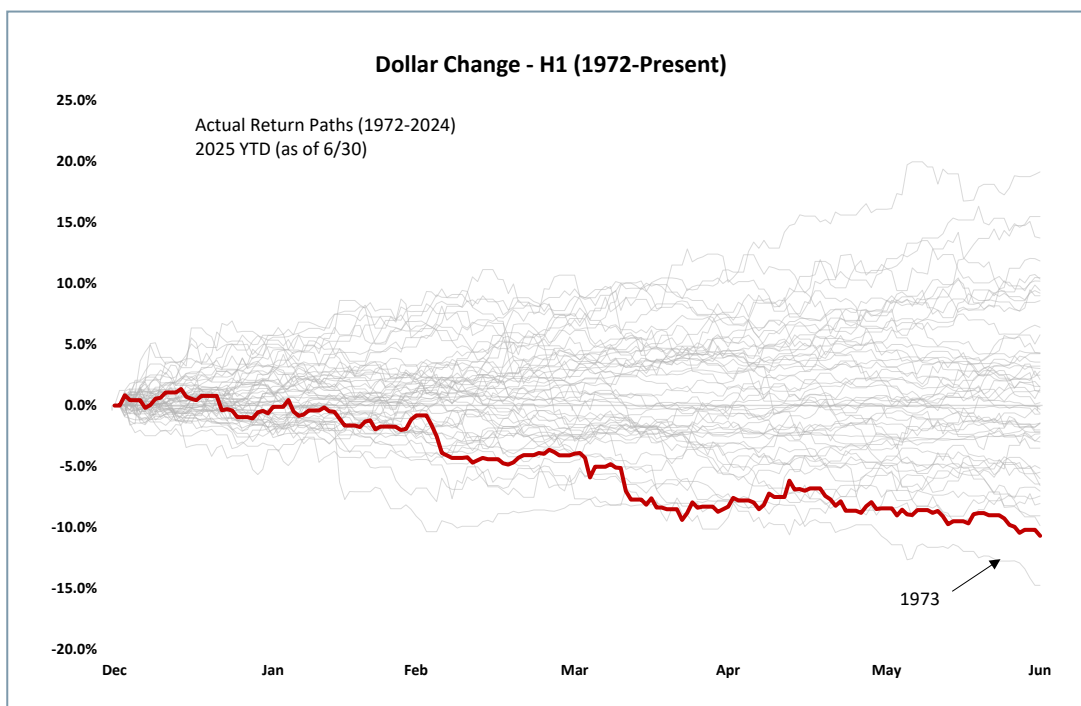
The Peterson Institute produced a recent working paper [here](#). They do an excellent job in getting deep into the balance of payments and the extreme imbalances that now exist, where basically the U.S. consumer and government are now borrowing from everyone else, at levels only seen during extreme years over the past 100 years. “The United States appears to have an unparalleled ability to convert its physical capital and public debt into marketable assets the world wants to buy. The upshot of these trends has been downward pressure on U.S. interest rates and upward pressure on U.S. asset prices, including the value of the dollar, which depresses U.S. saving and drives the external deficits that correspond to the capital inflow. So long as the United States retains these perceived advantages, this situation can persist, to the benefit of U.S. households. But there is no guarantee that the United States will always be perceived as the safest place to invest with the most attractive financial assets. Indeed, it is striking that the initial reaction to the recent tariff hike was a sell-off in the Treasury markets and a depreciation of the U.S. dollar.”

“More specifically, the U.S. seems to be better at creating marketable securities, including safe assets, that foreign investors wish to buy. These features make U.S. assets attractive to foreign investors and enable the United States to run large current account deficits at comparatively large levels.”

They go on to suggest that a 15 to 20% fall in the dollar is necessary to stabilize the balances shown below. The solid lines show the enormous twin deficit the U.S. runs and the dotted lines show the smaller fiscal deficit and large current account surplus key trading partners manage. The relative returns of the dollar become the lead indicator of these flows.



Shown below are the first 6 months of the Dollar Index (DXY) returns each calendar year starting in 1972.



Source: Bloomberg

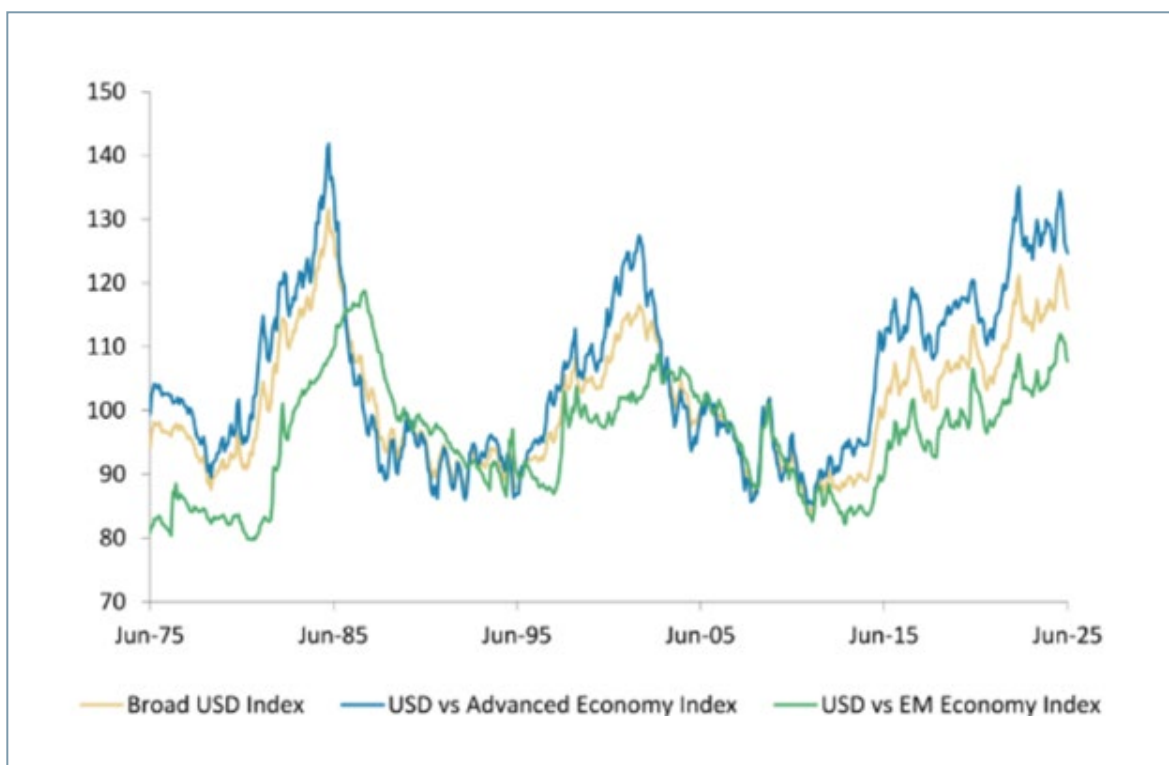


While we do not hold a strong short-term view on the dollar, we would expect that, given rising deficit spending and efforts to rebalance global trade, the dollar is unlikely to remain near all-time highs.

The last time the dollar was this expensive was in the 1980s, when the U.S., Japan, and Europe entered the Plaza Accord to effectively reduce the dollar's value and curb Japan and Europe's growing manufacturing cost advantage. It was incredibly successful in lowering the value of the dollar, but it did have side effects, such

as pushing the yen and its market to record valuations.

The key tell today may be currencies like the yuan, which have remained stubbornly undervalued. Any meaningful revaluation would signal that domestic consumption is becoming a greater priority for the Chinese government—and that its relentless push to export to the rest of the world may finally be slowing. The long-term chart for the dollar shows the rather small drop year to date, and the elevated historical level of the currency.



# Building Boxes With Chips And Fans

There is a long-standing view in economic think tanks—and yes, we know all the jokes about economists—that depressing real interest rates is a valuable tool for staving off crisis. However, if left in place for too long, it inevitably distorts capital markets in ways that are detrimental to both economic and social welfare.

Taking that view, it is not surprising that after 25 years of ever-lower real rates, and repeated demands by investors for policymakers to suppress every wobble, we are now seeing clear evidence of bubbles across many assets. We wrote about this back in [January](#).

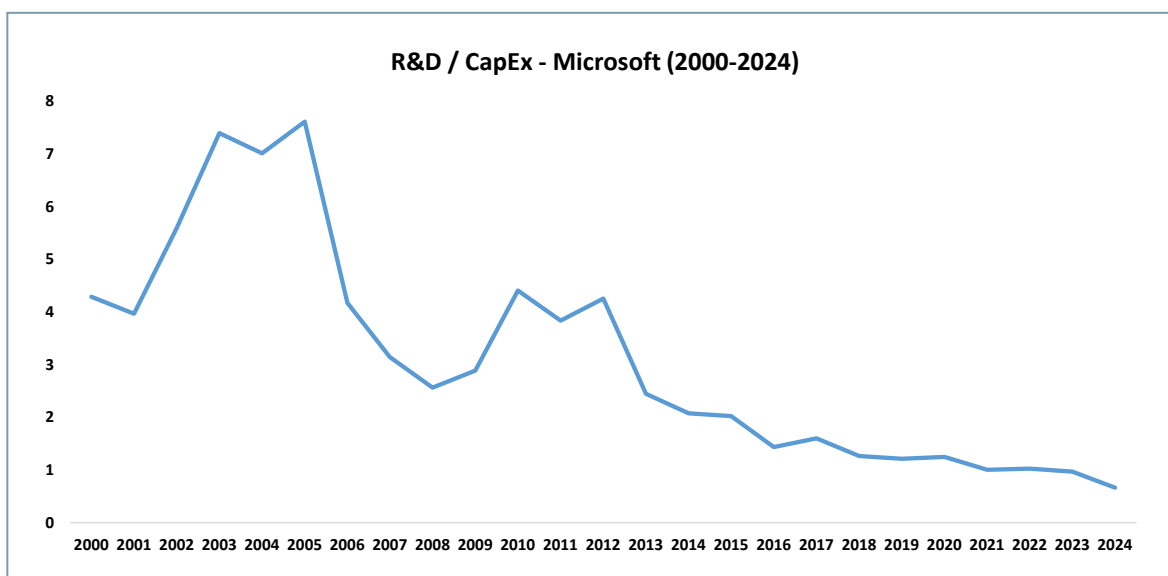
We are increasingly concerned that the AI narrative, while compelling and likely to persist over many years, may be hitting a capital spending wall, where investments by leading firms are delivering diminishing return on capital.

There have been anecdotes from Microsoft suggesting it does not need to spend as aggressively on data center buildouts. Meanwhile, there are now hundreds of reports showing actual return on capital on the new AI infrastructure falling into negative double digits. The chart below may be key: as we ask more and more from the AI engine, we appear to be getting less and less. That is good news for the picks-and-shovels suppliers we correctly identified 18 months ago, but potentially bad news for those who own the assets themselves.



To put this into context, consider that Microsoft has been the best-performing stock since 1993. The chart below shows its R&D spending in relation to capital expenditure. The point is striking; Microsoft no longer appears to be an IP-first business. Instead, it increasingly resembles a U.S. airline, with capital spending now reaching 20% of revenue.

R&D once outpaced capital expenditures by 4–5 times. Today, they are roughly equal. And according to forecasts, capital spending is poised to exceed R&D going forward. While one might argue that Microsoft's R&D created a monetizable asset in AI, it is harder to argue that building massive warehouses filled with identical chips and HVAC systems is similarly unique.



Source: Bloomberg

To put this in a broader perspective, the chart below shows the stunning amounts of capital being spent by just a few large-cap tech companies. For comparison, the capital spending-to-revenue ratio for U.S. airlines is around 10%,

and for large U.S. railroads, it is in the mid-teens. The point is that hyperscalers resemble telecom builders of the late 90s more than the profit machines of the past two decades, where they built monopolies to earn economic rent.



Source: Bloomberg and Goldman Sachs

# They'd Better Be Right

These infrastructure owners had better be right because the assets they are building depreciate quickly, tied to the rapid cadence of NVIDIA's chip releases and pricing power.

AI performance scales nicely, up to a point. But once computing demands cross a certain threshold, the costs skyrocket. Improvements become nonlinear, and the efficiency of turning computing into meaningful progress, breaks down. We suspect AI will indeed prove effective, but in narrow, targeted applications, not in artificial general intelligence (AGI).

Put simply, agents built to solve small, well-defined problems with smaller data sets are the call today. AGI remains headline-worthy, but increasingly expensive and speculative.

There is growing evidence, including comments from OpenAI, that costs are rising faster than performance gains, and that models are not yet achieving scale efficiencies. That is the key economic tension: if greater accuracy requires exponentially more computing power, then the path forward may be less about smart algorithms and more about brute-force infrastructure.

If that is true, expect the biggest AI builders, flush with cash but maturing in their core markets, to keep surprising the market with ever-larger capex budgets. In short, we are in the greatest arms race in the world, but everyone is using the same arms.

There is a counterargument that reads, "Emergent Behaviors Are Unpredictable." Scaling laws assume smooth, predictable gains, but new capabilities do not arrive linearly. Some appear suddenly at scale ("emergent behavior"), which makes investment harder to model. Additionally, benefits in other areas, such as robotics, are not as easily measured as scaling is in Large Language Models.



In the near term, the beneficiaries are not necessarily the builders, but their suppliers—energy producers (particularly natural gas, MLPs, and power companies), semiconductor firms with supply constraints, and cooling infrastructure providers.

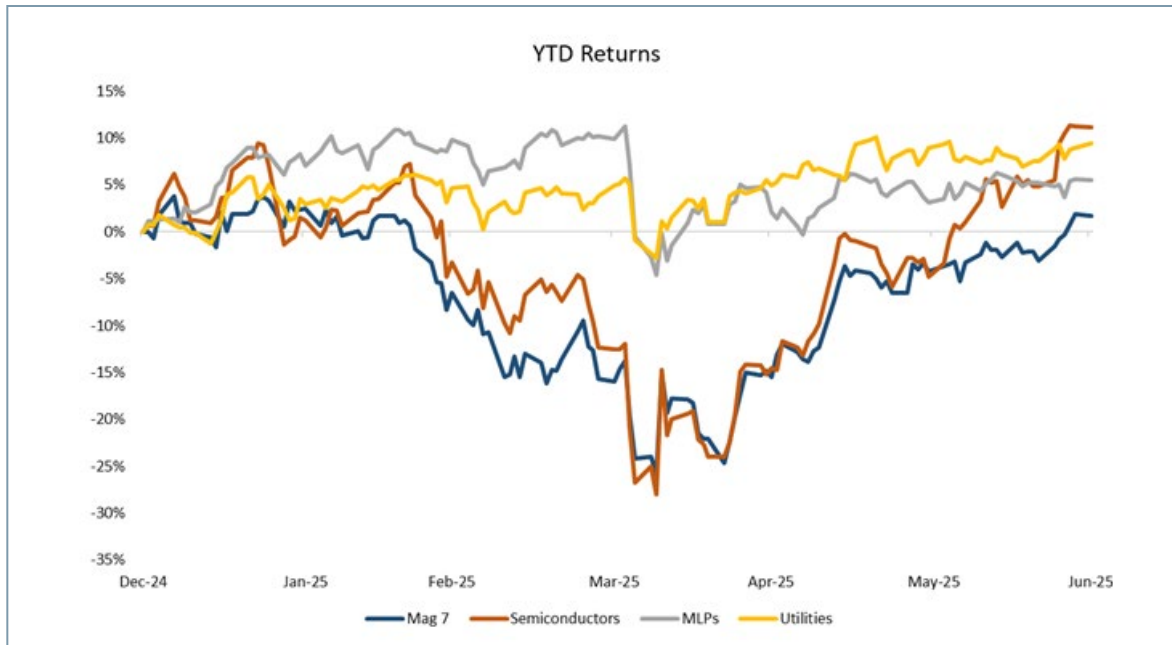
We asked Chat GPT, the ultimate circular reference for its thoughts on our views:

"Robust empirical foundation: Scaling laws broadly hold and are used in model planning.

Economic gap emerging: Gains in performance increasingly come at steep computational costs.

Strategic inflection: Investors should watch for the point where compute investment outpaces practical performance gains—a theme that aligns with your argument that infrastructure costs may outgrow returns, and that 'picks & shovels' suppliers may be better positioned in the near term."





Source: Bloomberg

The chart above shows that, year to date, the picks-and-shovels plays have generally outperformed the AI builders themselves. That trend reflects a market starting to question

where the real economic value lies, and whether infrastructure-led hyper-scaling is as investable as the narrative suggests.

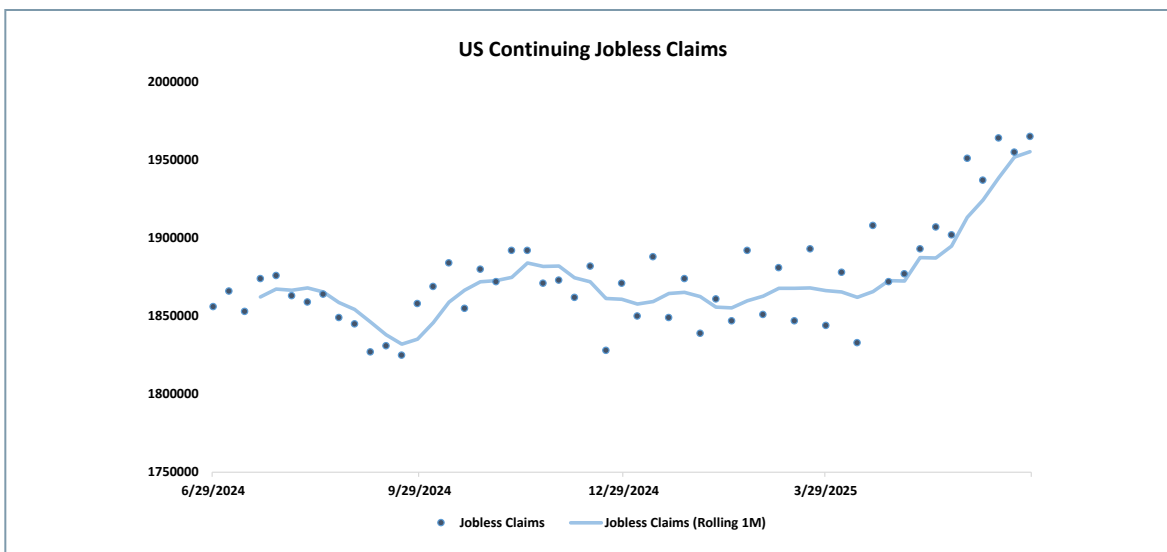
## Economy

The consistent refrain has been do not bet against the U.S., and particularly the U.S. consumer. We believe the new bet is not to bet against large fiscal spending as a support for capital markets. Said another way, fiscal dominance is overtaking central banks, which have had your back as an investor.

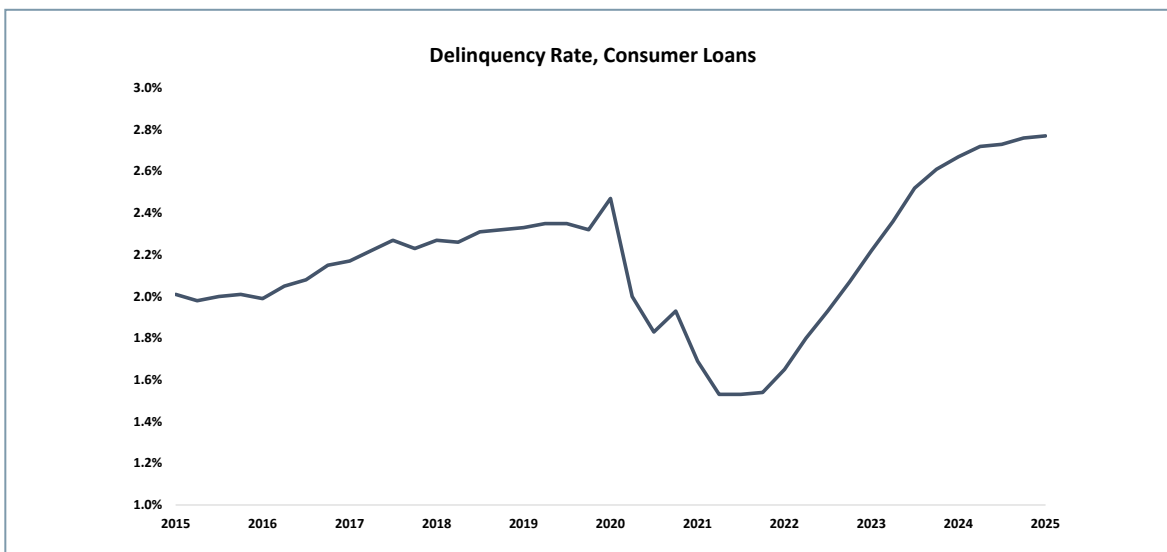
Just looking at the U.S. consumer, one would be quite concerned today, as this data does not include any of the short-run economic benefits from The One Big Beautiful Bill Act (OBBBA), which likely increase capital spending in targeted areas such as technology, infrastructure, and security. We expect some of these indicators to stabilize or improve in Q3/Q4.

- Unemployment claims trending up.
- Almost all credit metrics are in reverse.
- Housing starts are in reverse.

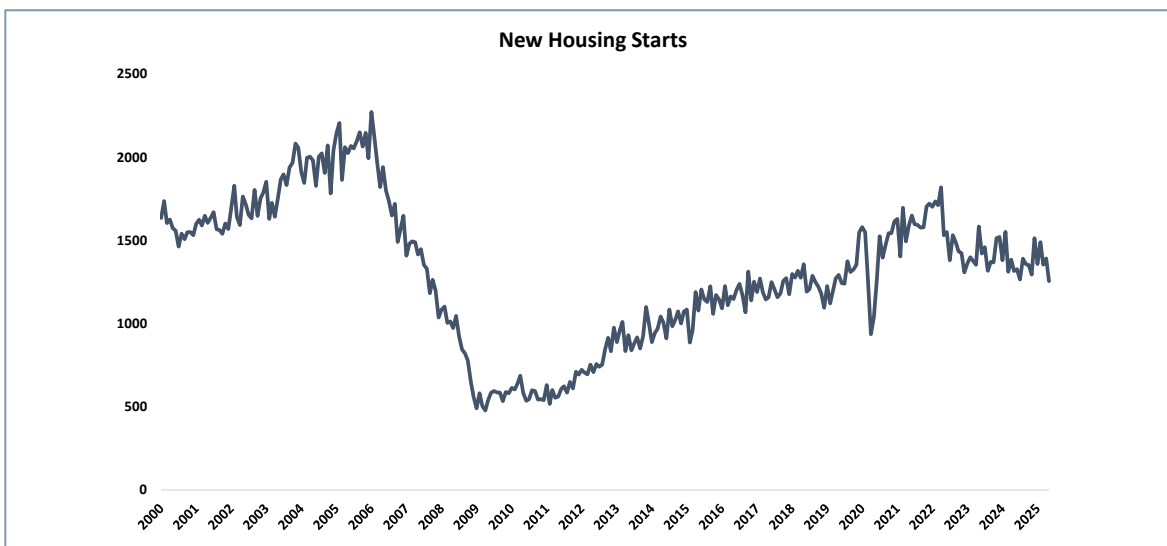




Source: FRED

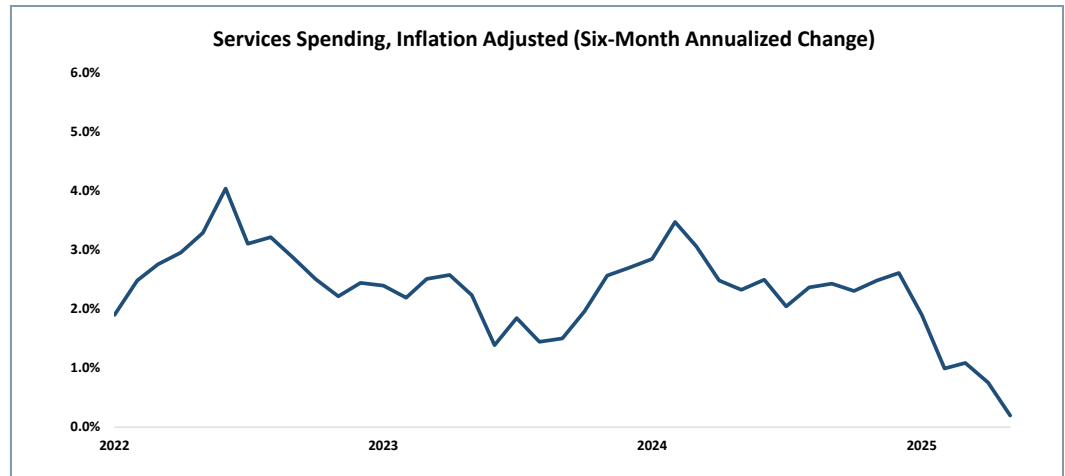


Source: FRED

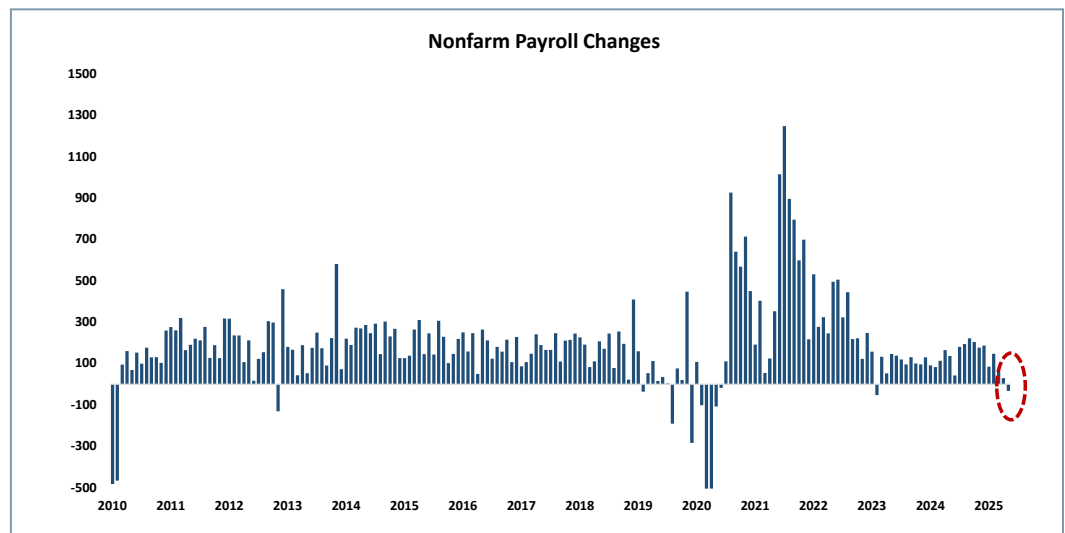


Source: Bloomberg

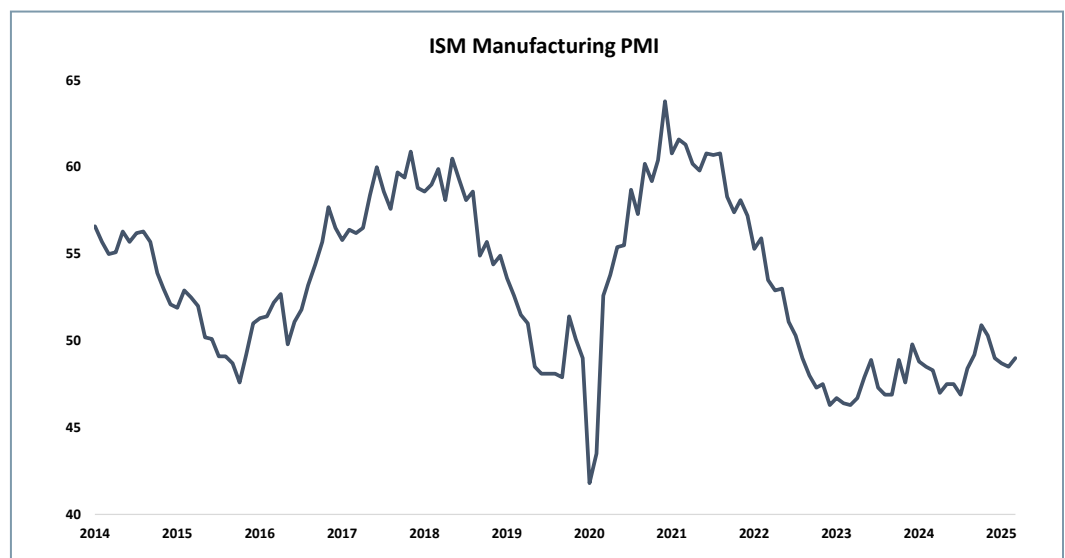
The manufacturing sector has been weak, and part of this can be attributed to the sky-high policy uncertainty in Q2, stemming from tariff discussions and capital market dislocations. That said, the Manufacturing PMI was weak before Q2, which leads us to a similar conclusion to the consumer, that it is slowing gradually. As alluded to earlier, many of the newer provisions in the OBBBA will be stimulative to U.S.-centric manufacturing and likely the PMI.



Source: FRED



Source: Bloomberg



Source: Bloomberg

# Closing Views: Investment Implications In A World Without Clear Patterns

While we typically conclude with five or six actionable ideas, the consistent refrain from markets has been “don’t worry—the U.S. consumer and economy always recover.”

We are less convinced. We believe the bond market is right, and that the economy will slow in the coming months. However, we also think that policymakers, on both the left and right, are increasingly responsive to populist sentiment, meaning policy support will arrive more quickly than usual, potentially offsetting economic weakness.

Call it populism with a fiscal bazooka—from the recent U.S. presidential campaign to the NYC Democratic primary to global election results, the recurring theme is “spend more to help”. Whether that is optimal or not, it appears increasingly entrenched.



## Investment Conclusions in a Wealth Preservation Model

### 1. Expect More Drawdowns, Not Fewer

With this many macro crosscurrents, drawdowns like Q1’s sharp drop are likely to become more frequent, not less. As we have emphasized, we may be entering a regime without historical precedent, where traditional market playbooks fail to soothe market players.

### 2. U.S. Exceptionalism: Still Valid, but With Headwinds

We still believe in the strength and innovation of the U.S. economy, but returns will be

harder to generate from current valuation levels, especially with real interest rates no longer providing a tailwind. Moreover, if the dollar is no longer structurally supported by twin deficits and foreign demand, dollar-based returns could weaken, dampening enthusiasm for U.S. assets.

### 3. Diversify Out of Dollar-Based Assets

For investors focused on global purchasing power parity, the case for diversifying outside of dollar-based investments is stronger now than at any point in the past two decades. We have outlined a framework for thinking about this shift, although positioning and sizing must be customized based on each investor’s current mix, tax profile, and goals.

#### 4. Defense Spending as a Secular Theme

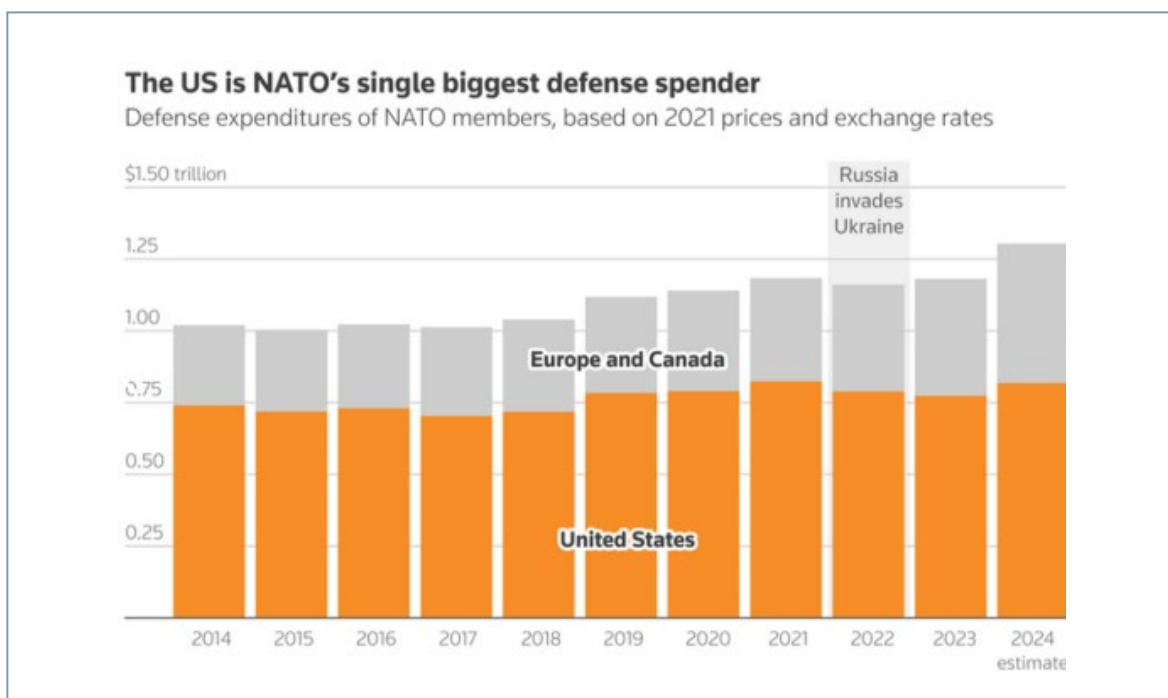
For the first time in a long time, NATO members are meaningfully increasing defense budgets. European countries have earmarked significant funds and are targeting a 5% of GDP level by the end of 2030, more than doubling.

- a. Whether one agrees with the policy or not, it is likely to drive a sustained investment trend. The chart below illustrates relative global defense spending; U.S. GDP is about equal to Canada + Europe.
- b. We see multiple beneficiaries from this trend, particularly in private markets:
  - i. One strategy seeks to offer mid-to-high double-digit returns by effectively lending against signed government contracts.
  - ii. Another operates like a venture lender focused exclusively on defense-tech startups.

#### 5. Be targeted in Private Equity (And...all illiquid exposures)

We have been generally critical of the “average” private investment opportunity, as we believe the illiquidity often fails to justify the expected returns. That said, we receive hundreds, if not thousands, of meeting requests each year soliciting us to invest in semi/illiquid investments, and it is not surprising that through those conversations, we occasionally uncover a diamond in the rough.

To begin, let us state our core concern: in our experience, the best private investments share three key traits—aligned incentives, a clear distortion in fair value, and a unique competitive niche. Our issue with many offerings is that they sound strikingly similar: excellent

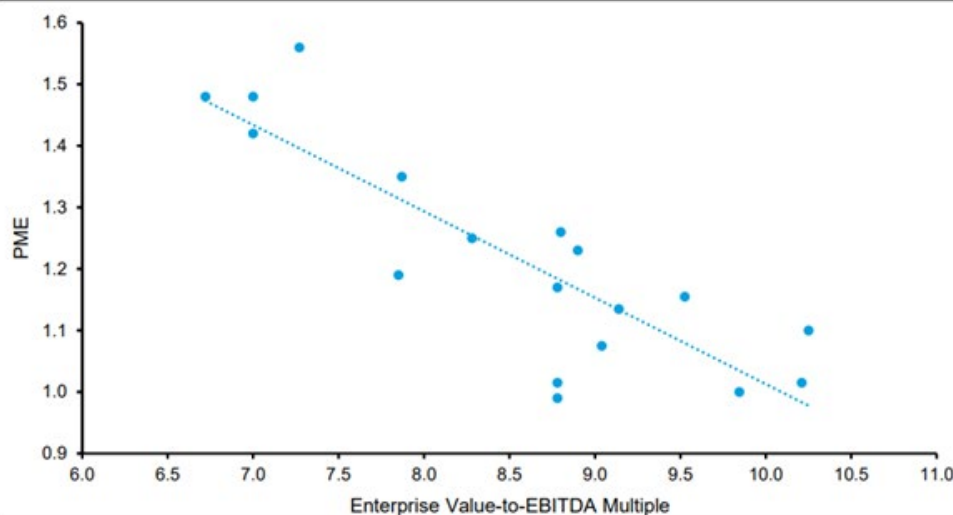




résumés, solid 15-year track records (but weak over the past five years), and a move upmarket driven by scale requirements, a relatively crowded capital space, and limited differentiation.

The chart below underscores the obvious: as entry multiples rise, expected returns fall. Entry multiples have climbed on average, and so too must expectations adjust downward accordingly for most new private equity and credit investments.

Exhibit 34: Enterprise Value-to-EBITDA Multiples and PMEs, 1997-2014



Source: Gregory W. Brown and Steven N. Kaplan, "Have Private Equity Returns Really Declined?" *Journal of Private Equity*, Vol. 22, No. 4, Fall 2019, 11-18.

That said, we have seen some compelling opportunities in the lower middle market, in capacity-constrained parts of the market that offer real value-added opportunities, and in the secondaries market, where founder demand for liquidity is leading to interesting, well-structured solutions to get exposure to that part of the market. We will continue, as always, to bring these to clients as we uncover them.

# Summary

In closing, while no one can say with certainty whether we have entered a new era, the evidence is mounting that the investment playbook of the past 15 years may no longer be applicable. Market leadership may have shifted as we enter a far more fiscal-dominant regime, and capital is beginning to flow in a different direction. For investors focused on wealth preservation, this is not a time

for prediction; it is a time for preparation. The opportunity lies in recognizing that change and when it comes, it does not announce itself—rather, it signals quietly, then moves quickly. We believe this is one of those moments.

We welcome your thoughts and perspective on our research.

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