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2Q25 Investor Letter

Peltzman Effect

Are we actually safer with the safety advancements that now exist? It might seem like an obvious question and answer, but the economist Sam Peltzman saw it differently. What is theoretically designed to make us safer can also change behaviors. Peltzman's research focused on automobiles, and after anti-lock brakes and seatbelts, he observed no reduction of automobile fatalities. Feeling safer prompted more reckless driving, and this risk-altering dynamic exists beyond our roadways as the Peltzman Effect also influences the financial markets. There are unintended consequences of technologies, ideas, and innovations that make us 'safer' as public policy can intersect with the private market in curious ways. This dynamic was on full display for investors in the second quarter.

Tariffs have been a defining characteristic of the investing landscape this year. They were a public policy initiative designed to make us 'safer' from massive federal debts (by increasing government revenues) and sourcing critical items abroad (by incentivizing domestic manufacturing). This past quarter, though, they did more. They had broad ramifications within the financial markets, from the commodities complex to currency movements. They had an unnerving effect, and just the hint that they could be reduced or delayed would breathe oxygen into risk assets. But the tariff saga had one clear, and unintended, consequence of upending investor sentiment. The AAII investor sentiment survey showed a bearish reading of 62% on April 2 (Liberation Day), which was only higher on March 5, 2009 (Global Credit Crisis) and October 19, 1990 (Gulf War). It would normalize to 34% by June 11, but still more negative than the historic average at 31%[i]. Markets now seemed riskier. Tariffs were intended as a safeguard, but from an investing standpoint, they had the opposite effect – the Peltzman Effect revived.

The tariff regime created other unintended consequences. First, the river of capital flowing into the United States started to change directions. The carrot of a more predictable government that would invite investment into the U.S. was perceived to have vanished in an instant, replaced by the 'Sell America' trade. Behaviors were changing. This led to international equities outperforming domestic equities by the widest gap in 15 years[ii]. Further, gold, up 26% year-to-date through the end of May, would surge as investors sought refuge away from the U.S. Dollar, which was losing value relative to other major currencies[iii]. What performed poorly were domestic equities, as they descended into correction territory. The S&P 500 Index had a peak-to-trough decline of 18%, and other indices, such as the NASDAQ and Russell 2000 (Small Cap) fared worse. Risk was back with a vengeance.

> **"...safety regulation has had no effect on the highway death toll. There is some evidence that regulation may have increased the share of this toll..."**
>
> **– Sam Peltzman**
>
> ***The Effects of Automobile Safety Regulation* (1975)**

This backdrop harkened the words of the famed storyteller, Michael Lewis, who said in his book *Boomerang: Travels in the New Third World:*

> "Everywhere you turn you see Americans sacrifice their long-term interests for a short-term reward."

The short-term effect of tariffs overpowered the view of other long-term factors. Was this the correct perspective? This hinged on whether the Peltzman Effect's imprint on the markets was real or perceived – the critical question to be answered this quarter.

The Constants

The decade of the 1950s has a positive connotation. There was a broad sense of nationalistic pride after winning wars on two global fronts and the economic resurgence that followed.

It was an innovative golden era, too, as the microwave oven, credit card, and color television were created that decade, amongst other technological feats. Yet, as noted in Morgan Housel's book, Same as Ever, distilling complex matters into singular perspectives means the best story wins, even while devoid of key points. So, for the 1950s, we gloss over the economic contraction that occurred during 1957 and 1958. That is when, on a population-adjusted basis, the U.S. economy incurred more job loss than it did in any single month during the Global Credit Crisis of 2008[iv]. The 'best' story in the second quarter centered on tariffs and their broad financial blast radius. That may be one truth. But we know there are more.

In the market tumult that immediately followed Liberation Day, we published an investor note saying the following:

"We also know that certain forces will not stop based off the news today. Innovating will go on and demographics are unaltered."

We were focusing on constants, and one was innovation. It also happens in countless ways, too. It can mean Netflix getting into live sports productions or Amazon building out a Starlink competitor (Project Kuiper). In the realm of finance, it means creating more effective tools for fraud detection. For instance, Visa prevented $25 billion in fraudulent transactions because of technology investments a few years back[v]. On a broader basis, the total number of new patent applications in the pipeline awaiting the examination is 826,974 (fiscal year-end April 2025), which is the highest it has been in at least 10 years[vi]. Businesses rarely sit idle. The opportunity to embrace a more digital operating environment was now intersecting with action. Tariffs were not stopping this.

"Perpetual optimism is a force multiplier."

-Colin Powell's 13 Rules of Leadership

Former four-star General Colin Powell faced many adverse situations, and he found the one key to effectively navigating through them was optimism. He described it as a "force multiplier." For investors, rampant negativity was not just manifesting with tariff concerns but also fears about the economy, inflation, and more. One positive we found too big to ignore was the digital revolution. AI is a multiplier. It is catapulting new industries, such as self-driving cars and robotics, and buttressing corporate profits. Keep in mind, there remains considerable opportunity as, despite all the chatter, AI is only being applied in 8% of businesses to produce goods and services[vii]. This untapped potential is a reason for investing optimism.

Nvidia is the metaphorical gas station fueling this AI phenomenon, and its revenues continue to defy doubters. For the first quarter, the company reported revenue of $44.1 billion, topping estimates of $43.3 billion. This number eclipses the $26 billion reported in the same period last year. Putting it in perspective, it is greater than the market capitalization of Target ($43.6 billion as of May 28)[viii]. This is how Nvidia contextualized its results:

"The era of robotics is here. Billions of robots, hundreds of millions of autonomous vehicles, and hundreds of thousands of robotic factories and warehouses will be developed."

–Nvidia's 1Q25 earnings call, May 28 2025

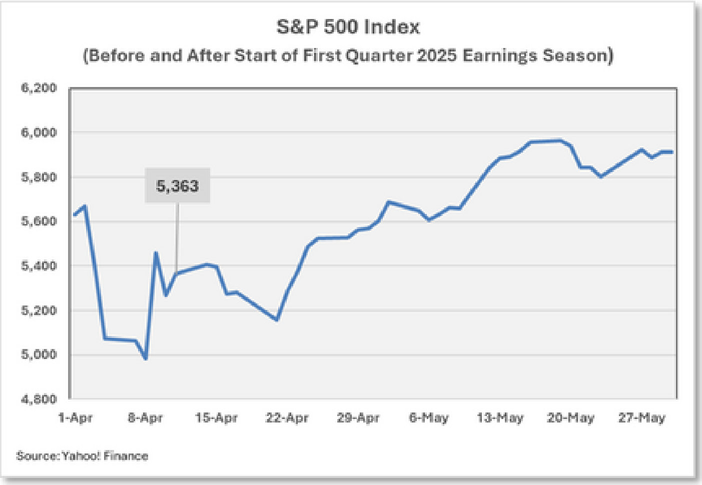
This tech-molded future was an underappreciated story earlier this quarter when tariffs took center stage. In the equity market correction, Nvidia's stock price fell to where it traded at a similar Price/Earnings multiple (forward) as Coca-Cola at 24-times[ix]. Said differently, investors were valuing the future growth of soft drinks the same as they were with software. That math made little sense to us. It is why we advocated then, as we do now, to remain strategically disciplined with respect to portfolio equity targets.

Several other constants remain in our investment focus – demographics being one, including the varied effects of an aging population. It presents problem-solving opportunities. For instance, one of our platform equity managers owns a company (EssilorLuxottica) that placed hearing devices on eyeglass apparel, which provided both a functional and fashionable way to solve for hearing issues. Perhaps the most exciting element is with drug discovery, because the longer we live, the more afflictions we can encounter. The first AI-developed drug, Halicin, occurred in 2020. Now, tech-enabled research will look to positively impact the treatment or management of a wide range of diseases from neurological to chronic in nature. More broadly, we continue to invest across the industry continuum from early-stage venture capital to buyouts to capitalize on accelerating developments across therapeutics, medical devices, and healthcare enhancements. These investments have dual potential: financially and societally.

Speculative Window

Another constant for us is the belief that earnings drive equity returns, but there are air pockets between reporting periods. Speculation can run rampant, as perception overpowers reality in these moments. That happened again with the saga about Liberation Day. Unpacking these events, the S&P 500 Index would shed roughly 700 points in the four trading days following the tariff announcement. Then the quarterly earnings season began in earnest on April 11 (S&P 500 closed at 5,363 that day). As the actual results came in, they created a floor, if not a springboard, for the broader equity market. And for good reasons.

As of June 3, 79% of the S&P 500 members beat earnings estimates in the first quarter, and by a median of 6%. It was a similar story for revenues. Overall, 63% of companies beat estimates[x]. So, it was not just Nvidia outperforming. Further, given the low expectations for earnings and revenues, it was not just investors showing a more bearish take on the business landscape (AAII survey) – Wall Street analysts were not overly optimistic either.



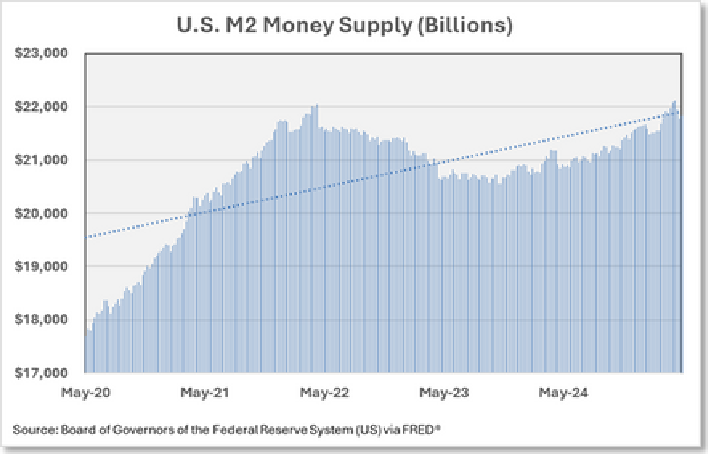
Speculation cannot outrun facts forever. Reported earnings and revenues were not as dire as expected in the first quarter, nor was the equity market 'riskier' than normal. Stock returns would tether to actual operating results again. Yet, speculating is another constant. It is why we spend a great deal of time understanding our clients' time horizons and liquidity needs (our Foundations 360 process examines this through a generational lens). While we cannot control when speculative forces will impact asset prices, this approach helps avoid becoming a forced seller during a distressed, speculative-driven market. It is how we attempt to limit risks perceived by others from turning into actual ones for our clients.

First You Borrow

"First you borrow, then you beg." This line from Ernest Hemingway's The Old Man and the Sea, written more than 70 years ago, has relevance for investors today. There has been borrowing of enormous proportions. There is currently $37 trillion in federal debt outstanding, and a growing burden to servicing it. Today the U.S. is paying over $100 billion per month in interest on the national debt, which means roughly 25% of all government revenue goes toward interest payments.

Whether through deep spending cuts or higher taxes, any serious efforts to rein in this debt are likely to weigh on the economy.

The colossal sum of government debt remains on a worrisome trajectory. Deficits continue to grow, and, after a short hiatus, the money supply (M2) is on the upswing again as increasing government spending pumps liquidity into the economy. Since 1960, though, this has provided support for the equity markets. The S&P 500 Index is up an annualized 12.7% when the M2 money supply grows on a year-over-year basis[xi]. Risks (growing government debt) can have rewards (equity support).



The federal government has yet to beg, and it may not have to, either. There is a large-scale buyer out there in the Federal Reserve. Its portfolio of assets (largely bonds it purchased) sits at $6.6 trillion, which is 25.6% below its early 2022 highs[xii]. It has shown a willingness and ability to play a more active role with the financial markets and government finances during troubled times. Since its launch in 1913, the Federal Reserve has been another constant – one that could provide safeguards to our economy, financial markets, and now our precarious government debt situation.

In Parting

As we look back at the quarter, the overall investing sentiment was one when there was a perceived need to slam on the brakes. The safeguards out there, namely tariffs, were felt to make us less safe. Yet, our decisions were based more on the constants that provided clarity when the road ahead looked more speculative. Innovation is one, demographics another, and even the Fed's record of backstopping the economy and markets. These constants not only anchor our decisions today but will continue to do so in the future. Please reach out to your relationship team to find out how these discussed themes and ideas are incorporated into your individualized portfolios.

If you would like a copy of Morgan Housel's *Same as Ever,* please let your Relationship or Investment Manager know and we will send you a copy.

Your relationship is valuable to us, and we thank you for it.

For more information visit us at:
www.callanfo.com

[i] AAII Investor Sentiment Survey | AAII
[ii] Harding Loevner Intl Equity ADR Quarterly Report 1Q25
[iii] Ticker: IAU. Morningstar
[iv] Same as Ever, Morgan Housel (2023)
[v] Visa Prevents Approximately $25 Billion in Fraud Using Artificial Intelligence, June 17th, 2019
[vi] U.S. Patent and Trademark Office
[vii] JPM Guide to the Markets, March 2025
[viii] Morningstar
[ix] Yahoo! Finance, April 4th, 2025
[x] FS Insights, June 3rd, 2025
[xi] Pauleen Perspectives, May 28th, 2025
[xii] ADG, May 29th, 2025

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