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Q1'2025 Newsletter

Economy & Market Valuation

US stock market has entered into correction territory which is defined as 10% drop from the peak. S&P 500 Index has dropped more than 10% and NASDAQ has dropped more than 20%. The big drop was triggered by Trump announcing tariffs on imports from most of the trading partners of USA. Tariffs will increase the cost of goods that are imported into USA. Simple example to illustrate impact of tariffs is iPhone. 100% of iPhones sold in USA are produced in factories outside USA (China, India and Vietnam). Tariffs (between 26 to ~50%) will have to be paid by Apple when the phones are imported to USA. Apple has two options; it can pass it on to the consumers which means the price of iPhone sold in USA will go up. Or it can absorb it and take a hit on its profitability. Trump wants Apple and other companies to start production in USA. For a company like Apple to start production in USA will take time and cannot happen overnight. Higher price for imported products could mean lower sales volume and higher inflation. Other countries can also retaliate and put tariff on imports from USA like China has done.

Tariff is a tool to correct problem of large trade deficits that US has. But tariffs if sustained, can cause a lot of economic pain in the short term and can lead to recession.

The question is when will the market downturn be over. There is too much negativity in the market right now. Any positive news could reverse the market trend. One trigger could be reduction in tariffs announced this week. We expect tariff policy to be reversed in phases. First phase could be reduction for tariffs for countries like Vietnam, Cambodia and UK etc. who are willing to lower tariffs on US imports. Already we are seeing some

signs like Vietnam agreeing to reduce tariffs on US imports. Second phase could be renegotiation of USMCA with Canada and Mexico that will lower tariff with these countries.

Another possible trigger could be Federal start cutting interest rates which we expect will happen starting in June of this year.

2025 investment strategy

We had started preparing for the downturn by

- Reducing risk in the portfolio by adding of safer names like AZO, ORLY and WSO etc.
- Selling/trimming some of the winners like AMZN etc.
- Raising cash in the portfolio. We have raised cash to the tune of ~16% in Alpha model.

Having cash gives us the flexibility to buy excellent companies at low prices in the downturn.

The question that some of our clients are asking is how we are going to handle the downturn in the market. Our strategy has been to buy only high-quality companies that can withstand the economic downturns. Many of these companies are buying back their own shares. They can buy even more shares when the prices are down. Share prices of quality companies increase faster when the stock markets recover.

Secondly, we will use the cash we have in the portfolio to buy good companies even at lower prices.