MEDALLION WEALTH MANAGEMENT

April 2025 Market Commentary

Eye of the Tiger

Risin' up, back on the street
Did my time, took my chances
Went the distance, now I'm back on my feet
Just a man and his will to survive

Rocky III – Eye of the Tiger – by Survivor

https://www.youtube.com/watch?v=ob8TNqQw2hY

Everybody loves a good turnaround story. A classic example comes to us from Rocky III. Rocky III starts with our hero, Rocky Balboa, languishing in his fame and fortune. This complacency soon causes Balboa to lose his title to young thug Clubber Lang (Mr. T), who inadvertently causes the death of Rocky's beloved trainer, Mickey, before their first championship bout. After the loss, Balboa sinks into a deep depression and turns to his old adversary Apollo Creed to help him find his "eye of the tiger," the hungry need to excel. In the end, Balboa faces off against Lang for a second time. You'll have to watch the movie to see how it ends.

As an equity analyst for several decades now, I'm very familiar with the "turnaround" situation. The classic corporate turnaround story goes something like this: the once great company has gotten a little fat and complacent and soon finds itself losing market share and relevance to some young upstarts. They bring in a new CEO who comes in to help them find their "eye of the tiger". This usually leads to a slash and burn strategy. Cut bureaucracy, cut excess employees, cut wasteful projects and take some big write-offs. The hope is that this newly slimmed-down company will be hungry again and focused on growth.

The unfortunate reality of this slash & burn strategy is that it generally leads to a "kitchen-sinking" of earnings. This is usually followed by an immediate, abrupt drop in the stock price. You see, management wants investors to believe in their turnaround today, even though that may require years of hope and good fortune. Good investors know that hope is not a profitable strategy.

Unlike Hollywood, corporate turnarounds are almost never successful. As Warren Buffett explained, ***"When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact."***

A good rule-of-thumb is to simply avoid investing in corporate turnarounds. They look tempting, with their star-studded history and attractive valuations, but the thing they can't control is the simple fact that their competition isn't going away.

This long-winded preamble brings us to one of the greatest attempted turnarounds in history...the United States Government. Donald Trump believes that for way too long our trading partners have been taking advantage of our profligate consumers. This has resulted in massive trade deficits, debt that far exceeds income, and interest payments on that debt that are larger than our defense spending.

Our current predicament started in 1944 at a resort town in New Hampshire called Bretton Woods. World War II was winding down and President Roosevelt invited the allies to discuss a new world order.

The primary agreement was that the US dollar would be fixed and convertible to gold (at $35 per ounce), and all other nations would peg their currencies to the US dollar. The dollar would become the global reserve currency. For 25 years this worked extremely well, almost too well. There was such a demand for US dollars that the supply of dollars exceeded the amount of gold by a 4-to-1 margin. This led to a very overvalued dollar which made imports cheap, exports expensive, and inflation rampant.

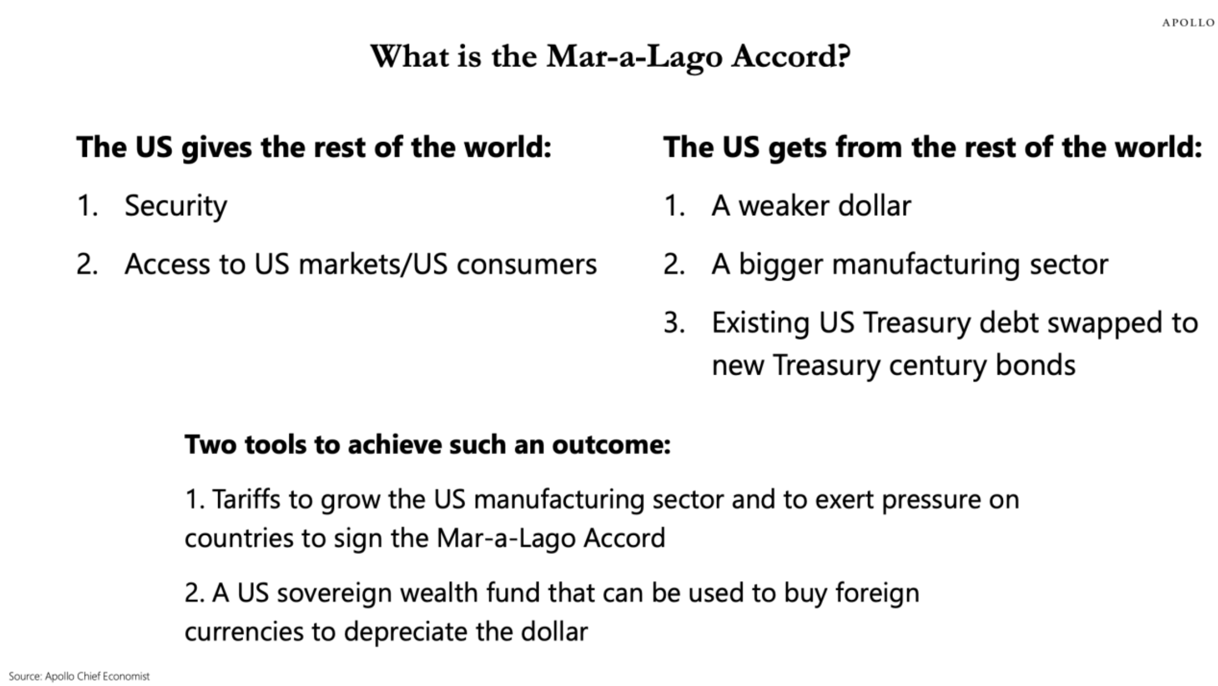
In 1971, President Nixon shocked the world by announcing that the US dollar would no longer be backed by (or exchangeable into) gold, instead it would be backed by the full faith and credit of the United States. This allowed the dollar to fall by 33% and was seen as a domestic manufacturing bonanza. Unfortunately, it didn't last long, as other nations abandoned their gold pegs too.

Fast forward to today. As the Signal app debacle has made evident, the Trump administration has a clear disdain for the current world order. When talking about a military strike on the Houthi rebels in Yemen, Vice President Vance crystalized the current situation stating that just, “3 percent of US trade runs through the Suez Canal, while 40 percent of European trade does.” Vance goes on to say, “I just hate bailing out Europe again”, while others in the administration are in agreement about “European freeloading".

To be honest, the Trump administration has a very valid point about the United States being the western world’s police force, and the fact that many of our allies collect significantly higher tariffs on US imports, pricing out many American exports. But our allies can also say, “Well, that’s the price you pay for the exorbitant privilege of having the world’s reserve currency.”

As James Hickman of Schiff Sovereign observed, this current tussle between the United States and its allies is like a long-married couple who’ve just had it with each other. One of the partners has been the breadwinner and resents the other partner always asking for more; while the non-breadwinner is tired of being looked down at and believes that they have been unthankfully supporting the other partner for years.

Having the world’s reserve currency has allowed US politicians to borrow and live way beyond their means. The Trump administration realizes that the United States cannot continue spending significantly more than they take in and are trying to break this cycle. They have a plan called the Mar-a-Lago Accord which aims for a new world order.



There are a couple of problems with this attempted reconciliation (or turnaround). One is that the non-breadwinner decides to go it alone; and two, that the breadwinner’s financial markets don’t believe that the current pain will be rewarded with the hope of a stronger future (at least not quickly).

Case in point, in a recent speech French President Macron calls for a new European paradigm. He stated that, “We have delegated everything that is strategic, our energy to Russia, our security to the United States, and our critical strategic minerals to China. We even import our food from other nations, who would be foolish enough to outsource their food?”

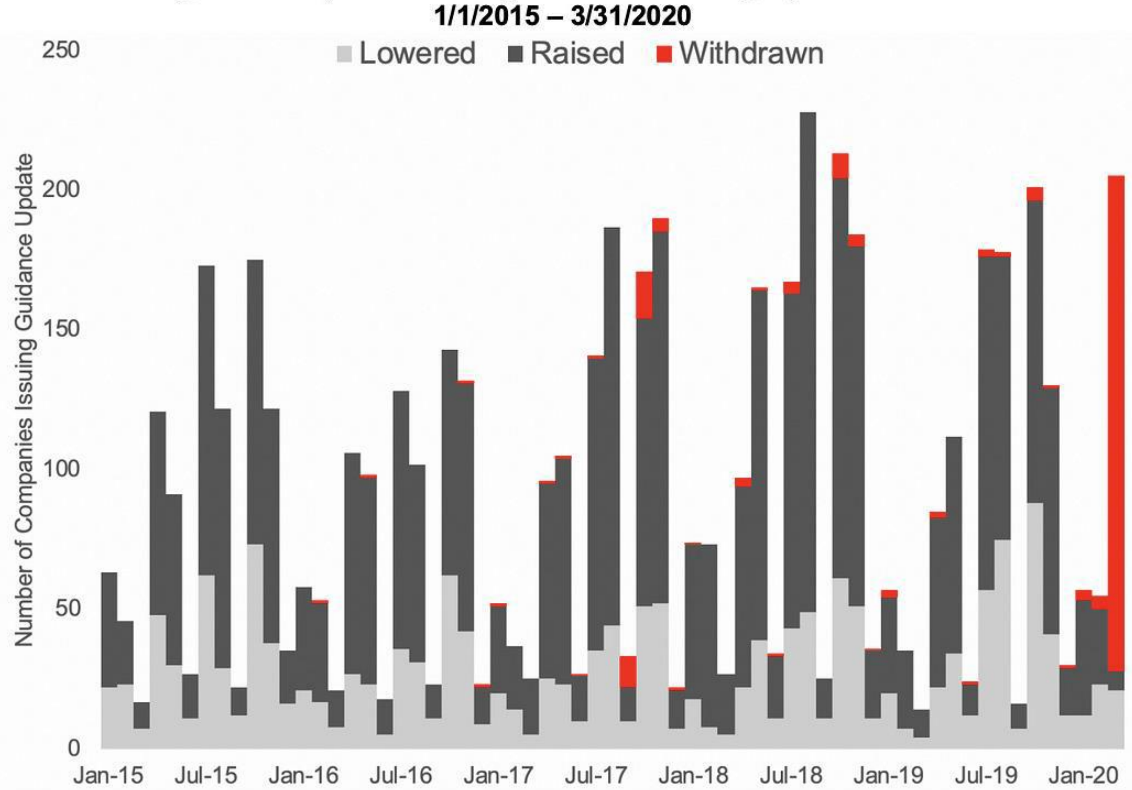
This sounds like our allies are willing to stand alone, or together without the United States; which looks like a divorce or at the bare minimum a trial separation.

The second hurdle is the pain being inflicted on the current United States administration by the financial markets. We’ve seen the US stock market sell-off by about 10% from its early February highs.

The reason for this correction is expertly summarized by JP Morgan strategist Michael Cembalest, *“Here’s the interesting thing about the stock market: it cannot be indicted, arrested or deported; it cannot be intimidated, threatened or bullied; it has no gender, ethnicity or religion; it cannot be fired, furloughed or defunded; it cannot be primaried before the next midterm elections; and it cannot be seized, nationalized or invaded. It’s the ultimate voting machine, reflecting prospects for earnings growth, stability, liquidity, inflation, taxation and predictable rule of law.”*

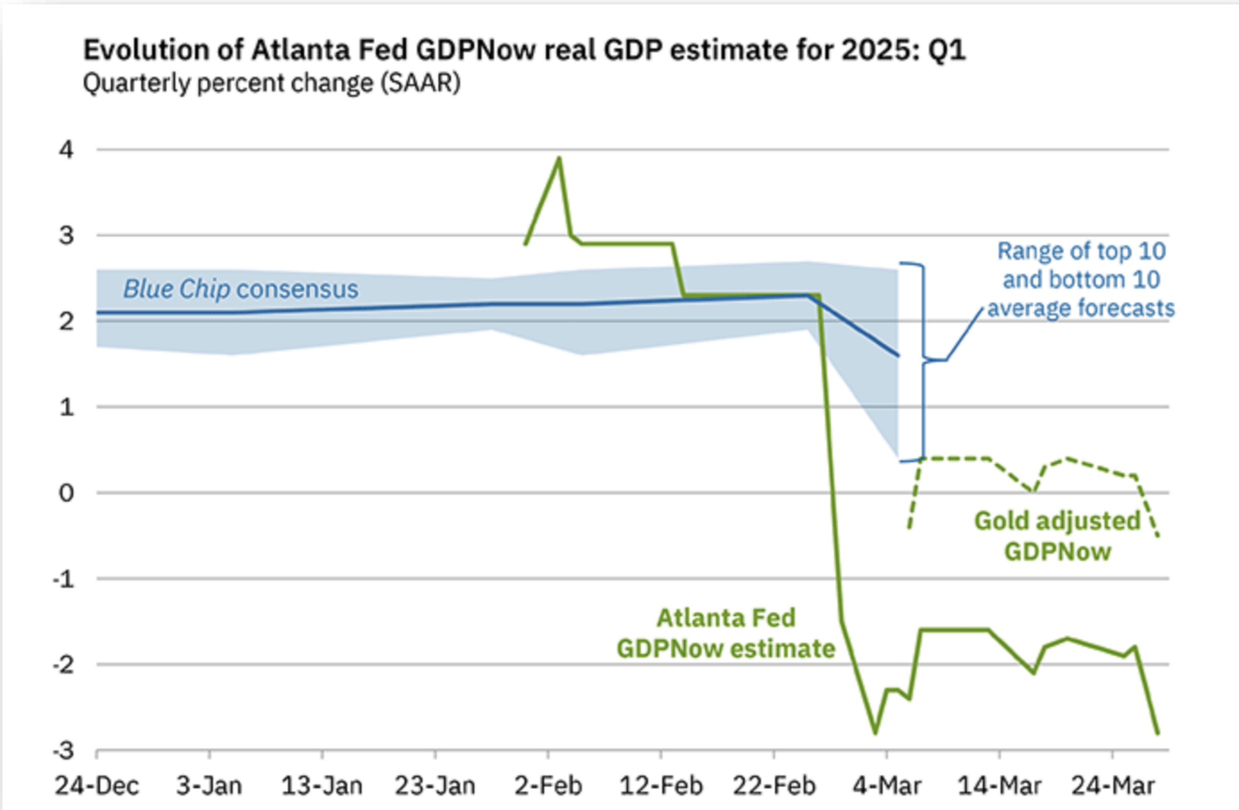
The simple fact is that increased uncertainty leads to slower economic growth and lower stock prices. As the graphic below shows we have an unprecedented level of uncertainty, with a record number of companies withdrawing their guidance (even more than during Covid).

Figure 1: Corporate Earnings Guidance Changes; Russell 3000
1/1/2015 – 3/31/2020



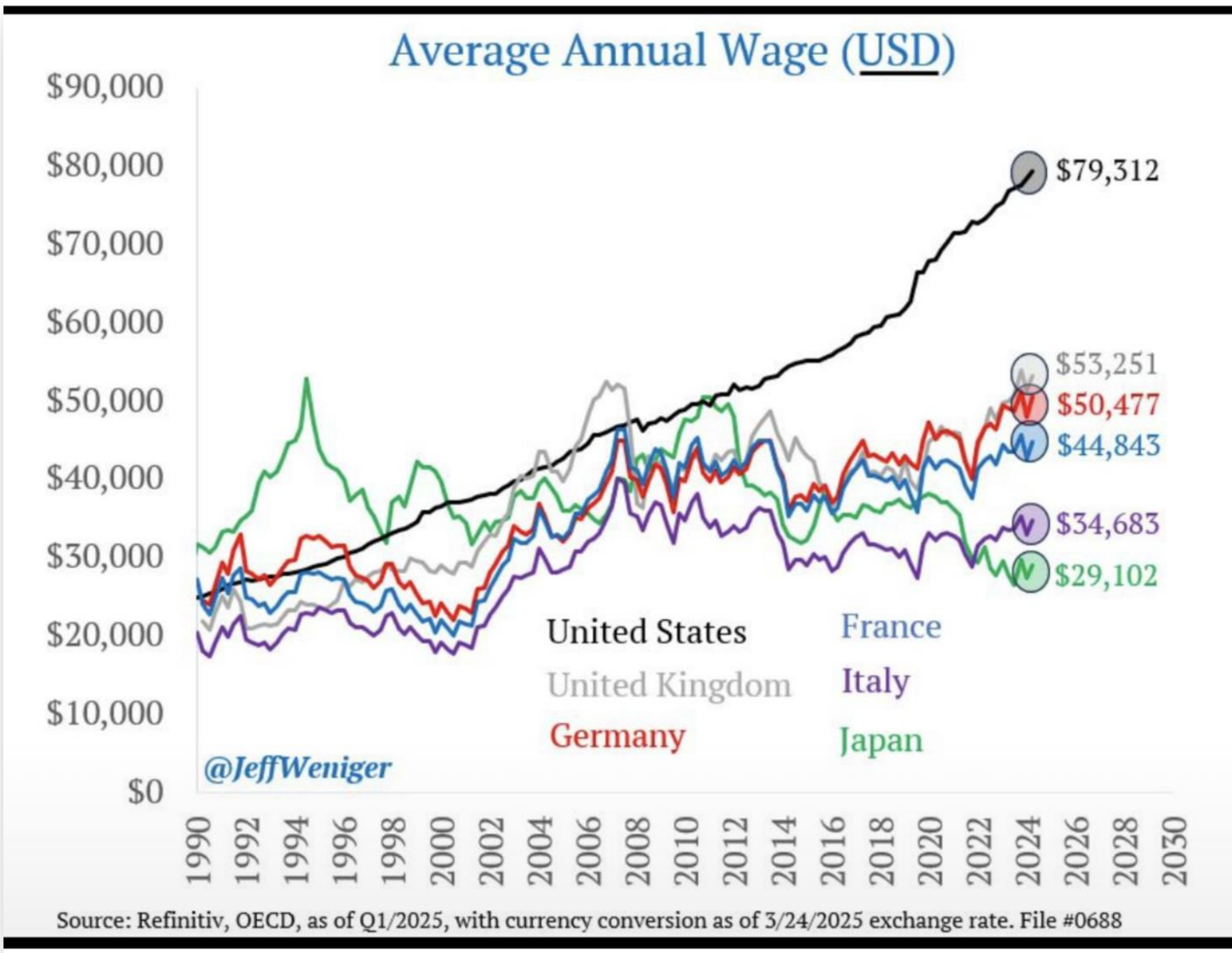
Source: S&P Global Market Intelligence Quantamental Research. Data as of 4/8/2020

This high level of uncertainty, and fear that the US is tinkering with its reserve currency status has also caused a flight to gold and lower expected GDP growth. This can be seen in the Atlanta Feds GDPNow forecast of –2.8% and adjusted for imports and exports of gold at –0.5%.



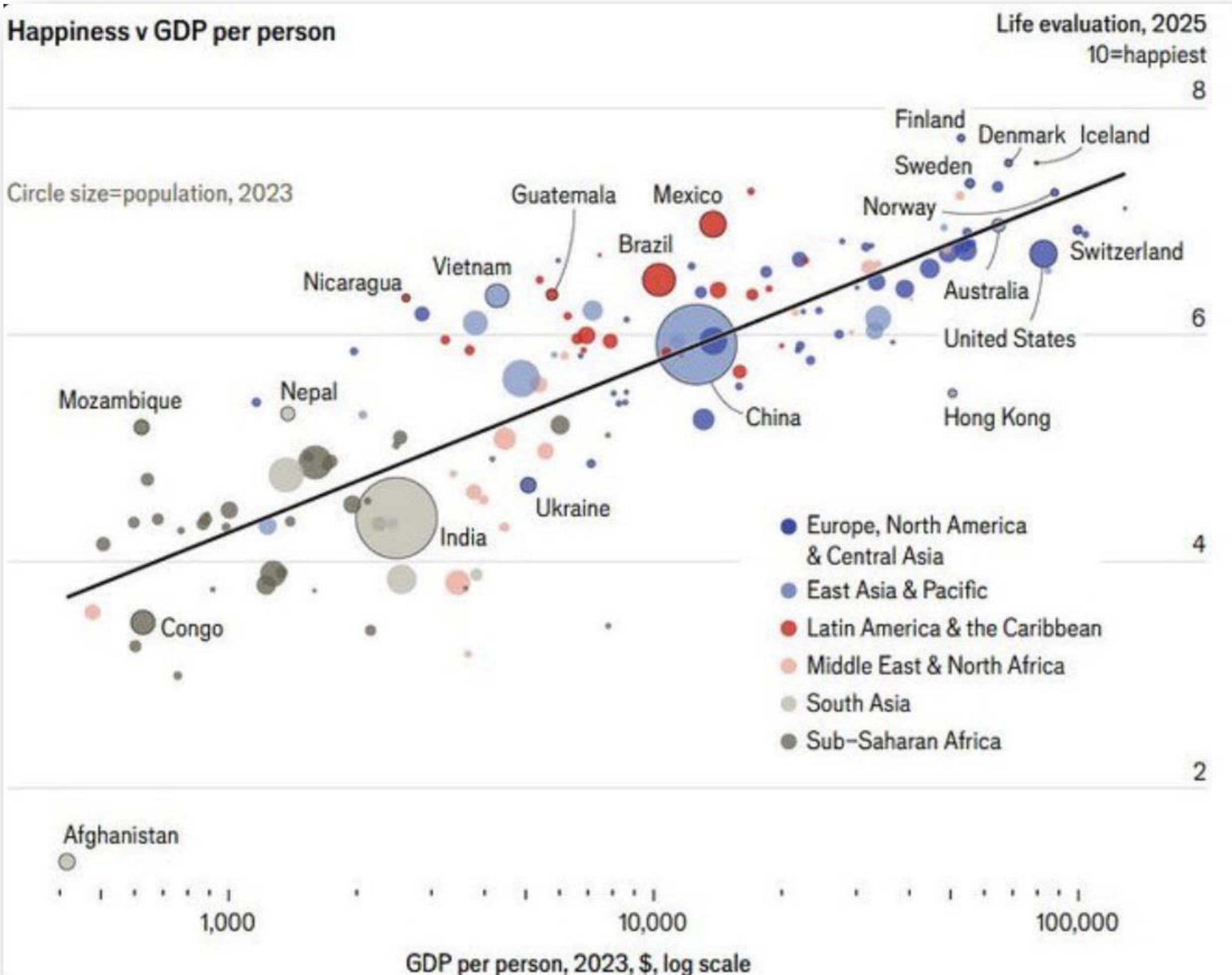
Another side effect of the Trump administrations drive to reshore manufacturing capacity into the US is our high wage costs. The average US worker makes $79,312 per year, while our main allies make between $30,000 and $50,000. A more granular example is the average annual salary for a US steel worker is $63,300, while a Chinese steel worker makes $12,400.

It's great that American workers make more than their global counterparts, but it's hard to see how after decades of exporting our manufacturing capacity to cheaper global locals, we won't have higher costs/inflation by reshoring to the US.



I credit the Trump administration for attempting to break our cycle of deficit spending and reliance on the willingness of others to continue financing our largess, but I also worry that we may be in for a pretty rough patch while we sort out this new world order.

As the chart below shows, the goal is higher GDP per person which should lead to more happiness.



I'm hopeful that America will find its eye of the tiger, but I'm also leery that we might have to get knocked down a few times first.

As always, be careful out there.

Chris Wiles, CFA

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