SMITH
CAPITAL INVESTORS

5x5 Market Update – April 2025

Five Things We've Learned &
Five Things We're Focused On

Introduction:
Policy Meets Markets in a New Paradigm

April has brought volatility but more importantly it has brought new opportunity. Markets are now reacting to something deeper than economic data: they're responding to a changing world order. Policy decisions, political strategies, and national priorities are shaping price action in real time. The macro regime has shifted.

We've long expected Trump and his team to follow through on their campaign promises. What we didn't anticipate was the aggressive and dismissive approach. The current "shock and awe" strategy is a wake-up call that this isn't just an 'Art of the Deal' moment—it's a structural reset of how the U.S. sees its role in the global economy. For those seeking clarity, the recent All-In DC and All-In podcast debates—particularly the sharp (and at times theatrical) exchanges between David Sacks and Larry Summers—offer rare insight into the strategic intent behind current policy.

There's wisdom in listening through the noise. Sacks, Bessent, and Lutnick present a view that this isn't chaos—it's calculated disruption designed to reset the board. The U.S. is shifting from globalization to national-interest economics. Broad-based tariffs, unilateral positioning, and pressure on the Fed aren't accidents. They are viewed through a lens of the world being out of balance. They are part of a high-risk, high-reward attempt to reassert U.S. leverage in trade, capital markets, and strategic industry. Whether this strategy enhances U.S. exceptionalism or triggers long-term fragmentation remains an open question. But what's clear now is this: visibility is low, volatility is high, and markets are adjusting in real time.

Contents

Five Things We've Learned

Five Things We're Focused On

Five Things We've Learned

1 Yields Are Rising While the Dollar Falls—A Signal of Stress, Not Strength

In a sharp short-term break from historical precedent, we've seen 10-year Treasury yields rise over 45bps in the span of a week (from April 4th to April 11th) while the U.S. Dollar Index (DXY) has declined over 3.5% (from April 7th to April 14th). Normally, rising yields signal stronger growth and a stronger dollar. This divergence reflects something else: disorder in capital flows, likely from leveraged basis trade unwinds, possible foreign selling of both Treasuries and the dollar, and a revaluation of U.S. fiscal stability.

This comes at a moment when the Treasury is staring down over $6.2 trillion in maturing debt over the next 108 days, including almost $5.5 trillion within 90 days at a weighted average coupon of about 2.3%. If confidence erodes further, yields could rise for the wrong reasons—not from strength, but from risk premium. Bessent put it bluntly that the Trump administration is focused on lowering the 10-year Treasury yield.

The dollar may no longer automatically be the flight-to-safety trade. In this regime, it's become a release valve for policy volatility. Higher yields, a steeper curve, wider credit spreads, and falling equities are delivering financial tightening—without a single Fed hike. We are NOT of the opinion that U.S. Treasuries and the Dollar have lost their significance and value. Bouts of uncertainty are just that, uncertain.

2 Treasuries May No Longer Be the Portfolio Hedge They Once Were—Cash Is King (For Now)

For decades, Treasuries offered the ultimate hedge in risk-off scenarios. Today, that relationship is being questioned. Bonds and stocks are falling together, and the long end of the curve is no longer acting like a ballast. The duration hedge is compromised—at least for now.

Investors are moving to short-dated bills and cash equivalents, yielding over 4.25%, with great liquidity. This echoes a GFC-era mindset: "return of capital, not just return on capital." But beware—the current front-end yields may not be sustainable long-term. They're a byproduct of volatility, not a foundation for recovery.

This shift could impact how portfolios are built, but our skepticism of this is high. We're reassessing curve exposure, liquidity buffers, and risk hedging assumptions. In the end, fundamentals will be the driver of rates, albeit technicals warrant attention. The important consideration in our minds is that market disruptions in the past have brought the Fed into play and we anticipate this will continue to be the case. The Fed may not cut rates in the near term, but it may have to intervene in funding markets if dysfunction intensifies. Could QE become a stability tool, rather than a stimulus lever? It's a real possibility.

3 The Global Capital Loop Is Fracturing—China Could Export Deflation Again

The cycle where the U.S. consumes, China exports, and dollar reserves are recycled into Treasuries is breaking. China and Japan may be reducing Treasury holdings. With global trade in flux and the RMB weakening, capital may no longer be flowing back into the U.S. like before.

China's policy response may be to reassert export dominance via currency weakening—strategic deflation. This was hinted at by both Bessent and Lutnick and could serve both trade and geopolitical aims. A weaker RMB means cheaper exports and downward global pricing pressure—just as the U.S. is bracing for tariff-induced inflation. Add in the risk of China liquidating its US Treasury positions and one could quickly draw the conclusion that wilder markets are in front of us. Don't lose sight that these actions may not serve China well either.

Markets have anchored on the idea that tariffs = inflation. But we raise the question: what if China reintroduces deflation just as U.S. consumption softens and margins compress? This could challenge the inflation thesis and pressure sectors with overestimated pricing power. To truly get the high impact outcome, we would need a win-win agreement between the US and China. Strong protective actions likely only yield greater responses and additional dysfunction.

One thing to consider – why did the world want China in the WTO in the first place? We believe the labor arbitrage, allowing developed nations to import deflation had to be a consideration.

4 Confidence Is the Most Fragile Asset Class

More than inflation or employment data, confidence is the critical asset class right now—and it's cracking. The drawdown in equities and market uncertainty is starting to impact corporate and consumer behavior. Companies could delay investments. Consumers could pull back. And overall consumption could decline. We know that many have front-run the tariffs with advanced purchases and consumption. This may be simultaneously borrowing from future growth while also delaying new commitments. This dual effect could feed into the labor market next.

Continued →

4 Confidence Is the Most Fragile Asset Class (Continued)

The broader concern? A wave of massive Treasury refinancing is colliding with rising uncertainty. There were fears around a weak 10-year auction in April given the negative sentiment, but the results showed no signs of concern. However, a failed auction or severe undersubscription could force the Fed into action—not to support growth, but to preserve market function. While it is still a low-probability event, the risk is rising. And the consequences would be severe: forced QE, accelerated dollar weakness, and widening systemic cracks. We view this as a low probability outcome.

Summers compared some of the actions to emerging-market behavior: currency instability, unpredictable policy, and fiscal fragility. We don't share that view. The U.S. is still the world's safest and largest economy with unmatched defense power, a highly ethical legal system, and home of the greatest consumers on the planet. But the rules of engagement are being rewritten and the premium that investors place on U.S. institutions is being tested. This is not a collapse-type scenario, but it is a repricing of what "safe" means.

5 The Strategy Is High-Risk, High-Reward— But Was the Old Trajectory Really Sustainable?

The market is questioning if Trump's strategy isn't random, but it might be purposefully erratic to establish leverage. Broad tariffs, aggressive threats, and contradictory headlines—these are all negotiation tools. The goal is to reindustrialize the U.S. in sectors deemed critical to national security: energy, technology, pharma, and materials. That much is clear. But the process is messy (at best).

The price of that strategy is uncertainty and it's showing up in risk premiums and illiquidity. CEOs need predictability to invest. They don't have it now. Until they do, we expect a corporate pause: in hiring, in capex, and in growth plans. That's why visibility—not taxes or rates—is the #1 ask from business leaders, as David Sacks emphasized.

Still, what if this works? What if the administration succeeds in drawing dozens of countries to the table and forges stronger bilateral trade agreements? What if the U.S. successfully incentivizes productive corporate leverage—not for stock buybacks, but for investment and reshoring? These are the right questions to ask. If even a third of the targeted countries cut better deals, it could mark the beginning of a new global trade structure—one more resilient and aligned with U.S. priorities. But it won't come without friction. The US's dominant position may have come into question in the media but forgotten might be seeing this through the lens of what could go right.

Five Things We're Focused On

1 Treasury Auction Health and QE Watch (Not the New Apple Watch)

Each auction now carries market-wide implications. We are carefully watching bid-to-cover ratios, tailing behavior, and foreign participation. The stakes are unusually high: over $6.2 trillion in U.S. debt matures between now and July 31, with just under $5.5 trillion due in the next 90 days alone, much of it originally issued at an average coupon near 2.3%. That rollover must occur in a vastly different rate environment—and without guaranteed demand.

If auction softness were to become systemic, the Fed may be forced back into the market—not to cut rates, but to preserve functionality through secondary purchases or balance sheet support. We believe QE could return not as a stimulus tool but as a funding backstop. That could change curve dynamics dramatically. In addition, Bessent has referenced that the Treasury could be a buyer too. This amplified the administration's focus on longer duration rates. We should all take them at their word.

We are positioning with optionality in mind—balancing the possibility of a sustained bid for long duration (in the event of a fall off in growth, recession or a Fed re-entry) with the risk that persistent supply and weak demand keep pressure on rates with the greatest risk in the long end. If Powell holds firm, the 10-year yield could do the Fed's work for it. But if dysfunction rises, we may see the first non-crisis QE since Operation Twist.

2 Credit Spreads, Liquidity Risk, and the Cost of Capital Reset

Credit markets are repricing—not just for default risk, but for liquidity, uncertainty, and a lack of visibility. BBBs and crossover names are under pressure—the market is decompressing. High Yield (HY) has corrected from near perfect pricing, and we expect a meaningful uptick in dispersion, both across overall credit markets and within sectors. Coming off the 20-year tights, credit will remain vulnerable to all forms of volatility.

Corporate issuance demands attention. We see two issuance waves ahead: one driven by proactive liquidity-raising and one by strategic re-leveraging, aligned with the administration's industrial policy. The former is defensive—companies locking in capital before spreads widen. The latter is opportunistic—deploying capital into productive CAPEX, not share buybacks, potentially encouraged by fiscal incentives. These are important considerations, especially with spreads still tight on a historical basis.

We have been selectively trimming exposure to lower-quality, refinancing-sensitive names while actively identifying resilient, investment-grade (IG) and HY credits with strong free cash flow, solid liquidity, pricing power, and strategic clarity as potential buys. In volatile markets, alpha is created by taking targeted offense after broad repricing. Security selection and avoidance are central to our process.

3 Corporate Re-leveraging— Strategic, Not Speculative

The administration's posture toward Corporate America has changed. This isn't post-GFC deleveraging. It's a call for balance sheet utilization to finance national interests—reindustrialization, technology investment, energy development, and infrastructure. Don't forget we went through one of the greatest debt transfers from the consumer and corporations to the Government during the GFC. This might be in reverse today.

Bessent explicitly noted that corporate re-leveraging is seen as part of the solution—not the problem. In this light, debt issuance could rise not despite policy risk, but because of it. We believe this warrants a reevaluation of how we interpret rising net leverage.

We are closely evaluating whether new debt is being deployed into productive growth or simply financial engineering. The answer will dictate future spread behavior. In an environment where the government is actively encouraging domestic investment, leverage tied to earnings power, value creation, and durable or expanding margins could be rewarded. The credit markets command great focus here.

4 Trade Repricing— Especially with Allies, Not Just China

Markets have been focused on U.S.- China tensions but Trump's tariff framework targets more than just Beijing. Canada, Mexico, Germany, and Japan may face scrutiny for acting as pass-throughs for Chinese goods. This has implications not just for trade balances—but for global supply chain assumptions.

Repricing "friend-shoring" is complex. Companies may need to reroute or reshore key inputs, which could alter cost structures, timelines, and competitive positioning—especially in autos, chemicals, machinery, pharmaceuticals, and electronics. This could disproportionately affect sectors with high foreign component dependency. But the long-term outlook is one of greater durability and more predictable outcomes. This is a positive.

We're mapping supply chain concentration at the issuer level, identifying potential exposure to tariff disruption and tracking margin sensitivity to rerouting. While some companies will be disrupted, others may benefit from domestic substitution dynamics. We believe this creates credit dispersion opportunities in both IG and HY.

5 The Inflation vs. Deflation Tug-of-War

The macro regime remains unresolved. Tariffs, deglobalization, and tight labor markets argue for higher inflation. But slowing demand and renewed deflation exportation risk from other countries and China—via a weakening RMB—suggest downside inflation surprises are back on the table. We raise the issue because the consensus has quickly moved to the commonsense response mechanism that tariffs are inflationary. We agree with this but in the medium term the surprise might be that deflation is a bigger and longer-term concern. Let's not forget that the administration campaigned on bringing prices down and likely won on this as a primary issue. With mid-terms on the horizon, success needs to show up sooner than later.

We are tracking real-time indicators: margin pressure, pricing trends, supply chain surveys, and earnings commentary. We're also watching wage growth data closely as it remains one of the most persistent inflation inputs.

This battle will shape the next major move in rates. If inflation fears fade faster than expected, rates could reprice swiftly, rewarding long duration positioning. If sticky inflation persists amid slower growth, stagflation fears may widen and further steepen the curve. Either way, as active managers with the ability to be nimble, we are building dynamic portfolios that can adapt quickly. With the extreme possible outcomes, we continue to be biased toward a defensive positioning, but the revaluation of the risk markets puts us in a position to consider moving toward neutral. The goal is always to focus on risk-adjusted returns and protecting capital.

Closing Reflections:
Discipline, Clarity, and Client-Centered Focus

In an environment marked by uncertainty, volatility, and noise, we return to what anchors us: disciplined process, out-of-consensus perspectives, and a strong focus on our purpose. At Smith Capital Investors, we believe this moment—challenging as it is—offers an opportunity for active managers who are disciplined in their analysis, intentional in their positioning, and aligned with their clients' long-term outcomes.

We are watching several key factors closely:

- Auction strength and the Treasury market's ability to absorb record supply
- The Fed's potential reemergence—not as stimulus, but as a stabilizer
- The trajectory of corporate issuance: defensive liquidity-raising vs. productive investment
- Global trade dynamics—especially how new bilateral negotiations reshape supply chains and sector margins
- The inflation/deflation tug-of-war and its implications for curve positioning and sector spreads
- What can go right and what can go wrong. This requires daily consideration.

These forces don't just drive markets—they shape portfolios. That's why our process remains rooted in our three foundational pillars:

1. Investment Excellence – we rely on our rigorous bottom-up credit work, a strong macro overlay, and disciplined risk/reward frameworks. We take pride in our credits and why they're in the portfolios—down to the individual bonds.
2. Relationships and People – we listen before we act. Listening to clients, companies, policymakers, and each other keeps our process dynamic and informed. Collaborative teams win.
3. Intentional Culture – our flat, collaborative structure empowers specialists to act as generalists and vice versa. After all, we are not just portfolio managers, analysts and traders, we are first and foremost investors. Strong culture drives speed of insight, alignment, and accountability. We believe this is a competitive edge.

Closing Reflections:
Discipline, Clarity, and Client-Centered Focus (Continued)

Our edge is not just analytical—it's emotional. In volatile times, we bring perspective, not panic. In complex environments, we simplify. In moments where clients are overwhelmed by headlines, we try and offer clarity, transparency, and conviction. We know we are not always going to get it exactly right, choosing to hit singles over home runs. But we strive to avoid terminal mistakes. We take protecting capital seriously. Our commonsense approach to investing has proven success over decades and is constantly evolving to address what is most important now.

We're not chasing or reacting to the noise—we are methodically working to identify mis-priced risk and position portfolios to perform through the cycle. As volatility reprices risk, we believe active fixed income will prove its value. And we intend to lead from the front.

We appreciate your trust. Expect more from us in the weeks ahead.

Let's Talk.

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