VERISMO FINANCIAL

Mid-quarter Market Update

> *Stock markets have continued to rally through the summer following another strong quarter of earnings. A selloff in the AI sector led to the liquidation of a large hedge fund, but damage remained contained and the impacted stocks have started to rebound. Focus remains on inflation, especially from the new Federal Reserve Chairman Kevin Warsh. It's unclear if we should expect the Fed to raise interest rates to combat it.*

Both the S&P 500 and MSCI All Country World Index have risen by 3-4% during the quarter and continue to make new all-time highs. The major driver was quarterly earnings, which continue to impress. The percentage of companies in the S&P 500 beating estimates was higher than 85% for the second quarter in a row. The typical rate is closer to 78%. The magnitude was also impressive. Earnings grew 48% from a year ago, with expectations for 20%+ growth for the rest of the year as well.[i]

Artificial intelligence was a key driver of the earnings growth. So-called "Other Income" from two major hyperscalers contributed roughly 40% of the overall earnings growth that we cite.[iii] Other Income is money that flows into a corporation from transactions unrelated to its normal business. It's analogous to a salaried worker winning a modest lottery jackpot or selling an unneeded appliance. The money is nice to have, but can't and shouldn't be part of a long-term budget because of its small, one-time, and/or unpredictable nature. Similarly, analysts typically ignore Other Income when providing earnings estimates. In the first and second quarters, however, a private AI technology company has been revalued upwards multiple times. The hyperscalers which

The Philadelphia Semiconductor Index, a decent proxy for the broad AI trade, experienced a dramatic pullback in July. It's still up 75% this year alone.[ii]

own stock in it have adjusted the value of their holdings higher as a result, to the tune of an unrealized gain of hundreds of billions of dollars.[iv] The biggest driver of earnings growth in the S&P 500 was not a company in the S&P 500 – it's not even a publicly-traded company! If it goes public at the $2 trillion valuation it currently expects, Q4 could see 60% growth for the S&P. A different AI developer hasn't raised cash since December, so we don't know its actual current value. But it's possible that we'll get a similar earnings bump when it inevitably does so.

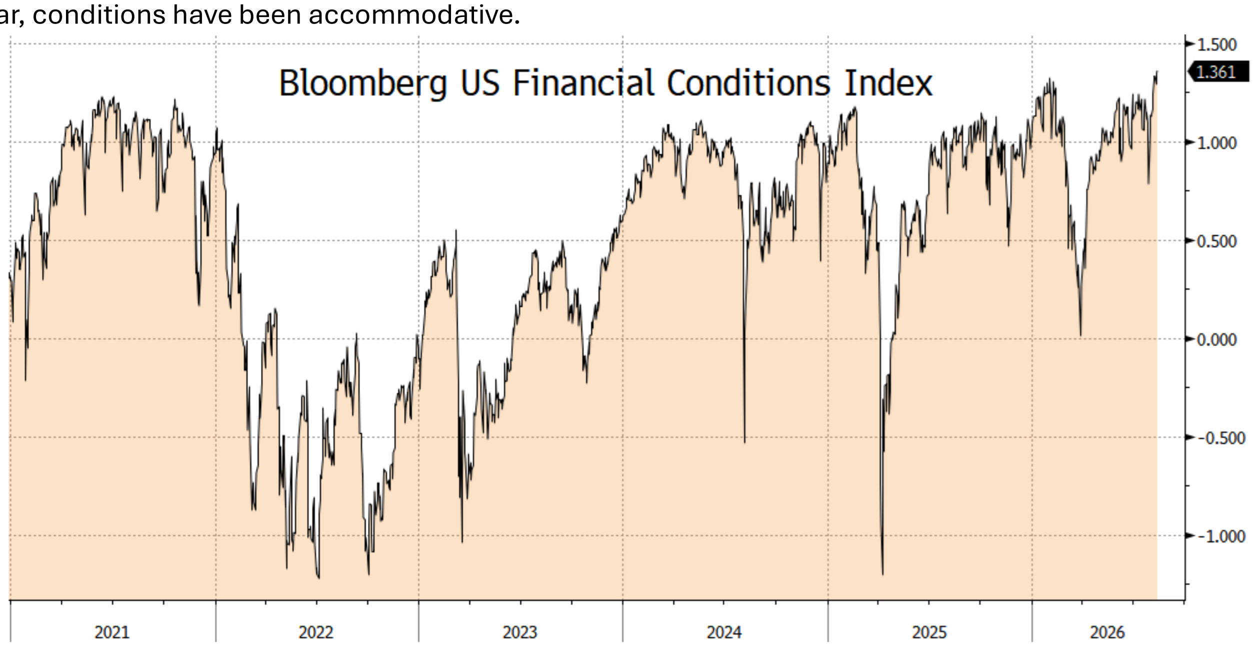
July was a tough month for share prices of public stocks involved with the artificial intelligence buildout as investors took a step back from the manic rally of the second quarter. One hedge fund with roughly $45b in assets under management was operating with significant leverage with a vision toward the long-term effects of AI. With nearly all of its holdings moving in the wrong direction, it faced margin calls and was forced to liquidate in late July at what turned out to be the bottom of the selloff. With its holdings now in steadier hands, the Nasdaq 100 (an index comprised mostly of technology companies) immediately experienced one of the strongest 4-day rallies of the last twenty years. At its peak the hedge fund had been up more than 350% in the previous twelve months, but because of its leverage and lack of diversification a relatively minor pullback was able to force its liquidation.

Separately, but similarly, the South Korea stock market experienced a 35% decline from the peak during July, as two major memory suppliers have grown to encapsulate nearly half the index. Its stock market had more than doubled through June of this year, drawing interest from retail investors and leading to the introduction of several leveraged ETFs.[vi] These ETFs borrow money to get double the return of the underlying stocks. During July's swoon the South Korean government had to take emergency measures to curb the use of these ETFs to attempt to prevent investors from getting wiped out. Both these stories demonstrate the risks of leverage and concentrated portfolios. The South Korean selloff was similar to the selloff in the United States during the pandemic – roughly 35% in approximately a month.

Since the Federal Reserve lowered rates by 50 bps in September of 2024 (circled), and another 125 after that, the 10-year yield has gone the other direction – rising by more than 1%.[v]

Stocks have done well despite high and rising interest rates. Bond investors continue to be wary of the risk of inflation. While inflation data isn't at levels from 2021, it continues to be sticky at the 3-4% level. Long-term yields have moved higher ever since the Federal Reserve began cutting rates in September of 2024. More recently, the Iran War isn't helping, as oil is currently above $80 per barrel, compared to $60 in January. Shelter prices are also a major contributor. The Fed has now cut rates by 1.75% since 2024. In that time, the 10-year yield has risen by 1%. This is the only time in history that rates have risen in such circumstances. Even the 2-year yield has risen since September of 2024. The only other time that happened was in the 1980's, leading the Fed to abruptly start raising rates again.[vii]

Markets and the economy can almost certainly handle higher interest rates. The Bloomberg US Financial Conditions Index combines money market, corporate & municipal bond spreads, stock prices, and the volatility of stocks & bonds into one measure. It's at its highest (most accommodative) level since 1997. The Office of Financial Research's Financial Stress Index breaks down components into five categories – stock valuations, money market liquidity, government bond health, corporate credit concerns, and market volatility. Since 2025 the only component which has been negative at any time was market volatility. Except for the volatility around tariffs and the Iran War, conditions have been accommodative.



The Bloomberg Financial Conditions Index indicates that conditions are nearly 1.5 standard deviations easier than historical norms. A reading of zero is average.[viii]

New Federal Reserve Chairman Kevin Warsh has been quizzed relentlessly at media events regarding the future path of interest rates. And he's sidestepped the questions every time, committed to the removal of "forward guidance" and instead casting uncertainty on the outcome of any given Fed meeting. He's described the policy discussions as "good family fights." In July they left the interest rate unchanged, but had three dissenting votes out of the twelve. Based on recent public comments, even more voters might dissent next time in favor of raising rates.[ix] The odds of a rate hike in September are currently a coin flip. Before the most recent Fed meeting, investors expected one rate hike with certainty, with a 10% possibility of a double-hike of .50%. [x]

The lack of forward guidance will continue to bother bond investors. The forward guidance we've become accustomed to originated in 2008. The Federal Reserve had lowered the Federal

Funds Rate to zero percent, exhausting their typical toolbox.[xi] Forward guidance was a new tool, "promising" low rates farther into the future, and was paired with quantitative easing (QE) which allowed them to manipulate other interest rates lower by buying bonds. Life was easier when the Fed broadcasted their policy decisions years in advance. But it also led to many of the most recent economic and market disasters. Forward guidance was a key contributor to the high inflation in 2021, for example, when the Fed was reluctant to react faster to incoming economic data. If you don't recall, the Fed was still buying mortgage-backed securities, directly contributing to higher housing prices, the month before they started raising rates in 2022. Forward guidance was also a major factor behind the banking crisis in 2023. Banks had purchased long-duration securities partially because the Fed had projected that interest rates would stay low for years. When the Fed aggressively raised rates in 2022 some banks became insolvent as a result.[xii]

August and September have historically been difficult months for markets. With all the crosscurrents, we expect volatility to continue. There's no doubt that investors have circled the midterm elections as an especially important date on the calendar.

Best regards,

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The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.

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[i] Bloomberg
[ii] Bloomberg
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[ix] Bloomberg
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[xii] Bloomberg