KANOS
CAPITAL MANAGEMENT, LLC

Kanos Capital Management

Quarterly Investor Letter

First Quarter 2025

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First Quarter Market Review

The first quarter of 2025 was one of dynamic change when the government-spending based economy of the outgoing Biden Administration transitioned to the change-heavy Trump 2.0 Administration, which moved quickly to start the transition to private economy growth through tariffs, regulatory changes and government streamlining/cost-cutting. Equally important to worldwide stock markets was the introduction of DeepSeek, produced by a Chinese artificial intelligence (AI) company and supposedly developed at a fraction of the cost and operating at a fraction of the energy needed to power current large language models used in US AI programs/apps, which caused a re-evaluation of the speed and direction of AI development, demand for datacenters and electricity, and need for expensive, high-powered semiconductors. In addition, inflation stubbornly continued to increase, while international trade ebbed, further fanning fears of stagflation and fears of slowing growth. Thus, after peaking on February 18th at 6,147.43, the Standard & Poor's (S&P) 500 Index dropped for much of the rest of February and March, resulting in a -4.3% (total return) drop for the quarter. Most bonds rose during the quarter, with the S&P Aggregate Bond Index gaining +2.6%. Gold bucked the trend and was up strongly during the quarter. European and Chinese stocks were the big gainers in world equity markets.

Looking Forward

Introduction

Wow – what a taxing few weeks we've been through in the financial markets. The Trump Administration 2.0 has continued its torrid pace of trying to get as much policy underway as soon as possible, with the new tariff regimes being the "biggest stick" utilized. However, as we all know by now, tariffs are being used to reshape the world trade structure, and they are being increased and decreased on the fly, adding uncertainty as bargaining leverage. As we write this in mid-April, some resolution of different trade treaties with a number of US allies appears to be near, while the situation with China, while fluid, seems to be increasingly antagonistic, unnerving equity markets and politicians alike.

We will work to interpret current financial, economic and political indicators and events to try to weave together the way we think markets are headed, with a huge caveat being any new occurrences in geopolitical events that are harder to imagine.

So, first on the tariffs. The Trump Administration, highlighted by President Trump but also prominently including Secretary of the Treasury Scott Bessent and to a lesser extent Secretary of Commerce Howard Lutnick and trade official Peter Navarro, has espoused a number of changes to the US political and economic situation that they introduced on the campaign trail.

One is that they want to "run the country for Main Street, no longer for Wall Street." This encompasses two main elements: returning more to workers than in the last few decades (financing has had lower taxes and more favorable regulatory treatment than labor since the 1980s) and "de-financializing the US," where interest rates were kept lower than in past periods, allowing the largest financial and business institutions easiest access to money, which has led to a) consolidation of industries in the largest companies and b) the huge expansion of private equity and debt industries, which are not deemed investible to 90+% of the US public.

Two, they are "watching the bond market, not the stock market." Trump famously quipped during his first term that the stock market was his "daily report card," So, most of the US public who weren't paying close attention to Trump's 2024 rhetoric and reason for victory (appealing to the common people left behind in booming financial markets and rising inflation) assumed it would be the same in his second term as well. However, with the US federal debt over $36 trillion and prior Treasury Secretary Yellen having failed to term-out much of the debt she had to refinance (rolling it into T-bills instead, leaving the government exposed to extreme interest-rate risk), Trump and Bessent are concentrating on getting interest rates as low as they can. This will allow the Treasury to sell trillions of bonds at the more favorable rates. All this means that the Trump Administration will be shaping policies, regulations and laws from Congress more to favor bond markets than in the past, at the expense of stock markets, a distinct change from the last eight years (Trump 1.0 and Biden terms).

Finally, the Administration is taking on out-of-control government spending which has been a problem for decades and has increased the national debt almost exponentially. They will do this two ways: First, cutting government spending, where the Department of Government Efficiency (DOGE), eliminates fraud and unnecessary governmental projects (and even departments), requiring fewer governmental workers. At the same time, the Administration is tackling excessive regulation to try to cut the time and expense to build and grow businesses in America. Second, raising revenue, but with a twist. Instead of raising taxes, which generally takes away from productivity, raise revenue from consumption. Thus, they will institute tariffs, which are charged during sales and may be at least partly borne by the producer (thus, not all charged to the American consumer). Taxes could in fact be cut to further incentivize growth and productivity, pushing more revenue gathering to tariffs, as we've seen with the Trump Administration's early April levying of reciprocal tariffs, which were much higher percentage-wise than the market was expecting.

These different approaches to the US economy, US financial markets, and the reordering of US-international trade flows has caused some big ripples in world financial markets, as traders, investors, politicians, economists and, of course, business people in many different industries wrestle with how these new regimes will settle out and how they can make money and be productive as new paradigms crystallize around them.

Meanwhile, the "Great Game" of world politics continues to evolve, as the US and China wrestle explicitly (tariffs, export controls, rhetoric) and covertly (influencing domestic and international players to do business with one country to the exclusion of the other, supplying arms and more to opposite sides in the Russia-Ukraine War, etc.). Meanwhile, the rest of the world has to decide if they want to pick sides, if their political makeup stays the same or changes, like the US has changed. Europe is in the midst of some turmoil politically, as the old guard players and institutions try to keep and take more power (France, Germany and others), while new, more polarized parties try to go more mainstream (AfD in Germany trying to do what Prime Minister Meloni did in Italy). These political machinations affect economic policy and thus European businesses, as well as monetary and regulatory policy. We will examine challenges facing Europe in the sections of this letter to follow.

We believe there is a lot of truth to the concept of the Fourth Turning in an approximate eighty-year cycle (or saeculum, as others have called it), where cycles happen that roughly coincide with the lifespan of a typical human being. In the parlance of generational studies by William Strauss and Neil Howe that culminated in the 2009 classic book called The Fourth Turning, western civilizations typically show roughly eighty-year cycles that can be divided into four twenty-year cycles called turnings. The fourth and last turning of each cycle typically involves political upheavals (and usually wars), many times with financial upsets included. Neil Howe identified that we are currently in a Fourth Turning, where the political, economic and business constructs of the last few decades are evolving into different-form systems, with new people, new or reformed institutions and often violent transitions to new equilibria. With that thought in mind, it is not surprising that we are seeing political, economic and financial upsets as the post-World War II period, as it reaches its end and evolves into different balances among countries, financial markets and people. Finally, these studies tell us that new equilibria have (so far) always formed, meaning the upset and confusion caused by the Fourth Turning transition will give way to more harmonious (at least for the majority of people) societal norms in the next couple of years, because 1945 (the end of World War II) + 80 years = 2025 (or so). Thus, the next 20 years should end up being much more settled, both societally and financially. We hope!

Our investment focus starts with present conditions, with an eye on history to better gauge possible future outcomes, and always trying to identify soon-to-be-important future trends that may be developing or crystallizing. Thus, we will be discussing in this letter: 1) the lessening dominance of the US dollar, but not its demise as the reserve currency, 2) the rise of trade protectionism due to national security and surety of supply chains and 3) usage of natural resources, especially energy. While we have talked about them in past Investor Letters, these themes continue to dominate our investment frameworks due to their structural importance and will impact the investments we hold. In addition, we strongly believe these companies' undervaluations compared to companies that have dominated financial markets the past few years will be recognized and rerated. We continue to evaluate our current holdings to make sure they fit possible future frameworks, making adjustments or replacing them as our point of view evolves or companies change.

Economy

We continue to be bullish on the future of the US economy, especially with the way the Trump Administration is in the process of rationalizing trade, industrial, energy and fiscal policies. We continue to be concerned that the transformation from the Biden Administration's government-led economy to the Trump restoration of corporate-led economy could lead to a painful slowdown in the US economy this year, as the negotiations of new trade agreements with the whole of the rest of the world not only takes time but has upset long-time allies who saw no reason for change (Canada being a prime example).

There continue to be so many conflicting indicators, many of which say the economy continues to grow, albeit slowly. Others point toward a slowdown, whether it's just a lull or something worse is hard to determine at this time. However, middle class workers face widespread affordability of the

American Dream, with debt levels climbing, savings being used and bankruptcies increasing, indicating lot of individuals are in trouble economically. Employment seems to be holding up, although part-time work and double job holders seem to skew those statistics to look stronger than they actually are. And manufacturing statistics have been positive, showing growth in US manufacturing since the election, as some companies immediately embrace the America First refocusing by the new Trump Administration. However, inflation, which has been quiescent in the past couple of months (with headline CPI even falling 0.1% in March), appears to have fallen only as low as 2.3-2.5%, with some analysts predicting increases later in the year. Despite the efforts of DOGE, the federal government has continued its enormous spending, where reductions are hard to get into budgets, and defense and medical services are increasing their budgets. These are a drag on the economy and don't help reduce inflation either.

The bright spot of 2023-2024 was the emergence of AI and its technological, spatial, energy and connectivity needs. Plans for 2025 continuation of capital spending on the technology and warehouse/data center elements of further AI adoption in business and commerce are nominally still growing, although there has been widespread speculation and some reports saying that at least some of the "hyperscaler" developers of AI (Microsoft, Google and a few others) have started to cut their capital budgets for some of the growth in AI development. Other negatives that appear to be looming on the horizon include credit spreads widening as weaker borrowers have to pay up to refinance and commercial real estate weakness (especially in the office sector), where more and more face refinancing and may cause revaluation downward in a larger amount of properties and thus loans, weakening the financial system, particularly regional banks.

Finally, the initial more business-friendly, law-and-order and fiscally conservative new administration led initially to a burst of growth in US business development post-election. However, the tariff drama in which negotiations for new trade agreements lead to constantly-changing tariff levels has anecdotally started to affect US business growth planning, i.e. businesses are supposedly postponing expansion decisions until a more stable tariff framework is understood and available for more accurate future business forecasting. If so, this could tip the country into a mild recession, although we think that the Administration's business friendliness will translate into business expansions as trade agreements are agreed to and signed.

Thus, for the US, the economy has so far held up, with businesses big and small trying to keep up with current tariffs until new trade agreements are signed. Hiring has generally held up, and retail sales have not been affected appreciably (so far). New capital expenditures and plant plans seem to be mixed, with many domestic companies putting new spending 'on pause' until the tariff drama resolves itself, while many international companies are already planning new facilities in the US to avoid the tariff headaches. The economy has slowed somewhat, and many pre-recession indicators have again moved to concerning levels; however, we have grown more sanguine on the chances of a recession. We think odds are still probably 50/50 we could have a mild recession later in 2025, possibly lasting into 2026, but we also think the Administration is focused on getting new agreements in place as fast as possible, trying to limit any economic damage from any slowdown in spending and/or new investment decision-making.

Europe's economies have avoided official recessions for the most part, although growth has been very slow in most western European countries. As the US continues to shy away from further support of the Ukrainian war effort, and by extension, possibly defense of western and central Europe as well (according to some European pundits), European governments have started to pivot to rearmament, which would boost European economic output but would have to be debt financed, further weakening European fiscal situations. Thus, Europe needs other sources of funds, and its long-standing overweight in US stocks in its financial and pension systems is apparently one main source starting to be used. The sell-offs in US financial markets, headlined by the tech-heavy US stocks as well as US bond and US dollar markets, are at least partially caused by European institutional selling. In addition, the need for European increases in defense and infrastructure spending has led to some ongoing rotation of investment capital out of overweighted US markets and into European financial markets, especially stock markets. This flow of funds has also helped European economies, relieving some inflationary and interest rate pressures that had been plaguing Europe since post-Covid recoveries. We don't really anticipate these flows continuing structurally more than a few months because we think the investment attractiveness in European companies is limited by excessive regulation, poor political climates and frankly, lack of innovation compared to companies in the Americas and Asia.

Japan's economy continues to grow, and interestingly, Japanese long-term bond yields continue to climb, indicating a combination of expected continued economic growth and some level of mild inflation, which of course, has been mostly absent for the past 2-3 decades, on a sustained basis. We are bullish on Japan and will be further examining their economy and possible further investments there going forward. We think Japan will be one of the winners with the US and China increasingly at odds and rapprochement harder and harder to manage.

China's economy continues to struggle, as domestic consumption continues to undershoot the government's plans and China's main savings vehicle, real estate, continues to try to find a bottom. In response, Chinese economic officials have tried to stimulate the economy with structural improvements and verbal encouragement, but so far the authorities have held off from direct stimulus, fearing an outbreak of inflation and thus, civil unrest among a populace that hasn't really recovered from the draconian Covid lockdowns. Thus, China has turned up exports to try to boost the economy, earning the ire of her trading partners, most notably the United States. As tariff negotiations continue to boil over and tariffs are raised, trade has started to dry up, forcing the Chinese to export products to other parts of the world, notably to the European Union, which most see as receiving goods planned for the US market but not going due to tariff costs reasons. We will see how the Chinese economy adjusts to lower US exports and higher shipments to Europe and other parts of Asia. We are pessimistic about how it will turn out for them in the short-term.

Emerging market economies have been slow growth for months/years and could benefit from making new trade deals in Trump's new trade paradigm. We see the developed world's need for natural resources for infrastructure and increased defense spending as further demand for suppliers of natural resources.

<u>Bottom line</u>: We see the US economy facing some headwinds but maintaining some strength and optimism that the new Administration's shakeup of international trade will benefit the US economy in the short-run through new infrastructure and industrial facilities, which will then allow the economy to grow more robustly in 2026 and onward. We are concerned that a 2025 slowdown will occur, but we don't think it will be much worse than the slowdown we've been experiencing in much of the US economy for the past couple of years. We are less certain about the rest of the developed world, which has depended on the US consumer to be the ultimate consumer of last resort. With new tariff and trade regimes being erected, we think international economies may have a harder time adjusting.

Only governmental stimuli, due to increased defense and infrastructure spending, may help them avoid more severe slowdowns.

We continue to be relatively fully invested in attractive situations with a relative margin of safety but watch economic reports carefully to make sure we keep an eye on how the economy appears to be shaping up. We see promise in the US and other high-tech oriented economies, but we also see so many statistics that show there is weakness in consumers' balance sheets and ability to live (and pay back debts). We are concerned about this dichotomy, but we think that cutting down government interference and its costs will help productivity and profitability, in both the US and worldwide economies, but only when governments step back from their more activist modus operandi of the past 10-15 years.

Equities

US equity markets have seen extreme volatility as the Trump Administration's shake-up of the world trade order combined with "headline roulette" of new and rapidly-changing tariff levels leads to increased uncertainty and hard-to-forecast profit projections. We believe these surprise announcements will calm down as trade partners reach new trade arrangements with the United States (and potentially other trade partners), cutting down uncertainties and helping analysts and traders better price future economic scenarios and thus equity price ranges.

We also think the America First campaign will lead to a lot of new development in the US, including plants, infrastructure, housing and associated businesses and services. Thus, as the US economy starts to gear up and start this development, we plan to look at more industrial, construction, infrastructure and suppliers as the US reindustrialization gets underway.

One casualty of this could be international investment in the US, especially foreign equity investments. The Trump Administration's heavy-handedness over international access to US trade and financial markets, combined with the Biden Administration's stripping Russia of its internationally held monetary reserves in 2022-23, is causing foreign holders of US equities to re-evaluate their risk of holding overweight US stocks (and bonds), their almost "default allocation" for many years as US mega-cap tech (and Treasuries) dominated world market performance. Now, with tough new US-centric actions being taken by the US Government, large pools of international capital are actively starting plan how to reduce and at least partially reallocate their overweighted US financial holdings, leading to selling of assets and selling of the dollars no longer needed for those investments.

This, combined with the still high valuations of US stocks, could lead to a consistent offering of stocks, leading to pressure on large cap US stocks which have benefitted so much over the last many years of over-allocation from both domestic and foreign investors. We believe this will have a larger effect on the largest cap stocks, which have attracted the most capital and pushed up their stock prices to very high valuations. Those stocks either with much smaller market capitalizations or not in the large popular stock indices could benefit, especially since many of these stocks are industrial or more prosaic businesses that should be boosted by the reindustrialization of America mentioned above.

One final factor affecting AI stocks and the ecosystem of infrastructure and power companies that trade based on the AI investment boom, a Chinese firm came out with a new AI engine last quarter called DeepSeek. It claimed that it was developed at a small fraction of the price of US large language models and that it can run on a large workstation and uses only a small amount of energy for queries. This caused a big stir in worldwide tech circles, and while some of the costs are thought to have been estimated too low, its appearance, effectiveness and the possibility of newer, smaller, more efficient to develop and run AI engines have caused many to re-evaluate US mega-cap tech spending on AI and its supposed monopoly on products. Part of the overvaluation of AI was due to scarcity, but the appearance of DeepSeek, along with other companies starting to offer AI chips (including Huawei in China, surprisingly), is threatening Nvidia's presumed monopoly on essential AI chips, and thus valuations throughout the AI and mega-cap tech ecosystems in general.

Thus, as we continually analyze for attractive investments, examining the US economy and world economies for sectors that are growing or have the potential for growth in the near future, we believe that industrial, infrastructure, resource and construction companies will start to look more attractive and be added or increased in Kanos's portfolios. Other industries like financials, utilities, and communications might also prove attractive. However, on a relative risk-and-return basis, we think technology, consumer discretionary, consumer staples and healthcare may not be as attractive as they have been in the recent past.

Despite recent outperformance, we think European equities are less attractive than their counterparts in other parts of the world, including the US, due to Europe's political, economic and demographic challenges. Their energy challenges, political divides and continued strong support of a weakening Ukraine all point toward trouble in European economies in the future, diminishing our enthusiasm for owning more European companies.

On the other hand, we see Japan as a place of possible further opportunity. We believe Japan will be one of the first countries to finalize new trade arrangements with the US, leading to some certainty in relations and trading patterns with the US. In addition, Japanese politics and business focus should be a good counterbalance to China for the United States, leading to more trade between the two countries, and meaning Japanese companies should be on our screens at Kanos to look for attractiveness.

Our thoughts on Japan may also extend to other East Asian countries, ex-China. If South Korea finalizes trade arrangements with the US, or Taiwan or other Southeast Asian countries do, we would think that there could be attractive companies due to their valuations and increasing focus being in the new US trade ecosystem.

As far as China is concerned, we have been a bear on Chinese equities for a while, since they have been stuck in a much slower growth "slowdown," and their equities are poorly structured for non-Chinese holders. The tariff-trade war only makes their equities less attractive in our eyes, and the possibility (albeit small) that the US puts some restrictions on US ownership of Chinese companies means there is even more risk in owning Chinese stocks.

Bottom line: The trade realignment and new US America First paradigm means focusing on companies that build, operate, expand and maintain existing and new US facilities as they should have bright futures in our opinion. Our recent focus on natural resources and essentials will be expanded to look at more industrials, infrastructure and construction/development companies to take advantage of these new opportunities as plans develop and are implemented around the US.

We also will continue to look at and add attractive non-US stocks where situations are favorable, and many valuations are very attractive.

We think high valuation stocks must continue to prove their profit projections are realistic or suffer rerating at lower prices; we continue to avoid stocks we think have inflated valuations versus their projected future profits.

Bonds

Bonds rallied during much of the first quarter as inflation statistics had moderated and economic growth seemed to be slowing. However, rates have since risen as inflation statistics have worsened marginally, and we all know that the United States must refinance a lot of Treasury debt during the next few months and years.

Treasury Secretary Bessent is a former hedge fund manager and understands markets, especially the Treasury market, very well. He and President Trump have both talked about wanting lower interest rates, especially long-term rates, and both have also de-emphasized watching certain levels of the stock market. People have speculated whether there is a "Trump Put option" in the markets, i.e. either verbal support or something more concrete if the stock market drops a certain percentage. From their ongoing rhetoric and action so far, it appears the Trump Put may be in the bond market, and at 4.50% on the 10-year Treasury, which, when exceeded in early April, Trump suspended implementation of the reciprocal tariffs, taking pressure off the bond market (and other financial markets, which recovered on the announcement). So, the market has now sensed this level of support, which may now possibly be a bottom in the bond market, at least short-term.

However, in the medium- and long-term, we are still concerned about bonds. The balancing of trade imbalances will be good for US business, but it also takes away dollars sent overseas for internationally-made products, which have historically been recycled back into Treasuries by exporting countries, supporting rates and the US dollar. The new trade rhetoric and higher tariff announcements have also been a shock to our suppliers, who are now more aware that the US could be more activist in treatment of their capital, meaning they may not recycle excess savings into US Treasuries and stocks, as they have in size in the recent past. So, this is another headwind for the refinancing of such a large amount of Treasuries currently needing to be rolled.

US high yield debt (HY) has performed well over much of the last two years as investors have treated these lower-quality bonds as equity surrogates, mirroring moves in the US equity markets. In the first quarter, HY performed slightly better than stocks, as investors felt HY bonds provided some more margin of safety than falling equities. However, we continue to be concerned about HY in the future because much of it was refinanced in the post-Covid lockdown low yield regime and is coming up for refinancing in the next couple of years at interest rates that could be 2-3 times higher than they are currently having to pay. With the US economy growing slowly and only strongly in a few sectors, we think HY could start to show weakness as liquidity gets pulled more and more into government bonds' near-insatiable need for deficit financing.

International bonds are not attractive at this point. With European countries running deficits, their need for additional deficit funding has driven yields up in lockstep with US yields. And Europe will be selling more and more bonds in the future to pay for ramped-up defense and public sector spending, leading to less attractive country fundamentals as deficit spending increases, also possibly pushing up inflation. We will not be investing in European bonds in the near future.

Japanese yields have also been rising, as the Bank of Japan continues to remove stimulus (at a snail's pace, however) as the economy strengthens slowly, but absolute yields are still the lowest in the developed world. We will continue to monitor Japanese bonds but they don't hold attractiveness for us currently.

Bottom line: Despite the Trump Administration's concentration on the bond market and their determination in keeping bond yields down, we don't see attractiveness in bonds in general, despite their role for many investors as "a port in a storm" especially if the US economy does swoon and cause equity markets to drop further during 2025. We feel other investments are better safe havens (precious metals) or stores of value (high quality, reasonably valued stocks).

Energy

Energy prices fell further during January and February as the world concentrated on China's lack of economic recovery and the drag that might create on forecasted energy demand in 2025. However, from March forward, crude oil prices have advanced, in spite of OPEC+'s announcement of the restoration of each country's prior (higher) production quotas as demand has continued to hold up.

Energy equities suffered during much of the first quarter as many hedge fund managers ran a long technology/short energy pair trade as they expected tech stocks to benefit most from a slower economy while energy was expected to suffer more due to worsening supply/demand statistics.

As energy research firm Cornerstone Analytics says in their 3/24/25 Morning Energy Update, jet fuel usage, while only 8% of total crude oil demand, tends to mirror changes in global oil usage closely, and jet fuel usage in 2025 has averaged the highest usage in history, pointing towards world demand exceeding 103 million barrels per day so far in 2025, above almost all forecasters' first quarter estimates. In addition, their preliminary March estimates show March Chinese energy usage up almost 3% from a year ago, meaning the "vaunted" Chinese slowdown does not extend to energy, and in fact, is around their forecasted economic growth, which makes sense.

Part of the concern in energy investing is the International Energy Agency (IEA) [not to be confused with the US Government's Energy Information Agency or EIA]. The IEA is Paris-based and formed in the 1980s by the Organization of Economic Development (OECD), which represents the developed nations of the world. In recent years, the IEA has seemingly let their focus/mission drift from being information providers and analysts to being government mouthpieces with an increasingly politicized message, possibly in contravention to the facts they have gathered.

In particular, the IEA has consistently for the last few months projected peak petroleum usage that will then drop off in following years, indicating that there is budding surplus in oil's supply/demand balance that will get worse in following years. These projections, widely disseminated and used by lots of governmental and non-energy businesses worldwide, point to plentiful energy and the need for falling prices.

However, the facts don't back up these recent projections. According to Cornerstone Analytics using national energy statistics from many countries, worldwide petroleum stocks are the lowest in years, far lower in 2025 than normal levels, indicating that the world's energy demand has exceeded supply (on average) for months, leading to the usage of stored inventories and leaving the world less prepared for any future shock, which should be boosting prices, not dropping them, as the IEA forecasts have done. In fact, some models put oil as much as 25% below fair value, normalizing them to comparable periods in the recent past.

In addition, there are other factors that also point to higher prices in the near future. Oil field service firms have been reporting their first quarter results, and industry spending on oil field services is supposed to drop high single digits (worldwide) and low double digits (North America) in 2025, indicating slowing drilling budgets and thus limiting future supply. In addition, the futures curve for crude oil is in backwardation for the next twelve months, in which the prompt (front) month future is more expensive than the next month, and so on for the next twelve month. Backwardation is less common than contango, in which each subsequent month's price is more expensive (indicating cost of financing and storage), and only occurs when prompt demand is higher than future demand, meaning users are willing to bid the crude oil out of storage and pay more than if they waited for the futures' delivery month. This shows current demand is higher than thought in analyst circles.

Thus, we continue to be bullish on energy, especially oil. Spending on development has slowed as prices have dropped, and the Baker Hughes domestic rig count is near multi-year lows, a concern since non-OPEC supplies, highlighted by US domestic production, has provided almost all of the growth in world oil supplies over the past few years.

Natural gas prices had been strong during 2025 as colder temperatures in the northern hemisphere led to higher demand than expected, but April has brought lower prices as LNG becomes one of the big pawns in the crosshairs of the tariff negotiations between the US and its trade partners. Tariffs specifically exclude energy products, including LNG, however, LNG may be used as a bargaining chip in tariff/trade negotiations, and as rhetoric has heating up with China, they have retaliated against US pressure by taking less LNG than previously ordered and cutting future purchases. In addition, producers have reacted to recent high prices and increased production in North America to a record 106+ bcf/day so far in April while the weather has moderated, driving down prices from recent highs. While we like natural gas long-term, we think the month-to-month machinations in natgas prices make more focused natural gas investments less attractive currently.

Bottom line: We are not deterred by lower oil prices since looking at the statistics, we think the market could adjust upward at any time. While our energy equity investments have fluctuated recently, we think energy will rebound strongly as demand statistics don't lie, and those caught short will try to buy into an increasingly tight market physically. We continue to think energy equities throughout the complex are undervalued, and we will stay with our current investments while looking at other attractive situations in the energy sector worldwide, especially as many companies pay attractive dividends.

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Currencies

The formerly invincible US dollar has dropped in value from mid-January (rallied a bit in late March) but then has resumed its slide during April. It was almost inevitable that the dollar would weaken, though. Our large trade deficit sent so many dollars overseas over the past several years that any change in the aforementioned reinvestment of these dollars into Treasuries could lead to weakness. In addition, the strength of US equity markets, especially post-Covid and post-Fed tightening, had attracted equity capital from all over the world, leading to a constant bid for dollars to buy US mega-cap tech stocks.

With the appearance of DeepSeek and the invincibility of US Tech starting to show some cracks, then mix in America First rhetoric where the Trump Administration is demanding “our way and not China’s way or you can hit the highway with your capital,” foreign holders of US assets are reallocating capital back to their homelands, requiring selling of dollar assets and then dollars, repatriating capital for increased domestic needs such as defense and public spending. Thus, we see the US dollar continuing its slow descent, as foreign holders redeploy and the Administration cheers as US exports get more competitive.

The euro has been a beneficiary of US dollar weakness, as investment flows favored euro-denominated investments after US stocks started to turn down in 2025. The euro also gained some strength due to anticipated future cuts in US interest rates during 2025, which contrasted with the narrative that the ECB would be cutting less than the Fed during the rest of 2025. The euro has also been boosted by the anticipated further economic growth caused by new fiscal expansions led by multi-year rearmament plans. Many have asked where the capital for European defense and infrastructure spending could be sourced. While they will compete with Treasuries for debt capital from around the world, European investment pools will also probably sell S&P 500 assets as well as other overweights, especially if the US continues to signal less or no defense support of countries in Europe. We don’t really think that Europe’s efforts are that dynamic; they are merely the beneficiaries of US dollar weakness and the “cleanest dirty shirt in the closet,” with weak prospects and fractured political situations that we have a hard time figuring out, much less betting on their prospects. Thus, we are not bullish the euro.

Even though we like the attractiveness of Japanese equities currently, the yen is still a battleground for many in macro markets, with huge bets on either side, with those betting on continued weakness due to the Bank of Japan’s reticence to loosen versus those thinking Japan is managing the situation well and the huge short position will have to cover at some point, driving up the yen. Without a strong opinion, we are staying out of the fray.

The Chinese renminbi/yuan is the other wildcard here. The Chinese government has been reluctant to let the currency move downward, not wanting to anger trade partners for letting the currency slide which makes their exports relatively cheaper, and they also don’t want to induce capital flight or fan any inflationary flames for the Chinese populace. With tariff bingo so focused around China currently, we don’t see getting involved in Chinese investments, much less speculating on how they will manipulate their currency, in current conditions.

<u>Bottom line</u>: We think dollar weakness will continue, hopefully at a measured pace. That being said, no other currency situations seem particularly attractive, so we will not be investing in currencies outright at this time.

Commodities

Gold has been the outright leader in commodities markets as it asserts itself as a safe haven asset and reacts to the falling dollar. It also has reacted to the tariff upsets of April, serving as a safe haven that is completely outside the arena of currencies, trade agreements and arguments between countries.

The Trump Administration's approach to trade also have a direct effect on gold. US dollars have made up the majority of foreign central banks monetary reserves for years, although gold has also been a significant component of reserves for decades. With tariff hikes being used as bargaining positions by the US on nearly all trading partners, international trust in the US as the most powerful superpower which would run monetary and trade arrangements to benefit the majority of countries has been shaken. Formerly, US trade deficits had been financed by surplus countries repatriating dollars received for goods into US Treasuries. Now large traders with the US, most notably China, is questioning whether this repatriated capital in Treasuries might be caught in the US (like Russia's overseas monetary reserves in London were taken over by Western powers in 2022-23). And it appears they have been selling Treasuries and their US dollar reserves to make sure they keep control of them, reducing their risk. What is one beneficiary? Gold – foreign central banks have been buying gold in earnest since 2022, and it is a natural beneficiary as an independent, unconnected reserve asset.

As shown in the following chart from Wolfstreet.com via Over My Shoulder's Clips That Matter April 16, 2025 edition, the dollar can vary downward in reserve amounts significantly:

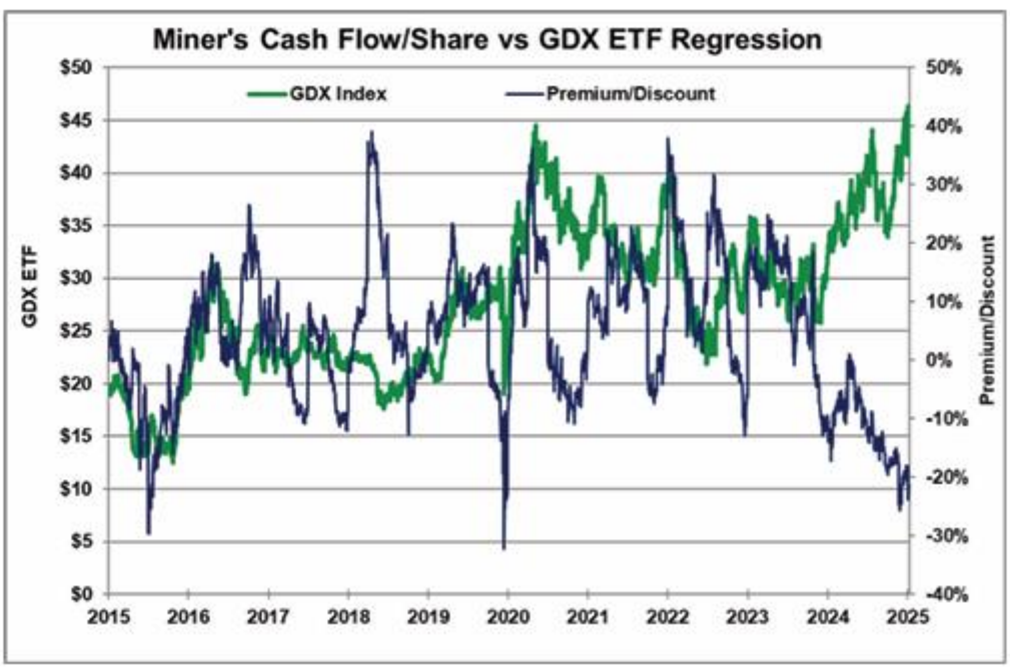
Source: Wolf Richter

The dollar dropped from 85% of global reserves in the early 1970s to about 58% last time the US had inflation / gold rose significantly. Now the dollar is back to about 58% of the reserves and will almost certainly drop in the reserve mix as the Trump Administration tries to adjust trade amounts, and resulting money flows. We see gold as continuing to be a key beneficiary of this reorganization, which is only in the first few months of a year-long or multi-year process.

In addition, we believe precious metals equities continue to be undervalued compared to the underlying gold dynamics, especially when compared to prior valuations in times of more widespread gold ownership.

In the following chart from the Golden Portfolio newsletter, April 2025 edition (goldenportfolio.com), Editor Garrett Goggin has regressed price movements of the GDX Gold Miners ETF (which is the best known and largest ETF invested in gold miner equities) versus cash flows for those mining companies. We assume that as gold prices rise (and mining companies manage their costs), gold miners' cash flows should rise, which would then cause mining share prices to rise.

The chart below shows that the GDX Gold Mining ETF has moved up in price (the green line on the right side of the chart). However, the blue line on the chart, which represents the premium or discount of the miners' Cash Flow per share has moved down, <u>or valuations on the miners are actually getting cheaper as the share prices move up.</u> Put another way, <u>profitability at the mining companies is rising faster than share prices</u>, again, saying gold miners are getting cheaper as they move up in price.

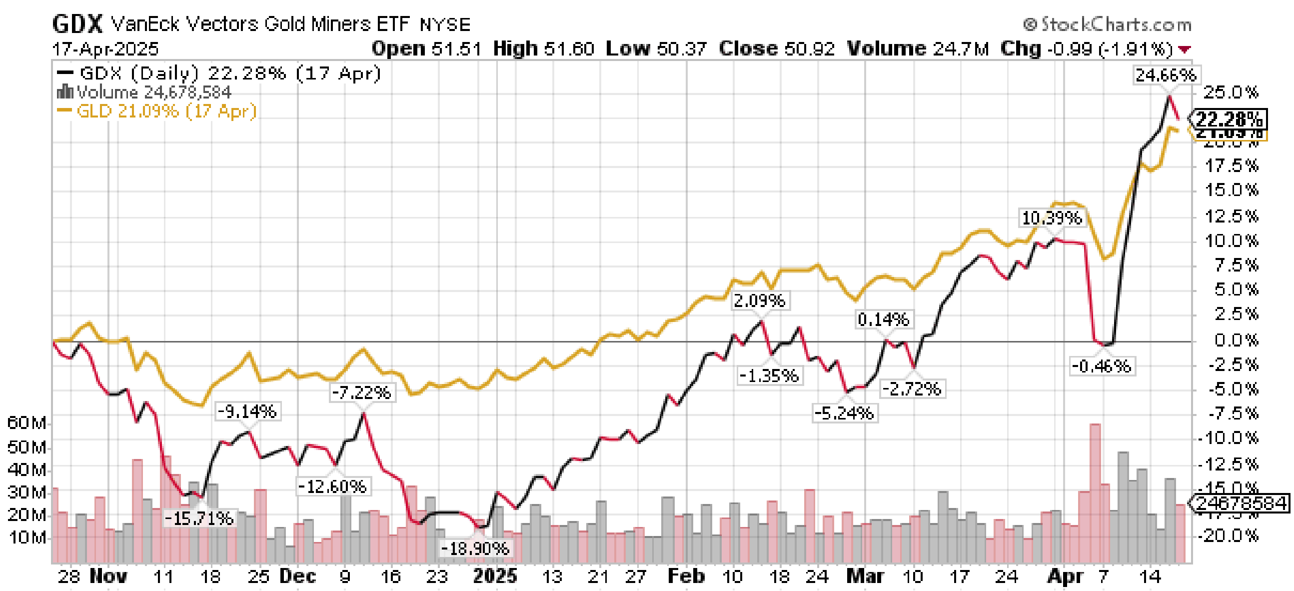


We know that one reason the gold bull market has been constant and robust in recent months is the consistent buying by central banks, most notably China but many others as well. They have been consistent, seemingly price-insensitive buyers month-in and month-out. Lately, they have been joined by international capital pool managers looking to diversify from equity and dollar investments, as is illustrated by the almost perfect negative correlation between gold prices and US dollar prices (not shown here).

Are investors in the US buying gold, and if so, how can we tell? There are a couple of ways that we think illustrate how much US or US-centric buyers are involved in the gold and gold miner trades.

First, while central banks and worldwide buyers generally buy gold bullion physically, many financial managers in the US buy gold in an ETF instead, and the biggest gold bullion ETF is the SPDR Gold Shares ETF, ticker GLD. As money moves to buy the GLD ETF, generally that money received is used to create new GLD shares, and then the cash is used to go buy bullion in a vault that backs those new shares. (If gold net sales are negative, the opposite happens – gold bullion is sold, the cash is received and given to GLD sellers when they sell). Thus, the size of the GLD ETF is a "tell" on how much interest there is in the US for gold. Currently, the GLD holds about 30 million ounces. During the last big gold boom (2011-2012), it never dropped below 38 million ounces and peaked at around 42 million. Even during Covid, the GLD ETF grew to as much as 40 million ounces for a few months during 2020. So, at 25% fewer ounces than at the last peak, there does not seem to be a financial rush into gold like in the past by US financial managers.

Second, only North American investors seem to buy mining stocks; typically, worldwide investors buy physical gold in bullions, small bar, coin or jewelry form, while many stock investors and speculators will buy gold mining shares due to their leverage to the gold price and ease of buying and selling in seconds on the stock exchanges. The following chart shows that gold miners (as represented by the GDX Gold Miners ETF) lag the gold price (as represented by the gold line, which is the GLD Gold Bullion ETF), falling more on down days and not rising back except on extreme days (like on the right side of the graph). To us, this shows that US stock buyers are only running into gold shares on big days, but letting GDX lag the GLD ETF on any given day, showing their only intermittent interest. When gold mining shares lead gold on a daily, weekly and possibly monthly basis, we'll have a better idea that the US financial market-oriented public is involved.



Interestingly, silver, another precious metal that is used in a lot of industrial uses these days, has not performed as well as gold, and lagged from its historical performance compared to gold. It's hard to know why, but our best guess is that industrial production worldwide is expected to slow (and may have already, very recently), weakening demand for silver on the industrial side with investment demand not picking up the slack. In the past, investment demand has ramped up as gold has risen in price in past bull markets. The public tends to buy silver later in bull markets because its price point is so much lower (in this case, $30/oz compared to $3,000/oz); however, that has not happened yet (again showing the public is barely involved in the precious metals bull market so far). The chart for silver looks very promising (not pictured here), but until it definitively breaks out above $34/ounce and stays above that price, it has not broken out like gold has.

In addition, copper, after rising strongly during the first quarter, has dropped significantly in price, similar to oil, as traders must think that the trade/tariff negotiations have put a damper on future business enough to hurt demand for products like copper for the present.

Agricultural commodities have not really moved much in price – they rallied in February but gave back most of the gains later that month, with March and April prices just bouncing around, without much of a catalyst or big factors moving them.

Bottom line: Up until the Liberation Day tariff announcements on April 2 and the subsequent market turmoil we continued to think the attractive valuations, increasingly attractive supply/demand characteristics of many commodity markets, and the geopolitical frictions (and added costs) of production and distribution of raw materials would push prices up, benefitting the producers and transporters of raw materials we own in our portfolios. We still think this will happen, but are less sure of the timing due to postponement of capital projects until trade agreements are signed. We obviously like our overweight in gold investments and will continue those in this environment, but we are disappointed in the postponements, so we will not be adding to more industrial commodity investments unless we see positive developments in worldwide or domestic economic activity.

Quick note: There are so many crosscurrents in the financial markets (and geopolitics) currently that we thought it would be interesting to present some different perspectives on what some industry/current situation experts see and how they see things unfolding. Thus, we are presenting three external articles in place of our usual commentary to show some of the influences we have run across that may influence our thinking. We find all three of these pieces intriguing and worthy of serious consideration.

Kanos Quarterly Commentary

Former hedge fund manager Russell Clark worked at banks and hedge funds mostly concentrating on macro strategy and trading, first in Asia and then London. He gave up his hedge fund a few years ago and switched to a macro strategy newsletter, where he writes his thoughts about macro investing and how he would like to run a new hedge fund when the market environment makes sense.

On February 17, 2025, he wrote the following commentary. It lays out a possible scenario for how the financial markets could progress in the recent future. We thought it was extremely instructive, so we are reproducing it here so that you can see how an innovative macro fund manager approaches our current setup and how he plans to manage capital in this environment.

"How I See It Playing Out
(And how I am going to play it)"

""Most hedge fund strategies are bullshit. I see reports of how it was a banner year for hedge funds - but most of them made less that the S&P 500. No denying that hedge fund managers are incentivised to pretend that is a good result - and at the end of the day, everyone has to eat. But if you are really just going to be a long investor in disguise, why not just go the way of Warren Buffett or Bill Ackman and set up a permanent capital vehicle, or go into private equity. Maybe overly harsh - but generally true...

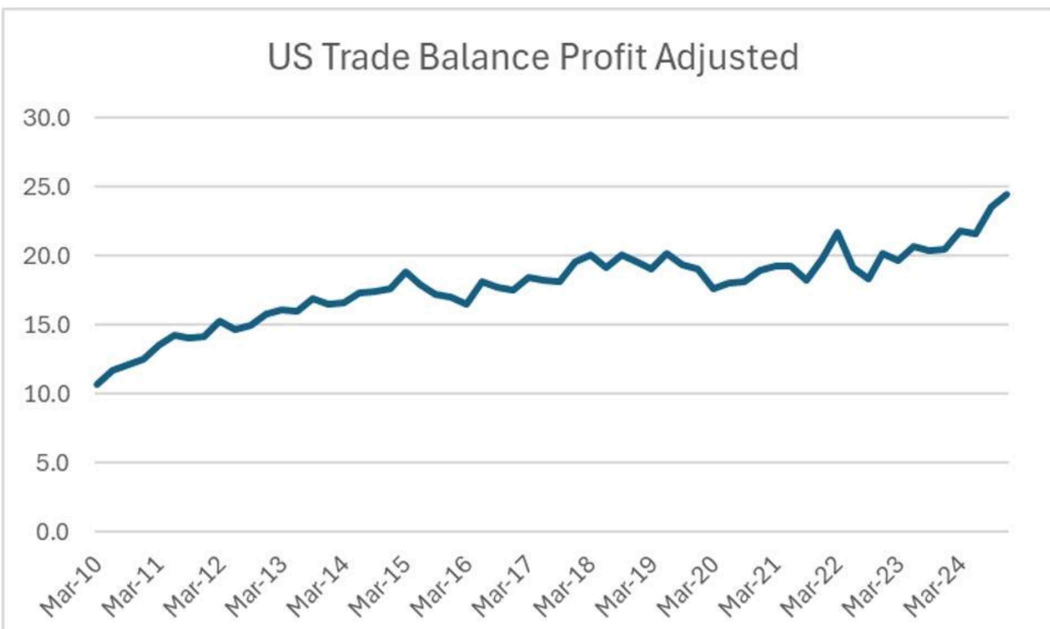
"Back in 2010, [when I started managing my former hedge fund] - China was heading for trouble, and at that time, the markets were 100% committed to China and inflation trades. Taking the other side of that trade, and explaining to allocators why China was in trouble, and how my fund would help them was the key to success.

So, what is the problem now, and how can I set up a fund that helps allocators? The obvious problem is that we are heading to a stagflationary market at some point. The US is running a 7% fiscal deficit, even with full employment, and record markets - this probably equates to 10% on a cyclical adjusted basis.

While the talk is of the US runs a trade deficit and hence has the upper hand in all trade negotiations, this is also bullshit. It is true in goods - the US runs a record deficit.

But the US is also running close to an all-time high in trade surplus in services.

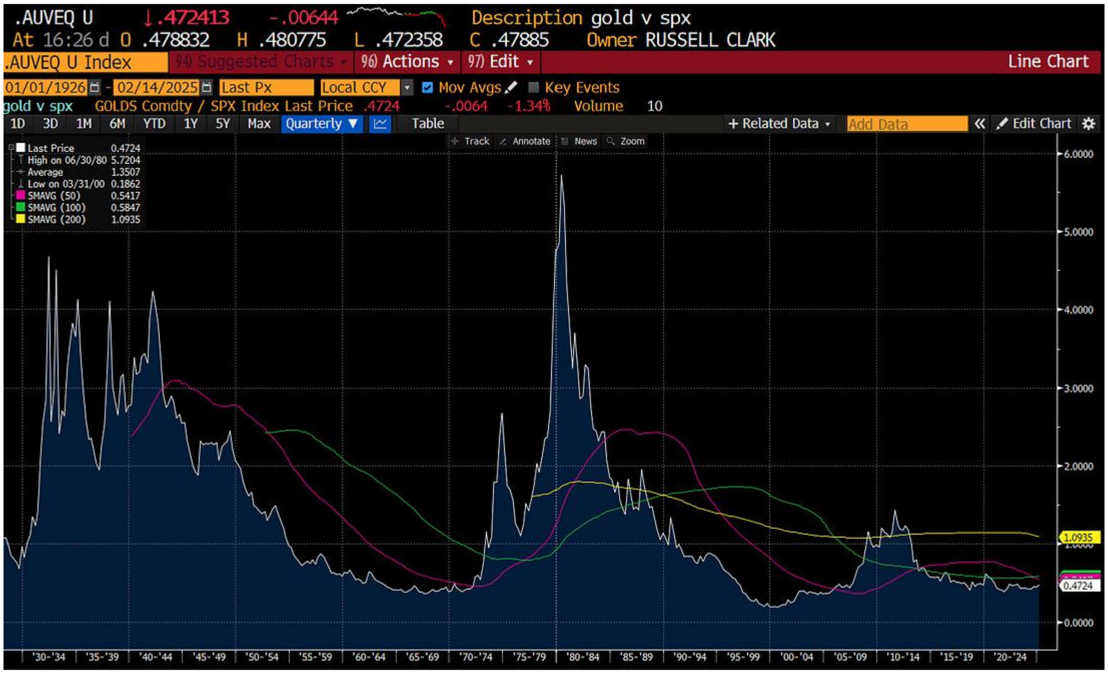
Generally speaking, most goods manufacturers would be lucky to make a 10% margin on exports, once shipping and all other costs are included in my view. However, on the service side, I think 50% margin is very likely, and potentially understating the profits. If we use these estimates for profit margins what does the "profit flow" of the US trade balance look like? New all-time highs in favour of the US - which is pretty much what the US dollar and US equities [have been] telling you.



If the US wants a tariff war to bring low margin manufacturing back to the US, then the rest of the world will more than likely use tariffs to bring high margin services back to home markets. Banking and all forms of finance could easily be reshored. Tariffs and regulations could be used to force companies to local domestically, as has already occurred. On a profit basis, the US has far more to lose. Ultimately, what I see happening is that we will slow move from a capital rich world to a capital poor world - a process that is already happening. The relative movement of gold and treasuries tells you this is happening.

The capital scarcity now seems inevitable. Tariff base policy making will lead to inefficient manufacturing being located in the US, while current service and software monopolies and cartels will come under pressure. That is US profits should come under pressure. So how to play this? First of all, I will continue to run a GLD/TLT trade [Long gold, short US long-dated Treasury bonds].

With GLD/TLT, I also like running a long gold, short S&P 500 strategy. It has been going sideways for 10 years now, when the politics first changed in 2016.



The risk is that GLD does not break away from S&P 500 - in this case, the fund will be flat. I think this is possible - maybe put a 30% chance of that. More likely, at 50% chance in my view, is that as China and Europe increase government spending in reaction to American First policy making, bond yields start rising in what has been deflationary area of the world. We also see retaliatory tariffs on US service exports - and so earnings fall in the US, even as bond yields go higher. So, gold doubles, TLT falls by half, and US equities fall by half. What causes this? Well at some point the US government prioritises its own needs over those of corporates. Current credit spreads reflect the opposite.

But In practical terms, we can already see the process of repricing capital has begun, as government needs suck capital out of the market.

As long as Japanese bond yields keep rising, this bear case on US equities seems very likely to me.

So, 30% chance that GLD/TLT keeps working and S&P 500 follows it higher, and 50% chance that GLD/TLT keeps working and S&P 500 goes lower, leaves a 20% chance for something else. What is this "something else"? I don't know - but it will be political whatever it is. Political change is in the air - a political reaction to Trump in the US - particularly if inflation accelerates is a possibility. Perhaps China sees civil unrest? Or a larger war breaks out in Europe. All are possible, and would change things - but it always best to assume the current political environment continues. The way I see if, a GLD/TLT trade combined with a Short S&P 500 trade will do nothing with a 30% chance - so you get a hedge at zero cost, or makes money with a 50% chance. And 20% chance it doesn't work because I get blindsided by politics. But as I have been through that before, I suspect I will react quicker this time! It makes sense to me, and most managers have given up even shorting. It probably seems childishly simplistic - but I am a fan of simple plans - they tend to work better."

We rarely get to hear an experienced macro hedge fund manager explain his strategies and in such a compact form. We thought it was very interesting, especially since we are effectively doing one of his trades independent of knowing his strategy: we are long gold/gold miners, and effectively are short bonds by not allocating to them – typically portfolios like ours would have a bond component. He seems sure that this GLD/TLT trade will continue, as do we, which gives us comfort.

KANOS
CAPITAL MANAGEMENT, LLC

Kanos Quarterly Commentary #2

Asia's Coming Deflationary Boom

Charles Gave is an octogenarian co-founder of the Hong Kong-based investment research and financial services firm GaveKal. He, his son and fellow co-founder Anatole Kaletsky founded the Asian-focused investment firm in 1998 after deciding Asia would be a long-term driver of global growth. Charles Gave is the dean of the firm and long-time European investment manager, researcher and author who started his career in 1970. His perspectives are interesting because they are global perspectives rooted in financial history and lots of different investment environments studied (and lived) by Mr. Gave. One of his latest pieces, reproduced here, is a very interesting prediction of how monetary systems may change in the near future. We have not seen this perspective before, and we have to pay attention to the implications of these predictions possibly occurring.

Asia's Coming Deflationary Boom

By Charles Gave, Gavekal | March 21, 2025

In my research, I try to concentrate on known knowns. Known unknowns and unknown unknowns are too difficult for my limited intelligence. In this spirit, I can identify two crucial known knowns about how the world has changed in recent years, which must be incorporated into all tools used to make future investment decisions.

1. The US dollar has lost its monopoly for pricing and trading energy. The consequence is simple: central banks around the world used to accumulate massive foreign exchange reserves in US dollars, not to buy US products, but to buy energy. These US dollar reserves are now useless.

2. German bunds used to be the best available reserve of value. So, central banks used to hold most of the rest of their foreign exchange reserves in bunds. However, Mario Draghi's "whatever it takes" speech in 2012 sounded the death knell for bunds as a reserve of value. Reserves held in bunds are now also useless.

Ricardo's return

My first conclusion is that any central bank which still has 60% of its reserves in US treasuries and 40% in bunds has suffered massive losses over the last few years. Hope it will ever recover its lost purchasing power is nonexistent. My second conclusion is that nobody in his right mind will continue to accumulate foreign reserves in US treasuries and bunds.

The important question is: what are the world's central banks going to do with all their useless reserves?

If the countries with excess savings, which are mostly in Asia, stop investing their surpluses in US dollars and euros, then what are they going to do with their surpluses?

The answer is that in Asia, they will make future investments not on their potential to generate US dollars or euros, but according to the return on invested capital of each individual investment.

Since the 1997-98 Asian crisis, the overriding goal of economic policy for most Asian countries was to make sure that never again would they have to go cap in hand to the IMF. This meant running perpetual current account surpluses and accumulating ever-increasing foreign exchange reserves. In turn, this required keeping their currencies massively undervalued against the US dollar.

In simple terms, the desire of Asian countries to avoid the clutches of the IMF led the region's economies to grow at well below their potential. Because they were all trying to maintain surpluses with the US and Europe, promoting trade with their neighbors took a poor back seat when it came to formulating policy.

Over the last 25 years, **David Ricardo's principle of comparative advantage has played no role at all in Asia.** Instead, the countries of the region pursued a crudely mercantilist policy. Their objective was not to acquire gold, as in the time of the gold exchange standard, but to accumulate US dollars.

Today, however, the era of accumulating US dollar reserves at all costs is over. From now on, the law of comparative advantages will rule across Asia. This implies that the region's excess savings will disappear, which in turn will lead to much higher nominal and real interest rates in the US and Europe.

Wicksell and the snake

My second conclusion is that in Asia the Wicksellian natural interest rate will rise, probably quite sharply (see Stagnation or Bust?). This means that market rates in the US and Europe are likely to go up too. And if US and European market rates do not go up, their currencies will go down—by a lot.

This shift has already started in China, where the market rate is now way below the natural rate. This almost guarantees that China has entered a deflationary boom. This deflationary boom will last as long as the price of oil remains as low as it is today. It calls for a maximum overweight position in Chinese equities—and overweight positions in other Asian markets.

Why do I believe that financial markets in the rest of Asia will follow Chinese markets rather than US markets? Simple. Over the last 15 years or so, Asian countries have established an informal currency "snake" with the renminbi as its anchor.

Another known known dictates that in any monetary system, long rates always converge towards the lowest rate in the system. This is simply because everybody borrows at the low rates to lend at the high rates.

So over time, each country in Asia which has a higher long rate than China will see its long rate converge towards the Chinese long rate. And as these countries' long rates converge towards the Chinese long rate, they will retire whatever long-dated debt they had in US dollars, and replace it with long-dated debt in renminbi (or possibly in Hong Kong dollars).

This will allow them to benefit from lower rates, lower currency volatility and easily obtained swap agreements with the People's bank of China.

And as local currency long rates decline, long-duration assets in Asian countries—real estate, growth stocks—will go through the roof.

One objection I hear is that Asia's smaller countries need US military protection from an increasingly dangerous China. My response is to point out how reliance on US military protection has worked out for Europe lately. The move by the US to retreat behind the walls of an American fortress should convince everyone in Asia to be very, very nice to China.

Hong Kong trillions

Finally, where will the capital come from to finance Asia's new boom? My answer is from the Hong Kong banking system. Part of the excess savings earned by Asia (including China) over the last few years has not been recycled back to the US, as it was formerly, given US "imperial privilege." **Instead it has been parked in Hong Kong bank deposits—which have grown by almost US$1trn in the last 10 years.** ***[emphasis ours – Kanos]***

If Hong Kong banks lend out these excess savings in Hong Kong dollars, the US authorities will no longer have any oversight over the flows, the identity of the borrowers or how the funds are used.

Conclusion

China is leading other Asian countries into a massive deflationary boom, which will see the development of what I have always called "a triple merit scenario:"

- Rising currencies
- Falling interest rates
- Rising stock markets.

The time has come to borrow in US dollars or euros to invest in Asia. It will be fun.

Kanos Quarterly Commentary #3

We have long maintained that the communist system in China cannot compete long-term with Western capitalist democracies due to the absence of the freedom to fail while maintaining a mechanism for renewal so that dreamers and entrepreneurs can continue to fail and try new ventures. We believe the Chinese communist system punishes failure and tries to homogenize its citizens. These forces tend to stifle creativity and non-traditional thinking and solutions, making Chinese society and business, and thus the political setup, risking failure on a continual basis. The rise of Xi Jinping and his purge of other power brokers, while emphasizing social and political goals to the detriment of business and societal realities, makes us think he could be setting up China for a darker period than the last 30+ years. The first article presented a bunch of reasons that this might happen in months, not years. We think this article is thought-provoking and its points and conclusions considered seriously. The following article tells of current conditions and the uncertainty that plagues Chinese export businesses right now.

2025: The CCP's 'Year Of Living Dangerously'

MONDAY, FEB 03, 2025 - 10:25 PM

Authored by James Gorrie via The Epoch Times, via Zerohedge

The 1983 film “The Year of Living Dangerously” tells the story of a journalist who faced intrigue and risk during the collapse of the Sukarno regime in Indonesia. Like [the Sukarno] regime [in the movie], the Chinese Communist Party (CCP) [today] faces significant challenges to its legitimacy and the stability of Xi Jinping’s rule in 2025.

At the core of these challenges are the erosion of public trust, deepening economic crises, internal political purges, and rising social discontent. But external factors will also damage the CCP’s credibility, not the least of which is the new Trump administration’s focus on pushing back against Beijing’s trade and foreign policies.

Erosion of Trust

In broad strokes, one of the most profound threats to the CCP’s legitimacy is the erosion of public and political trust. The Chinese people are very aware of the state’s egregious abuses on multiple fronts and are pessimistic about the future. As a result, many Chinese, particularly the younger generation, are feeling alienated. This is partly because the Party has strengthened its control over nearly every aspect of Chinese society, at great expense to public opinion, and partly due to the lack of well-paying jobs.

Beijing’s grand promise of so-called common prosperity, for example, has fallen short and revealed itself to be a wealth and power grab by the CCP. This erosion of trust also extends beyond social grievances and into the investment community. Investors' loss of confidence in the CCP's ability to reverse the economic decline and lead the country back to prosperity helps explain record levels of capital flight from China. Even global investment funds are avoiding Chinese bonds.

These financial events indicate serious long-term concerns about the sustainability of China's financial system.

The erosion of trust is a critical challenge because the CCP's legitimacy has always rested on its ability to provide economic growth and stability. Fewer Chinese believe that the CCP can do that. Hence, the trend of discontent isn't new, but it is rising.

A Slew of Economic Crises

China's deepening economic crises also weaken the CCP's grip on power. Once lauded for lifting millions out of poverty, Beijing's policies are the direct cause of China's ongoing economic collapse. As noted, good jobs for young, educated Chinese are disappearing, and youth unemployment (ages 16–24) is at an all-time high. But that's just a symptom of a deeper malaise.

The real estate sector, which has accounted for more than 30 percent of GDP, has been imploding for years and continues to do so. This has led to job losses and financial ruin for millions. At the same time, income and wages are down, making housing unaffordable.

What's more, state-owned enterprises make up an estimated 28 percent of GDP and are mired in inefficiency and corruption. These and other economic obstacles have crushed consumer confidence and spending, causing stagnation and deflation in the domestic economy and slowing growth to its lowest levels in decades.

Compounding these internal crises is the growing capital outflow from China. Billions of dollars are leaving the country each month, driven by both Chinese elites and ordinary citizens seeking safer havens for their wealth. This outflow signals a lack of confidence in the Chinese economy and raises serious concerns about the sustainability of China's financial system.

A weakening economy undermines the CCP's core promise of prosperity, further threatening the Party's credibility at home and abroad.

Political Purges: Strengthening Control at a Cost

Xi has consolidated his power more than any leader, even surpassing Mao Zedong. Like Mao, political purges that include the business, financial, and military spheres have become a hallmark of Xi's leadership.

However, as I noted in a previous post, they are also a source of fear, friction, and instability among even the highest officials. They are also a sign of Xi's paranoia and insecurity. While many purged officials are believed to have been genuinely corrupt, others are believed to have represented potential threats to Xi's power.

The repeating cycle of purges has created uncertainty within the Party itself, making effective governance more difficult.

Distinct but related to the purges is the aforementioned increase in the number of state-owned enterprises. As economic conditions worsened, the CCP resorted to taking over more private companies as a means of perpetuating its control over the economy and the populace. This is only accelerating the downward spiral.

Social Discontent

The social contract that secured the CCP's legitimacy for decades—economic growth in exchange for political obedience—is unraveling. Despite its unrivaled surveillance state, social discontent is still a potent force. The grievances of the younger generation—which is deeply dissatisfied with life, their prospects, and the Party's pervasive control—are bubbling to the surface.

Consequently, a rising number of protests have erupted across the country in recent years.

Discontent within the political and military echelons is also rising. The Chinese regime has responded with increasingly harsh crackdowns and constructing hundreds of new detention centers. Doing so, however, may well undercut loyalty to Xi and his ability to govern.

External Headwinds Pose More Challenges

Given the Trump administration's determination to push back against Beijing in trade, technology, and foreign policy, the rivalry between China and the United States will intensify in 2025. Decoupling from China is a top priority for the United States, and doing so will make economic growth more difficult for the CCP in 2025 and onward. Tariffs reaching 60 percent are on the table, as well as other trade policy options.

But it isn't just the United States that wants to decouple from China. Some countries in the European Union are wary of being reliant on China and seek to limit Beijing's exports to the EU. Japan and South Korea are also cooperating to blunt Chinese trade and influence in the region and globally. The Taiwan question looms large, as does the Trump administration's declaration to take back the Panama Canal and reduce Beijing's influence there.

All of the above are but a few of the many external challenges the CCP faces in 2025, which may indeed be a pivotal year for the CCP, Xi, and the Chinese people.

China's Workers, Companies Fear Economic Crisis As Beijing Vows To 'Fight To The End' On US Tariffs

SATURDAY, APR 19, 2025 - 10:20 PM

Authored by Leo Timm via The Epoch Times via ZeroHedge

People and businesses across China are feeling the pressure as the Chinese authorities vow staunch resistance to the United States and the Trump administration's tough approach to trade and bilateral relations.

Chinese companies, workers, and industry insiders have reported being caught in a bind by the escalating U.S. tariffs, as usual orders are not coming in, and some companies are being compelled to take extreme measures.

While Chinese social media is flooded with anti-U.S. propaganda and nationalist content, posts and videos warning of mass layoffs and prolonged "vacations" offer some indication of the unease spreading throughout an export-driven economy already struggling with high unemployment, shrinking profits, and declining foreign investment.

On April 11, U.S. President Donald Trump hiked the blanket tariff on most Chinese products to 145 percent in response to the Chinese regime slapping its own 125 percent retaliatory duty on American goods the same day.

In addition, Beijing on April 14 restricted the export of seven types of rare earth products critical for high-tech and military manufacturing in the United States and other countries.

According to a White House fact sheet published on April 15, some Chinese products may now face U.S. tariffs of up to 245 percent.

Trump has cited unfair trade practices and illegal drug trafficking as reasons for imposing the levies on Chinese goods.

Washington, particularly starting with the first Trump administration, has long called out the Chinese regime for decades of distortionary and protectionist economic policies, as well as rampant industrial espionage.

Trump also criticized Beijing for failing to curb the production and export of the deadly synthetic opioid fentanyl, which often entered the United States through Mexico.

The U.S. Drug Enforcement Administration said in a December 2024 press release that more than 107,000 people died from drug overdose in 2023, with nearly 70 percent of those deaths linked to opioids such as fentanyl.

Chinese Companies Feel the Crunch

Li Meng-chü, a Taiwanese businessman, told the Chinese edition of The Epoch Times that **the heightened U.S. tariffs will force a significant number of export-oriented factories in China to scale back their businesses or close entirely.**

The owner of a factory that makes flashlights in the city of Yiwu, Zhejiang Province, told The Epoch Times that while export companies used to place three or four bulk orders with the factory a month, business has completely dried up as of late. Many workers who used to work six days a week now take three or four days off.

Li, the Taiwanese businessman, said that to his knowledge, factories in the southern Chinese province of Guangdong that produce electronics, garments, and lighting that had U.S. orders placed through to the end of the year, have now seen those orders abruptly canceled. Much stock has been left sitting in the factories.

The South China Morning Post, a Hong Kong-based English-language outlet, reported on April 10 that **some Chinese exporters have opted to surrender their cargo to the shipping companies mid-voyage rather than deal with the new tariffs.**

"**No one will buy them after the tariffs are imposed**," the publication quoted one client as saying to a Chinese exporter.

Mainland Chinese outlet Caixin reported that the port of Shanghai—normally bustling with ships—was virtually empty on the day after the United States imposed its 145 percent tariff. The outlet expects U.S.–China shipping to fall by half in the near future.

In the wake of the tariff hikes, Chinese fashion giant Shein attempted to shift some of its production out of China, but was barred from doing so by the Chinese authorities.

Shein and Temu, another Chinese online retailer, will see price hikes following the cancellation of the de minimis shipping exemption, which allows packages containing goods worth $800 or less to be imported duty-free to the United States.

The restriction is set to apply to mainland China and Hong Kong starting on May 2, affecting about 11 percent of current U.S.–China trade.

Beijing Doubles Down

On April 8, a day before the Trump administration put a 90-day pause on tariff hikes targeting scores of countries worldwide, Beijing's commerce ministry said it would "fight to the end" with the United States on trade.

The Chinese commerce ministry said China's retaliatory actions were a "completely legitimate" means of protecting national interests and "maintaining the normal international trade order."

Introducing a 28,000-word white paper on U.S.–China trade, a commerce ministry official said on April 9 that **Beijing "possesses resolute determination and a wide range of measures" to counter American tariffs and other economic and trade restrictions.**

In a regular press conference held April 10, Chinese foreign ministry spokesman Lin Jian said that Beijing "is not scared" of fighting a trade war.

Tough Times Ahead

Meanwhile, Chinese businessmen and bloggers have questioned where the Chinese Communist Party's (CCP) obstinacy and propaganda will lead them.

According to an early April report by a mainland Chinese blog called "Logistics and Supply Chain Management," a furniture factory owner in Jiangsu Province, eastern China, calculated that with all the additional fees, a tariff of just 20 percent would consume the factory's entire profit.

Liu Ming, director of an electronics factory in the Jiangsu city of Suzhou, who used a pseudonym, told the blog that while the company had a profit margin of 16 percent in 2024, "now that the tariffs have been applied, we are operating at a loss."

Posting on social media platform X, **a Chinese exporter who works with American clients said that when the tariff was still 34 percent, it was still possible to work with the raised rate, but the 125 percent tariff "amounts to wiping out Chinese workers' jobs."**

"As far as I know, nearly all U.S. importers have stopped shipments from China," he said.

A worker in Dongguan, Guangdong Province, said in an April 9 video posted to Chinese social media that with tariffs eliminating all profit margins from those exporting to the United States, factories and suppliers will be compelled to compete with each other in the domestic Chinese market.

"It's going to be a race to the bottom," he said. While not directly criticizing how the CCP handled the trade disputes, he called out Chinese netizens who "spend all day on the internet talking about fighting [the trade war] 'at all costs.'"

"I bet you'll soon find yourselves among those 'costs,'" he added.

A vlogger in Nanjing, the capital of Jiangsu Province, said earlier this month on social media that the Chinese market's ability to absorb the country's consumer products would not be enough for a significant number of workers to keep their jobs.

"**Many companies engaged in foreign trade are sure to cut production**," the vlogger said.

A finance worker in Xiamen, a coastal Chinese city in Fujian Province, warned on April 9 that the export business coming to a standstill would have far-reaching effects beyond manufacturing and logistics. "Don't quit your job, keep it if you can," she said in a social media post.

'A Series of Traps'

China expert and current affairs commentator Wang He told The Epoch Times that the CCP may not have anticipated Trump's move to pause the raft of global reciprocal tariffs he announced on April 2.

"The CCP wanted to take the opportunity to form an anti-U.S. united front" with countries around the world affected by the U.S. tariffs, only to be the odd one out in refusing to negotiate, he said. "As a result, communist China walked into a series of traps that Trump set for it."

Earlier, on April 9, while at a White House event, **Trump had expressed confidence that "China wants to make a deal." However, he added, "It's one of those things they don't know quite—they're proud people."**

Speaking on April 15 at a press briefing, White House press secretary Karoline Leavitt said that "the ball is in China's court" as far as talks go. "China needs to make a deal with us. We don't have to make a deal with them," Leavitt said, noting that she was quoting the president.

On April 17, Trump told reporters at the White House that China had contacted his administration. "I believe we're going to have a deal with China, and if we don't, we're going to have a deal anyway, because we will set a certain target, and that's going to be it," the president said.

The Managers of Kanos Capital Management