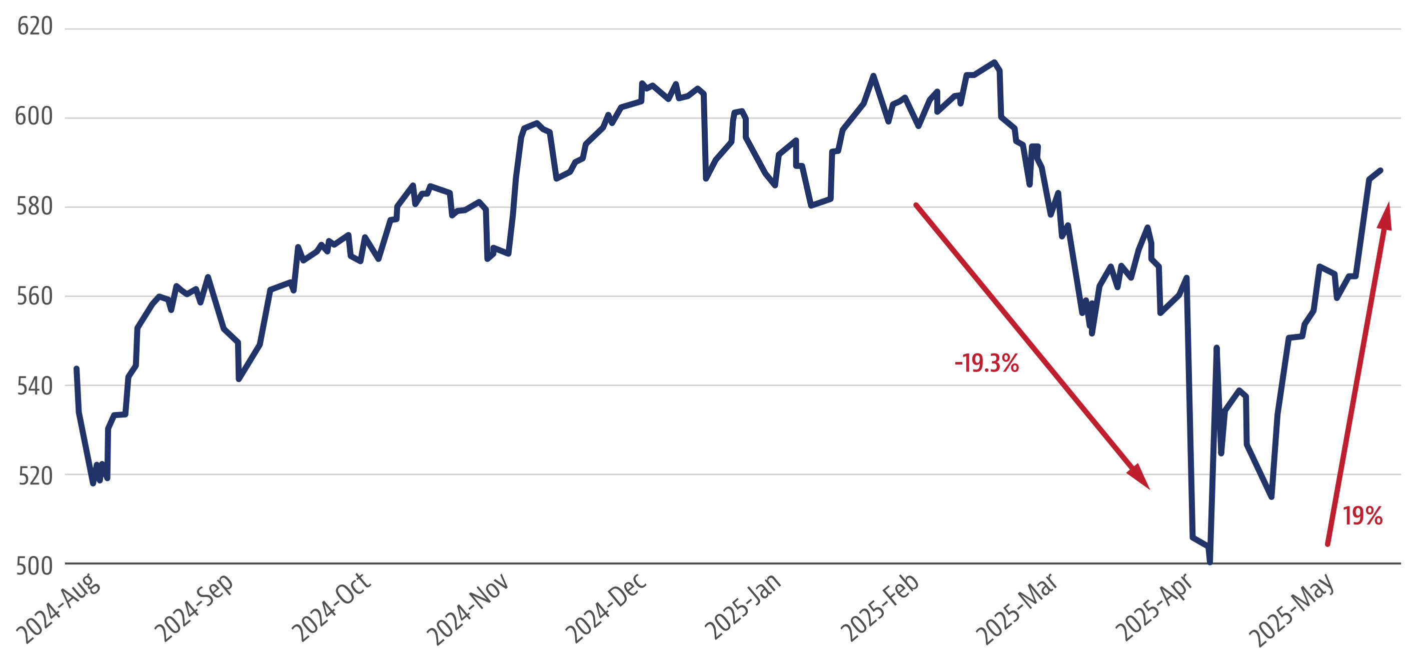
A GREAT BEAR MARKET RALLY! NOW WHAT?

After seeing the rapid drop following “Liberation Day”, the S&P 500 rallied back about 20% and is now trading higher than the day preceding the announcement, despite tariff issues being far from resolved (90-day pause, baseline tariffs of 10%+). Investors seem to believe in a complete retraction of those tariffs, which is unlikely as the minimum of a 10% levy is most likely going to stick (for example, the U.K. deal which included a 10% baseline tariff permanently). Therefore, in our opinion, the risk/reward profile of the markets is even less attractive than it was at the beginning of the year.

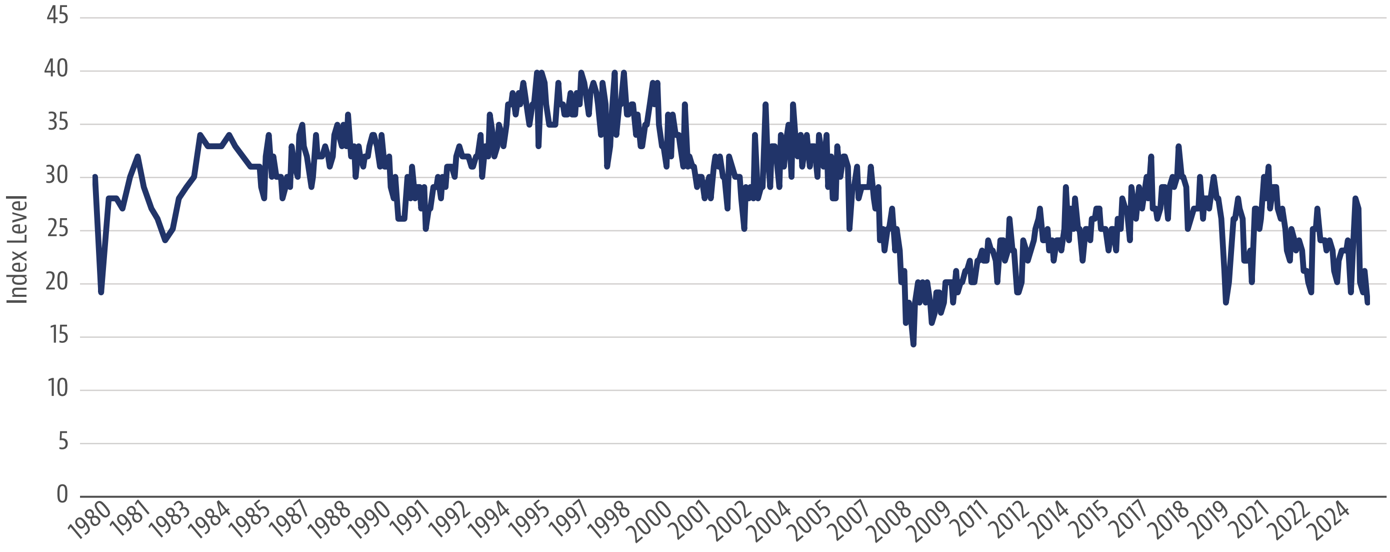
SPY (S&P 500 ETF)



Source: Bloomberg Finance L.P.

During the last few weeks, we heard from many management teams about the current decision-making freeze. As we wrote in our last comment (February), companies are putting their investment, expansion and hiring decisions on hold during this uncertainty. You can see this in the small business capital expenditure plans (chart on next page): having spiked in November and December, now they have collapsed back to recent lows. That’s why this is going to have a direct effect on GDP growth for the 2nd and 3rd quarters even if these tariff announcements get completely reversed.

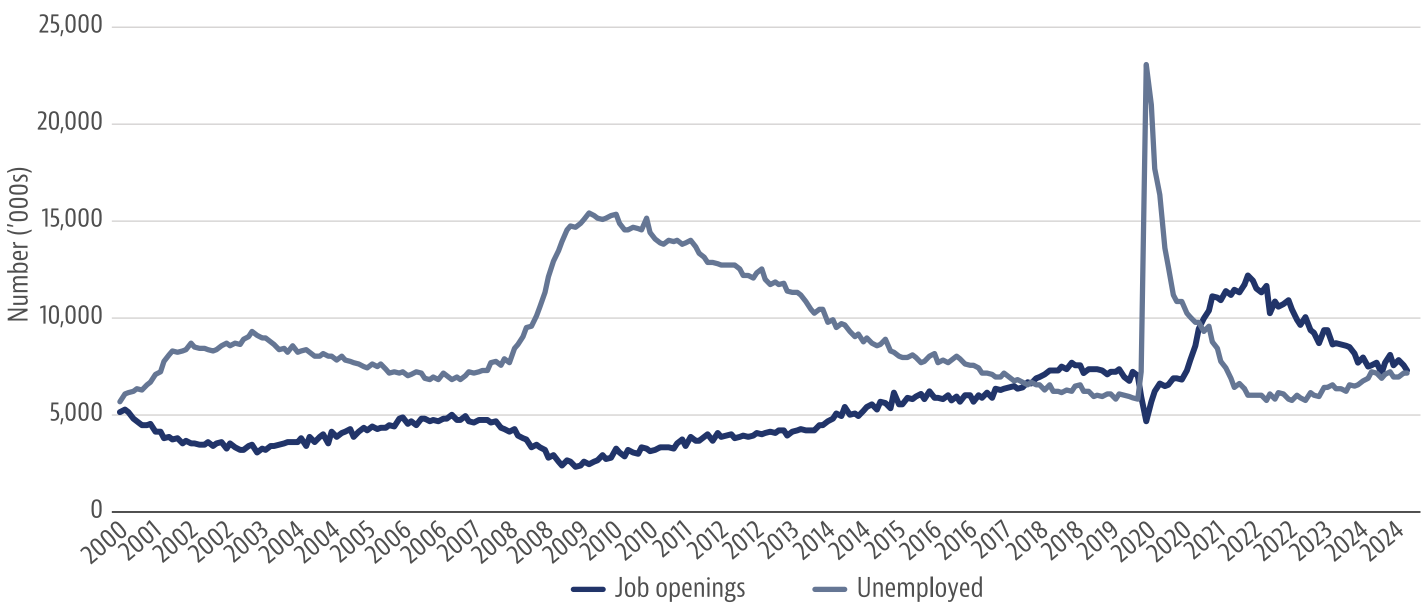
NFIB SMALL BUSINESS CAPITAL EXPENDITURE PLANS



Source: Bloomberg Finance L.P.

Even ahead of this "Liberation Day," we already saw that job openings have continued to decline in March in the U.S. (chart below), which we view as a leading indicator for higher unemployment levels in the near future.

U.S. JOB OPENINGS VS. UNEMPLOYED



Source: FRED

In our opinion, what we wrote in our February letter (see quote below) remains true today, and we think it showed up with weak Q1 GDP of negative -0.3% in the United States.

"Indeed, it is clear that during uncertainty, some businesses will delay the next investment, the next expansion, the next hire, etc. It is also clear that consumers with the fear of potentially losing their jobs (through D.O.G.E. or through tariff causes) will cut discretionary spending just in case. All of that decreases the size of the economy (GDP)."

BOND VIGILANTES IN OUR MIDST?

There is something else that we saw during the most recent turmoil in the equity markets. The long end of the interest rate curve, while initially falling, started rapidly increasing before the markets bottomed. There was some media blame pointing to deleveraging in the "Bond Basis" strategy world (buying cash treasuries and shorting the futures), which are levered in some cases as much as 50 to 1.

But the main problem is the U.S. budget deficit, which we have been writing about for a long time. For the first 7 months of the new fiscal year (U.S. fiscal year starts on October 1st), the deficit was up $194 billion from $855 billion as of April 2024 to $1.049 trillion as of April 2025 or +22.7% year-over-year.[1] This is definitely not the direction we want, especially not during good economic times. Spending was up again—a staggering 9% from last year. Revenues were up only 3%. We are at a non-sustainable level and most experts agree.

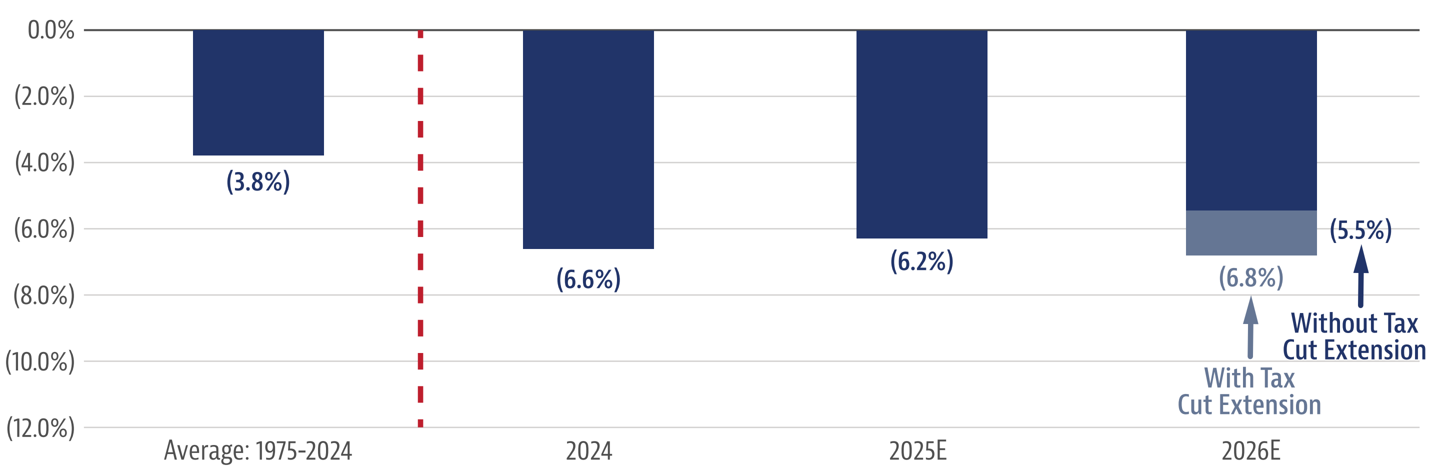
If the budget deficit continues to run at this level, long-term interest rates are unlikely to go down significantly as the requirement to source that funding is too large in relation to the pool of savings (Ray Dalio has talked about this recently – Link*). This has been made worse by the fact that many investors outside the U.S. are uncomfortable with the current administration's way of running things. If foreign buyers turn into sellers or just boycott new buying, long-term rates could easily go up further with these high budget deficits.

The trend is definitely higher:

30 YEAR U.S. TREASURY YIELD

Source: Bloomberg Finance L.P.

U.S. FEDERAL BUDGET BALANCE (% OF GDP)



Source: CBO, Timelo. As at May 16, 2025.

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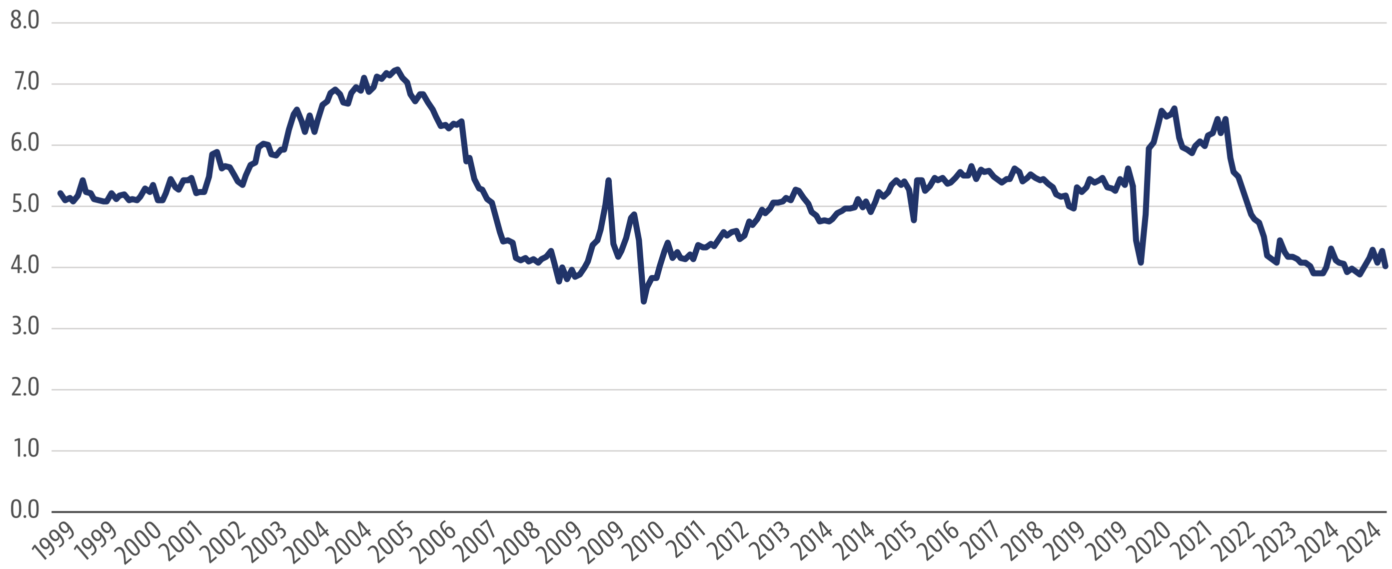
* Link only in English

[1] https://www.fiscal.treasury.gov/files/reports-statements/mts/mts0425.pdf

HOUSING RISKS AT HIGHER RATES

The topic of higher rates is very relevant to the housing sector. Existing home sales have continued to remain at the low end of their historic range. Housing affordability is also close to the lower level of its historic range (new mortgages at much higher rates + much higher home prices). Since most people have a locked rate at much lower levels than the current market level, that gives them little choice but to keep their current house. For first-time homebuyers, it makes it harder than ever for them to make home ownership possible.

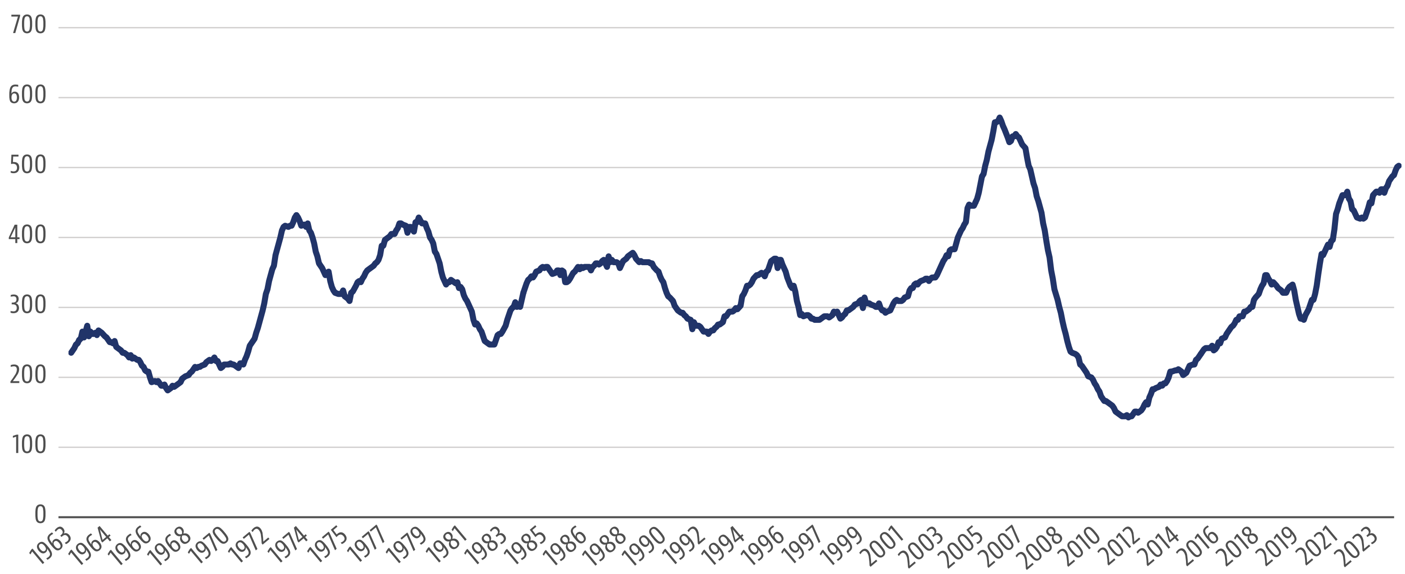
EXISTING HOMES SALES (ANNUALIZED IN MILLIONS)



Source: Bloomberg Finance L.P. As at March 31, 2025.

Therefore, the number of new single-family homes for sale is reaching levels not seen since the housing boom prior to the Great Financial Crisis (chart below).

NEW ONE FAMILY HOMES FOR SALE (IN '000S)



Source: FRED. As at March 31, 2025.

We believe home prices are most likely to decline in both the U.S. and Canada. The only possible savior would be much lower rates, which we believe are not possible with the current budget deficit, as discussed earlier. For the majority of families, their house is their most significant asset, and therefore when/if housing prices start declining, it would add to the negative wealth effect and impact consumption and GDP (see further below).

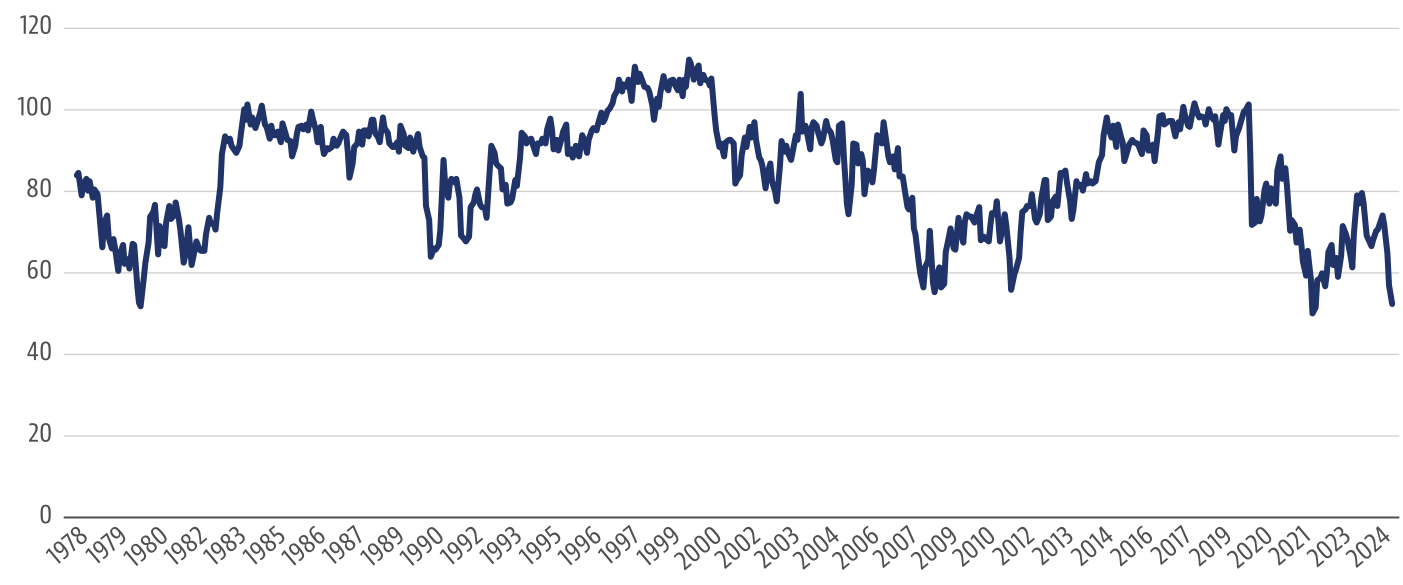
CONSUMER IS NOT IN THE CLEAR

With all of the above in mind, it was not a shock to us when we saw the most recent consumer confidence readings from the Conference Board and University of Michigan.

CONFERENCE BOARD CONSUMER CONFIDENCE

Source: Bloomberg Finance L.P. As at April 30, 2025.

UNIVERSITY OF MICHIGAN CONSUMER SENTIMENT



Source: Bloomberg Finance L.P. As at April 30, 2025.

Both readings would echo some of what we see from specific companies. McDonald's, a bellwether name closely followed by investors to monitor the health of consumer spending, reported negative quarterly same-store sales growth in the U.S. of -3.6%, its worst result in over 6 years outside of the peak Covid lockdown of 2020 Q2 (-8.7%). Similarly, Chipotle reported negative quarterly same-store sales of -0.4%.

Both companies talked about worsening consumer sentiment as evidenced by even worse results for restaurant traffic. McDonald's specifically is highlighting traffic declines of -10% with low-income consumers and clear indications of consumers tightening the belt and reducing their frequency of visits to restaurants.

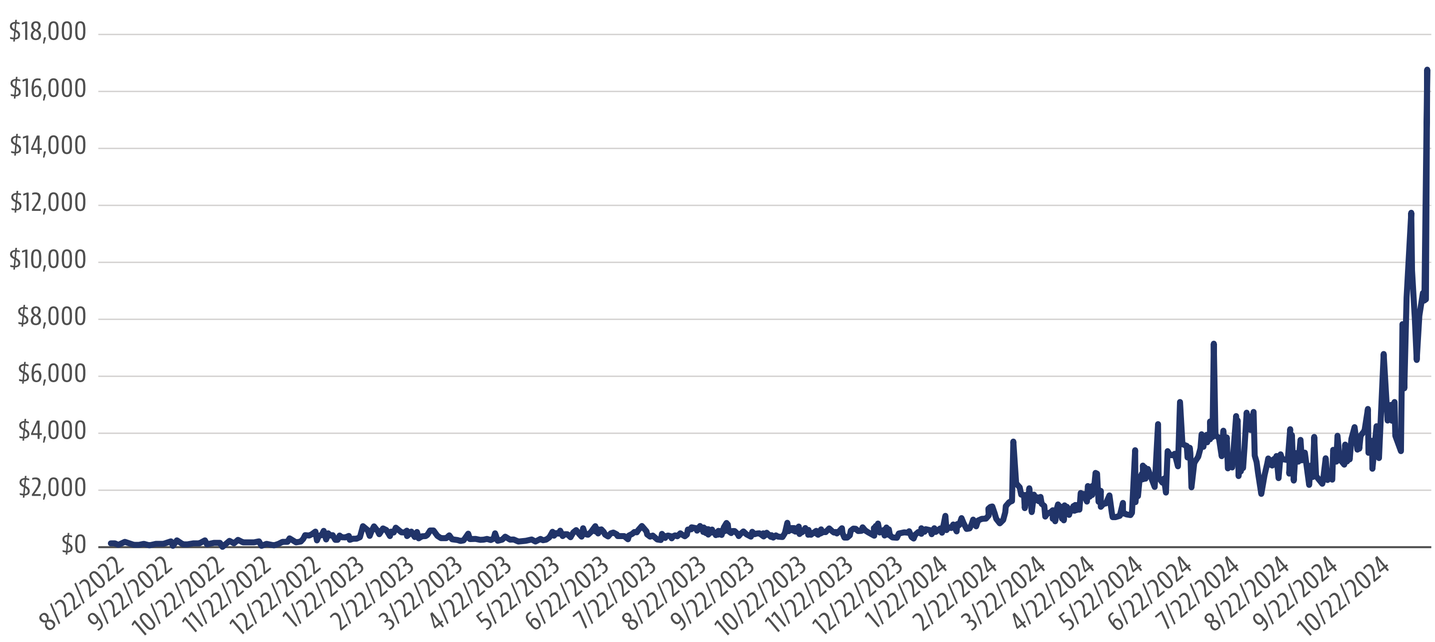
WEALTH EFFECT ON CONSUMPTION: DOES THE HIGH-INCOME CONSUMER FINALLY CRACK?

If the last consumer group that has not slowed down spending yet is the high-income group, the most recent market turmoil could be the straw that breaks the camel's back. It is important to remember this group has the most exposure to the equity markets, so it is the group that feels the market turmoil the most. So, with the combination of too high budget deficits that need to be cut, house prices likely to go down and consumer spending being weak, the upcoming bear market could be the final nail in the coffin to break this group.

EXCESSES CONTINUE – THEY ARE NOT THE SIGN OF A TROUGH

We see many examples of excesses out there. For example, retail investors looking to gain leverage in single stocks through ETFs is an exploding trend.

SINGLE STOCK LEVERAGED ETF VOLUME ($MM) DATA VIA STRATEGAS, 11/21/2024



Source: https://simplevisor.substack.com/p/leverage-and-speculation-signs-of.* As at November 21, 2024.

* Link only in English

In conclusion, we believe we have just started a much-needed bear market to correct the many excesses of the last few decades. This could potentially result in one of the longest and deepest recessions of our career. We also believe we are likely to see much higher volatility (both up and down) due to record amounts of money invested in passive strategies. We believe "buying and holding" the largest and most expensive names will not work for many years to come. In fact, looking at history, stocks that benefited the most from the rallies will get hurt the most (bubble bursting). As an example, the Nasdaq was down 78% from the peak of 2000 to the bottom of 2002; the U.S. Bank Index ETF was down 80% from the peak before the Great Financial Crisis of 2008 to the trough.

Today, the areas the most at risk (bubble stocks) are:

1. Most of the software space, whose stocks trade at a very high multiple to sales and exclude a good chunk of their most important costs, which are their software and sales teams through stock-based compensation adjustments.

2. A good part of the AI infrastructure spending, which we believe will end up being very cyclical.

3. The very large companies which are part of the major indices.

4. Meme stocks.

5. Most of the crypto world.

We believe that there is potential downside in each of these themes, depending on how the economy and markets play out. What we do not think people are ready for is a sustained drawdown. Most people in the finance industry today have not seen a sustained drawdown where the markets went nowhere, like they did many times in the past 100 years. The "buy the dip" mentality is firmly planted. The concept of retail investors selling at the bottom when they can't take the pain anymore is nowhere close to being realised. Get ready.

Jean-Francois Tardif

President & Portfolio Manager
Timelo Investment Management Inc.

For more information, please visit ci.com.

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