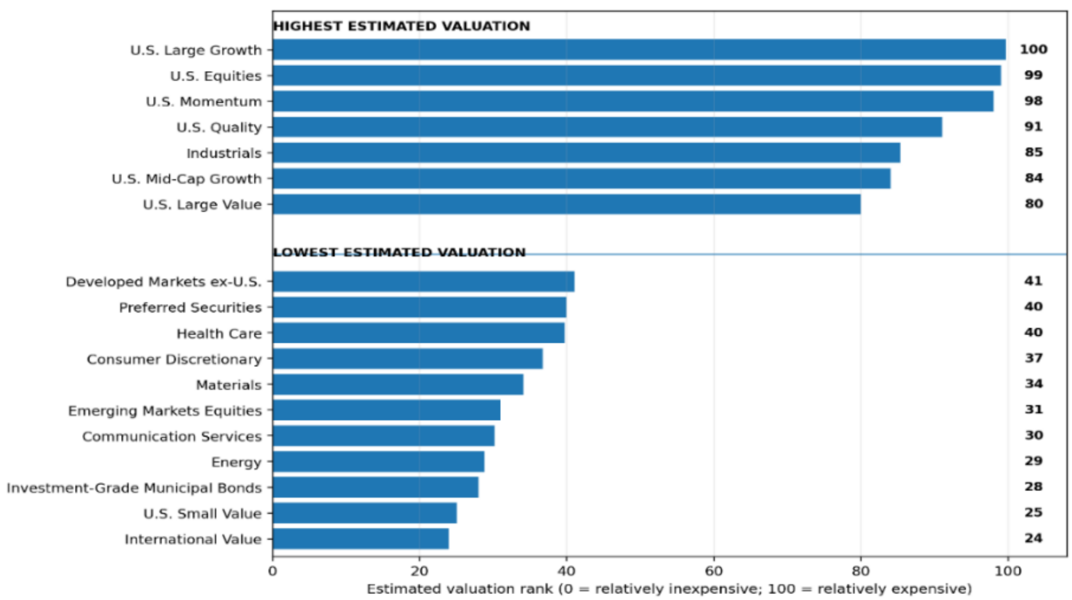
Beyond the Visual Line of Sight

We begin with some easily observable, yet instructive, metrics about the markets. Then, we will turn our attention to events and their potential consequences, which, while less observable or predictable, could be just as important to investors.

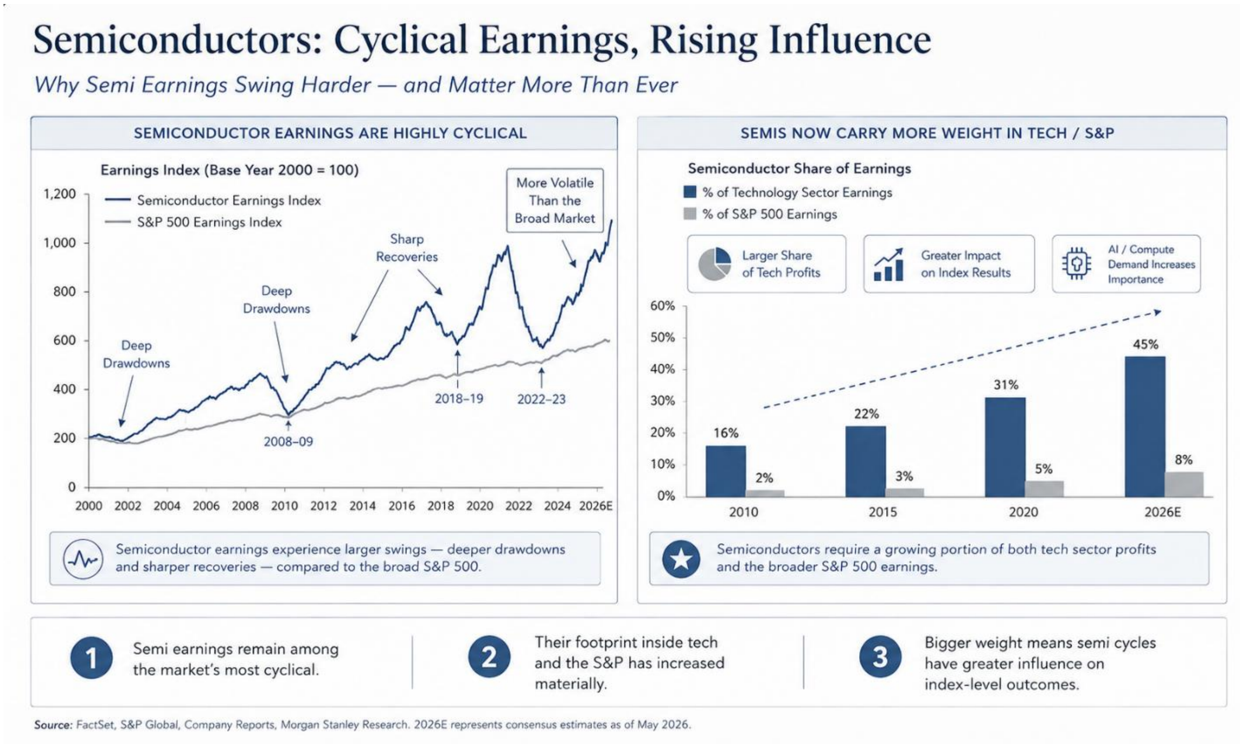
A few charts are helpful in conveying information relative to current market valuations and composition. A couple of things are worth noting. First, valuation should not be viewed in isolation, nor does a low valuation automatically make a sector or asset class investable or not. The matrix below reflects some judgment as well as quantitative inputs and, as such, should not be viewed as a purely mathematical ranking. The takeaway should not be that one class or the other is simply, inherently more or less attractively valued. Rather, it should convey that, even in what could be considered a broadly expensive market, meaningful valuation differences remain—and several sectors and asset classes, including some traditionally viewed as defensive, are trading near the lower end of their historical ranges.

Estimated Relative Valuation Rankings Across Asset Classes and Market Segments



Sources: Vanguard fair-value CAPE; State Street SPDR Sector Scorecard; FRED and ICE BofA; MSCI and Russell index statistics; JPMorgan Guide to the Markets; GMO seven-year forecasts; Nuveen preferred-securities research; Bloomberg U.S. Aggregate and S&P municipal index references. Preferred Securities is an estimated relative-value ranking based on yield, OAS, duration, tax characteristics and Nuveen's sector assessment. International Value replaces broad ACWI ex-U.S. equities. Rankings mix historical series, published models and clearly identified estimates and are not forecasts of realized returns. Direct real estate, listed REITs, gold, TIPS, high-yield credit and international developed small cap are excluded.

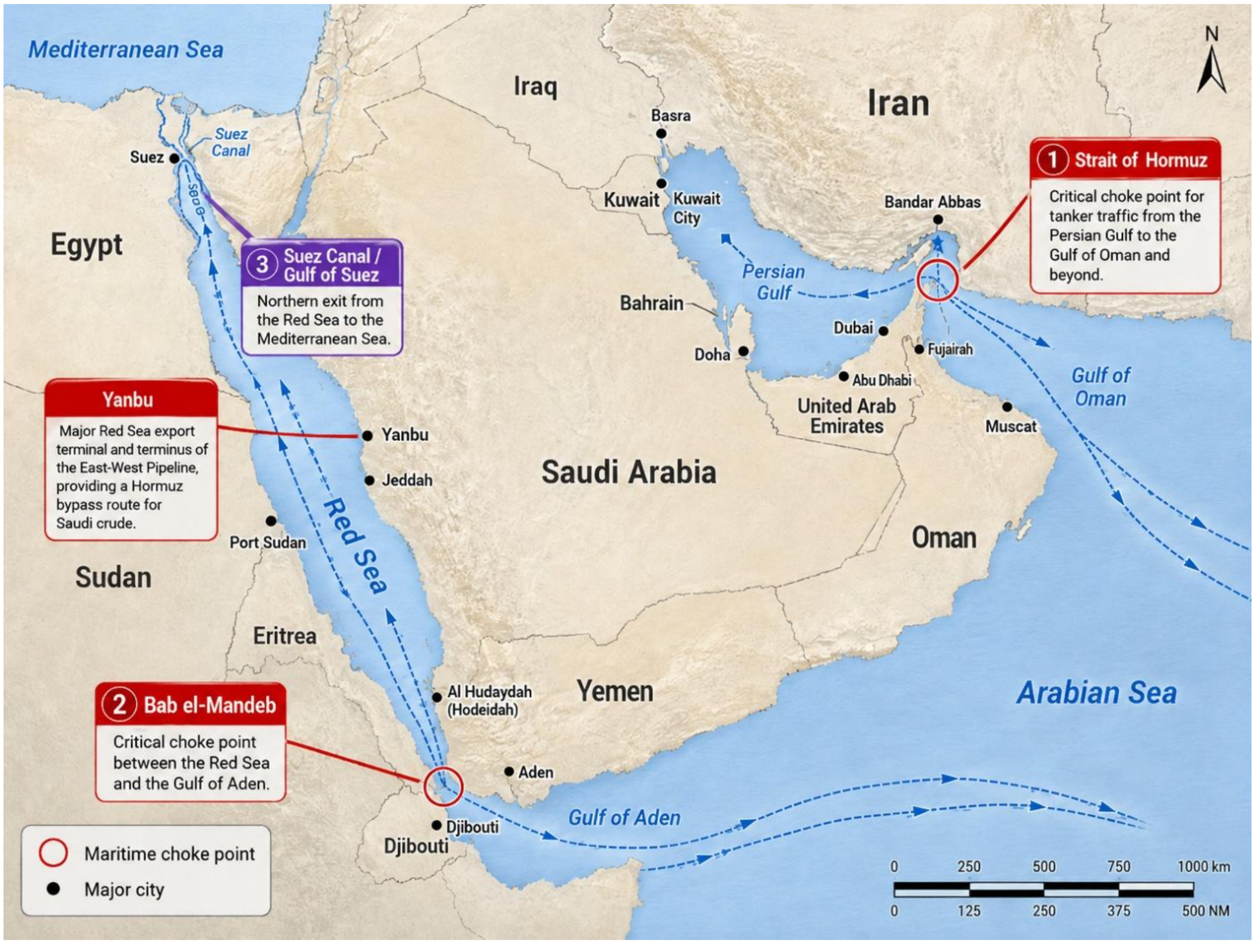
While market/sector composition, fundamentals, cyclicality, and risk are all important inputs, valuations do matter. Although cheap assets can remain cheap for some time and expensive assets can continue rising (particularly in the short run), over longer periods extremes in valuations rarely persist. Growth does not compound at extraordinary rates forever nor do assets trading far below their historical valuation norms typically trend indefinitely toward zero. As we observe these valuation contrasts, AI, semiconductors and such continue to drive news cycles. Accordingly, it is worth considering the market composition, as the importance of semiconductors to markets and major indices has grown. This is particularly important for investors who have long been encouraged to view the S&P500 as a passive and nearly decision-less investment, a *forever* holding for many.



Whereas the S&P and the news media that follows it have, in recent years, focused on stalwarts who were principally asset light toll-takers, the market is increasingly influenced by semis. The market, in fact, looks different – *is different* - today than just a few years ago.

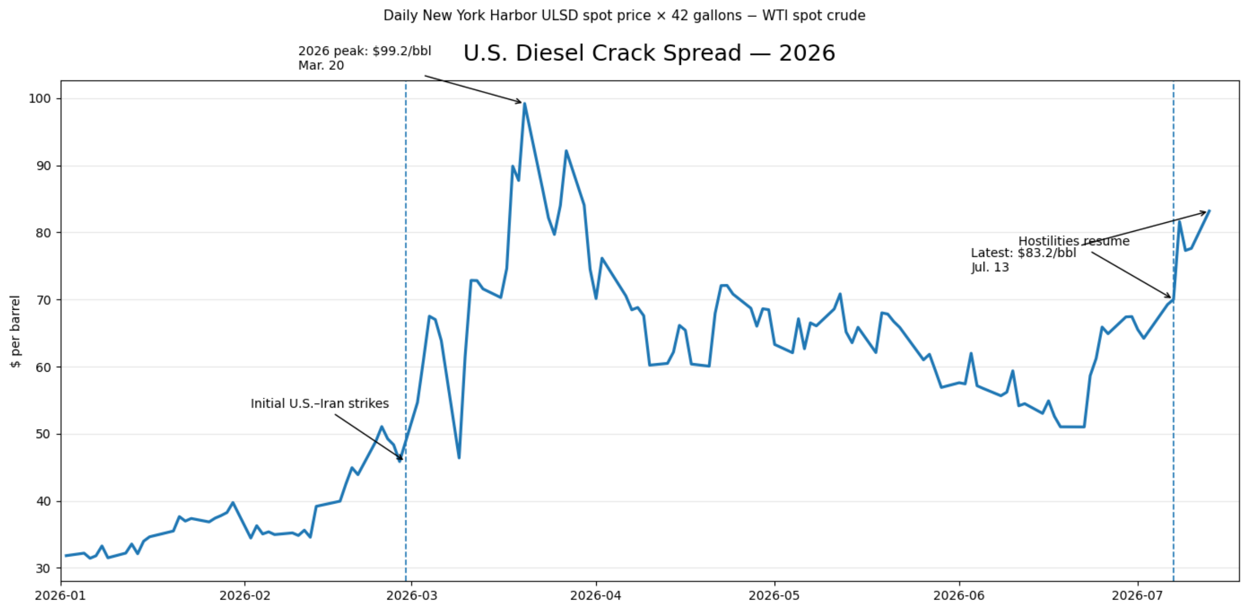
Against this backdrop, another story has been unfolding. While our initial view of the events in the Mideast largely played out as we expected, we have the sense that the next developments, honestly, may be a little beyond the line of sight. The range of possible outcomes is now quite large; and, the probabilities that one could assign to any of the possible outcomes are not skewed heavily toward any given outcome. Further, the possible outcomes are very tightly tethered to the actions and decisions of a relatively few world leaders. And, the events could unfold faster than some market participants can react.

Some aspects of the conflict that we pointed out long ago remain true. Iran has a population of more than 90 million, is nearly the size of Western Europe and is, of course, strategically well positioned relative to global oil supplies. The map below demonstrates this strategic positioning and calls out the Strait of Hormuz and Bab el-Mandeb choke points. When these shipping channels are threatened, somewhere on the order of 30% of global oil trade is impaired.



If Hormuz and Bab el-Mandeb are the legs, perhaps, Yanbu is the stool. Yanbu is a major Saudi export terminus that is now being used extensively to avoid tankers having to enter and transit Hormuz (estimates range from 4-7mm bpd). It is, without doubt, on the target lists of Iran and the Houthis - and well within range. Interestingly, most of the oil facilities at Yanbu and elsewhere are anything but 'hard targets.' It is hard to impossible to either hide or harden them. While the narrative circulates about the success of missile intercept systems (manufacturer estimates as high as +/-90%), Dr. Ted Postol, professor emeritus of missile defense at MIT, claims such systems have an estimated 2-30% success rate. We might assume the actual success rate lies somewhere in between those estimates and that a lot of missiles or drones can be launched simultaneously at exposed, soft targets. Given that Yanbu is served by more than 700 miles of pipeline and more than a dozen above ground pumping and control stations along its route, we can assume vulnerability of a critical system.

Casual observers will immediately conclude that gas prices could rise. That conclusion, while true, is also incomplete, as diesel could also rise fairly dramatically. Refining capacity is being hit in both the Mideast and Russia. Without refining capacity, oil isn't really energy. The graph below shows the widening crack spread, which we can loosely think of as the price of converting oil into diesel. This effectively captures the increasing price of refining diesel over and above the already elevated price of the raw crude.



January 1, 2026 through latest common EIA observation, July 13, 2026. Source: U.S. EIA.

Importantly, while gasoline powers personal vehicles, diesel powers commercial rigs and ships, the kind that deliver food, medicine, building supplies. Not surprisingly, the consumption of diesel is somewhat less discretionary. Gas prices up? Cancel the trip this weekend? Diesel up? Pay the price unless one is prepared to do without the necessities of life.

Those with economics or math backgrounds will immediately recognize in the demand curves that higher prices of both gasoline and diesel generally tend to lead to lower demand for both products (subject to a lag effect), although gasoline is more sensitive or more 'elastic' in economics terms to price whereas diesel is less so. The price of higher oil/fuel is felt both at the gas pump directly and in many goods indirectly, of course. In fact, many products derive a substantial proportion of their total cost from the transportation used to get it to you. Petroleum actually accounts for 50% of the total value of some building materials, for example. Further, petroleum production is the starting point for things from plastics to fertilizer…, and, yes, even some skin care products and pharmaceuticals.

As regular readers may well remember, we talked about oil some time ago when forecasts among our white shoe peers in the industry suggested oil would collapse to $47/bbl and gold was considered entirely un-investable as an asset class. We closed our positions in gold miners a while ago when gold flirted with $5,000/oz, far above the expectations of many of those same analysts. We lightly trimmed some of our oil company exposure when oil was first flirting with $120/bbl. Markets have remained somewhat surprisingly, comfortably numb to the possible consequences of oil impairment. Markets can be interesting and confounding places in which to work at times. Ultimately however, physics is physics. Every business owner reading this, will very much identify with the contention that, if you need X to make or move Y, it behooves you to have an ample and secure supply of X. Oil is X in your equation. Given the high degree of uncertainty around oil and aware of its attendant impact on economic activity, we are very much aware that some things have, in fact, moved beyond the visual line of sight. We continue to actively attempt to maintain some optionality in our positioning in the face of uncertainty.

Constantly changing geopolitical events, market relationships and economic variables create real constraints in adapting strategy in markets just as it does in dealing with dynamic circumstances in military and geopolitical analysis. Military assets cannot be moved, fueled, loaded, and re-positioned real-time. Investors, likewise, cannot immediately reconfigure entire portfolios perfectly in response to every headline. When uncertainty is high and outcomes depend on a few unpredictable actors, it is sometimes advisable to prepare in advance for a wide range of possibilities, preserve optionality, and resist reacting to every development. This is not indecision. No, it is disciplined positioning. It is lowering one's center of gravity, maintaining contingency plans, and recognizing when events have moved beyond the visual line of sight.

That kind of discipline can also be described as prepared patience. I can recall lying in a fox hole in Saudi Arabia long ago when US war ships hundreds of miles away struck deep into Iraq with the initial salvo of cruise missiles. Some peers thought that we should all go immediately to battle stations. I could not help but think that we should ensure our equipment was ready, rest and be prepared for when we might be called upon to move. When prepared and appropriately positioned, not every piece of news requires action. Like a soldier simply preparing gear or resting before a mission, patience can be an active strategic advantage. In the current environment—marked by geopolitical escalation, strained resources, rising household costs and speculative enthusiasm around semiconductors and AI—the challenge is not to predict every outcome, but to remain reasonably ready for any of several of them.