Beneath the Mainstream News Cycle Beyond the headlines of opinion these days there are some relevant facts which can inform judgment.

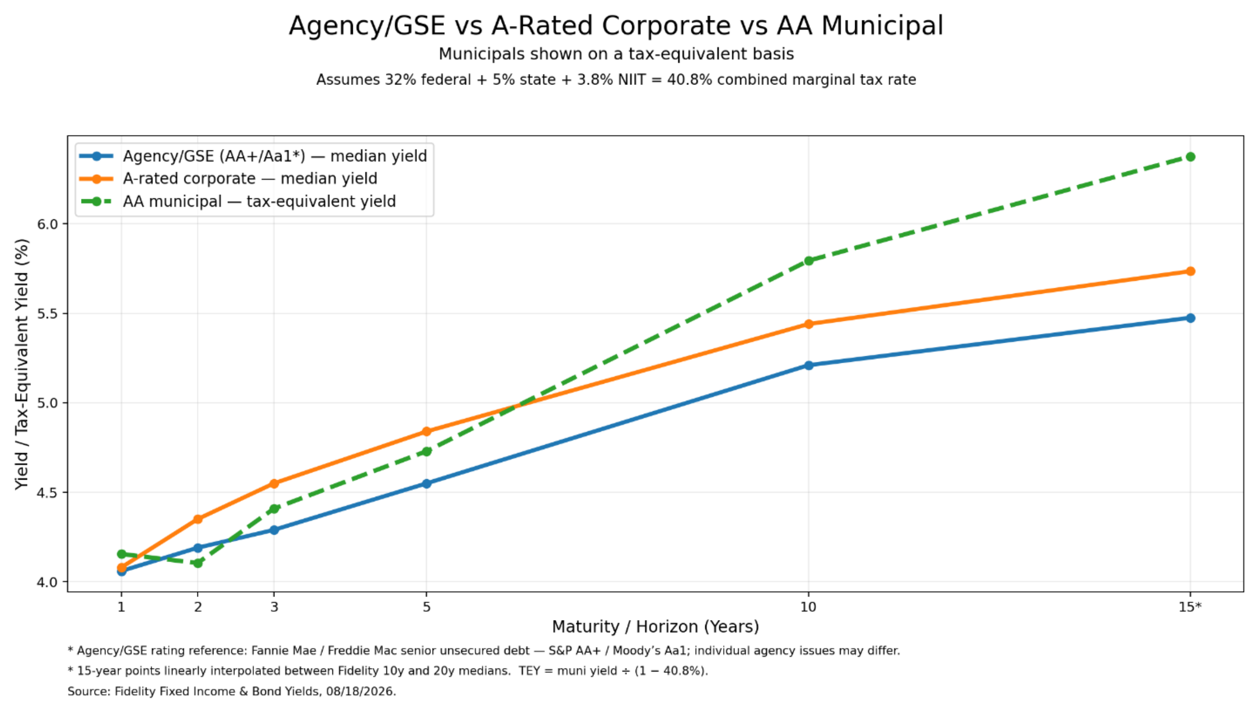
Equity Markets There is a lot of discussion now about what rate could effectively break the market, with various commentators suggesting 4.5%, 5% or some other somewhat random threshold, begging the question, "Why, then, did zero to close to 5% not break it, yet?" Should not a rerating of multiples on very long horizon earnings (tech/growth) been occurring all along the move. Oddly, if enough people believe a specific threshold is important, it could be. To be sure, valuations and concentration remain very high.

Beyond market discussions about whether AI leads us to Shangri La or transforms us into a jobless economy or otherwise, there is the broader market which is, at once, highly concentrated, momentum-driven and passively invested. The latter two are closely related. Reminding that passive, cap-weighted index funds and ETFs effectively buy companies in proportion to their weight in an index, a company whose price is rising relatively faster than the market as a whole is weighted more heavily. So, if, for example, a sector trades at a PE of 33 or thereabout and its cap-weighted proportion of the index rises 7.5%, an investor contributing funds to an index-driven strategy will be buying that sector at that increased weight, irrespective of things like valuation, earnings quality/persistency and other factors.

Now that around 53% of all funds are passively invested (and, presumably much more that is *shadow* indexed), the market may be losing its ability to efficiently allocate capital as John Bogle himself suggested long ago. One wonders if investors may eventually question the process of buying companies solely on the basis of their aggregate share of the total market cap of an index. It all begs the question like: Should a majority of assets be in a popular cap-weighted index when the majority of the market is now doing it? Should it be relied upon heavily when valuations are relatively high and a handful of highly valued companies constitute a significant majority of the indices being used most widely? Has the rise of indexing been somewhat self-perpetuating in its mechanics and in its increasing reliance over the years by retirement plan flows? Importantly, what are the implications of a downwardly-, rather than upwardly-biased, market? Notably, a considerably smaller proportion of daily transactions are now being executed by investors whose trades are based on considerations other than relative size.

Income Opportunities While the traders on financial networks debate where to be on the yield curve and wait in anticipation of whether a ¼% rate change is coming this morning, most actual fixed income investors have limited interest nor participation in the speculation around rates. Rather, they may be invested in a portfolio of actual bonds (as opposed to a bond fund) and anticipate collecting coupons/interest until a bond matures and returns it's par value to the investor.[1] While higher rates can impact mark-to-market which we will discuss, they also offer a fixed income investor with a bond ladder, the opportunity to invest maturing bonds at potentially higher rates. Further, bond price/rate dispersion has created some opportunities to be thoughtful in allocating fixed income portfolios to take advantage of differential rates, terms, ratings and tax attributes.

The chart below highlights how, for example, an investor is asked to give up very little in yield relative to corporate bonds at certain maturities to pick up government agency credit ratings. Likewise, investment grade tax-free municipal bonds out the curve present an investor in a 32% Federal bracket and paying 5% state and 3.8% net investment income tax to pick up a yield that could approach 7% on a fully taxable bond.



Broadly speaking, rising rates lower bonds' trading price as they are marked-to-market relative to newly issue bonds at higher/lower rates. A bond investor continuing to receive his coupon payment of, say, 5.5-6%, will see the price of the underlying bond (prior to maturity) reflecting higher or lower prices to approximate the value the investor might receive should they sell it prior to maturity. At maturity, however, the company is obligated to pay the investor par.

While much recent commentary focuses on Kevin Warsh's Fed or bonds of 20+ years, a more useful exercise may be to consider how rates could evolve through an entire cycle of inflation or oil shock. Assuming higher prices and/or rates could serve as an economic brake on economic activity, higher forever cannot be assumed, as is currently being done, as interest rates effective price the demand for borrowing. Lower economic activity generally reduced that demand. While there are a number of variables that influence day-to-day prices of fixed income investments, portfolios diversified across maturities and most often held to maturity largely avoid the necessity to speculate on rates – an endeavor in which economists have consistently failed.

The conundrum is that deficit spending must slow down or rates could be pushed higher, serving as that brake we discussed. With midterms in November and a presidential election in two years, which brave lawmakers want to embrace austerity. Further, austerity presents real recession potential. Recessions also result in lower tax receipts. Printing money to more cheaply pay off debt, as has been done in the past, creates inflation which is in itself is eventually a brake, as well as having many more economic and political implications.

The Domestic Economy

DISCRETIONARY RECREATIONAL MARKETS: 2022–2025 COMPARISON

CATEGORY	2022 (UNITS / USD)	2023 (UNITS / USD)	2024 (UNITS / USD)	2025 YTD* (UNITS / USD) (JAN–MAY 2025)	CHANGE 2023→2024	CHANGE 2024→2025 YTD	OBSERVATIONS
MOTORCYCLES U.S. New Motorcycle Sales (Units)	537,234	509,432	463,176	211,211	-9.1%	-10.6%	Three consecutive years of decline; off 13.8% from 2022 peak.
PERSONAL WATERCRAFT (JET SKIS) U.S. PWC Sales (Units)	66,263	67,110	70,704	30,562	+5.4%	-13.1%	Peak in 2024, then down ~13.1% in first 5 months of 2025.
NEW BOATS (ALL) U.S. New Boat Sales (Units)	252,413	255,227	236,070	90,562	-7.5%	-10.4%	Significant two-year decline; largest drop in 2024–2025.
NIKE REVENUE (USD) Nike, Inc. Annual Revenue (USD)	$46.7B	$51.4B	$46.3B	$18.1B* (9 Months FY2025)	-9.9%	-9% to -10%	Revenue down ~10% in FY2025 vs. FY2024.

Sources: NMMA (boats & PWC) – Sept 2025 data for boats & PWC are NMMA final estimates; Motorcycle Industry Council (MIC) – through May 2025; Nike Annual Reports (FY2025 ended May 31, 2025). | *Most recent reported period.

The graphic illustrates something we discussed long ago when we proposed a Jordan and JetSkis index that would presumably capture spending on some of the most discretionary categories of spending. When one considers the higher prices and lower unit sales through the lens of what many have called the K-shaped economy (the wealthiest spending and the lower income bracket not), what emerges is evidence of breakage. In a K-shaped economy, where a boat/trailer combo costs a Kuarter million dollars, manufacturers are finding that the top of the K-shaped economy is not price insenstive. These uber discretionary spends are breaking down in things like motorcycles, personal watercraft, boats and, even, Nikes. One of the largest boat retailers, West Marine with which many readers will be familiar, has now declared bankruptcy. We now hear, too, that dealer lots are filling up with unsold trucks.

This spending strike is starting to arrive in housing markets, as well. In markets like Miami and Houston there is a historic imbalance with twice as many sellers as buyers. Will prices soon follow? The phenomenon is not isolated to those markets, but they are showing some of the earliest and most severe signs of stress.

The Credit Cycle Delinquencies are notably picking up among lower quality borrowers across a range of loan types. That is a story easily understood from the vantage points of prices and the cost-of-living. The more intriguing aspects of this credit cycle, however, remains the opacity of private credit and, more recently, the circularity of lending/financing in the hyperscaler/AI markets. Imagine Company A investing in or lending to another and the Company B using the proceeds to buy the products of Company A, lease compute power or fulfill some other obligation. The complexity of many of these transactions confound even seasoned technology and financial analysts with their complex balance sheet and off-balance sheet obligations. Buffett famously repeated that you shouldn't get involved in things that you don't understand. A reasonable concern is that very few, if anyone (including career analysts), truly understand the trillions in motion nor the complexity of it all.

Deficit and Dollars Inflation favors the borrower, as payments are made with currency that has less purchasing power than when the loan was drawn. There is an argument, not without merit, that a government with $40T in debt will attempt to inflate its way out of debt. It is the basis for the resurrected gold trade, the recent rise in crypto and some of the action in rates and bond markets.

The Treasury and the Fed are tasked with the challenge of insulating against rampant inflation while simultaneously managing long term rates to avoid increasing debt funding cost and, ultimately, becoming an economic drag. It would seem that Warsh's first move of doing nothing and Bessent's first overtures respecting what is, in effect, a twist operation could be interpreted as Warsh being at least somewhat willing to tolerate some slowing to satisfy the mandate of price stability, while Bessent's move reflects his longstanding focus on the ten-year.

The oil situation cuts both ways, transmitting higher prices, while eventually serving as a brake of sorts on the economy. While we were in the minority in suggesting that the Mideast situation would not be resolved quickly, there are a myriad of incentives for it to come under control, however, as its repercussions are both negative and severe for nearly everyone. Assuming that hostilities cease and oil comes back onto market at eventually lower prices, it both lowers prices and improves economic conditions. By that point, it is quite likely that some real economic damage will be showing up in the numbers. So, it is somewhat possible that eventually lower forward oil prices could have the effect of lowering prices while being somewhat stimulative economically. That would, to some unknown extent, begin to offset the weakness and higher prices from the prior conflict period. Hence, one could argue that Warsh exercised some patience/prudence in doing nothing with rates in the last meeting. He has strongly intimated an intent to let the market do part of the work. Bessent, on the other hand, has his hand on the switch now very aware that rapidly or harshly higher rates break his ability to pay government bills while possibly breaking a lot of others things, notably real estate, long duration and growth equities, credit and fixed income to name a few. One may not like curve control, but its objective is understandable. While many are apoplectic about rates in general, we could find ourselves in a somewhat stable short term rate environment accompanied by a modestly managed long end, creating a somewhat flatter yield curve than many are predicting. Assuming that Warsh can keep inflation from running away from him, Bessent's job could be somewhat easier. If the Fed and Warsh were to commit a major policy error, Bessent would find his job incredibly difficult.

While all eyes are on rates and inflation, we should not overlook the very real possibility that government might well attempt to close its funding gap by raising revenue. Might they suggest that hyperscalers use lots of water and energy and could potentially reduce employment? Could they use that as a basis to impose a tax on an industry which has also been disproportionately aggregating wealth? If not, what are the likely other revenue opportunities for government?

Geopolitics On August 18th, Israeli fighters apparently struck a Syrian airbase housing Turkish military equipment. Turkey has since called for the arrest of Netanyahu. As many readers may know, Turkey is both a formidable military presence and is a NATO member. Israel suggests that the airbase, presumed to ultimately be reinforced with more Turkish equipment and personnel, is a security threat. Turkey, Pakistan and Saudi Arabia have also recently signed a mutual defense pact. The heightened potential for broader Mideast conflict is far more important than the motivation or justifications of either Israel or Turkey. The US envoy for Syria, Tom Barrack, related, "This underscores the need for a deconfliction mechanism involving Israel, Syria and Türkiye. That is something we are actively working on to establish in order to prevent future miscommunication. The priority now is to lower tensions and allow space for a more measured approach." Yes, it would seem some *deconfliction* might be in order.

We suggested long ago that alliances are not always as stable as presumed. While the world and the media are preoccupied with the price of gas and whether the US or Iran will w*in*, coherent observers globally are beginning to fear that geopolitics and military actions are not-so-quietly reshaping the shifting sands of the Mideast.

President Trump, August 17th offered the following: "If Oman gets in the way, we'll bomb the s--t out of them." We will let that stand on its own as it would be hard to misunderstand the intent of the statement. The graphic later distributed by President Trump further confirms the view.

Meanwhile in Ukraine, there are calls for elections and reporting that multiple competing factions have emerged as Operation "Forrest Gump," an anticorruption investigation alleging that involved former parliamentarians and senior official in Zelensky's office gets underway. Yes, that is actually the name and, yes, it is alleged that some money was used to bail out others charged in a separate corruption case called "Midas." All the while, the country faces a near complete stoppage of Black Sea shipping and a new threat to Kyiv from jet powered drones and relentless missile strikes. Make no mistake, Russia's infrastructure is being targeted and its exports are also being curtailed. In part due to the shut-in of both Ukrainian and Russia grain exports, wheat prices in Chicago have risen approximately 17% from early July. In large part due to both Ukrainian and Iranian refinery strikes, cost of producing diesel from crude (the crack spread) now hovers around $100, having risen nearly another 40% since we mentioned it in last month's commentary.

As Russia has escalated beyond *conflict* to *war*, reports are rolling in that NATO countries have been encroached and, per US intelligence, an imminent Russian attack on NATO allies is imminent. One would have believe that Russia had assessed and satisfied a wide range of contingencies to rationalize a Russian decision to actually engage NATO directly. On the other hand, absent NATO engagement, it is seeming more and more like both Ukraine and Russia have sufficient motivation to move beyond the conflict. It would not be surprising to see pivots in both military and negotiation strategies soon. That would take coherent leadership on both side, as well as, perhaps more importantly, the acquiescence of US/NATO/Europe which all very much need political/military wins desperately.

A Million Other Things These are just a few things that strike us as not being discussed or not being discussed in ways that satisfactorily address their true significance. As the fluidity and magnitude of some of the ongoing issues may eventually necessitate course corrections, it would not be unreasonable to expect some pivots soon. Developments in areas from consumer confidence, housing, geopolitics, energy to foreign exchange continue to hold our attention. We will continue to monitor, evaluate, consider and communicate as things develop.

[1]Assuming no default and subject to call provisions.