PICTON INVESTMENTS

THE PICTON REPORT
2025 MID-YEAR UPDATE

FRAGILE CONVICTIONS: WHY MINDSET MUST TRUMP MARKETS

TABLE OF CONTENTS

01.
EXECUTIVE SUMMARY

FOREWORD FROM DAVID PICTON

As we reach the halfway point of 2025, the one thing we can say with certainty is that uncertainty still defines today's markets.

But while the headlines may shift, our goal remains the same: to help advisors and their clients navigate change with clarity, discipline, and conviction.

In this mid-year edition of *The 2025 Picton Report*, we take a step back to assess the market narratives that shaped the first half of the year and more importantly, to share how we believe advisors can prepare for what's next.

Across asset classes and strategies, our teams offer practical insights designed to help advisors strengthen portfolios with greater confidence through the rest of the year.

Here's what you'll find inside:

- **Our Macro Outlook** looks at the early market response to the unintended consequences of Trump 2.0 and how renewed protectionist policies are creating ripple effects across global equity markets. We examine the immediate impact of tariffs and the longer-term, second- and third-order consequences that could shape portfolios for years to come.

> *The fragile state of markets currently feels like something different. Regardless of the risks and many potential outcomes,* ***we believe mindset must trump markets****.*
>
> *Careful planning and thoughtful preparation* ***can create opportunities to deliver better outcomes*** *for investors when they need it most. This means focusing more on strategically re-allocating assets* ***to make portfolios more resilient*** *so they can protect capital and generate returns regardless of what comes next.*

David Picton
President and CEO

- **Our Equities Team** observes that while corporate earnings have remained resilient through 2025, the recent market rally has left little room for error. That said, they caution that the recent sharp rally has largely eliminated the margin for error, leaving the market vulnerable with valuations stretched and investor positioning extended, especially if momentum starts to fade.
- **Our Fixed Income Team** sees a continued disconnect between yields and risk. While longer-duration Treasuries remain volatile, lower-quality credit has started to show signs of strain. They suggest a cautious approach, emphasizing quality and yield sustainability.
- **Our Arbitrage Team** sees signs of recovery in event-driven strategies. With a more favorable regulatory tone from U.S. authorities, M&A pipelines are starting to rebuild. They expect an uptick in activity in the second half, particularly in the convertible bond market as issuers face looming refinancings from the 2020–2021 capital cycle.
- **Our Portfolio Construction Team** underscores the importance of thoughtful risk and fee budgeting. Their research supports a deliberate approach combining low-cost beta with high-conviction alternatives to maximize the value delivered per dollar invested, especially in portfolios under pressure to do more with less.

At the start of the year, we shared our view that the U.S. equity market was showing signs of bubble-like behavior. In the weeks following "Liberation Day," markets corrected sharply, validating some of those concerns. But by late April, equities had begun to rebound, helped along by a softening of tariff rhetoric from the White House and a series of rulings from the U.S. Court of International Trade that invalidated some measures. With systematic strategies forced to cover shorts and re-risk, the stage was set for a sharp, sentiment-driven rally.

We have since seen a sizable rally for equities off the April lows. The headlines have been better, with the White House backtracking on many tariffs, and the U.S. Court of International Trade invalidating others. Changes in positioning (especially from systematic strategies) could well fuel further upside in the near term. But the market bouncing back to where we were months ago means some risks we identified earlier, like unsustainable valuations have resurfaced, while new risks have emerged.

For investors, we believe this is a moment to stay grounded. Use strength to rebalance and take advantage of inexpensive downside protection where possible. But we also think the bigger opportunity lies in taking a longer view.

The probability of a U.S. recession has increased relative to the beginning of the year, in part because the heightened economic uncertainty should lead to a pause in hiring by many employers. Stagflation risks also loom large, especially if the Republicans are successful in reinstating some tariffs.

The market for U.S. government debt is unlikely to ride to the rescue of richly valued equities given elevated bond issuance and a persistent supply/demand mismatch. Add in the possibility that nascent U.S. protectionism could be akin to America's Brexit and we may see continued upward pressure on rates, which could also impact equities. We think investors should consider selling into rallies and exploring downside protection when it's cheap.

"**_For investors, we believe this is a moment to stay grounded._**

Use strength to rebalance and take advantage of inexpensive downside protection where possible."

On a longer-term horizon, the jarring end of U.S. exceptionalism strikes us as a key theme to monitor. However, taking a more global view, we do see attractive opportunities as countries are forced to establish new trade relationships and make bold policy choices to bolster their economies. Many countries have already enacted fiscal stimulus to respond to tariffs, and their central banks have more scope to further loosen monetary policy.

As a result, international equities have much more reasonable valuations than the U.S. stock market. So, on a relative basis, we think investors should consider looking abroad. The "Sell America, Buy the Rest of the World" trade likely has considerable legs.

Uncertainty is a persistent and defining characteristic of markets, but the fragile state of markets currently feels different. As we watch the tectonic shifts in global markets take place, caused by the end of the era of U.S. exceptionalism and globalization, there will likely be unforeseeable risks as well as new winners and losers.

Instead of trying to predict how this plays out, we want to underscore the importance mindset provides over market movements. To us, this mindset is rooted in building resilient portfolios that rely less on chasing rallies or predicting drawdowns, and more on creating better outcomes by finding opportunities to generate returns and protect capital regardless of market movements. Amid this fragile background, we believe an allocation to alternative strategies can play a vital role in making portfolios more resilient.

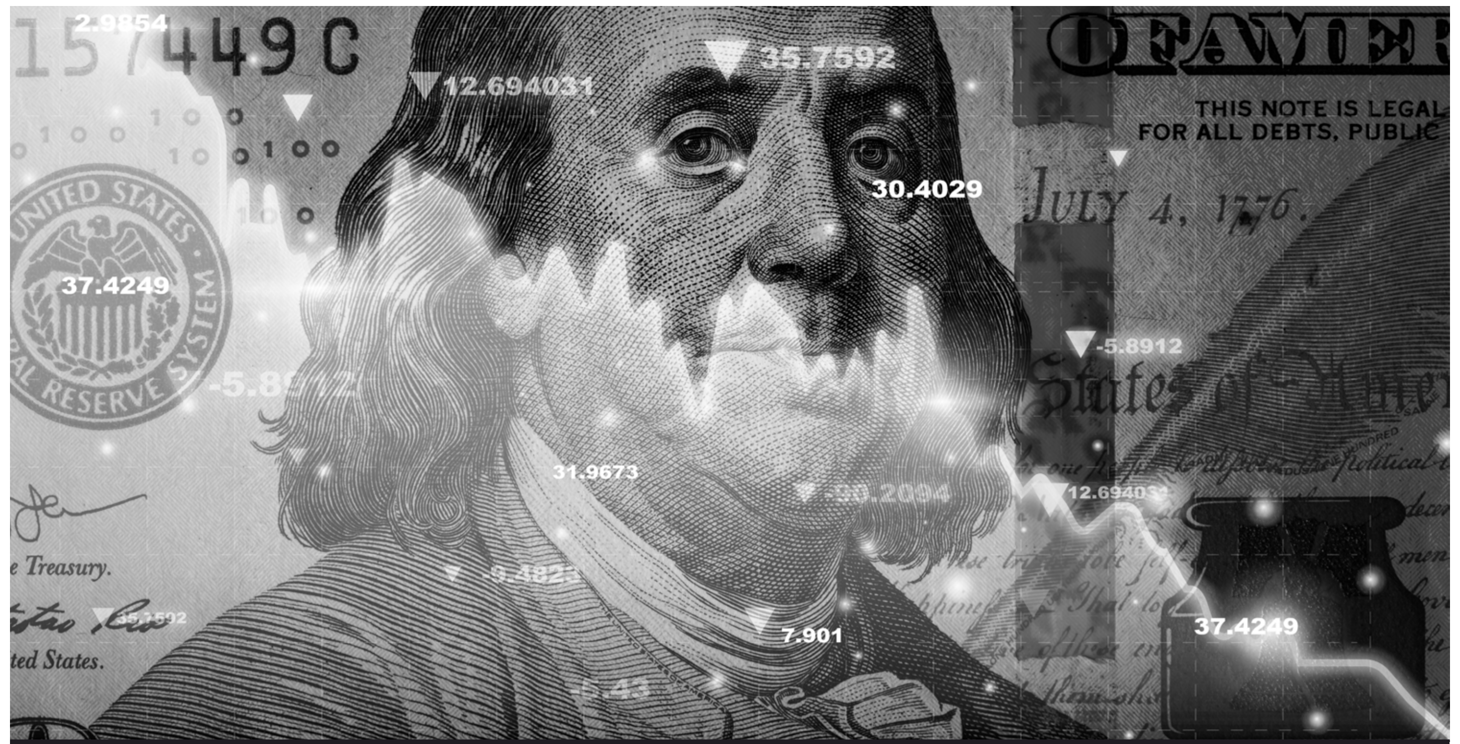
The road ahead may not be certain, but with preparation, perspective, and a steady hand, there's every reason to feel hopeful about what's next.

Instead of trying to predict how this plays out, we want to underscore ***the importance mindset provides over market movements.***

02.

MACRO OUTLOOK

NAVIGATING THE NEW REGIME: AMERICA VS. THE WORLD



01.

Threat of U.S. Recession Still Looms

The ongoing trade war and policy uncertainty continues to weigh on markets and business activity as the Fed awaits further data on the economic impacts before making monetary policy decisions. While increased inflation expectations, weakness in the housing market and an increasingly tapped out U.S. consumer points to elevated recession risk.

02.

Equities Remain at Elevated Valuations

The bounce back in U.S. equity markets from the lows in April could mean continued strength in the short term, but rich valuations with elevated price-to-earnings levels still warrant caution. The potential impact of rising U.S. protectionism could impact corporate earnings and profit margins in the second half of the year.

03.

The End of U.S. Exceptionalism

The U.S. policy of disengagement from the rest of the world is impacting global trade, the strength of the U.S. dollar and appetite for U.S. Treasuries. Second and third order effects like reduced tourism and re-routing trade flow will likely also have economic impacts. The result is increasingly attractive opportunities for investors in international markets.

A BEAR IN A CHINA SHOP: THE UNINTENDED CONSEQUENCES OF TRUMP 2.0

Haphazard policy announcements from the Trump administration altered the backdrop for equity markets leading to a sharp drawdown into April. Whether these were the intentions of President Trump playing a game of 4-D chess with the world or completely unforced errors from a misguided regime, we expect the chaos that's been unleashed will have several unintended consequences in the short and long run. There is a possibility that this new aggressive U.S. trade policy, combined with widespread de-regulation and increased tax cuts will lead to better economic times, especially for millions of displaced factory workers that the Trump regime purports to be helping.

However, the risks of a U.S. recession and even stagflation odds have increased in the short run and there is a chance that economic isolationism, burgeoning budget deficits, and the undermining of the rule of law will severely dent the aura of U.S. exceptionalism in the longer run. We expect that U.S. Treasuries will likely feel some ongoing impact from recent events, requiring higher yields to attract capital flows to continue financing high budget deficits now and in the future.

Meanwhile, the Rest of the World (ROW) is waking up to the reality that the U.S. may not be a reliable partner on the trade or geopolitical fronts. This is leading to the loosening of fiscal purse strings in many countries to support their local economies. Many of these same countries have also been cutting interest rates, which should help as well. Finally, we get a sense that many countries (including Canada) are now doing some self-reflection and embarking on new strategies that could make them more productive longer term. Already, new trading relationships are being strengthened amongst ROW countries, with China even trying to position itself as a long-term stable and reliable partner relative to the U.S.

Equities have staged a considerable rally since the early second quarter lows, driven by U.S. tariff reduction headlines and re-positioning tailwinds. Many ROW stock markets have surged to new highs and are outperforming the U.S. as capital flows rebalance away from the U.S. to markets trading at lower valuations. In the near term, this bullish momentum may continue as investors redeploy cash reserves, and systematic strategies are forced to continue chasing the rally. However, we caution against getting carried away with exuberance here. U.S. equities have all but returned to their peaks, and valuations are again very rich. Against this backdrop, several risks remain which could become reality later in the year and send investors to the exits once more.

While markets forced Trump to backtrack on the worst of his initial tariff threats, he has not shelved them even with the invalidation of key tariffs by the U.S. Court of International Trade. Important deadlines to meet his demands loom over the summer months while difficult negotiations lie ahead, especially with China.

The trade war could easily reignite at the same time as recent chaos starts to contribute to slowing economic data. Building pricing pressures in the U.S. from new tariffs and a surprisingly weaker U.S. dollar could exacerbate these negatives. The risk/reward in equities, especially in the U.S., isn't attractive to us and preparing for further bouts of weakness strikes us as wise.

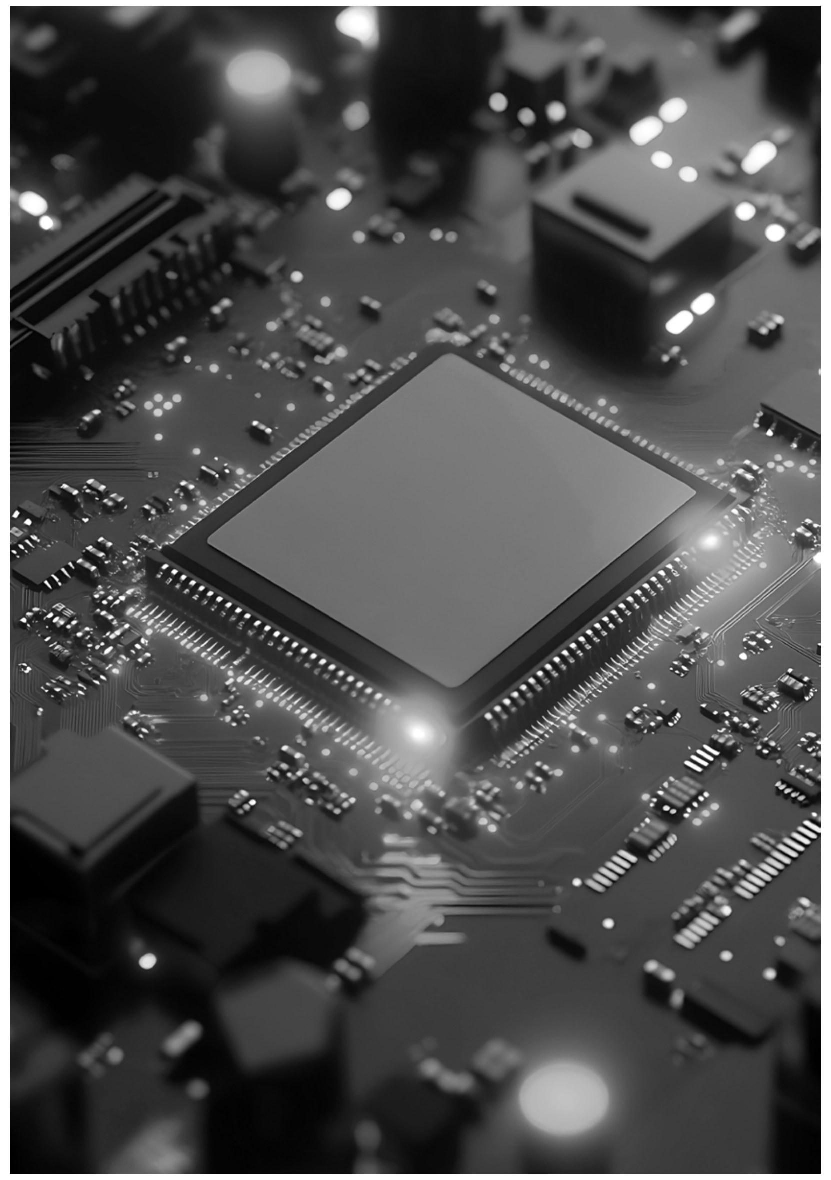
> “***The risks of a U.S. recession and even stagflation odds have increased*** *in the short run and there is a chance that economic isolationism, burgeoning budget deficits, and the undermining of the rule of law will severely dent the aura of U.S. exceptionalism in the longer run.*”

THE FACTORS THAT CONTRIBUTED TO THE U.S. EQUITY BUBBLE

At the start of the year we made the case in The 2025 Picton Report that the U.S. stock market was in a bubble supported by five key factors:

Strong economic growth, with fiscal policy as a tailwind

The U.S. Federal Reserve (Fed) preparing to move to a more accommodative stance of monetary policy



The artificial intelligence (AI) narrative

The new Trump administration's perceived friendly attitude towards business and deregulation

U.S. exceptionalism contributed to strong capital flows that pushed U.S. equity valuations higher than other markets

PILLARS SUPPORTING U.S. EQUITY BUBBLE FALTER

As 2025 has progressed, the pillars supporting the U.S. stock market bubble started to falter.

DeepSeek undermined the AI theme, with its release showing how quickly cheap competition can emerge and challenge the need for the massive capex required to train future generations of large language models (LLMs). This in turn raised doubts about whether lofty valuations for AI-related companies built on prior assumptions of massive R&D spending growth were justified. On the other hand, there are new applications of these LLMs beginning to commercialize which could boost spending on the inference side of AI and new companies are emerging to take advantage of these opportunities.

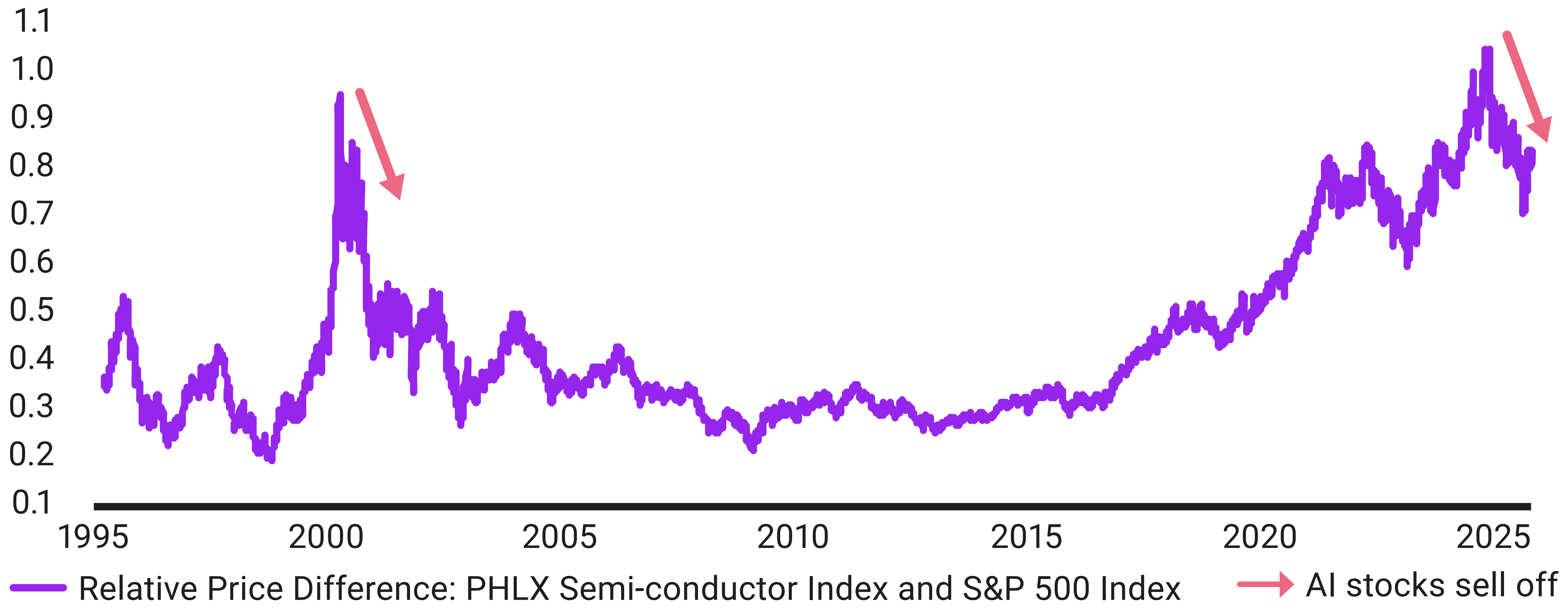
Tariff policy has brought volatility to both markets and the economy. Uncertainty promises to be a key feature of the Trump administration, which markets do not like. There is a clear link between investor uncertainty about U.S. economic policy and equity volatility.

Hopes for a dovish Fed are fading, as the central bank stays on hold at restrictive levels while they await the fallout from Trump's tariffs on inflation. Fed officials held interest rates steady in early May, expressing risks of both higher unemployment and inflation stemming from the Trump administration's trade policy.

At a May 19th conference, Federal Reserve Bank of New York President John Williams described the Fed's current policy setting as "slightly restrictive" and said policymakers may need months to get a better understanding of the outlook for the economy: "It's not going to be that in June we're going to understand what's happening here, or in July, it's going to be a process of collecting data, getting a better picture, and watching things as they develop."[1]

FIGURE 1

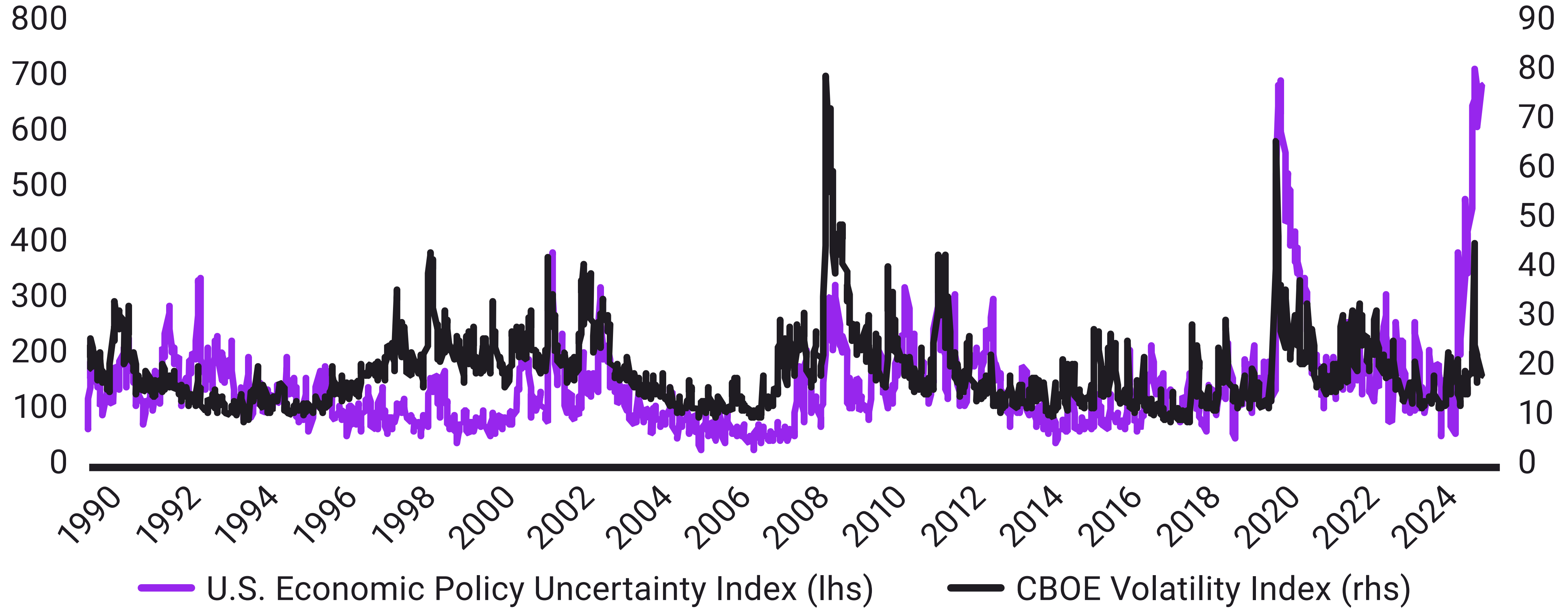
AI Stocks Have Lost Altitude



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1995 to Jun 2025.

FIGURE 2

U.S. Economic Policy Uncertainty Causes Equity Volatility



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1990 to Jun 2025.

[1] Bloomberg, Williams Says Fed Needs Beyond June/July to get clearer Outlook, May 19, 2025.

U.S. RECESSION ODDS HAVE INCREASED

The initial U.S. tariff policy was so extreme and poorly thought out that it couldn't last for long without severe consequences for the global economy and markets. If fully implemented, the April 2nd average tariff rate would have been the highest in a century.

Trump's hand was forced as equity markets plunged towards bear market territory in the aftermath of the "Liberation Day" announcement, the bond market threatened to seize up, and countries fought back with their own tariffs.

The regime found off-ramps for the worst of its policies and stocks soon recovered.

A surprise decision by the U.S. Court of International Trade to invalidate the majority of Trump's tariffs fueled hopes that these harmful policies would be further unwound. Even so, unintended second and third order effects from the protectionist measures are contributing to higher recession odds.

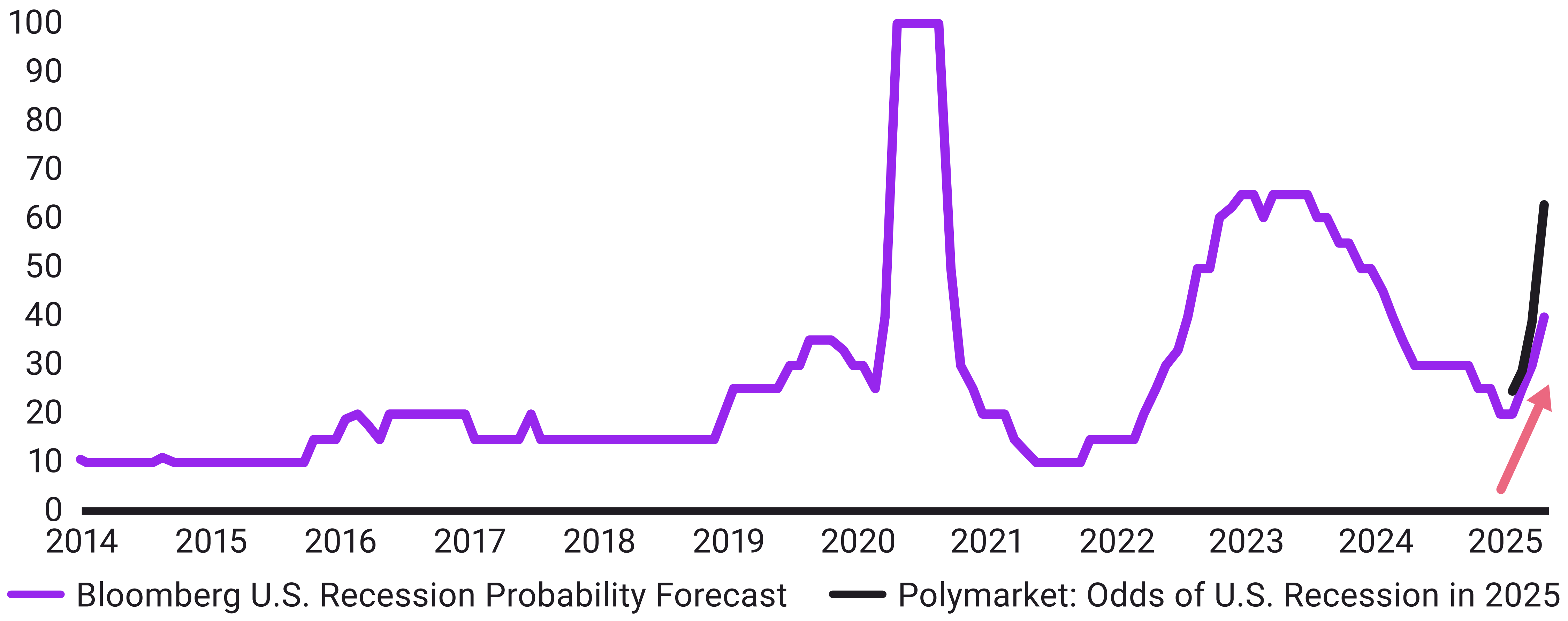
Policy uncertainty is not only bad for equities: It's also a problem for corporate planning:

Small businesses account for almost 80% of job openings in the U.S., and many are facing unprecedented uncertainty. Even if we don't see the invalidated tariffs reinstated, it's reasonable to expect a pause in spending and hiring will create some economic drag.

> *The unintended second and third order effects from the protectionist measures are contributing to **higher recession odds.***

FIGURE 3

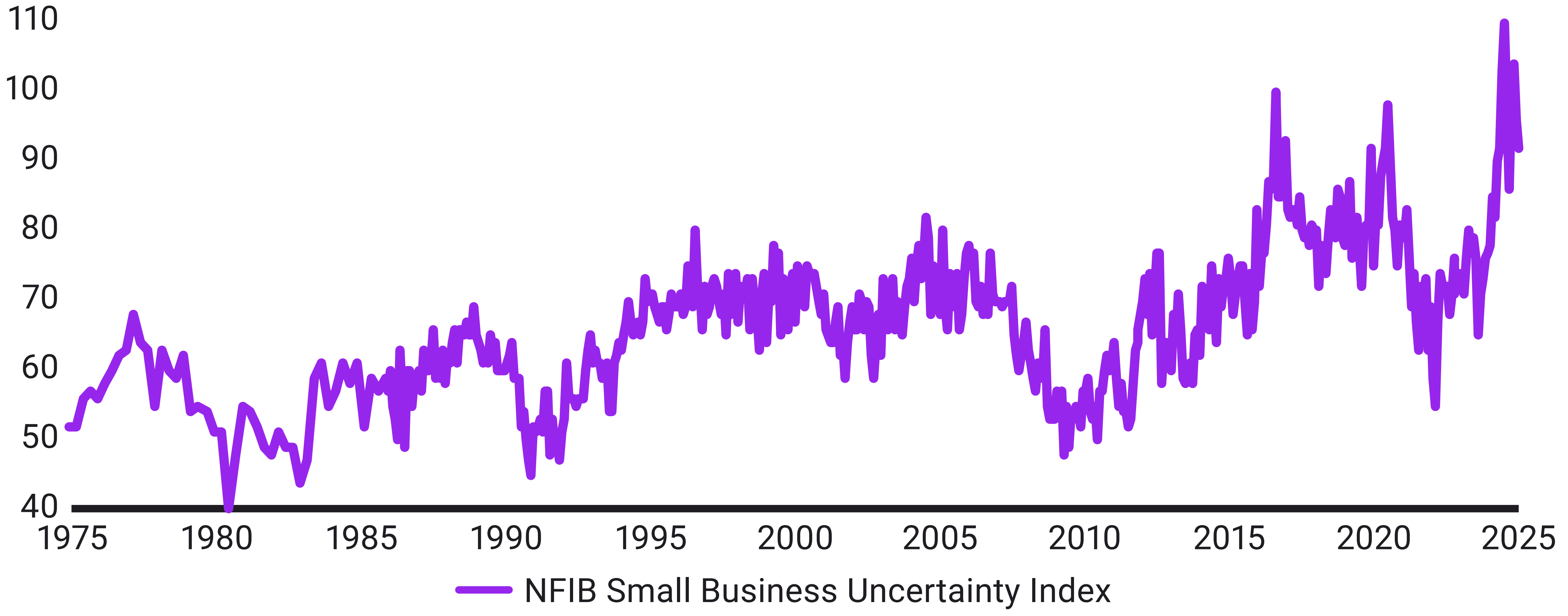
U.S. Recession Odds Have Increased



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2014 to Apr 2025.

FIGURE 4

Small Business Uncertainty is Elevated



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1975 to Apr 2025.

Wealth Effects from Housing and Stocks Could Go into Reverse

Elevated stock and house prices have been a tailwind for U.S. consumer spending via the wealth effect. But declines in either asset class could dampen these wealth effects and become a drag on consumption.

The U.S. Housing Market is Under Pressure

For most Americans, their home is their single biggest asset. And the U.S. housing market is weakening, which could spell negative direct and indirect (i.e. a negative wealth effect) consequences for consumption.

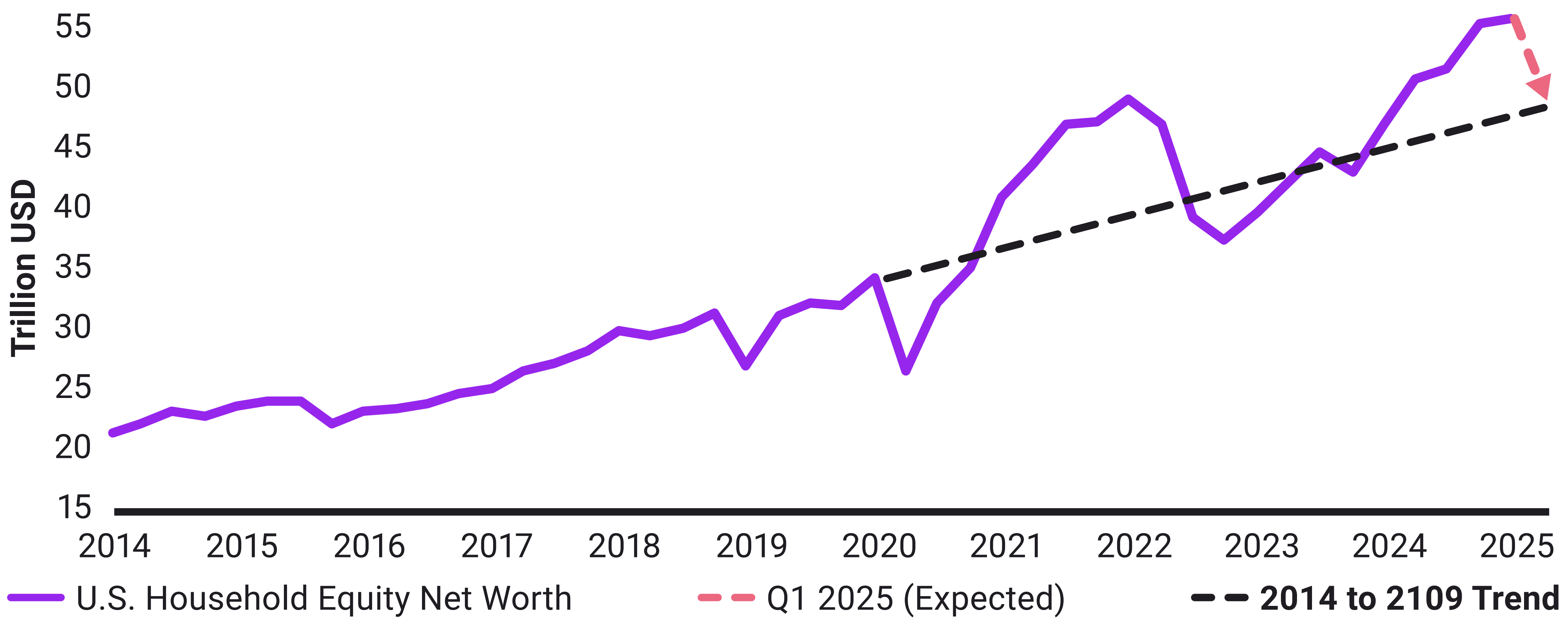
Consider the following data points:

- House listings in key markets are on the rise, while prices fall.
- In eight states, inventory is now above pre-Covid levels. Previously hot markets like Florida and Texas have much higher listings—with many Canadians not only looking less at buying property but also moving to off-load existing properties they own.
- The latest U.S. Homebuilder Sentiment fell to 34 in May, below all estimates and the lowest reading since November 2023. Ever since mortgage rates spiked to the 7% range in 2022, homebuilder sentiment has languished as new homes have become less affordable.
- In the words of National Association of Home Builders' Chairman Buddy Hughes:

> *The spring home buying season has **gotten off to a slow start** as persistent elevated interest rates, policy uncertainty and building material cost factors hurt builder sentiment in May.*[2]

FIGURE 5

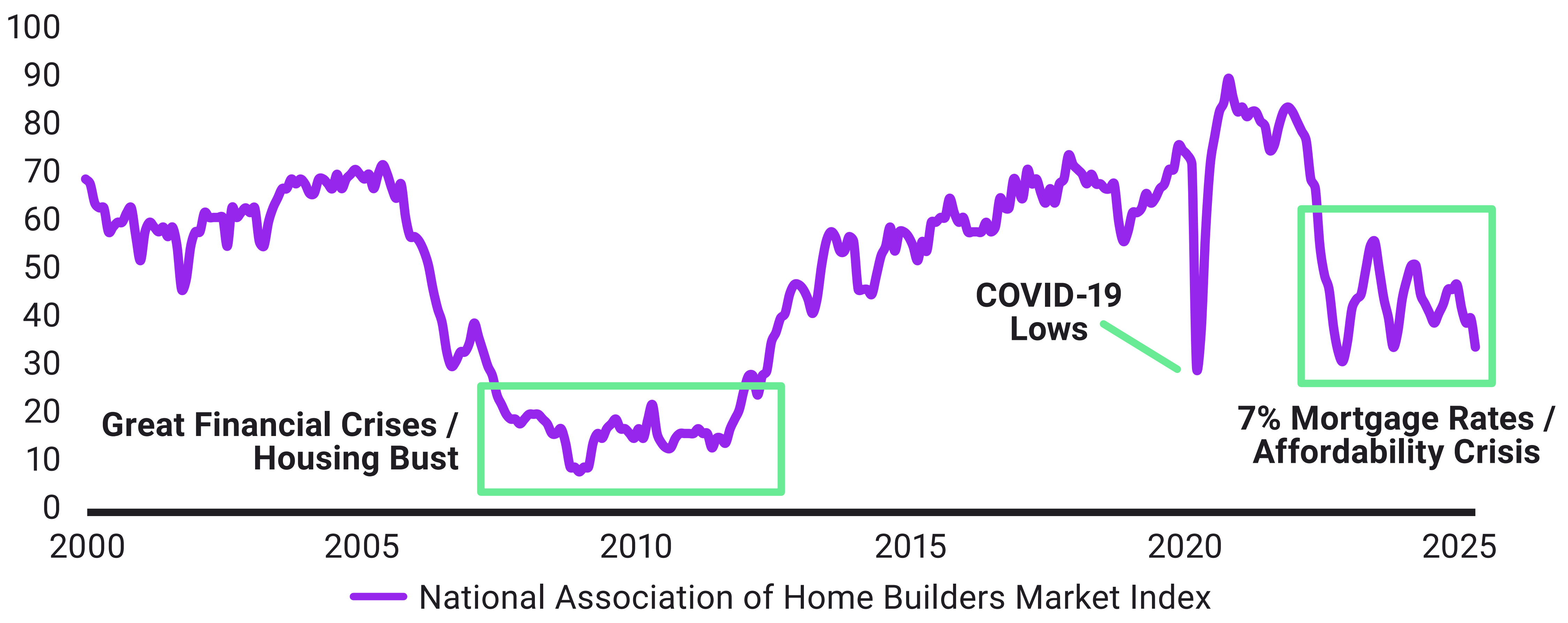
Could We See a Reverse Wealth Effect as Asset Prices Decline?



Source: Federal Reserve Board, Picton Mahoney Asset Management Research. Jan 2014 to Mar 2025.

FIGURE 6

Homebuilder Sentiment Has Languished



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2000 to May 2025.

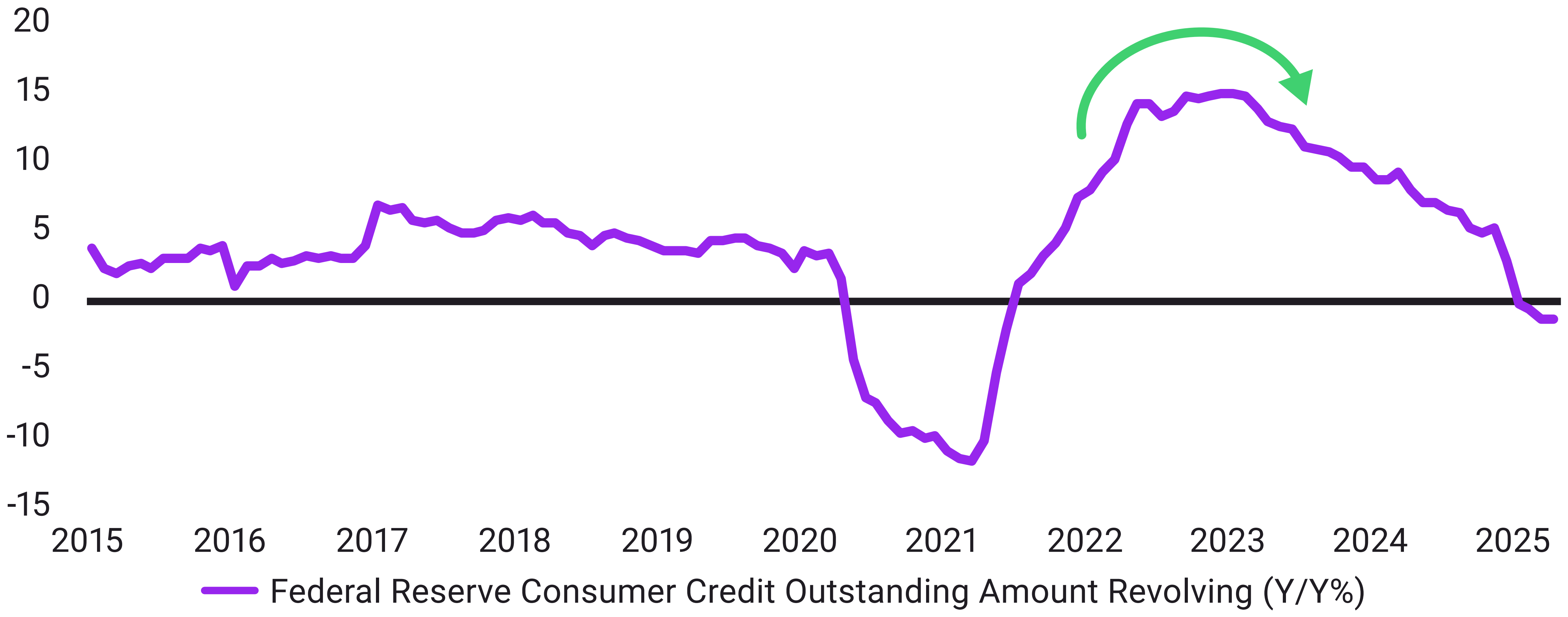
[2] Barrons, Builder Stocks Shrug Off Bad Construction Data. Mortgage Rates Matter More, May 19, 2025.

The U.S. consumer has no more savings buffer from the pandemic. At the same time, revolving credit has dried up. This is a sea change from 2022, when excess savings were plentiful and consumer credit growth was accelerating.

> "The U.S. consumer has **no more savings buffer** from the pandemic."

FIGURE 8

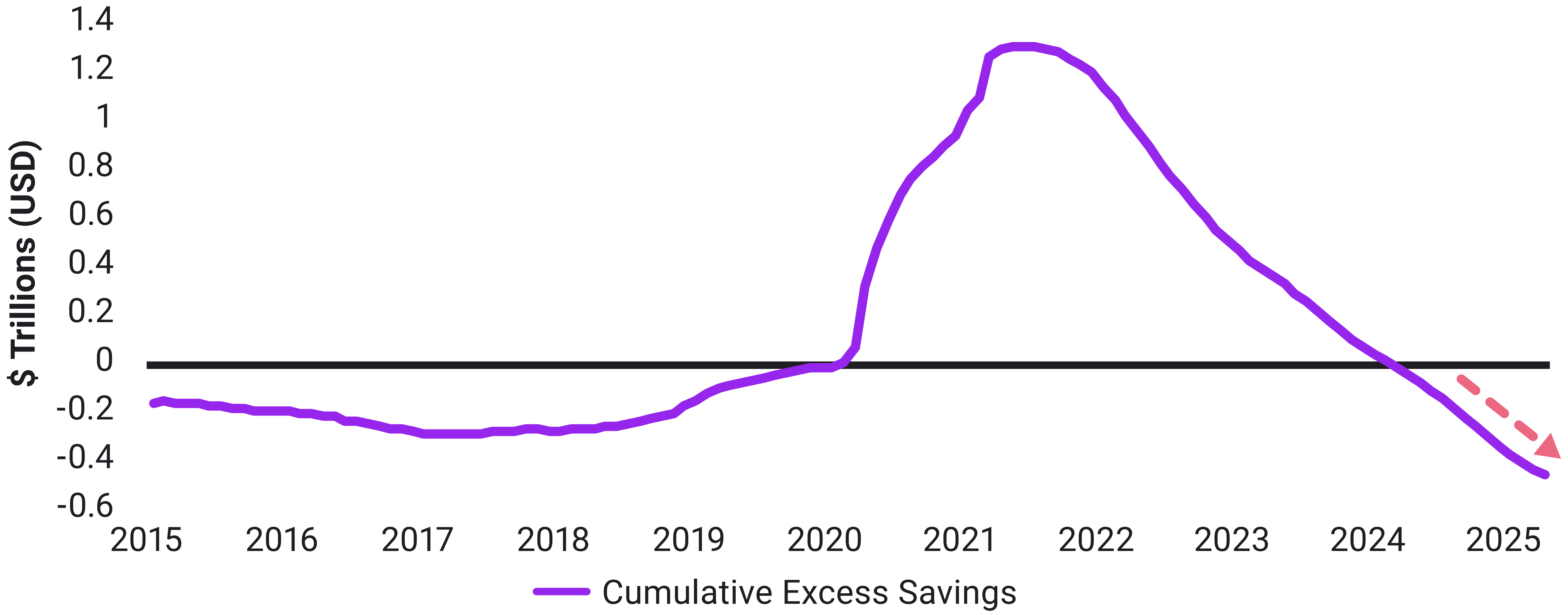
Consumer Credit Growth Has Gone Negative



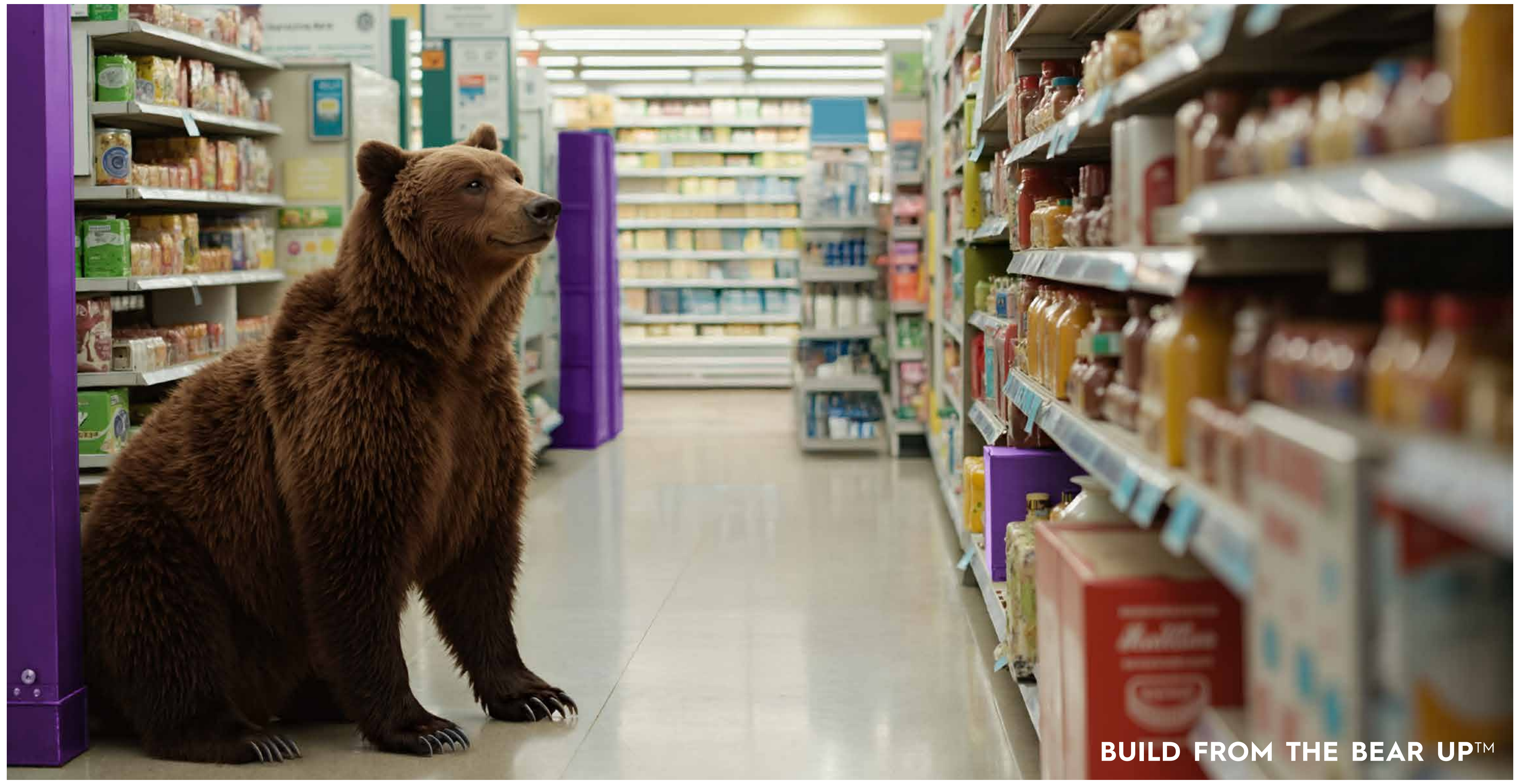
Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2015 to Apr 2025.

FIGURE 7

Excess Savings Are No More



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2015 to Apr 2025.



TRUMP'S TRADE WAR POSES UPSIDE RISKS TO U.S. INFLATION

Beyond ushering in weaker economic growth, the Trump administration's trade war also may lead to higher U.S. inflation. Indeed, there's the possibility that supply disruptions from tariffs mirror some of the shortages—and higher core goods prices—witnessed during the pandemic. The spike in import prices could be a one-two punch; first due to the direct effects of the import tax and supply shortages, and then a secondary impact from the lower purchasing power of a weaker dollar.

Amid this backdrop, short term measures of market-based inflation expectations have drifted far away from 2% in the last year.

Meanwhile, consumers' longer term inflation expectations have become "unanchored", leaving the Fed in a tough spot. This is a level that has not been seen since the early 1990s in the aftermath of the 1970s inflation spikes.

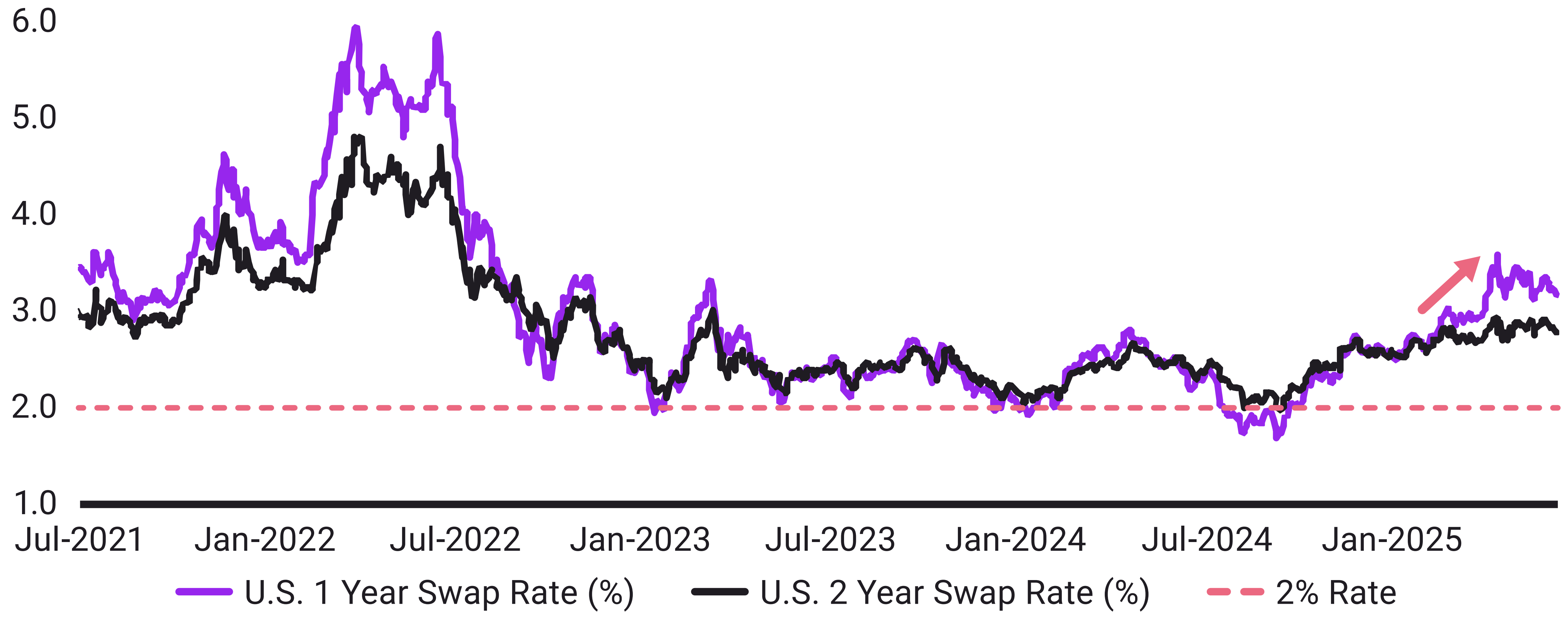
However, there are some factors that may help dampen inflation. The tariffs may have only a one-time effect on inflation data which then rolls off after the tariffs are annualized. Lower energy prices could also offset some price pressures. Finally, while Chinese goods may cost more in the U.S., they may be "dumped" into other markets at lower prices.

Higher U.S. inflation may prove to be a short-term phenomenon if the swap market is correct, but markets will still be faced with worsening data over the next couple of quarters which likely keeps the Fed from cutting rates in the short run.

> ***The spike in import prices could be a one-two punch;*** *first due to the direct effects of the import tax and supply shortages, and then a secondary impact from the lower purchasing power of a weaker dollar.*

FIGURE 9

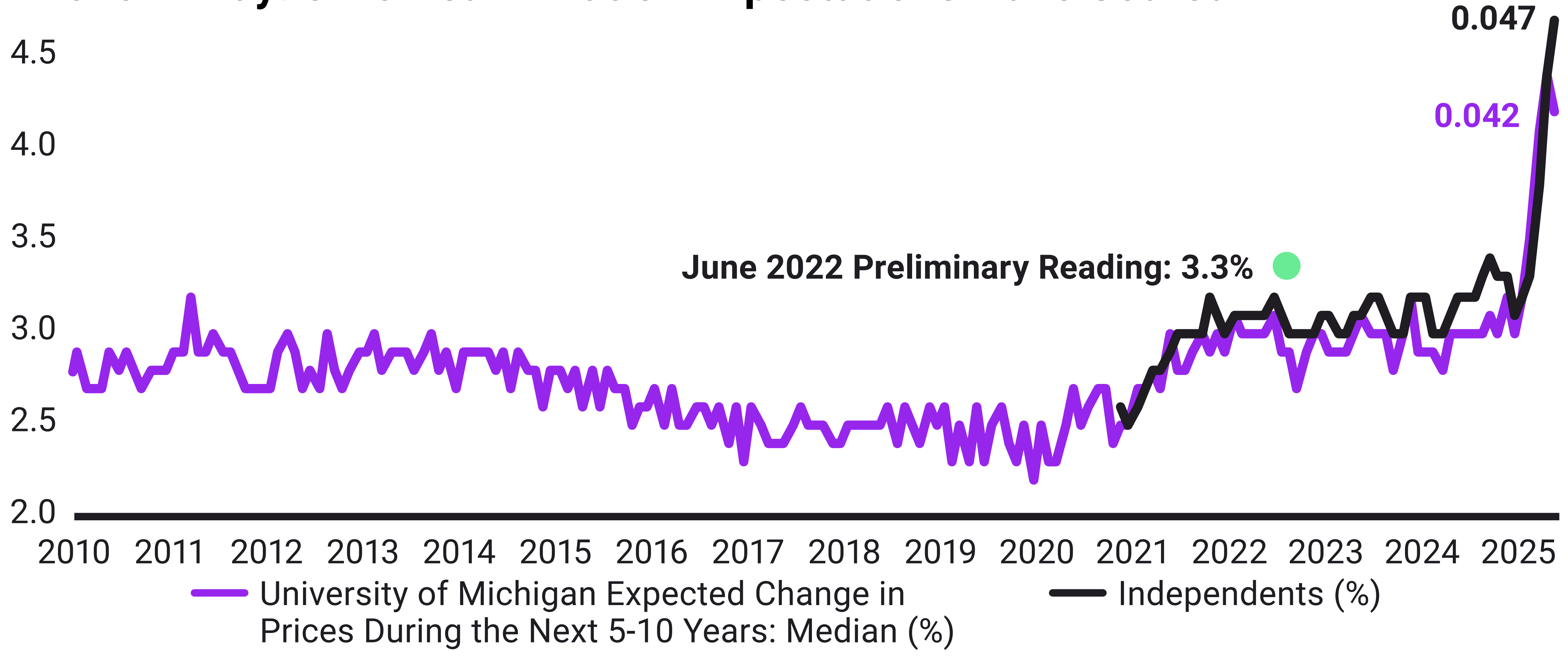
Not-So Great Expectations: The Market is Pricing in Higher U.S. Inflation



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jul 2021 to Jun 2025.

FIGURE 10

Anchor Away: 5-10 Year Inflation Expectations Have Soared



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2010 to May 2025.

Are We Headed Towards Stagflation?

Given the points above, it's no real surprise that survey data is pointing to a stagflationary environment. The ISM Manufacturing PMI's Price Index has spiked, while new orders have fallen into contraction territory. This would not appear to be a great backdrop for risk assets.

Investors are Back to Thinking the Glass is Half Full

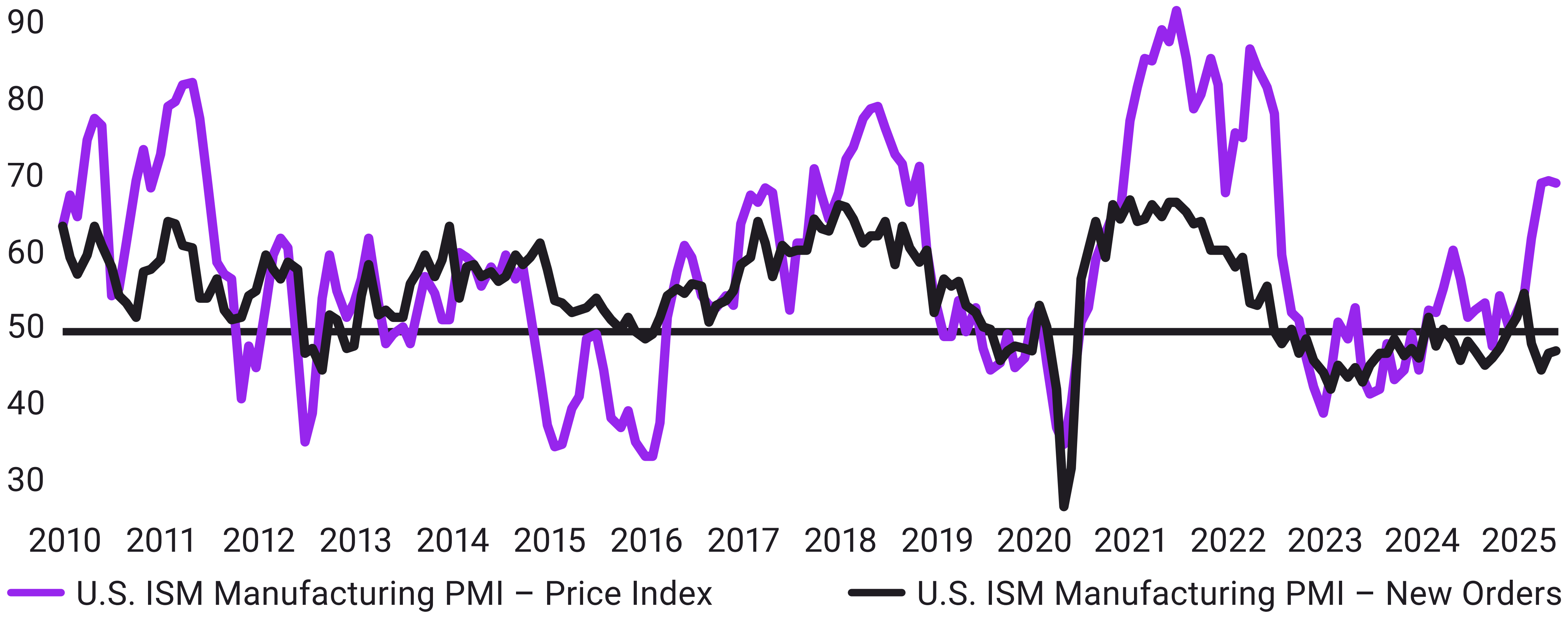
As President Trump backed off the worst of his tariff policies, markets shifted to focusing on the potentially pro-growth benefits of better tariff deals, tax cut extensions and increases along with benefits to come from de-regulation.

Some guestimates are these measures could lead to $500 billion of stimulus for the U.S. economy. According to Piper Sandler research[3]:

- House Republicans have successfully marked up legislation to hit their target of $1.5 trillion in spending cuts, about $300 billion in defense and border security funding, $4 trillion in tax cuts (all scored on a current law basis), and raising the debt limit by $4 trillion.
- In a simple fiscal impulse framework, this would imply 0.2% GDP fiscal expansion in FY25, an additional 0.6% in FY26, and tightening thereafter.
- However, the overall fiscal impulse depends critically on what is assumed for tariff revenues.
- Estimates suggest tariffs could fully offset any fiscal expansion from the reconciliation legislation.

FIGURE 11

U.S. ISM Manufacturing Surveys Suggest U.S. Stagflation



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2010 to May 2025.

[3] Source: Piper Sandler, "The All-In Fiscal Impact Of Reconciliation", May 16, 2025.

Re-Positioning Helped Drive Equities— Further to go in the Short Run?

Positioning became very bearish in the aftermath of the Liberation Day meltdown, so as news improved, flows began to reverse across many systematic strategies. Positioning is not overly aggressive here, so any continuation in bullish tone could bring more systematic flows into equity markets. However, the pull forward of good news headlines and the reversal in flows to more crowded long positions might leave markets vulnerable later in the year. While the news flow around tariffs and taxes is better now, it is likely net negative to the economy and expectations relative to the beginning of year.

There's also the distinct possibility that the tariffs invalidated by the U.S. Court of International Trade (the Court) could be revived. A reversal could be achieved by successfully appealing the Court's ruling, reinstating the tariffs under different statutory authorities, or Congressional Republicans mustering sufficient support for legislative action.[4]

Performance is Often Muted Following Sharp Rebounds

The rebound in equities since the early April lows has been dramatic. But as the following charts show, such sharp recoveries have not always signaled a renewed bull market.[5]

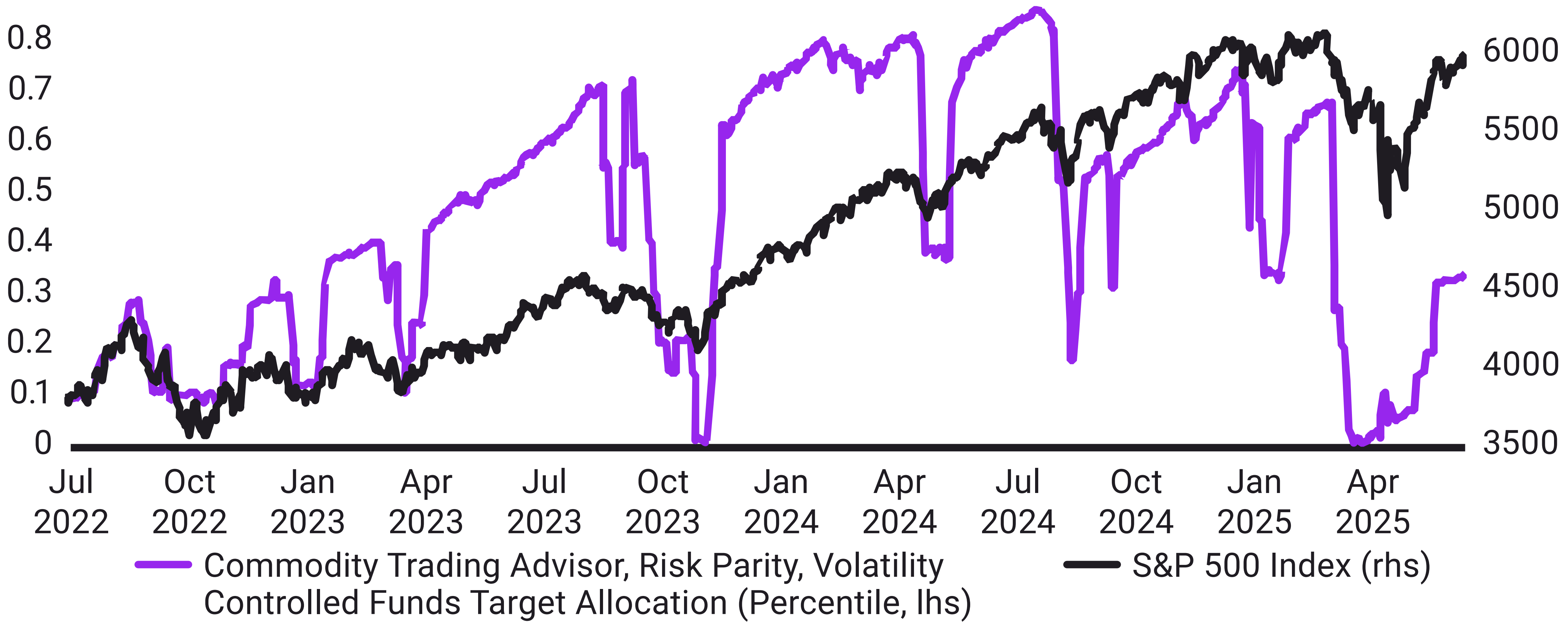
Given the elevated level of U.S. P/E ratios, it is tough to visualize U.S. equities driving considerably higher from current levels.

In fact, it would make sense to us that investors would want to build in some valuation cushion to reflect the more volatile nature of current U.S. geopolitical strategy. As BlackRock Chairman Larry Fink eloquently put it in an April 11th CNBC interview:

> *The United States, post-World War II, was a global stabilizer.*
> ***We are the global destabilizer.***[6]

FIGURE 12

Systematic Strategies May Fuel More Upside in Stocks

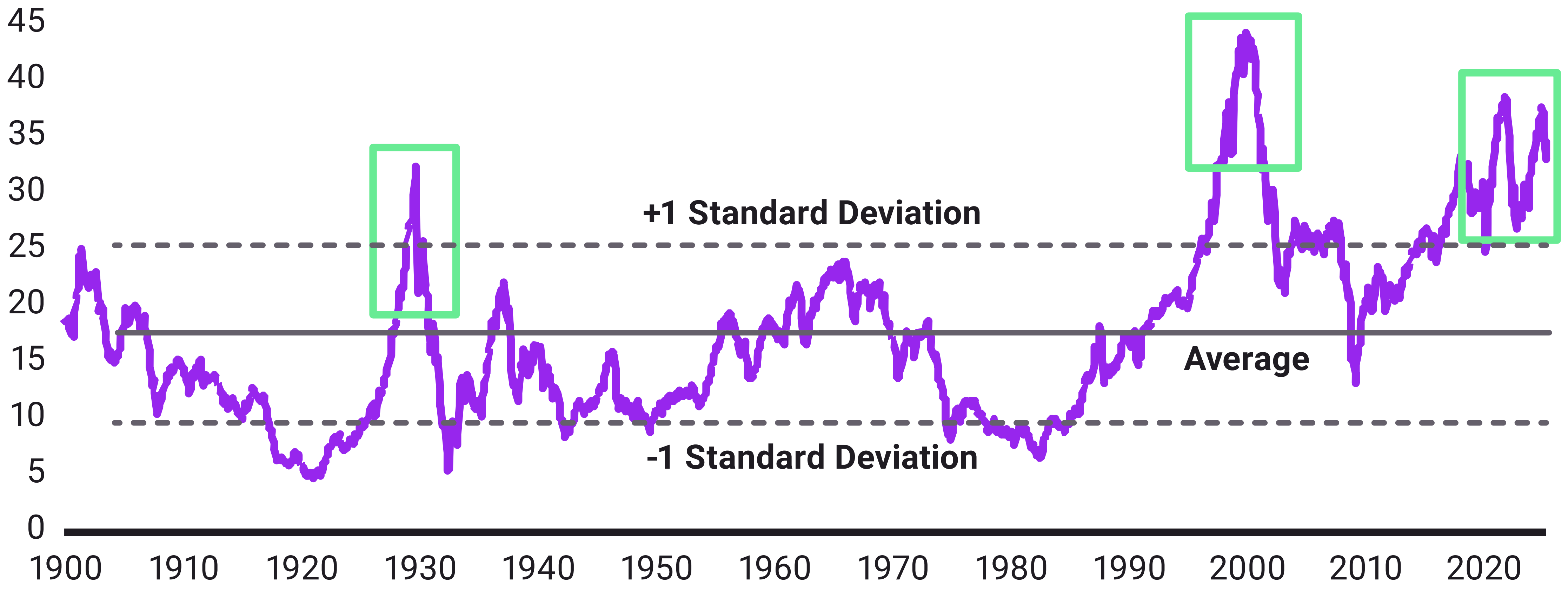


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jul 2022 to Jun 2025.

FIGURE 13

U.S. Equity Multiples Remain at Lofty Levels

Shiller Cyclically Adjusted Price/Earnings



Source: Robert Shiller, Picton Mahoney Asset Management Research. Jan 1900 to May 2025.

[4] Bloomberg, Goldman Sachs, Morgan Stanely Say Trump Can Deploy Other Tariff Tools, May 29, 2025.

[5] Twitter, Sentiment Trader, May 28, 2025.

[6] CNBC, BlackRock Chairman & CEO Larry Fink Speaks with CNBC's "Squawk on the Street", April 11, 2025.

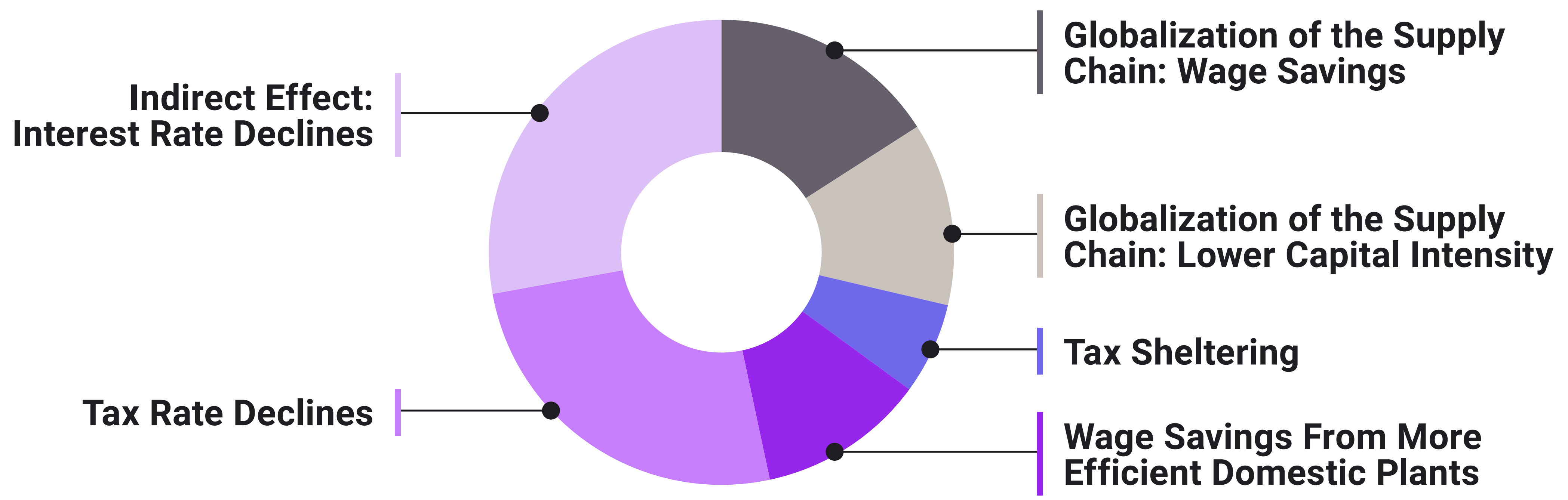
There is also earnings risk from the rise of U.S. protectionism that could impact equities. According to Empirical Research Partners, globalization was responsible for at least 1/3 of net profit margin expansion over the last 20 years for S&P 500 Index manufacturing companies.

> *Globalization was responsible for **at least 1/3 of net profit margin expansion** for U.S. Manufacturing companies over the last 20 years.*

FIGURE 14

Globalization Fueled S&P 500 Index Margin Expansion

S&P 500 Manufacturers Margin Expansion Dynamics 2024 vs 2000



Source: U.S. Census Bureau, U.S. Bureau of Labor Statistics, Corporate Reports, Empirical Research Partners Analysis and Estimates. As of June 6 2025.

U.S. BOND MARKET ISN'T PROVIDING **BUOYANCY FOR U.S. STOCK MARKETS**

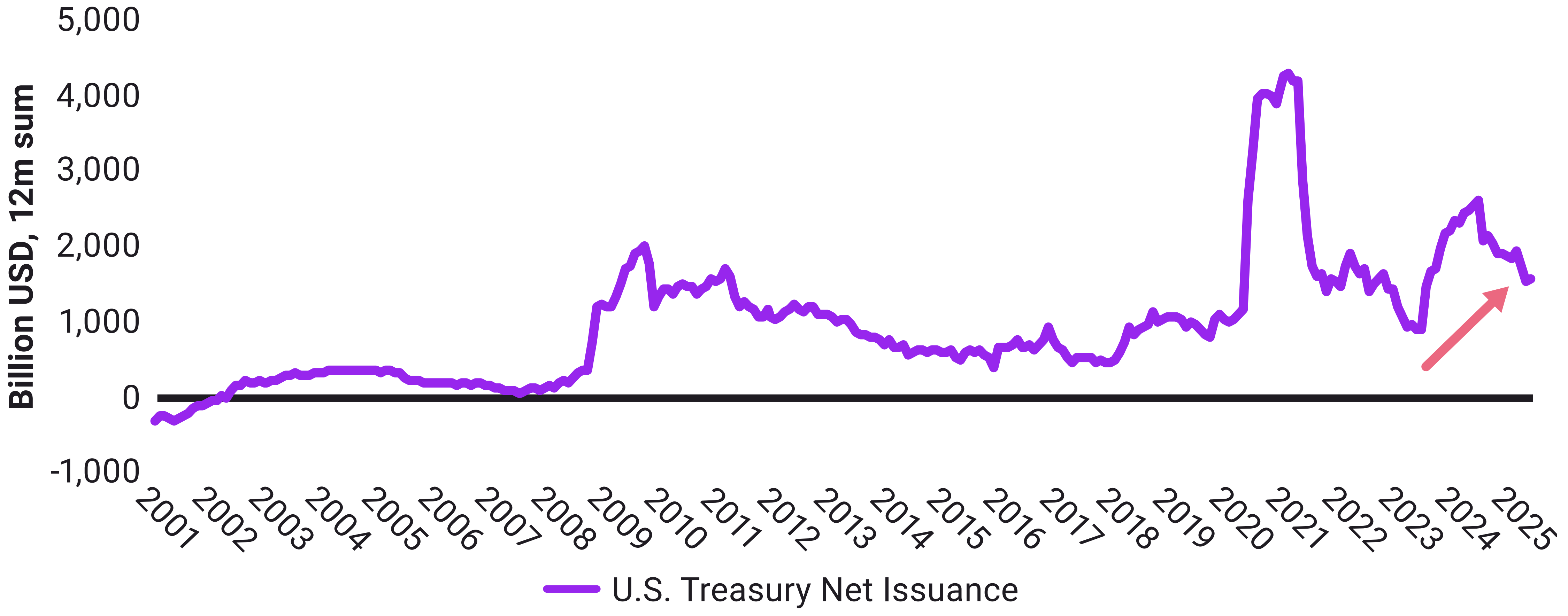
During previous signs of systemic risk, one could usually count on U.S. Treasuries and the U.S. dollar rallying as nervous investors sought out safe havens. However, this did not happen during the dramatic tariff-inspired equity sell-off in April; U.S. treasury yields went higher while the U.S. dollar sold off. Could this be an early sign of potential concerns regarding the reputation of the U.S. and its capital markets?

U.S. Treasury Supply/ Demand Update

This may not be a great time for the U.S. government to face less global demand or higher interest rates for issuing bonds. While the level of net issuance of U.S. Treasuries is about $1 trillion less year-over-year (on a rolling 12-month average), it is still elevated relative to historical levels. The U.S. is projected to run considerable deficits for the foreseeable future and would require buyers to help fund them.

FIGURE 15

Treasury Issuance Remains Elevated



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2001 to Apr 2025.

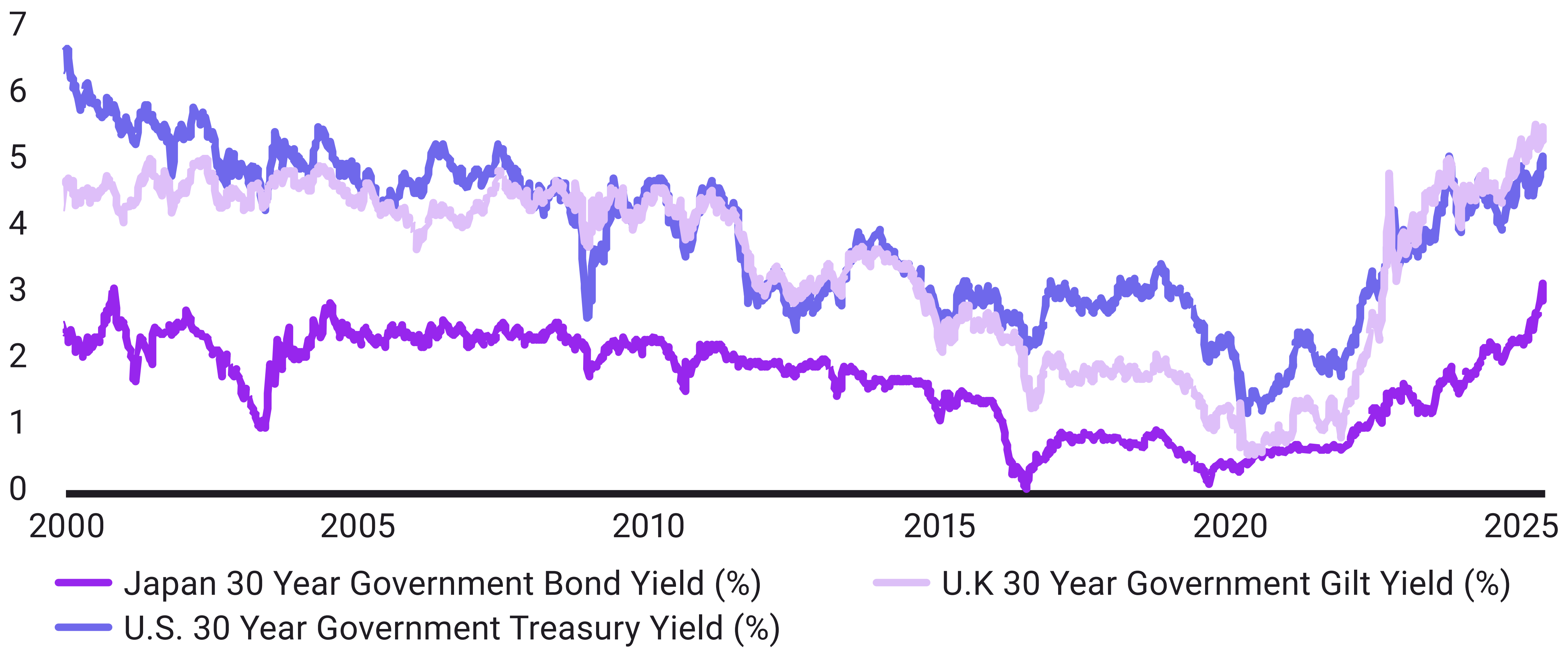
The story of fiscal overspending is not just a U.S. one. In Japan, a weak Japanese Government Bond (JGB) auction on May 20th (lowest demand in a decade), and the Prime Minister comparing their financial position to Greece, saw 30-year JGB yields soar to record highs, spiking nearly half a percent in May alone.

Unfortunately, foreign buyers won't be too tempted by U.S. Treasuries right now. As it stands, Japanese and European investors currently get higher yields from domestic bonds once currency hedging costs are factored in.

The bottom line is that long-term borrowing costs for major economies are surging as investors question governments' ability to cover massive budget deficits. Investors are warning that governments can't keep borrowing at the current pace, particularly with trade tensions and sticky inflation reducing the likelihood of dramatic monetary policy easing, especially in the U.S. and Japan.

FIGURE 16

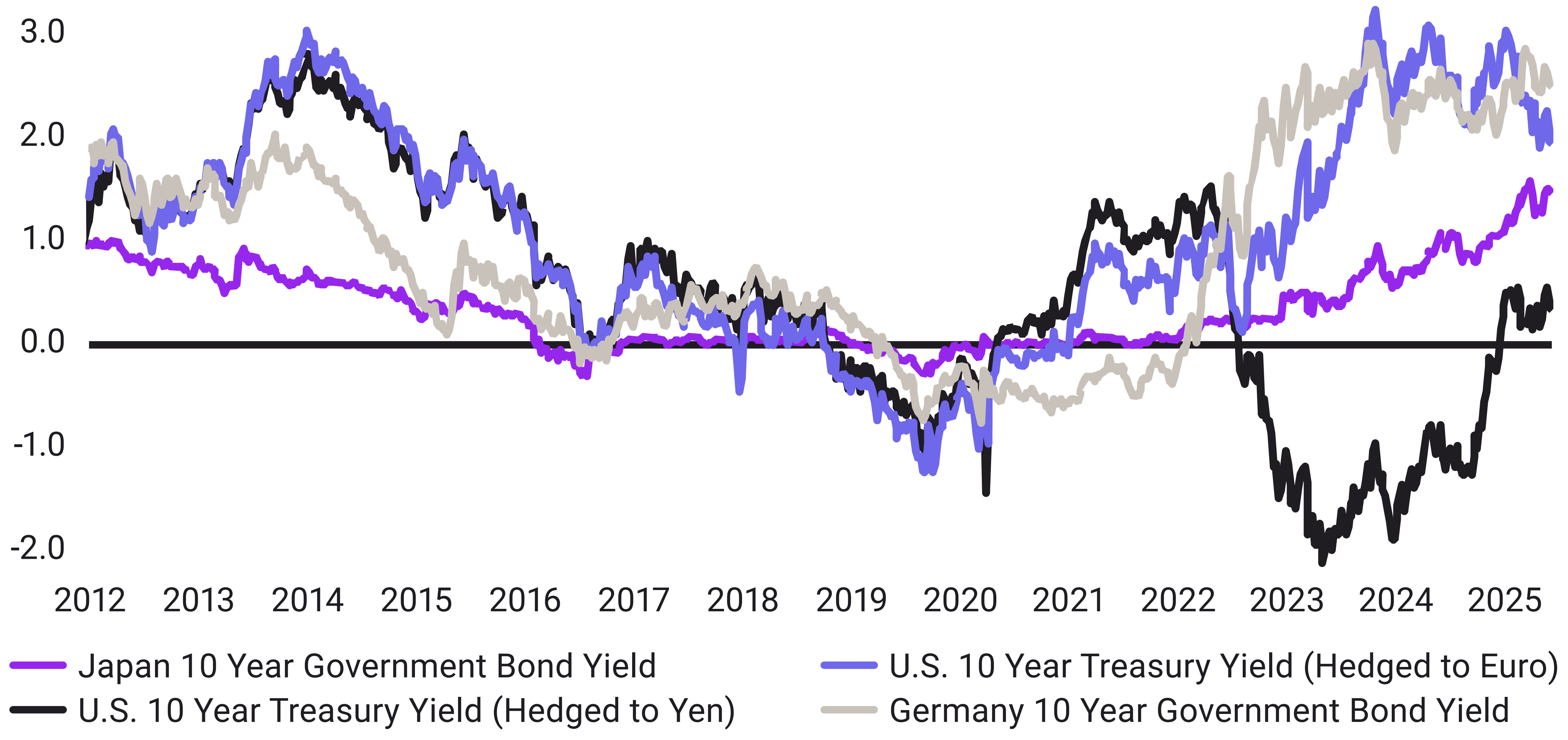
Japan - Land of the Rising Yields



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2000 to Jun 2025.

FIGURE 17

Home Sweet Home? Once FX Hedging is Accounted for, U.S. Treasuries Aren't So Appealing



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2012 to Jun 2025.

> *Long-term borrowing costs for major economies are surging as* ***investors question governments' ability*** *to cover massive budget deficits.*

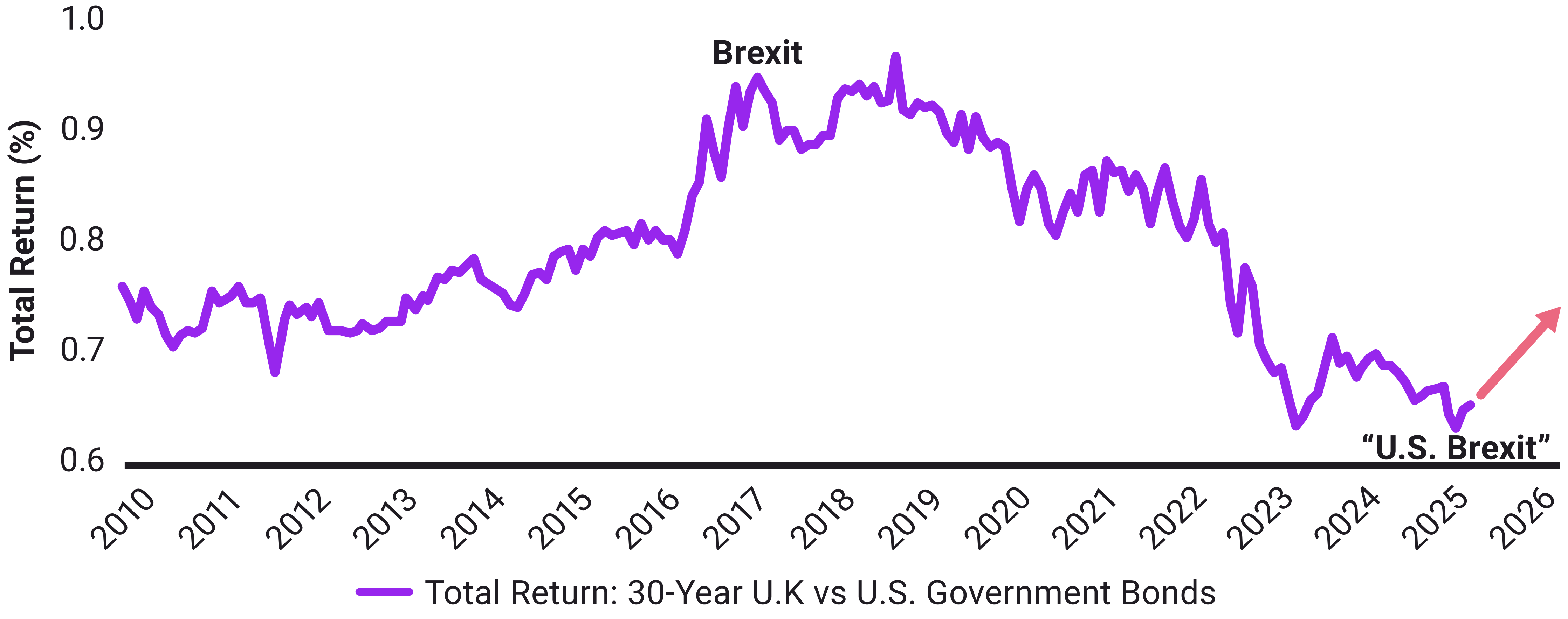
Comparing 2025 U.S. Protectionism to 2016 Brexit

Given the United States' new policy of meaningfully disengaging from much of the rest of the world, it's worthwhile to compare the current backdrop to Britain's 2016 vote to leave the European Union. In this regard, Trump's tariffs can be likened to 'America's Brexit'.

The Brexit vote in 2016, and the protectionism that it unleashed, meant that U.K. inflation – both actual and expected – surged versus that of the U.S. Moreover, Brexit's 'economic rebellion' meant that U.K. Gilts lost their privileged haven status among investors. The result was that Brexit ushered in a major structural underperformance of U.K. government bonds. So, if Trump's tariffs are akin to America's Brexit, then could the same thing happen again should U.S. Treasury bonds suffer a similar loss of the privileged haven status they've long enjoyed?

FIGURE 18

If Trump's Tariffs are America's Brexit, U.S. Bonds May Underperform



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2010 to Jun 2025.

If Trump's tariffs are akin to America's Brexit, then ***could the same thing happen again*** *should U.S. Treasury bonds suffer a similar loss of the privileged haven status they've long enjoyed?*

LONGER-TERM IMPLICATIONS OF A LOSS OF U.S. EXCEPTIONALISM

Since World War 2, the United States has clearly been the globe's pre-eminent economy. Its privileged status has conferred upon the country considerable tangible benefits. The U.S. dollar is the top global reserve currency because it has the highest international trade value. This has allowed the U.S. to enjoy lower equilibrium interest rates than it otherwise would. Consumers have benefitted from these lower rates which have contributed to their consumption. Meanwhile, policymakers have been able to issue virtually limitless government debt, and the Fed has been able to expand its balance sheet considerably with minimal damage to the currency.

Trump's erratic policy decision puts into question these benefits. Reducing global trade via massive tariffs could reduce U.S. dollar accumulation and capital flows to U.S. markets. A weaker dollar combined with less available U.S. dollars to recirculate back to the U.S. could ultimately provide less flexibility for U.S. policymakers to engage in fiscal and monetary stimulus. U.S. consumers could have less purchasing power going forward if the U.S. dollar weakens while interest rates are higher than they otherwise could be.

U.S. Equity Risk Premium is Still Low—But is That Justified?

Despite all the turbulence thus far in 2025, the U.S. equity risk premium (ERP) remains very low. We question whether this is justified.

The economic and financial landscape, in our view, does not support such a depressed ERP given that:

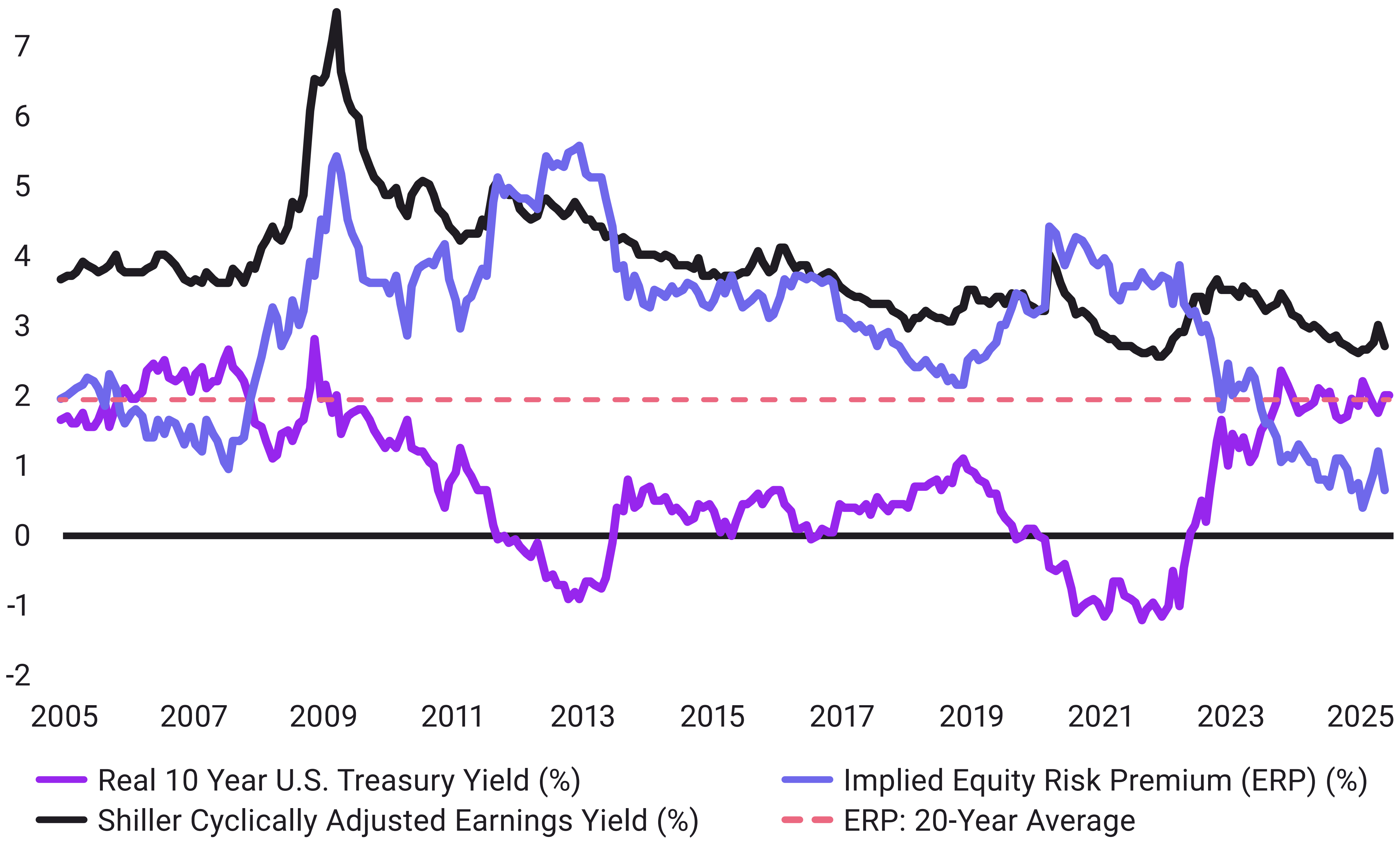
- Recession concerns are increasing
- Inflation worries haven't abated
- The Fed seems to be in no hurry to cut rates
- Flows are rebalancing away from the U.S.

Assuming corporate earnings stayed flat, the current 2% real yield on 10-year U.S. Treasuries was maintained, and the ERP moved back to its 20-year average of 2.0%, the S&P 500 Index could trade around the 4,000 mark.

> *Despite all the turbulence thus far in 2025, the U.S. equity risk premium (ERP)* ***remains very low.***

FIGURE 19

The Equity Risk Premium is Historically Low



Source: Robert Shiller, Picton Mahoney Asset Management Research. Jan 2005 to Jun 2025.

However, the U.S. Market isn't a Monolith

The U.S. equity market is essentially two markets: the "Magnificent Seven" (MAG-7) and everyone else. The Magnificent Seven companies in the U.S. are in a unique position. Many of them arose from the ashes of the Internet bubble that popped post the year 2000 to become fast growing and cash-flowing companies with incredible moats around their businesses.

To then have many of these same companies be winners again in the next big thing – artificial intelligence – puts them in very rarified air. Their large market caps combined with strong earnings growth and great prospects moving forward have outsized impacts on the performance and valuation of the S&P 500 Index. This can be seen in the graph below, which measures valuations of different segments of the U.S. stock market. Much of the difference between the 21x forward P/E multiple of the S&P 500 Index and the 17x multiple of the S&P 500 Equal Weighted Index can be attributed to the MAG-7 stocks.

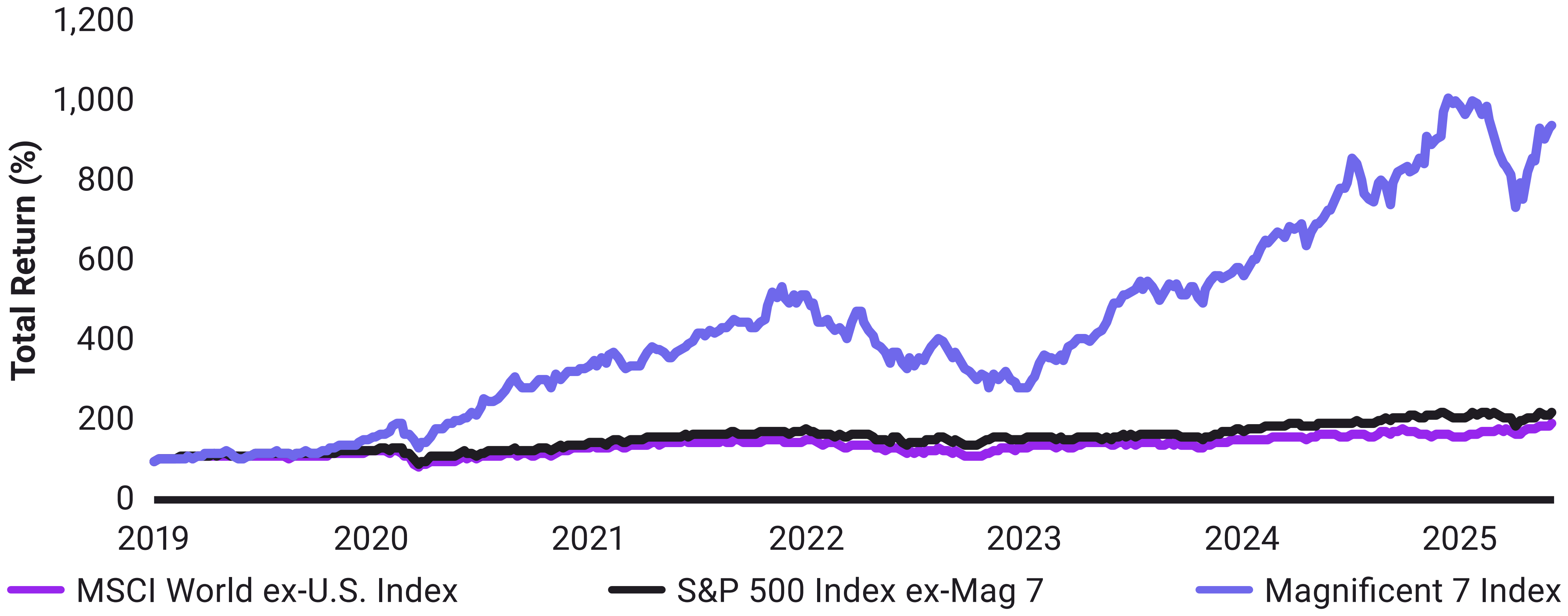
The surge the MAG-7 stocks have seen with the onset of the AI narrative has also contributed to the plunge in the ERP over the past few years. Therefore, barring some worse than expected macro outcome, we don't expect the S&P 500 Index to hit 4,000. But we do believe a test of the Liberation Day tariff lows around 4,800 is certainly possible if trade tensions resurface after the 90-day tariff reductions expire at the same as a more stagflationary backdrop develops.

International Equities Have Started to Outperform the U.S.

For years, U.S. stocks handily beat foreign counterparts. But that has not been the case recently. While some of this could be due to rebalancing flows out of the U.S. because of some loss in the U.S. exceptionalism theme, there are other macro reasons to explain this outperformance. Many countries outside the U.S. have been cutting interest rates to boost their economies, and their consumers and businesses face fewer price pressures owing to tariffs. What's more, these tend to be cheaper markets than the U.S., which has attracted value-oriented investors worried about elevated U.S. valuations. The confluence of these factors has contributed to U.S. stocks lagging global developed market peers by a record amount so far this year.

FIGURE 20

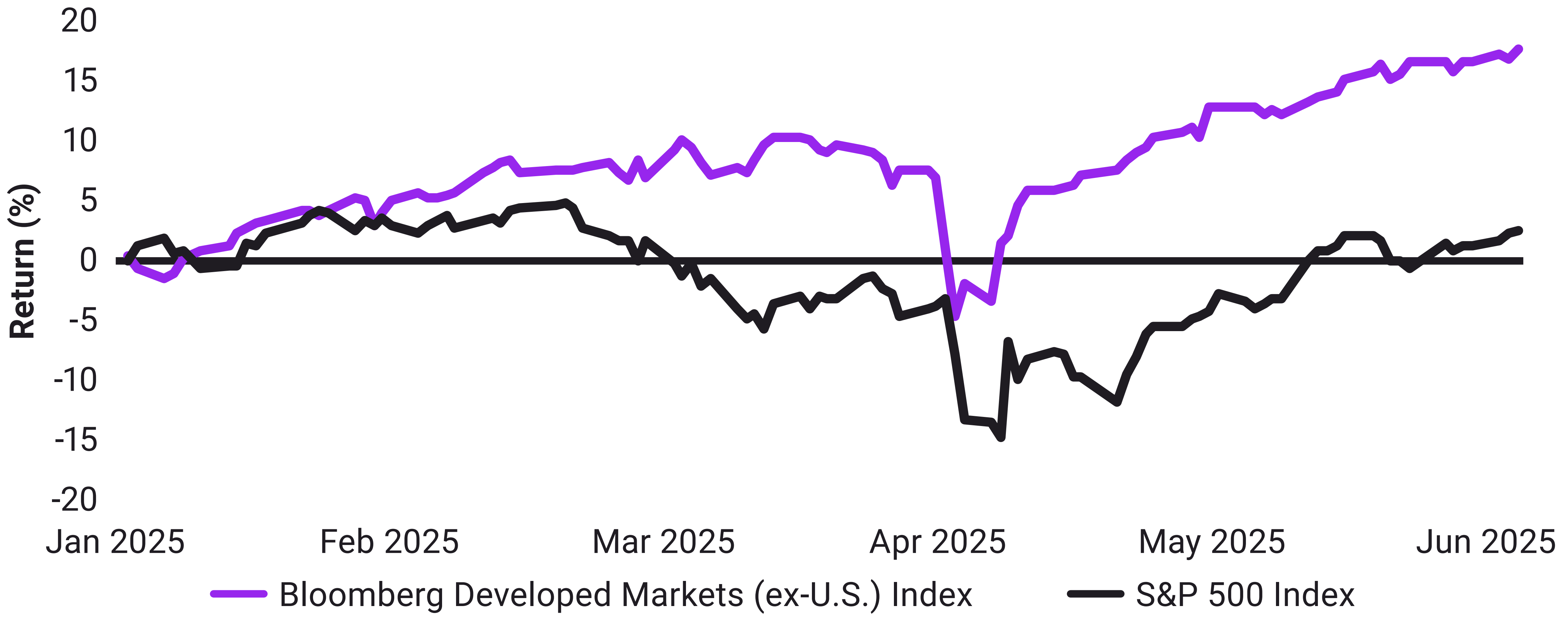
MAG-7 Distorts U.S. Index Performance



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2019 to Jun 2025.

FIGURE 21

U.S Equities are Lagging Global Peers so Far in 2025



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2025 to Jun 2025.

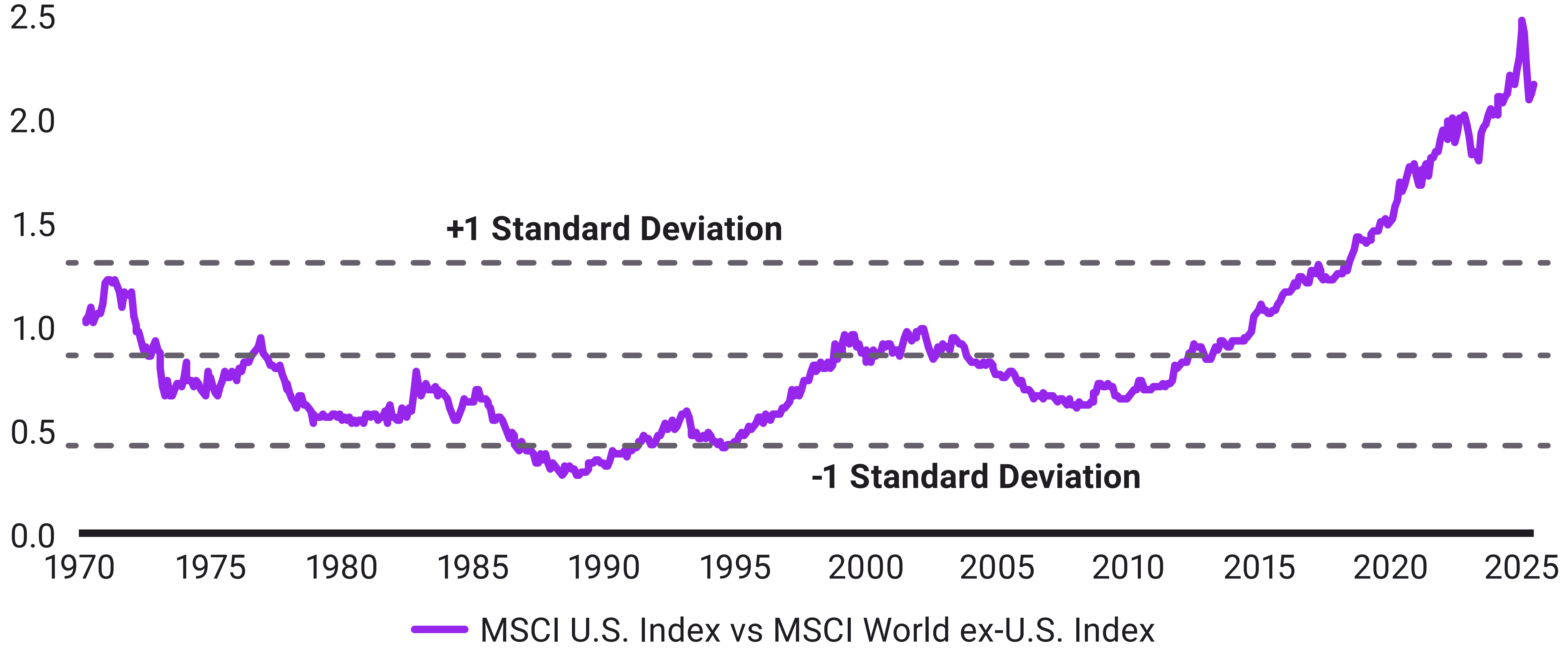
There may be room for this outperformance to continue since recent trends barely register on longer-term charts…

… and valuation data supports the idea that international equities still appear cheaper than U.S. markets on forward earnings multiples.

FIGURE 22

International Equities Have Room to Run on a Relative Basis

MSCI U.S. Index vs MSCI World ex-U.S. Index Relative Performance



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1970 to Jun 2025.

> *International equities **still appear cheaper** than U.S. markets on forward earnings multiples.*

Of course, only the U.S. has the MAG-7 companies which do distort these comparisons somewhat. However, as we've noted, consumer expectations of inflation in the U.S. have increased due to tariff concerns while this has not been the case in many other major economies where households expect more stable prices. Lower inflation expectations allow non-U.S. central banks to be stimulative with monetary policy compared to the U.S. Fed, which remains in restrictive territory.

MAG 7 Market Cap

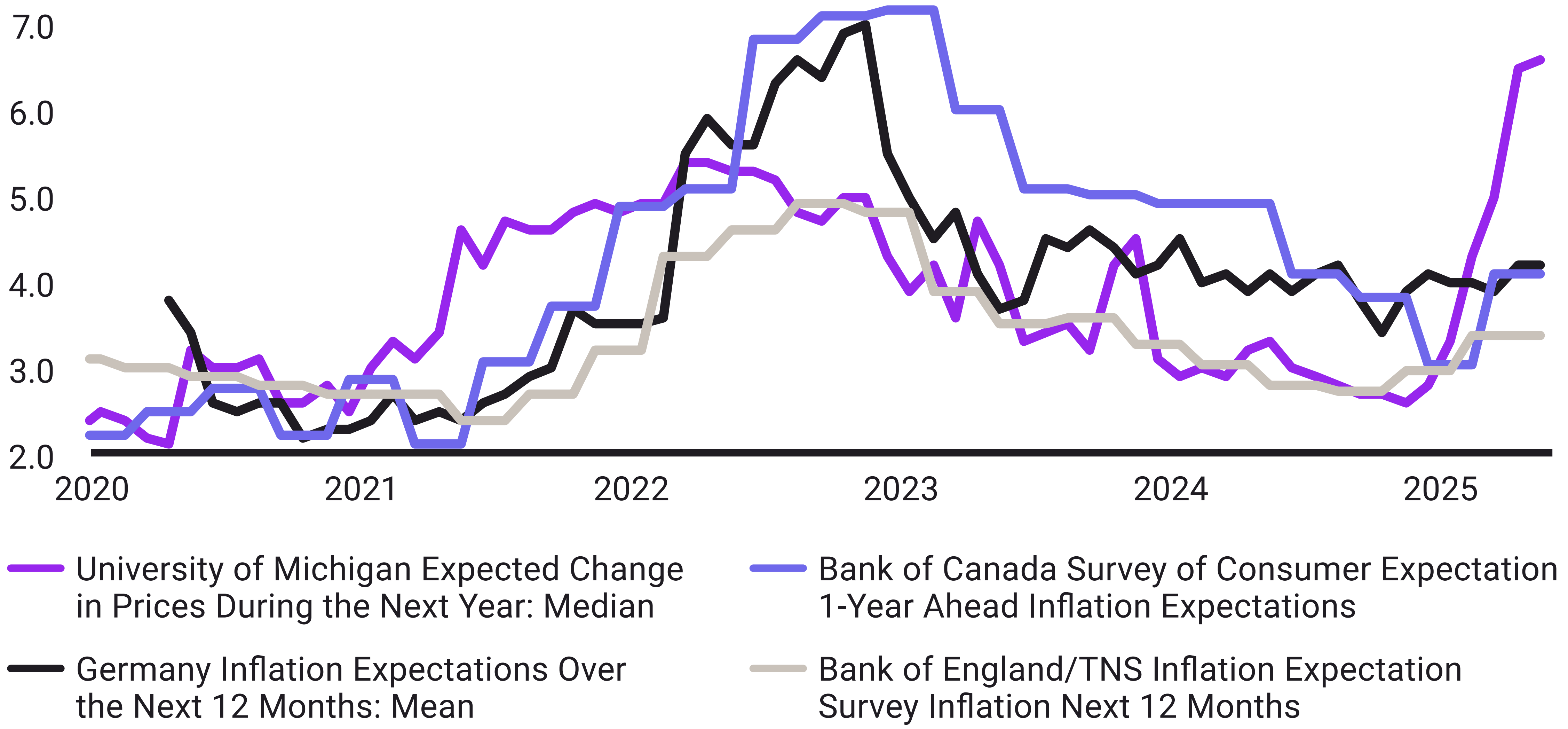
$16.7 Trillion (USD)

*as of May 31, 2025

Source: CompaniesMarketCap

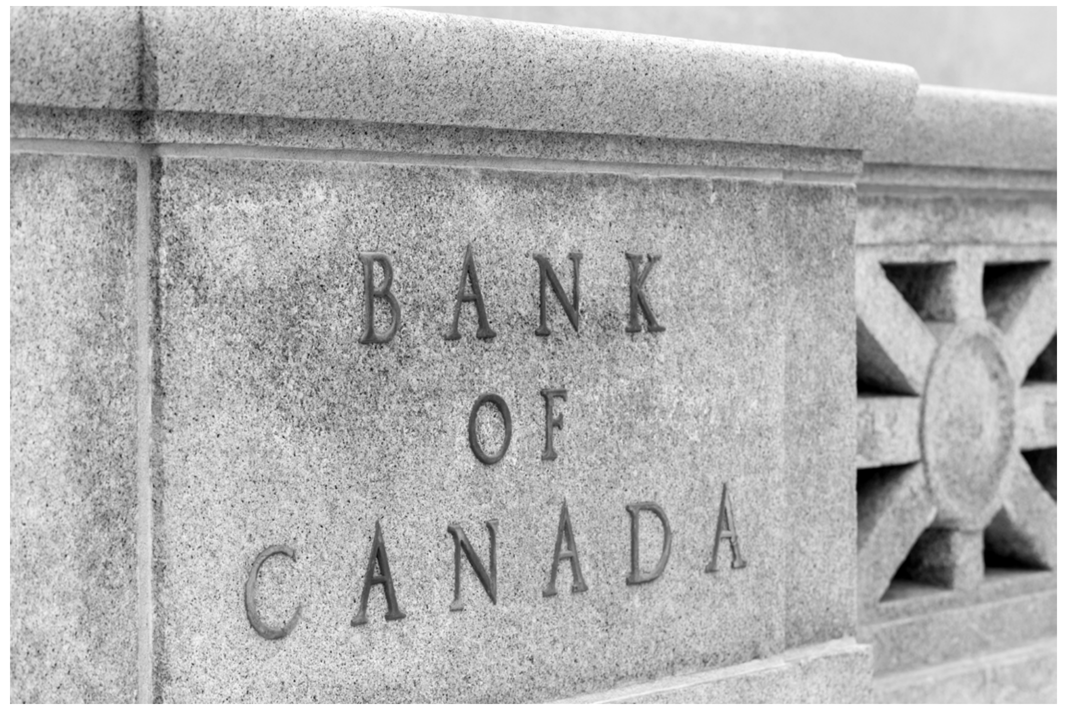
FIGURE 23

German, Canadian, and British Inflation Expectations Remain Contained



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2020 to Jun 2025.

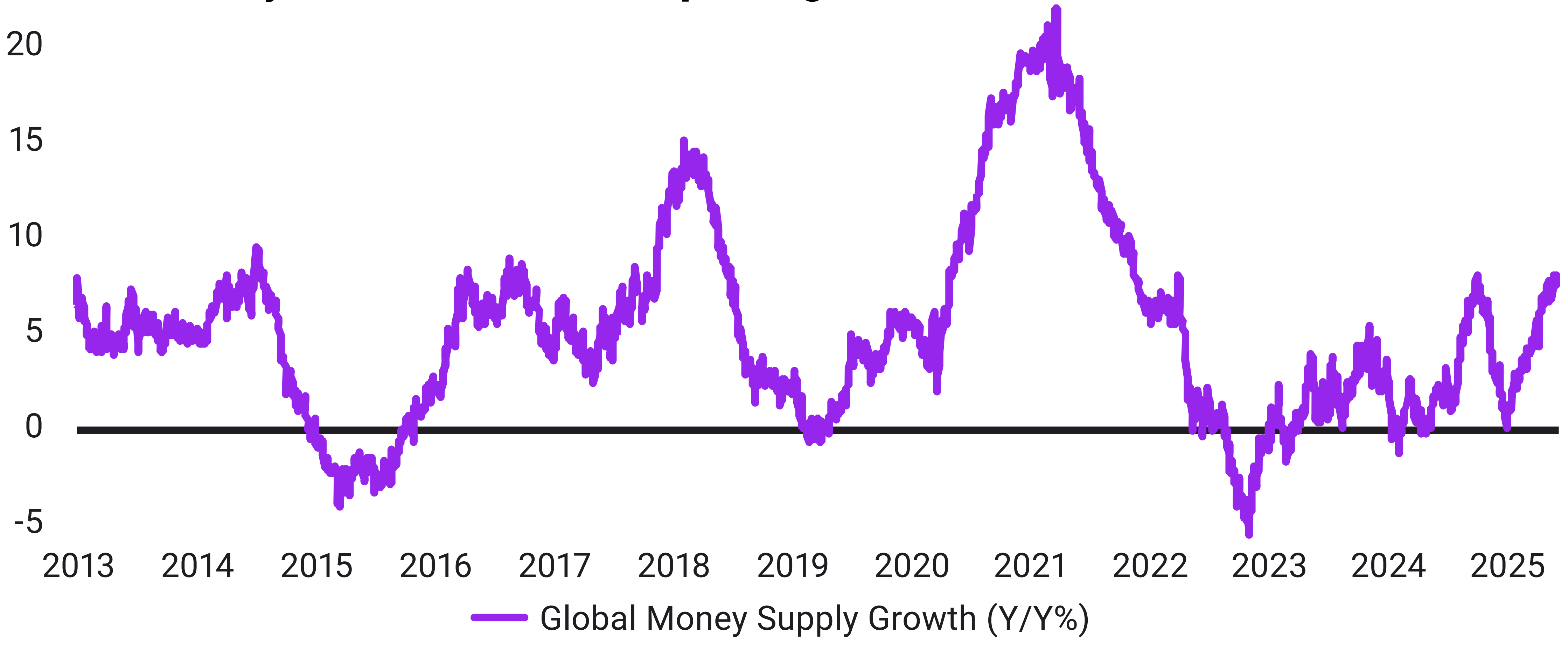
Money growth should also be a tailwind for the rest of the world's economies. Having bottomed around 0% year-over-year, it has since staged a strong rebound.



> *Assuming defense spending is ramped up, Germany could run budget deficits of up to*
> ***5% of GDP.***

FIGURE 25

Global Money Growth is On the Upswing

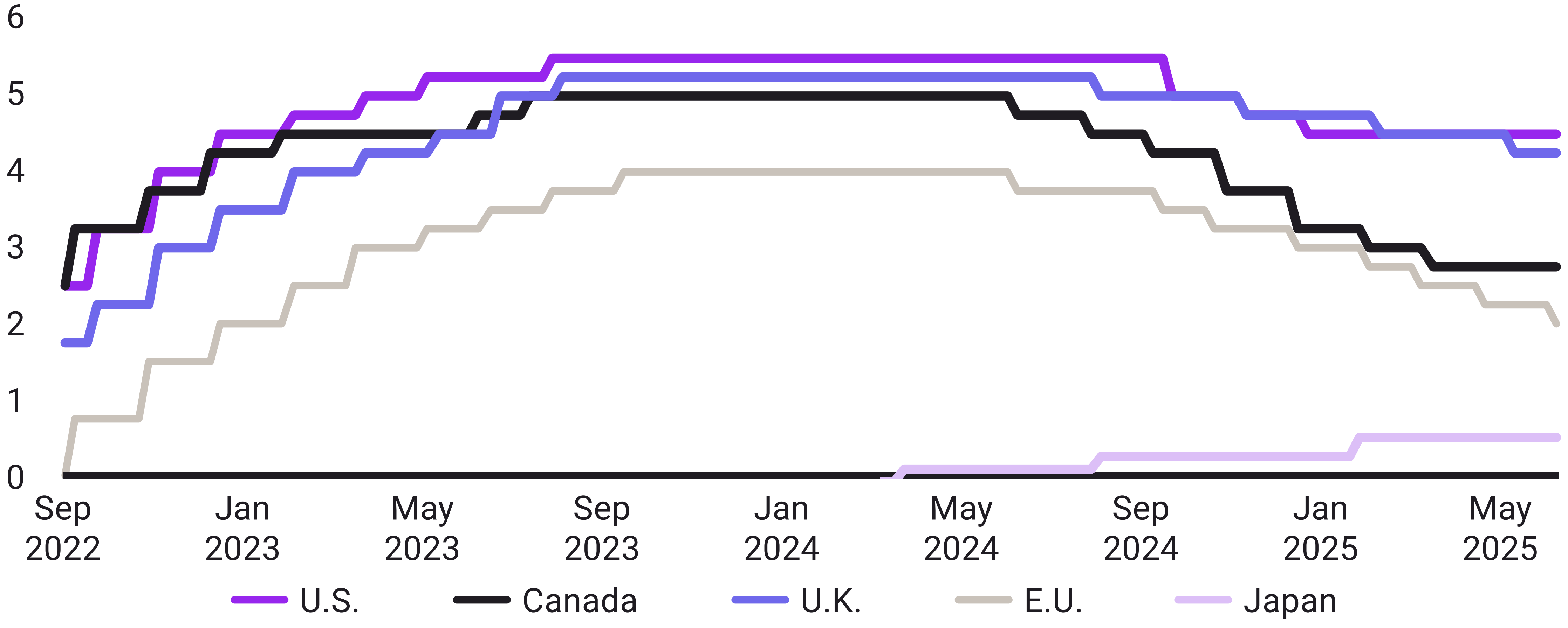


Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Sep 2013 to Jun 2025.

FIGURE 24

Non-U.S. Central Banks Have Set Interest Rates Lower Than the Fed

Central Bank Rate (%)



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Sep 2022 to Jun 2025.

Fiscal Stimulus to the Rescue?

In addition, the trade war has sparked greater fiscal stimulus around the world, which may allow some countries to cushion the impacts of U.S. tariff policy even as their central banks are cutting rates.

Take Germany, for example. As JP Morgan notes, recent changes to the nation's fiscal framework allow for considerable firepower that previously was not possible.[7]

Assuming defense spending is ramped up, Germany could run budget deficits of up to 5% of GDP. Fitch Ratings estimates that new spending could add 0.4% annually to growth in the 2025-2027 period.[8]

Chances are Germany won't be alone in opening the spigot, either. China, for instance, may also take measures to boost its own economy. Long story short, while tariffs have inflicted near-term damage to many countries, fiscal stimulus may increasingly cushion the blow.

[7] Investing.com, JP Morgan, Equity Strategy: Could Some of the Long-held US Positives, and Europe Negatives, Be Turning?, May 12, 2025.
[8] Fitch Ratings, German Spending Plans Show Willingness to Use Fiscal Space for Geopolitical, Growth Challenges, March 18, 2025.

Tourism Is Re-Routed

It's now well known that many international tourists are electing against travel to the U.S. That doesn't mean they're staying at home, though. Tourism continues to flourish, and other countries are the beneficiaries. Oxford Economics estimates a 9% drop in overall foreign visits to the U.S. in 2025 and a $8.5 billion decrease in related spending.[9] Yet Booking Holdings, as well as numerous hotel chains, report booming business overseas.[10] America's pain from foreigner substitution is the rest of the world's gain.

Trade Flows Are Shifting

U.S. tariff policies are forcing countries to find new markets for their goods that might be more open and less expensive to deal with than the U.S. The chart below shows that China especially has done a good job of preparing for U.S. tariffs in this regard. Its exports are actually at a new all-time high. What's more, the rest of the world may benefit from China exporting deflation, as it seeks to divert goods from the U.S. market where it faces tariffs and "dumps" them into other markets open to receiving their cheap goods.

Short Term Pain for Long Term Gain

There's no doubt that in the short term, Trump's tariffs have caused at least some short-term pain for the rest of the world. But maybe on a longer-term horizon this won't be such a bad thing. Weaning off the U.S. will force other nations to boost domestic consumption while exploring ways to improve productivity. In Canada, for instance, there has been a concerted effort to remove inter-provincial trade barriers to encourage a better trading environment with the country.

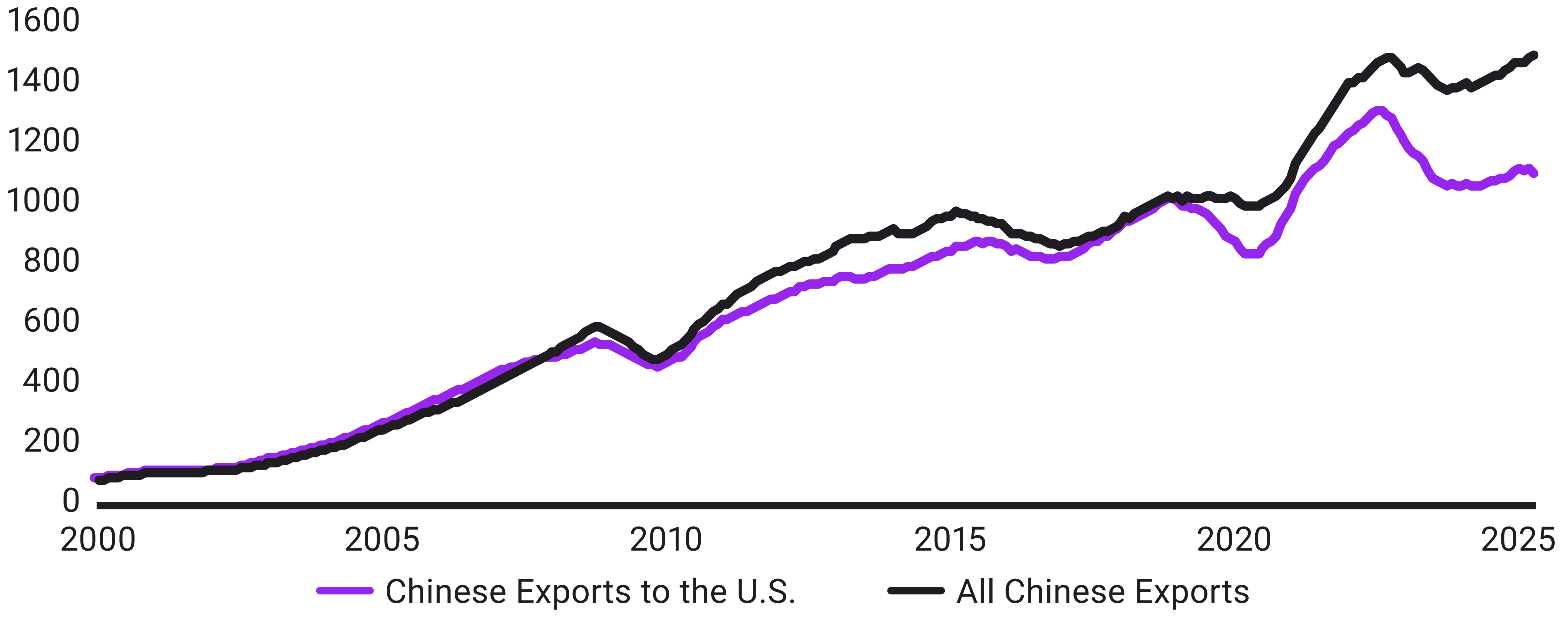
$8.5B

forecast declined in international visitor spending year-over-year for the U.S.

Source: Negative Outlook for U.S. Inbound Travel Hasn't Budged

FIGURE 26

Higher Chinese Exports to the Rest of the World Could Mean Lower Inflation



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2000 to Apr 2025.

[9] CNBC, Fewer international tourists are visiting the U.S. — economic losses could be 'staggering,' researchers estimate, May 28, 2025.
[10] Reuters, Booking Holdings posts upbeat quarterly results helped by international travel, April 29, 2025.

CONCLUSION

The Trump administration's trade war could well end with a whimper, depending on the whims of the regime head or reactions from the judicial or legislative branches of government. That, plus the passage of a stimulative Big, Beautiful Bill could lure more flows into equity markets, especially from more trend-following and systematic strategies. Rest of World equity markets may be better positioned going forward given fiscal and monetary stimulus occurring in many countries, along with longer term attempts to boost productivity and consumption.

However, U.S. equities, in particular, are back to lofty valuations, and risks abound as we enter the second half of the year. U.S. tariff postponements could be reversed as deadlines for new deals pass. This could occur against the backdrop of shorter term stagflationary forces which would magnify the bad news. If bond yields continue to rise as the U.S. exceptionalism theme weakens the situation could get even worse. It seems the risk/reward in chasing stock markets at this time just isn't that attractive. With implied volatility levels receding, the time to be adding downside protection could be at hand.

The lengthy run-up in equities hasn't been evenly distributed. U.S. stocks clearly have been the place to be. But they may lead on the downside when the next bear market hits, and investors who focus on relatively cheaper international equities could be rewarded.

Rest of World equity markets may be ***better positioned going forward*** *given fiscal and monetary stimulus occurring in many countries, along with longer term attempts to boost productivity and consumption.*

03.

EQUITY OUTLOOK

Jeff Bradacs, CFA
Co-Head Equity Strategies, Head of Portfolio Management & Trading

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Co-Head Equity Strategies, Head of Fundamental Equity Research

FROM WHIPLASH **TO RENEWED LEADERSHIP**

The start of 2025 has been anything but predictable for equity investors.

Since our last update, markets have experienced dramatic swings—so much that an investor who stepped away in early March and returned in early May would generally find the major indices virtually unchanged, despite a rollercoaster of volatility in between. This “whipsaw” environment has tested most market participants, with sharp declines and swift recoveries driven by shifting policy and sentiment.

Tariff Announcements Triggered Plunge, Then Sharp Rebound

- The catalyst for the Q1 selloff was the unexpected announcement of sweeping tariffs—dubbed “Liberation Day” by some—which caught markets off guard both in scope and execution.
- A lack of clarity around the administration’s endgame created uncertainty, spooking investors and triggering a sharp 15% drop in the S&P 500 Index through April.
- However, the subsequent rebound was equally dramatic, with the S&P 500 Index rallying 18% as incremental positive developments emerged.
- Notably, the announcement of a 90-day pause on tariffs for countries other than China provided much-needed breathing room, signaling that the worst-case scenario may already be priced in and that the administration’s aggressive stance could be walked back.

Earnings and Consumer Spending Support Stocks

Further supporting the market’s rebound was a strong first-quarter earnings season and a divergence between hard and soft data. While U.S. GDP dipped due to surging imports, consumer spending remained robust and not overly reliant on credit, offering comfort to investors concerned about a broader economic slowdown.

> *This **“whipsaw” environment** has tested most market participants, with sharp declines and swift recoveries driven by shifting policy and sentiment.*

Leadership Changes: Dynamic and Extreme

At the start of the year, investors crowded into mega-cap AI-related stocks, a trend that morphed from momentum (MOMO) into fear of missing out (FOMO). However, news of advancements by DeepSeek undermined long-term capex growth expectations, leading to a sharp reversal in the Nasdaq Composite Index and a nearly $1 trillion (USD) loss in market capitalization for AI bellwether Nvidia.

- Investors quickly repositioned, with leadership shifting into other growth stocks and propelling markets back toward new highs—only for momentum to unwind again as tariff concerns resurfaced.
- The momentum factor experienced one of its fastest declines in 40 years, with investors rotating into low-volatility stocks for protection.
- As markets rallied once more, capital flowed out of low-volatility and back into other areas of the market.

Today, momentum and market leadership are less crowded and more diversified than at the start of the year, with less concentration in any single factor, theme, or industry.

Corporate Earnings: Resilience Amid Uncertainty

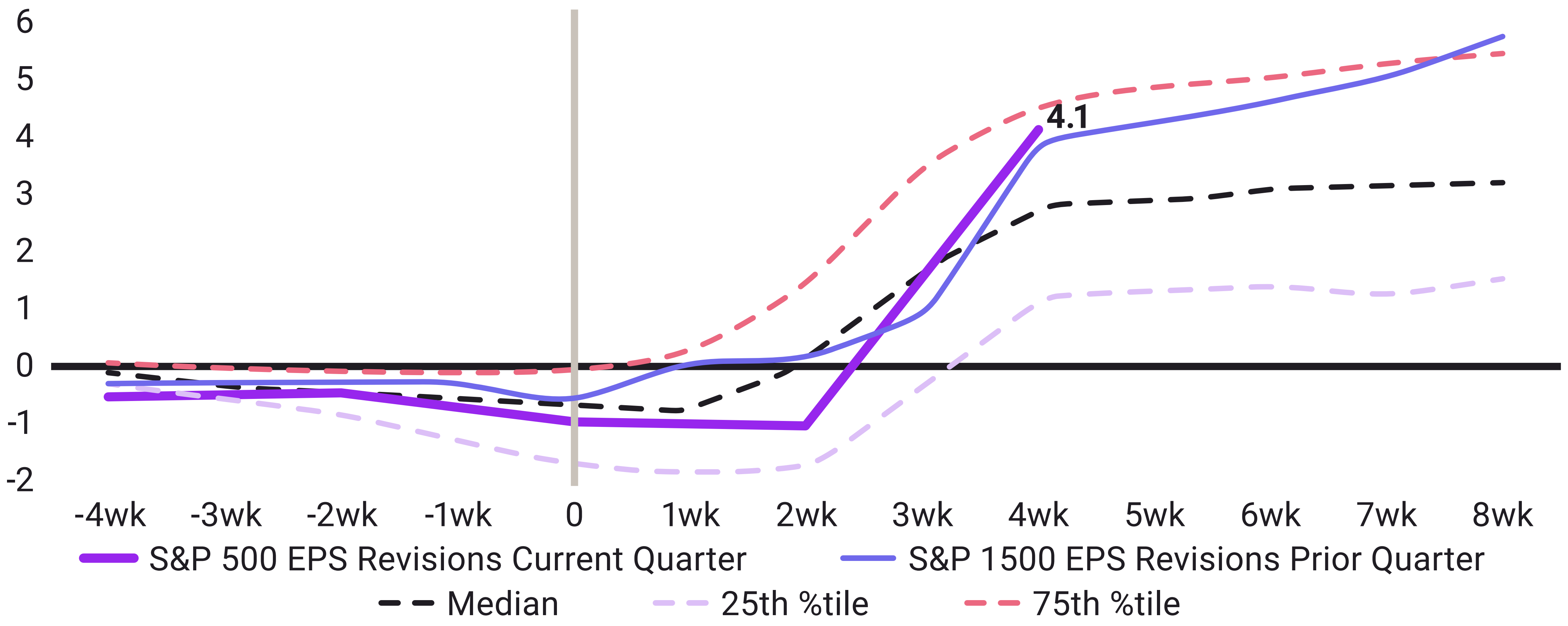
- The first quarter of 2025 has underscored the resilience of U.S. corporates. Heading into earnings season, expectations had been slashed due to tariff concerns.
- Earnings releases, however, were much better than feared with 63% of companies beating revenue estimates, and 78% beating on earnings per share (EPS)[11].
- Even more surprising, 2025 revenue estimates for reporting companies have increased by nearly 6% over the past three months, reversing some of the earlier cuts.
- Areas of corporate weakness tended to be industries that are already facing structural headwinds, such as transports working through post-Covid inventory distortions and manufacturing sectors in prolonged contraction.
- On the consumer front, management commentary from Q1 earnings reports was consistent: Lower-income consumers generally remain under pressure, upper-income consumers are relatively resilient, and there are early signs that spending by the middle-income cohort is softening.
- Weak consumer confidence and soft data has yet to hit corporate results.

A Tale of Two Retail Models: New Keeps Beating Old

Traditional brick-and-mortar retailers continue to struggle, but companies benefiting from the “New Consumer” reported standout results. Amazon.com, Inc., Netflix, Inc., Spotify Technology S.A, The Walt Disney Company, Uber Technologies, Inc., and DoorDash, Inc. all delivered strong performances in the first quarter of the year, highlighting a stark contrast with traditional consumer companies. This shift underscores where consumer spending is likely migrating.

FIGURE 1

EPS Revisions in First Quarter Surprise to the Upside (%)



Source: FactSet, Bloomberg, 22V Research.

[11] FactSet, Q1 2025 by the numbers, May 29, 2025.

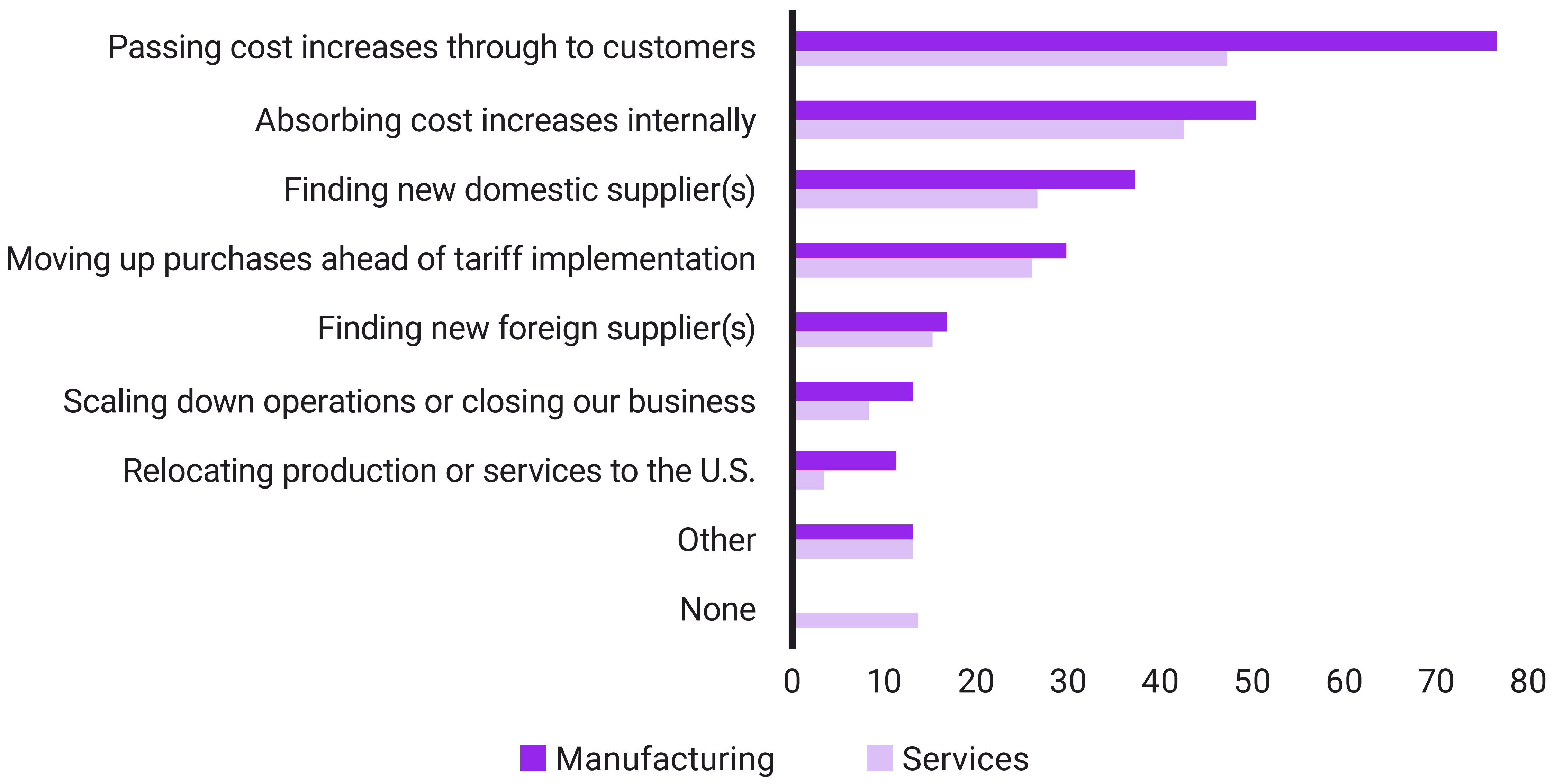
Cost Pressures from Tariffs Manageable (At the Moment)

- Guidance trends reveal that most companies have incorporated in-force tariffs into their outlooks, leaving room for adjustment should new tariffs be enacted.
- Cost pressures from tariffs to date are expected to be manageable and largely mitigated by year-end as supply chains are reworked.
- Surveys in May conducted by the Federal Bank of New York and Atlanta showed companies are primarily passing cost increases through to consumers, though some may be reluctant to publicly acknowledge this due to political sensitivities.

FIGURE 2

For the Most Part, Companies Plan to Pass Tariff Costs Along

What actions, if any, are you taking (or planning to take) in response to higher tariffs?



Source: Federal Reserve Bank of Dallas. Apr 2025.

The Big Test for Earnings Lies Ahead

- Looking ahead, the key question is whether high uncertainty, weak corporate confidence, and a possible pullback in consumer spending will ultimately weigh on earnings.
- Early May earnings may have been boosted by demand pulled forward ahead of tariffs, clouding the true demand picture.
- The housing outlook also bears watching, as rising bond yields could ripple through the broader economy, dampening growth.

MAG-7 Magnificent Once Again. But Can it Continue?

The AI trade rebounded during the Q1 earnings season, with the "Magnificent Seven" and other major AI capex spenders showing resilience. Meta Platforms, Inc., for example, announced in it Q1 earnings report that it raised its 2025 capex guidance by $5.5 billion (USD), citing strong returns from AI investments in advertising.

While AI remains a bright spot for now, the critical question is not 2025 growth, but the sustainability of growth rates from 2026 onward—especially given the outsized weight of these companies in equity markets.

Vigilance Required: Markets Vulnerable to Unwelcome Surprises in Q2

With stocks rallying from April lows, any negative surprises in Q2 could be met with outsized reactions, as the margin of safety is now lower. The pull-forward of good news and a reversal in flows may leave markets vulnerable later in the year.

Despite the recent dominance of macro factors and periods of high correlation, longer-term structural changes in market dynamics—including reduced correlation and increased dispersion—can continue to create attractive opportunities for skilled long-short managers to generate alpha through security selection.

04.

FIXED INCOME OUTLOOK

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Portfolio Manager,
Co-Head Fixed Income

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RATE MARKETS CONFRONT A NEW RISK

Exceptional rate volatility through April (71.8 bps trading range on U.S. 30 Year Treasury Yield, 4th highest month since 2011) has exposed a new risk for the rate market: foreign investors reducing their U.S. Treasury holdings due to a declining U.S. Dollar, U.S. policy uncertainty, or simply to rebalance from a generally overweight U.S. positioning stance.

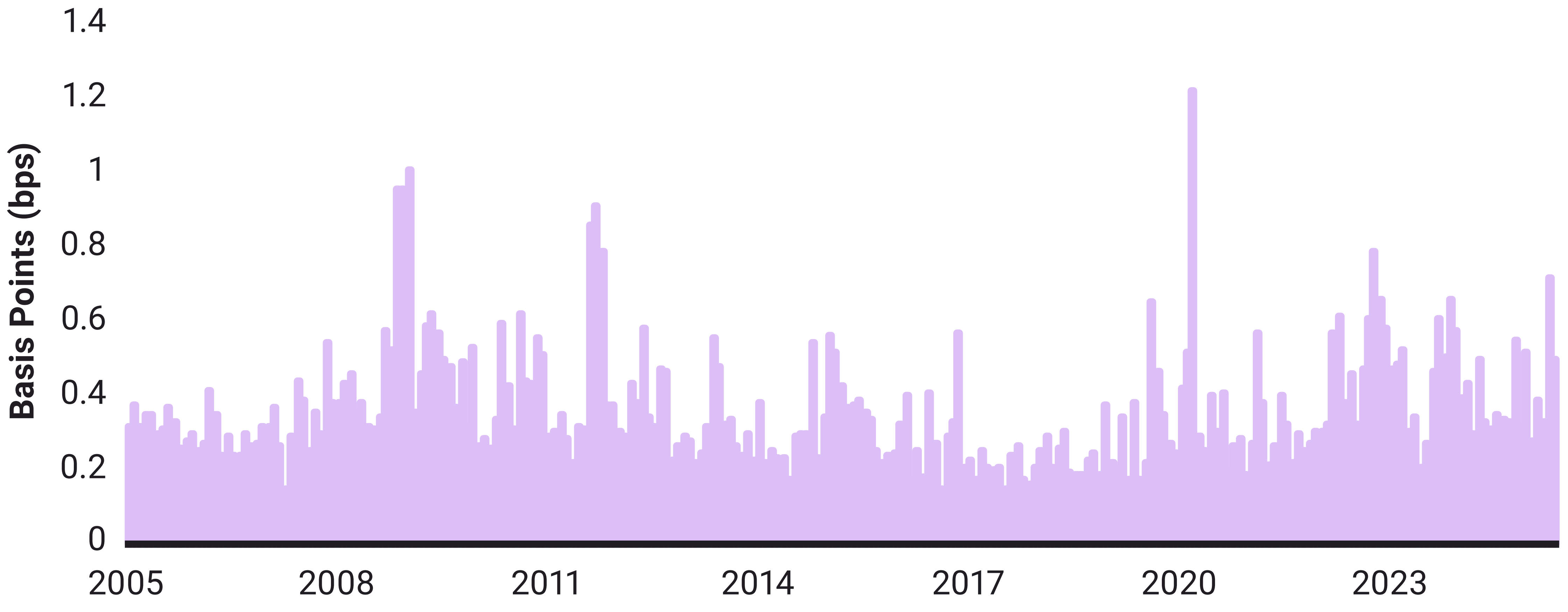
- Fiscal sustainability remains a key issue – interest expense continues to increase faster than any spending cuts
- The Rest of the World expanding their fiscal deficits, driven by defense spending and stimulus
- Taken together, we think this pressures the supply/demand balance especially at the back end of the yield curve – steepening of the yield curve should continue – and U.S. 2 Year Treasuries/ U.S. 10 Year Treasuries should have another 50 bps to go just to get back to long term average

Investors Need Better Yield to Take on Duration Risk

We believe investors will require a more significant yield pickup vs. money markets to justify taking on the volatility of longer-duration Treasury bonds. At the front end of the curve, we think the inflationary impact of U.S. tariffs likely limits the Fed's ability to be pre-emptive with rate cuts – and indeed may force them to be "late" if employment data rolls over.

FIGURE 1

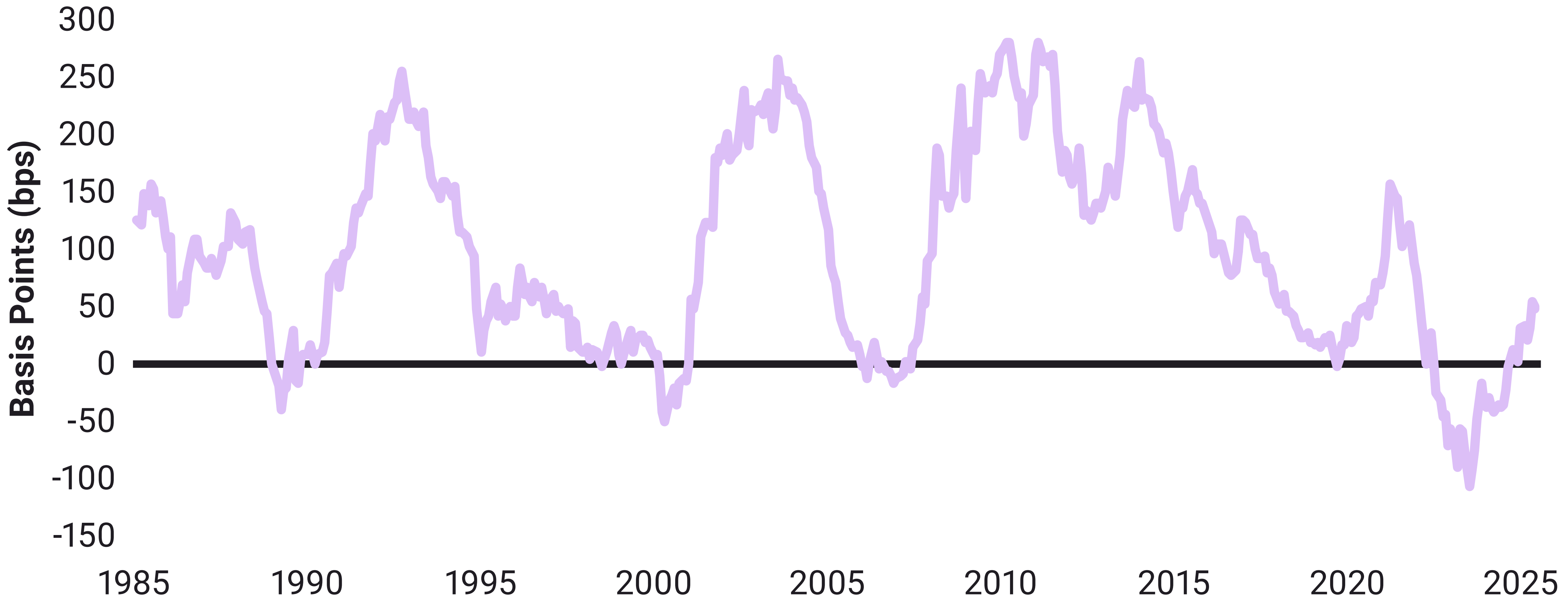
Monthly Trading Range of 30-Year U.S. Treasury Yields



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2005 to May 2025.

FIGURE 2

Curve Appeal: U.S. Treasury 2 Yr/10 Yr Spread Should Continue Steepening



Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 1985 to Jun 2025.

Credit Markets Fared Well During a Volatile April

Credit markets held up relatively well during the April swoon for equities. Despite spread volatility through March and April, we observed continued strong demand for high and mid-quality credit (i.e. BB-BBB). Remarkably stable inflows into corporate bonds combined with a slowdown in new issue supply created a strong technical set up for the market.

While spreads remained at the lower end of the range historically, there are some significant structural improvements that should be considered:

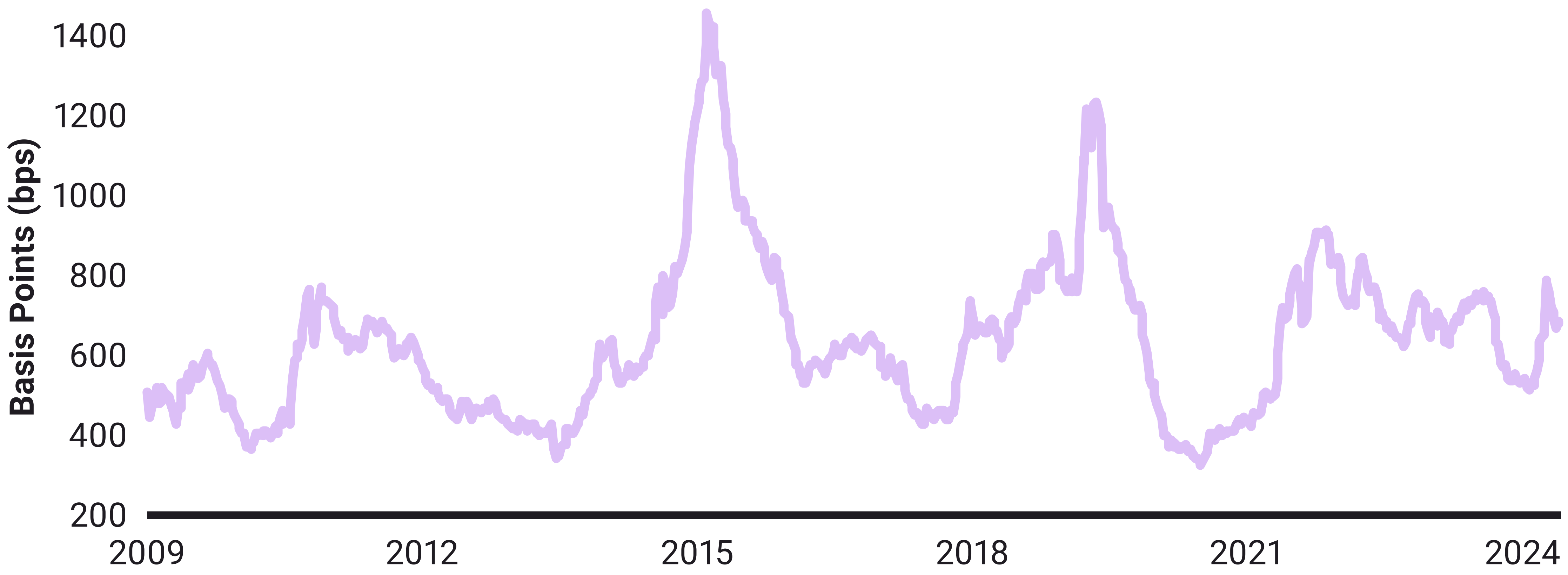
- Higher quality/ratings and more secured bonds within the ICE BofA U.S. High Yield Index
- Fed buying corporate bonds in 2020 sets a precedent
- Growth of private credit has shifted default risk out of public markets
- All-in yields look very attractive for mid to high quality credit, likely providing an additional margin of safety against potential spread widening

Outlook: Are Lower Quality Credits Telling Us Something?

However, we also observed increased divergence within credit markets where lower quality names sold off the most and subsequently rallied back the least. This could indicate that investor credit risk appetite is waning and could be an early warning sign to the broader credit market.

FIGURE 3

CCC - BB spreads: An Early Warning Sign of Future Weakness in Credit?



Source: Bloomberg L.P. Dec 31, 2009 to May 31, 2025. BB Bonds is represented by the ICE BofA BB US High Yield Index, & CCC Bonds is represented by the ICE BofA CCC & Lower US High Yield Index.

05.

ASSET ALLOCATION OUTLOOK

Michael White, CFA
Portfolio Manager,
Multi-Strategy

Neil Simons
Portfolio Manager,
Head of Multi-Strategy

NAVIGATING GROWTH, INFLATION, AND POLICY **UNCERTAINTY THROUGH A 40/30/30 LENS**

Big Picture: What We See Ahead

Post-election euphoria has quickly morphed into a "Trump Slump". Recession expectations are rapidly rising after the Trump administration came out hot out of the gates with many new policy initiatives that have a net stagflationary impact (i.e. push inflation higher, and economic growth lower).

Our outlook is built on three key scenarios (base, bull, and bear) that explore possible outcomes over the next 3 to 12 months and their potential impact on asset classes.

Base Case: Stagflation

Our previous bearish scenario has now become our new base case: Higher inflation has caused the Fed to stop cutting rates and take a more cautious, balanced approach. Trump has quickly implemented his most disruptive policies within the first year of the second term of his presidency (perhaps so that there is time to take credit for the recovery by the fourth year of his second term). Inflationary trade and immigration policies are expected to result in outright stagflation and policy uncertainty is likely killing business confidence. At the same time, the AI bubble seems to have popped, and the resulting reverse wealth-effect can be another headwind to growth.

> *Our previous bearish scenario has now become our new base case: **Higher inflation has caused the Fed to stop cutting rates and take a more cautious, balanced approach.** Trump has quickly implemented his most disruptive policies within the first year of the second term of his presidency.*

ASSET CLASS POSITIONING: WHERE WE STAND

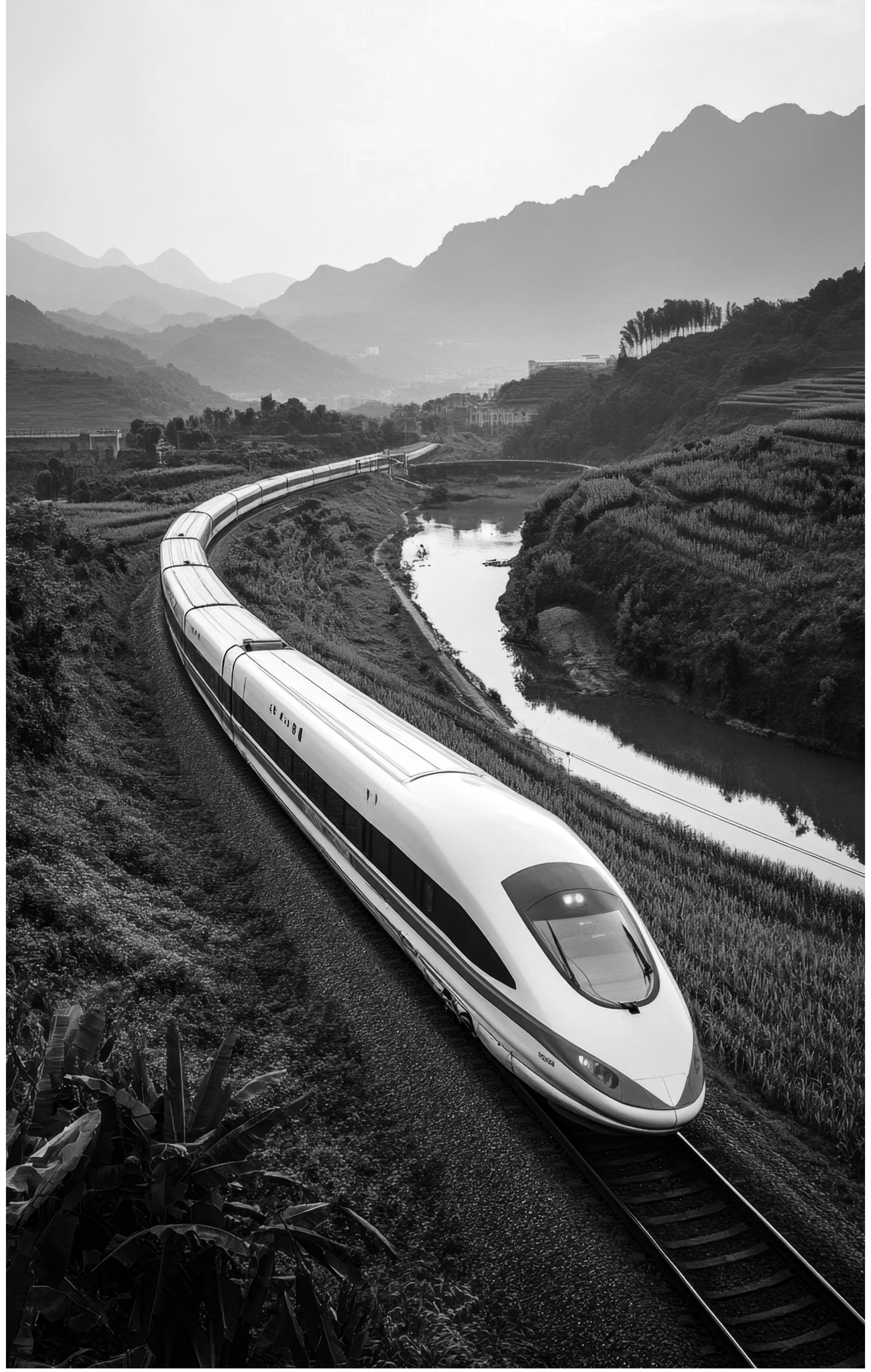
In terms of positioning, weightings are discussed relative to a broad 40/30/30 target allocation of equities/fixed income/alternatives based on our belief that this asset allocation mix is a better way to build portfolios that deliver greater certainty.

> *While large-cap U.S. equities have bounced considerably off the lows, **we don't think markets are returning to the U.S. exceptionalism trend** of the past decade.*

EQUITIES

Fade American Exceptionalism, Look to the Rest of the World for Better Opportunities

- **We are Neutral Overall.** While large-cap U.S. equities have bounced considerably off the lows, we don't think markets are returning to the U.S. exceptionalism trend of the past decade. As such, we have added a "Developed Markets Ex-U.S." equities category in our allocation table to show our preferences within Developed Markets as the end of U.S. market dominance seems to be upon us.
- **Where We're Focused:** We're looking for opportunities outside the U.S. and in Emerging Markets, where monetary and fiscal policy conditions are better (as are valuations).
- **Inflation Impact:** We're tilting back toward manufacturing sector, where the impact of tariffs and trade wars could lead to rising inflationary pressures.



FIXED INCOME

Neutral with a Hedged Approach

- **We're Neutral.** Government bond yields offer a decent return relative to equities, especially outside of the U.S., where bond vigilantes are becoming increasingly concerned with the lack of fiscal discipline. This could result in some stress events where policy makers will need to respond to sharp spikes in bond yields.
- **Credit View:** We view the credit market broadly as overvalued and expensive, prompting our defensive, hedged stance in this space.

ALTERNATIVES

A Vital Diversifier

- Our base case has become more cautious, and we remain vigilant to tail risks, including unexpected policy shifts from the Fed or geopolitical developments, which could significantly alter the trajectory of markets. These risks are reasonably accounted for in our probability-weighted scenario forecasting.
- With heightened uncertainty around U.S. economic policy, especially with relation to trade policy, alternatives remain a key pillar of our diversified model. Alternatives are comprised of three components: Enhancers which can add to Equity or Fixed Income risk; Diversifiers which provide returns independent of market moves, and Inflation Protection.
- Within Alternatives, we believe maximizing exposure to Diversifiers can reduce the beta of the overall portfolio to traditional Equity or Fixed Income risks. For example, this could mean a shift from long-only equity to long/short strategies, or a shift from long/short exposure to market-neutral strategies.
- We also believe in maintaining exposure to Inflation Protection given we see the risk of inflation surprising to the upside.

> "*With heightened uncertainty around U.S. economic policy, especially with relation to trade policy,* ***alternatives remain a key pillar of our diversified model.***"

Key Risks We're Watching

While our base case is cautious, we remain vigilant to potential disruptors:

- **U.S. Government Policy Shifts:** Tariff policy was temporarily paused, likely due to unfavorable market reactions (such as the U.S. 30-year bond yield briefly hitting 5% on May 21). However, these postponements may not last, and long-term resolution may require the (re)negotiation of complicated trade details, which can take longer than anticipated.
- **End of Globalization:** Markets will have to eventually deal with the fact that the policy environment has changed, and the era of unconstrained globalization is likely behind us.
- **Geopolitical Events:** Unexpected developments on the world stage could increase market volatility.

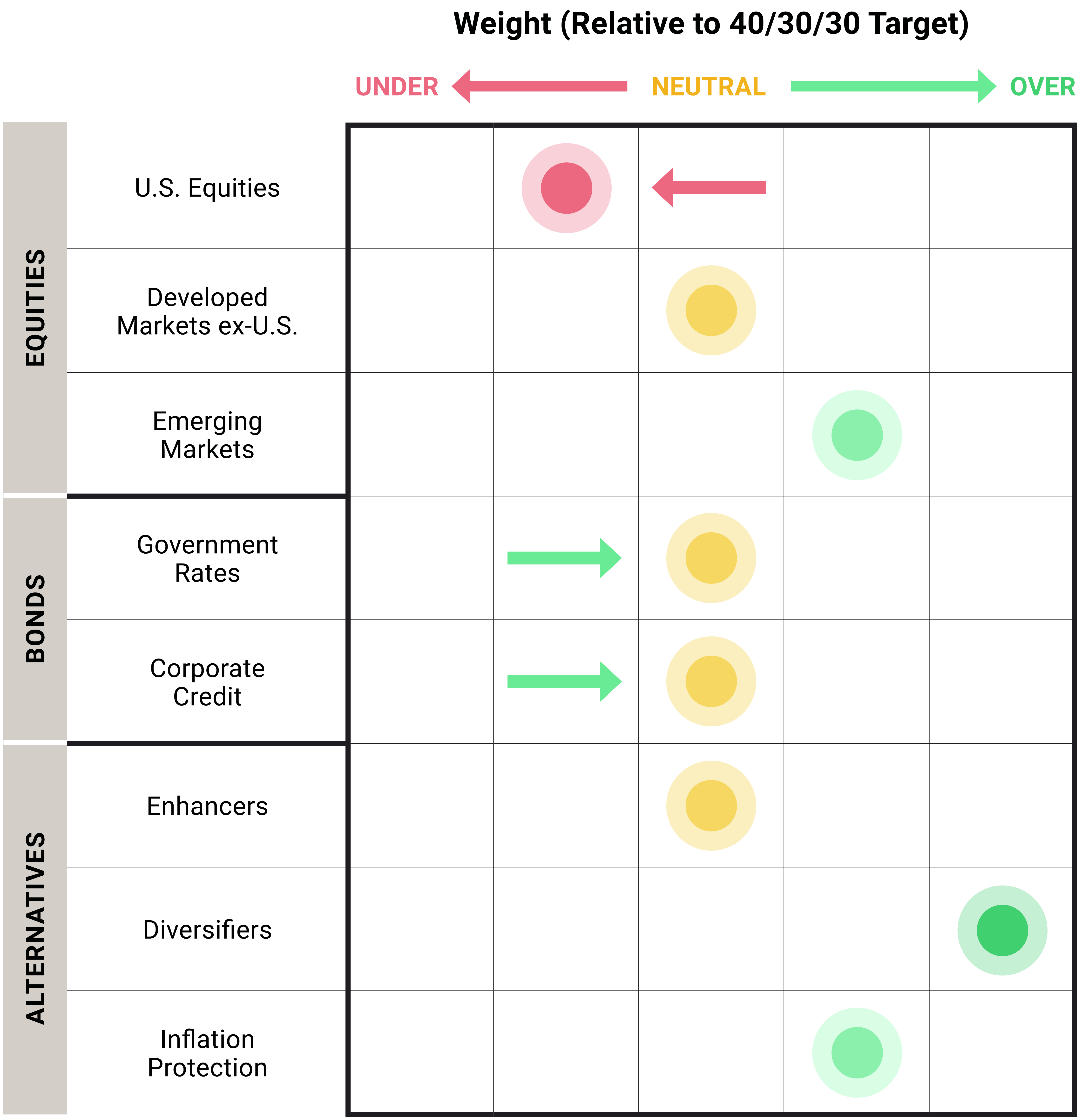
Strategy: Thinking in Terms of Possibilities, Not Certainties

To navigate this landscape, we're staying nimble, leveraging a scenario-based approach that aims to help prepare for a range of possible market conditions. Our allocation decisions are tied to a core 40/30/30 framework, with positioning adjustments made as market dynamics shift.

40% TO EQUITIES

30% TO FIXED INCOME

30% TO ALTERNATIVES



06. ARBITRAGE OUTLOOK

Tom Savage, CFA
Portfolio Manager,
Arbitrage

Craig Chilton, CFA
Portfolio Manager,
Arbitrage

POSITIVE TAILWINDS STARTING TO EMERGE

It has been an eventful first half for our arbitrage strategies, which were able to generate strong returns in a volatile equity market.

Our small allocation to convertible bond arbitrage bore fruit in the April market sell-off as our synthetic put positions generated high returns on capital.

We largely rotated out of these puts and have redeployed capital into more balanced (lower delta) convertible bonds, taking advantage of wider credit spreads.

> *We have already seen the impact of this new antitrust regime as deals are progressing* ***at a much faster pace.***

Regulatory Tailwinds South of the Border

We've discussed in past updates how the Biden administration's antitrust regulators, helmed by Lina Khan at the Federal Trade Commission (FTC) and Jonathan Kanter at the Department of Justice (DOJ), created a very challenging environment for merger arbitrage investing. The election of Trump and the appointment of Andrew Ferguson at the FTC and Gail Slater at the DOJ has eliminated this regulatory headwind from the strategy:

- While the Trump administration is continuing the existing antitrust battles against Big Tech, the messaging from the new leadership on merger and acquisition (M&A) is that where they don't see a deal violating antitrust laws, they want to get "out of the way"[12].
- The new DOJ antitrust leader has also indicated they are open to robust consent decrees for merger remedies, which is a return to past practice. We have already seen the impact of this new antitrust regime as deals are progressing at a much faster pace.
- As an example, Johnson & Johnson's acquisition of Intra-Cellular Therapies, Inc. (announced in January) closed in 80 days. While no two deals are identical, a fair comparison is the acquisition of Seagen Inc. by Pfizer Inc. in 2023. Under Lina Khan's FTC, this took 277 days to close.

M&A Should Benefit from Reduced Trade Uncertainty

M&A volumes were impacted by the uncertainty caused by Trump's tariff policy, though activity is picking up in May as trade deals are being signed. We anticipate a strong M&A market in the second half of the year, driven by the friendlier regulatory environment and clarity regarding tariffs.

[12] Axios "Scoop: Trump FTC tells CEOs when agency will get "out of the way" on M&A.

SPACs are Back: 2024's Seeds Become 2025's Harvest

If 2024 was a year of planting seeds in the Special Purpose Acquisition Company (SPAC) market, 2025 is shaping up to be harvest time:

- The market has been catalyzed by the announcement of the Cantor Equity Partners, Inc. (CEP) business combination with Twenty One Capital Inc, a new vehicle that will be the third-largest Bitcoin treasury globally.
- With partners like Tether Limited, Bitfinex, and Softbank Corp., the new company has been embraced by retail investors and is trading in the $40 range by the end of May (vs. $10.31 in reported cash per share in trust).
- This is the best performing de-SPAC announcement since the SPAC bubble of 2020. CEP has served as a reminder of the valuable optionality imbedded in SPACs. Post-announcement, we've seen a broad increase in SPAC warrant values which has increased our SPAC arbitrage returns. We anticipate a further increase in SPAC new issuance in the second half of 2025.

Looking Ahead: A Promising Convertible Calendar Awaits

With market volatility abating, we are seeing new convertible issue activity picking up and anticipate a strong calendar for the second half of the year as many issuers need to refinance capital raised in the 2020-2021 boom.

> *We are seeing new convertible issue activity picking up and anticipate* ***a strong calendar*** *for the second half of the year.*

07.

PORTFOLIO CONSTRUCTION TRENDS

Robert Wilson, CFA, CAIA
Head of Innovation, Portfolio Strategist, 2ND ENGINE

MINDSET RESET: USING A "BUDGETING" FRAMEWORK TO ACHIEVE BETTER INVESTMENT OUTCOMES

HOW TO NAVIGATE UNCERTAINTY AND ACHIEVE CLIENT GOALS WITH GREATER CERTAINTY BY ALLOCATING RISK AND COST WITH PRECISION.

Navigating Complexity with Deliberate Portfolio Construction

The macroeconomic outlook for the remainder of 2025 is expected to remain uncertain with persistent inflation concerns, interest rate ambiguity, and ongoing geopolitical risk. This calls for allocators to use disciplined, consistent and defensible approaches to constructing portfolios. We believe that against this backdrop of uncertainty advisors helping their clients make smarter, data-driven decisions to improve portfolio outcomes is becoming more challenging, and for many will require a re-think of existing behaviours.

We are encouraged by our ongoing work with advisors as they apply new tools and frameworks to enhance diversification, eliminate unintentional and inappropriately scaled risk exposures, and direct fee budgets where they can create the most value for their clients. Acting on these insights, they are realigning portfolios more closely with their clients' goals and seeking to reduce the likelihood of shortfalls against rising client expectations.

Adopting a Budgeting Mindset

In our view, one of the most effective frameworks for approaching portfolio design is through a budgeting lens, one that treats key dimensions of portfolio construction as finite resources to be allocated deliberately.

We advocate for a disciplined focus on four critical budgets:

Each of these can play a pivotal role in shaping long-term outcomes. Over-allocating in one can erode the efficiency of another. Overlooking any of these areas can destabilize the entire investment strategy.

For advisors looking to reposition portfolios in the second half of 2025, reassessing both the Risk and Fee budgets could be valuable. Thoughtful management of these two areas can reduce unintended exposures, enhance diversification, and improve value relative to cost.

Conclusion: Resilience Through Re-Allocation

Advisors today have more tools than ever to design portfolios with precision. By using these tools to apply a "budgeting" framework, advisors can:

- Build portfolios that are more diversified by source of return
- Reduce exposure to hidden concentrations and wasted costs
- Unlock higher-value outcomes per dollar of risk or fee deployed

By reshaping portfolios through data-driven, disciplined portfolio design advisors can deliver more resilient, cost-effective portfolios that may stand a greater chance of meeting (and exceeding) their clients' long-term goals.

> *"One of the most effective frameworks for approaching portfolio design is **through a budgeting lens**, one that treats key dimensions of portfolio construction as finite resources to be allocated deliberately."*

RE-ALLOCATING RISK: A FRAMEWORK FOR GREATER PRECISION

Volatility: A Starting Point, Not a Solution

Since the advent of Modern Portfolio Theory (MPT) in 1952, volatility has become a widely accepted proxy for risk. However, volatility is generally a poor measure of risk. It rewards illiquidity, fails to distinguish directionality, ignores regime shifts, and underrepresents tail risks.

It does not account for the broader behavioural characteristics of asset classes, such as mean reversion or momentum. In isolation, it can create a false sense of understanding of portfolio risk.

> ***Volatility is generally a poor measure of risk...*** *it can create a false sense of understanding portfolio risk.*

Risk Budgeting: Evolving Towards a Total Portfolio View of Risk

The benefit of MPT was that it provided a framework for allocating risk in a portfolio rather than simply allocating capital. However, over the past 73 years allocators have built on this foundation to create more comprehensive approaches to risk budgeting in portfolio construction. For example, risk factor models are now used to provide a total portfolio view of risk that looks through each asset and strategy to enable risk to be thoughtfully allocated in multi-asset multi-strategy portfolios.

This approach allows for portfolios constructed with building blocks that aren't just diversified by label, but that are diversified by risk exposure, avoiding the hidden correlations and unintended exposures that can cause portfolios to disappoint at the worst times.

Key Principles for Deploying a Risk Budget Effectively

01. Begin with the Beta Footprint

Leverage a robust factor model to understand the primary drivers of risk and return. This ensures exposures are intentional and appropriately scaled, rather than incidental or redundant.

02. Become Unanchored to the Past

Markets rarely repeat the same movements they did in the past. Preparation is about considering what surprises could impact markets and portfolios, not just looking at how markets reacted to perceived risks in the past.

03. Allocate Risk, Not Dollars

Dollar-weighted allocations show where money is positioned within a portfolios; risk-weighted allocations reveal where outcomes are driven. Shifting to a risk-based lens can empower advisors to diversify more meaningfully, reduce concentration risk, and align allocations with true contribution to portfolio behaviour.

04. Incorporate a Goal-Based Framework

Beyond traditional volatility, consider shortfall risk—the probability of failing to meet financial goals. This may require reducing exposure to interest rate sensitivity or equity beta, creating portfolios capable of withstanding a wider range of economic and market regimes.

Case Study: Moving from Capital Allocation to Risk Allocation

Synopsis: A balanced investor holds a traditional 60/40 portfolio (60% global equities, 40% government bonds) that appears to be diversified on paper, as they own over 1,200 equities providing exposure to large and mid-cap equities from developed markets countries around the world, complemented by over 500 government bonds of varying maturity and credit quality. They wish to maximize their spending power in retirement by seeking higher returns and by reducing the concentration risk in their portfolio so that they can decrease the likelihood of taking a large loss at an inopportune time.

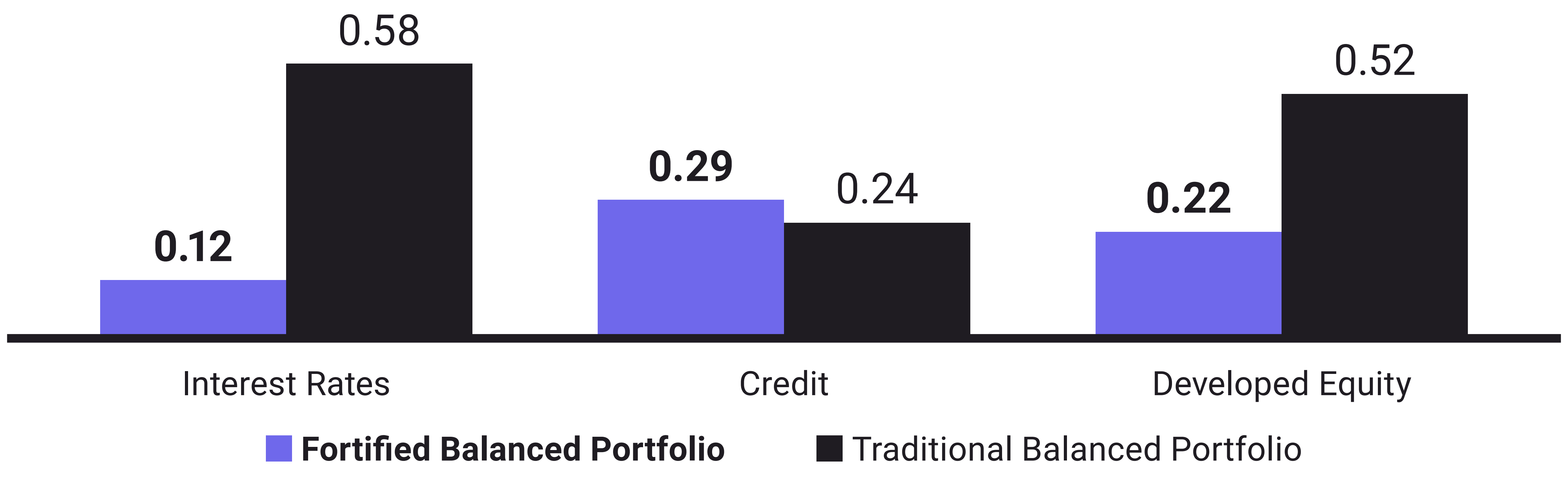
The investor decided to reallocate into the Fortified Balanced Portfolio which seeks to deliver higher returns while offering greater breadth of diversification so that returns are less dependent on the equity market and resilience is less dependent on interest rates.

This diversification of risk in a Fortified Balanced Portfolio can be less sensitive to changes in the broad equity markets and changing interest rates.

> *A balanced investor holds a* ***traditional 60/40 portfolio*** *that appears to be diversified on paper.*

FIGURE 2

Beta Exposure - Fortified Balanced Portfolio vs Traditional Balanced Portfolio



Source: Picton Mahoney Asset Management Research. Based on data from Jan 1, 2025 to May 31, 2025. Beta exposures provided above are based on a multiple regression of the items against the PMAM asset classes as indicated above. The PMAM asset classes have been constructed using a proprietary PMAM process using the return streams of the individual assets. These individual assets are represented using actual and historical performance data of the investible indices or futures contracts. When assembling the individual assets into asset classes we assume monthly rebalancing and there is no impact due to transaction costs, fees, expenses or commissions. Performance of an actual portfolio may differ significantly.

FIGURE 1

Fortified Balanced Portfolio vs. Traditional Balanced Portfolio – Asset Allocation & Risk Allocation

Fortified Balanced Portfolio	Dollar Weight	Risk Weight
Equity	**30.5%**	**53.0%**
Fixed Income	**16.5%**	**9.3%**
Alternative	**51.0%**	**37.7%**
Enhancers	14.0%	11.9%
Diversifiers	27.0%	19.5%
Inflation Protection	10.0%	6.3%
Cash	**2.0%**	**0.0%**

Traditional Balanced Portfolio	Dollar Weight	Risk Weight
Equity	**60%**	**80.4%**
Fixed Income	**40%**	**19.6%**
Alternative	-	-
Enhancers	-	-
Diversifiers	-	-
Inflation Protection	-	-
Cash	-	-

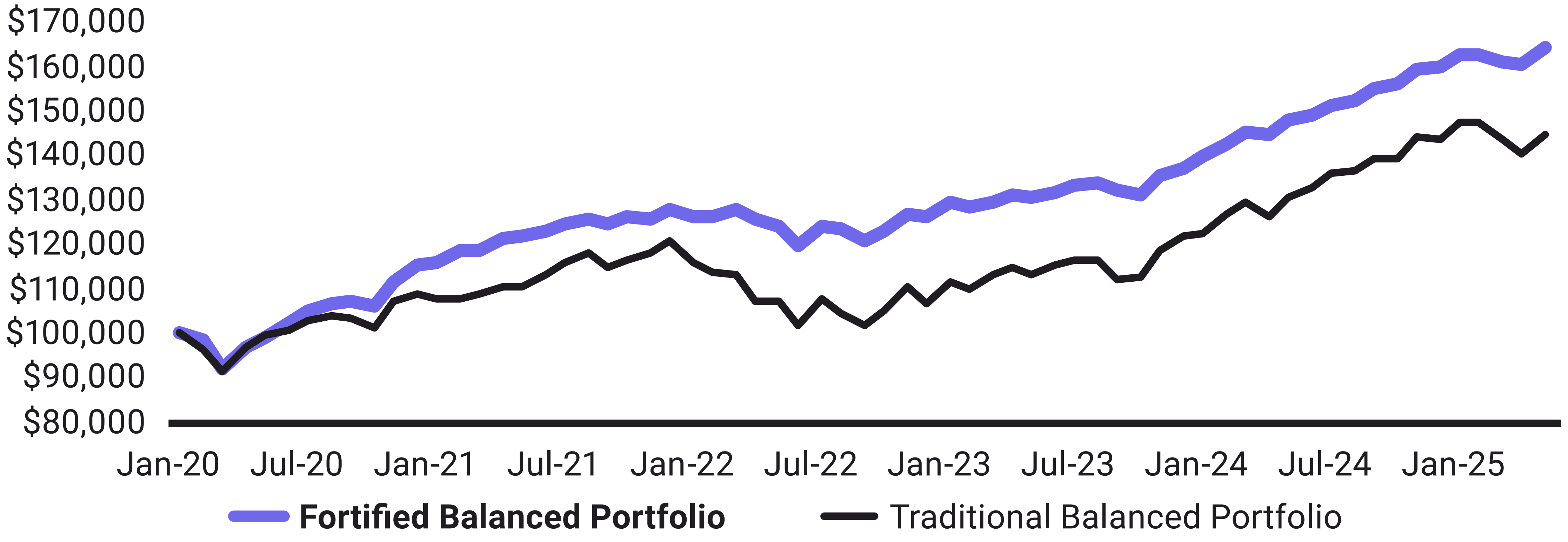
Source: Picton Mahoney Asset Management Research. As of May 31, 2025. For illustrative purposes only. Dollar weight refers to the percentage of the total portfolio value represented by a specific investment or asset class. Risk Weight is intended to measure the risk contribution to total portfolio risk (in percentage) by asset class and by holding. Generally, asset classes and holdings with higher stand-alone volatility, greater weight, or higher correlation tend to make a larger contribution to portfolio risk.

With equity risk more evenly distributed in the Fortified Balanced Portfolio, it aims to achieve better risk-adjusted returns with less volatility, while improving the risk-reward profile of the portfolio.

FIGURE 3

Fortified Balanced Portfolio vs. Traditional Balanced Portfolio Performance

Growth of C$100,000



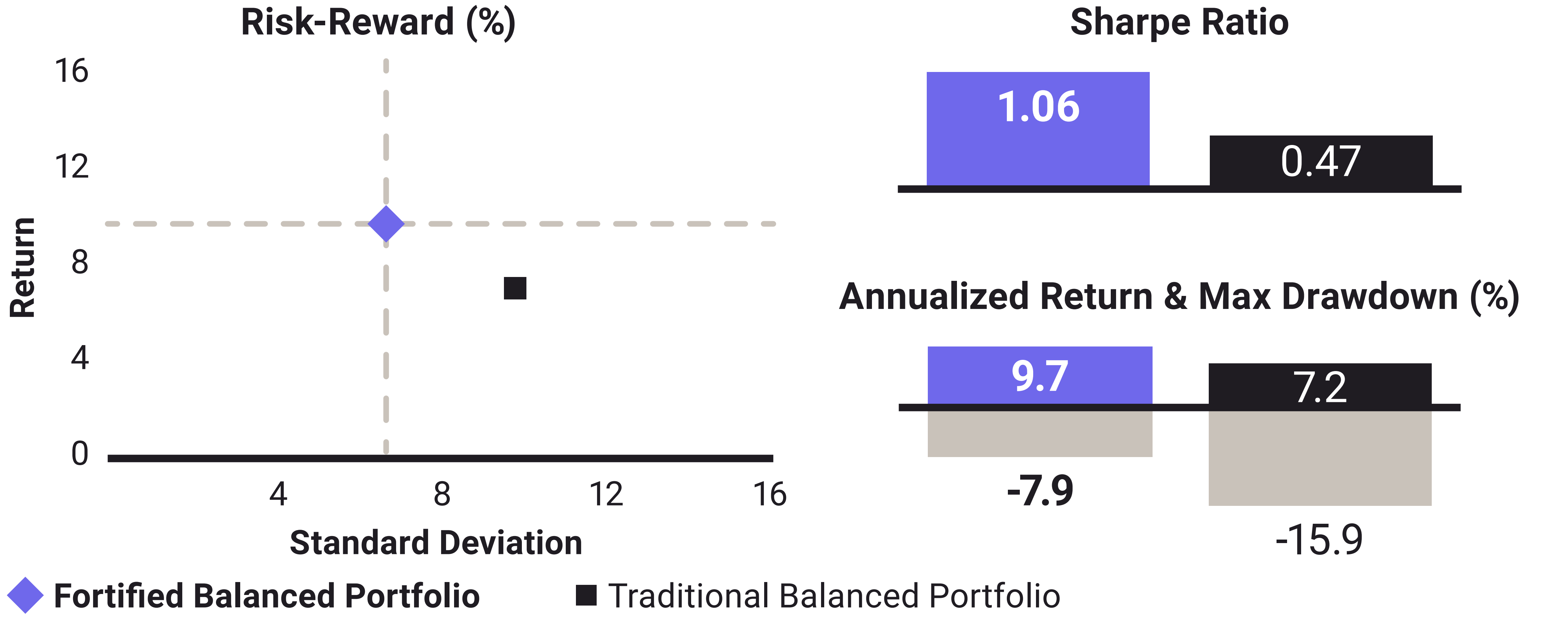
Source: Morningstar, Picton Mahoney Asset Management Research. From Jan 31, 2020 to May 31, 2025. The rate of return shown is used only to illustrate the effects of the compound growth rate and is not intended to reflect future values of the investment or returns on investment.

Trailing Returns	Fortified Balanced Portfolio	Traditional Balanced Portfolio
1 M	2.3%	3.1%
3 M	0.8%	-2.1%
YTD	2.6%	0.7%
1 Yr	11.0%	10.8%
3 Yrs	9.8%	10.5%
5 Yrs	10.6%	7.8%
Since Inception*		
Return	9.7%	7.2%
Volatility	6.7%	9.8%
Sharpe Ratio	1.06	0.47
Sortino Ratio	1.42	0.76
Max Drawndown	-7.9%	-15.9%

This diversification of risk in a ***Fortified Balanced Portfolio*** *can be less sensitive to changes in the broad equity markets and changing interest rates.*

FIGURE 4

Redistributing equity risks can provide competitive returns with less volatility



Source: Morningstar, Picton Mahoney Asset Management Research. From Jan 31, 2020 to May 31, 2025, annualized based on monthly returns.

ENHANCING VALUE: THE ROLE OF FEE BUDGETING IN PORTFOLIO OPTIMIZATION

Global Shifts in Fee Allocation

Over the past two decades, we've seen a meaningful evolution in how capital and fee budgets are allocated in a portfolio:

Two decades ago, 72% of capital was allocated into traditional long-only active funds. Today, that share has declined to 45%, while allocations to alternatives and low-cost passive strategies have risen to a combined 42%.

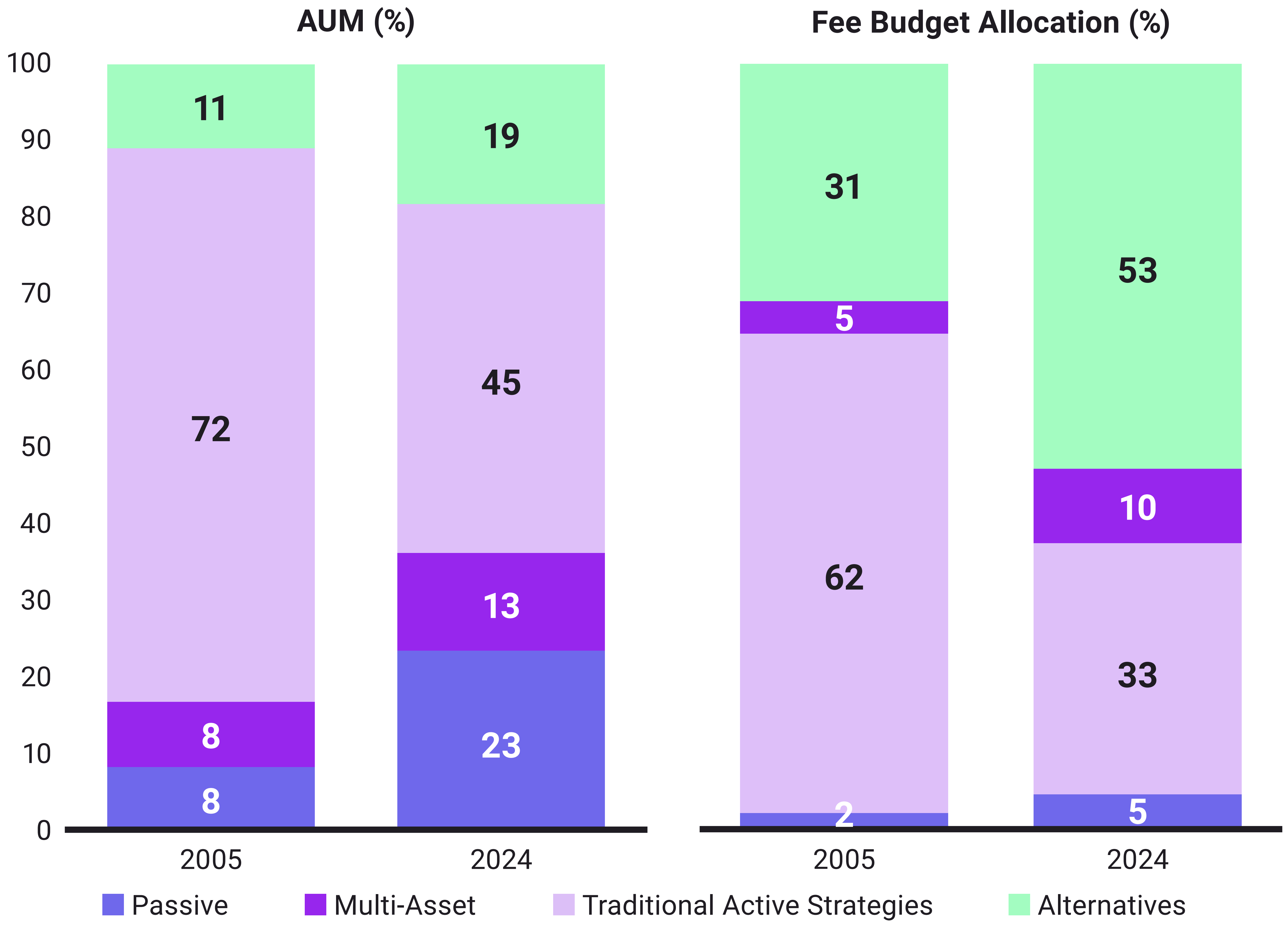
Fee allocations have shifted in parallel. Traditional active management's share of total fees has dropped from 62% to 33%, while alternatives now command 53% of the fee budget (this is based on management fees and excludes performance fees).

This trend reflects not a rejection of active management, but rather a realization that potential manager skill can be accessed at a lower overall cost by pairing high value add alternative strategies with cost-efficient market exposures.

> *Two decades ago, **72% of capital** was allocated into traditional long-only active funds. Today, that share has **declined to 45%.***

FIGURE 5

The Evolution of Capital and Fee Budget Allocations in Portfolios



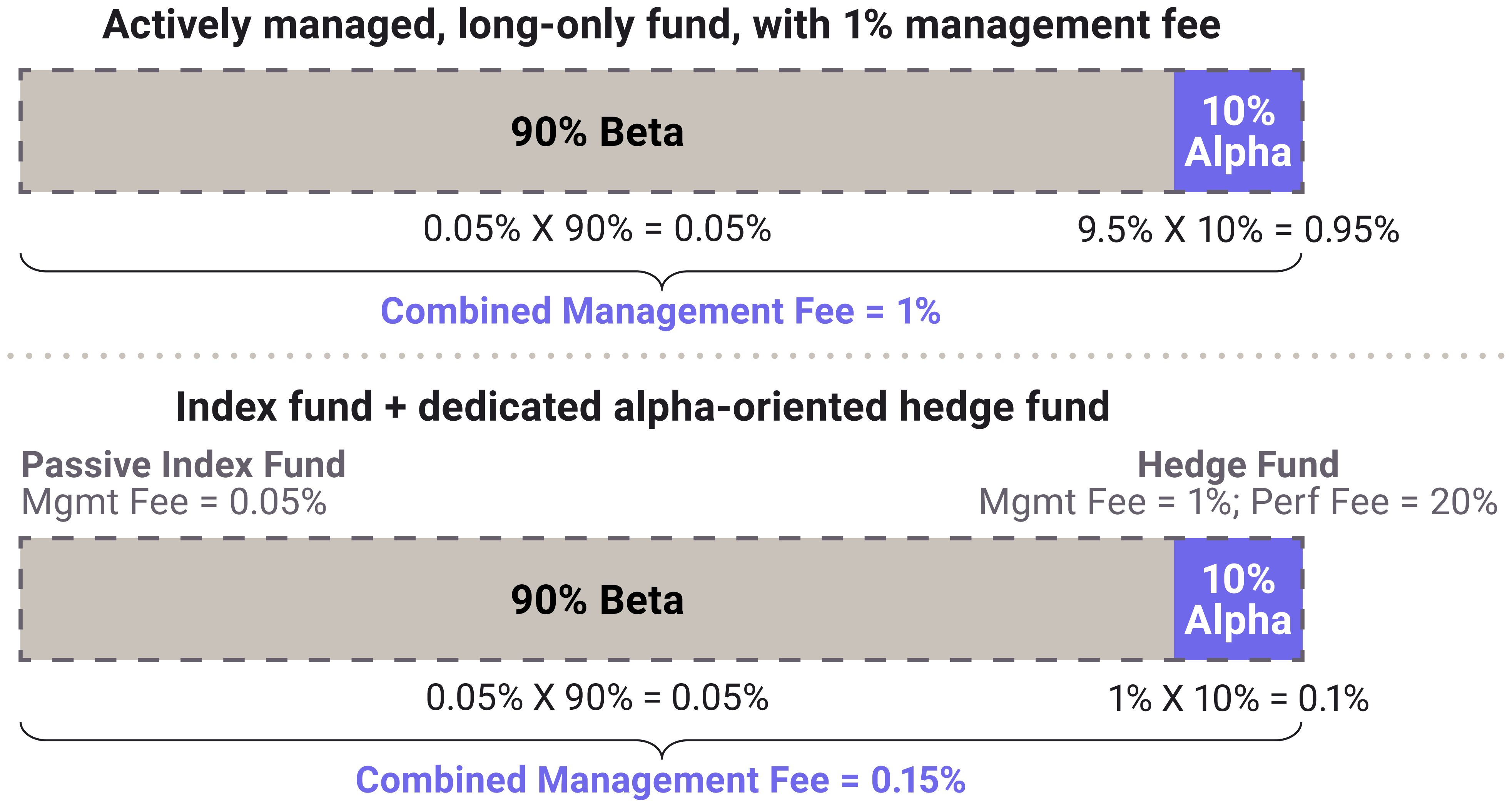
Source: Bloomberg, L.P., Picton Mahoney Asset Management Research. Jan 2005 to May 2025.

A Useful Analogy: Lessons of the Streaming Era to Investing

Just as streaming platforms have disrupted cable by offering curated, on-demand access to only the content consumers value, modern portfolio construction enables investors to "unbundle" market exposure from manager skill. In the past, a mutual fund bundled both together and charged for the whole package. Today, investors no longer are forced to access manager skill by buying a traditional long-only mutual fund and paying active fees for the entire package—even if only a small portion was worth the premium. Instead, investors can separate market exposure (via low-cost passive funds) from manager skill (via high-value alternatives), with the aim to achieve better outcomes at lower costs. It's the streaming model for investing.

FIGURE 6

Unbundling Alpha to Help Reduce Costs



Source: Picton Mahoney Asset Management Research. For illustrative purposes only.

Fee Budgeting in Action: A Comparative Example

Consider a traditional actively managed long-only equity fund charging 1% management fee. If 90% of the fund's returns come from market beta, the investor is effectively paying 95 bps for the 10% of active value—equating to a 9.5% fee on that small portion.

Now compare that to an "unbundled" allocation: 90% in a passive index ETF (with an assumption that management fee is 5 bps) and 10% in a hedge fund (with an assumption of 1% management fee). The total management fee drops by 85% to 0.15%. Even factoring in a 20% performance fee, the hedge fund would need to earn a gross return of 43.5% before total fees matched the traditional fund's 1% flat rate.

A 70/30 split still lowers management fees by 67% (to 0.33%) while tripling exposure to manager skill. Management and performance fees for this approach could only surpass the traditional actively managed fund's management fee if the hedge fund delivered more than 11.17% gross return.

As you can see, combining high value add alternatives with cost efficient market exposures can be a dominant strategy that may provide investors with meaningfully more access to manager skill at a meaningfully lower overall cost.

Looking Ahead: Strategic Asset Re-allocation

Using a budgeting framework to allocate risk and cost in a portfolio with precision can offer the compelling advantage of making a portfolio more resilient while improving value delivered relative to costs.

Equally importantly, it fosters a mindset reset that aligns portfolio construction more closely with investor goals. By deliberately allocating every unit of risk and dollar of fee spend advisors can gain a defensible, repeatable process that can adapt as their client goals market regimes and regulatory landscapes evolve.

In practice, this can be a meaningful step for advisors as they move towards a Total Portfolio Approach with the goal to deliver greater certainty in meeting their client goals while navigating tomorrow's unknowns.

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All figures provided are sourced from Bloomberg L.P. unless otherwise specified, and are based on data as at the dates indicated.

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