We're Going to Need a Bigger Boat – Transcript

Angeles Investments Webinar – April 11, 2025

Michael Rosen, Chief Investment Officer

Introduction (Sydney):

Hello, everyone. Thank you for joining us and welcome to the Angeles Investments webinar, "We're Going to Need a Bigger Boat," hosted by Chief Investment Officer Michael Rosen. Michael will respond to questions after his prepared remarks, so please feel free to enter your questions into the chat box during the presentation. Thanks again for joining us, and now I'll hand it over to Michael.

Michael Rosen:

Sydney, thank you so much. I appreciate that.

I hope the theme to Jaws is playing in your mind right now as we look at this image. "We're going to need a bigger boat" - I hope in this presentation I'll be able to tell you what I mean by that from an investment perspective.

Three months ago, I did a webinar called "Whirlwind" and talked about the confusion and uncertainty swirling around the world at that time. Looking back on those three months, that was a gentle breeze compared to what we are seeing today - levels of volatility and uncertainty that are really unprecedented. Let me show that to you.

The president made his announcements on tariffs on April 2nd. April 3rd and 4th saw a two-day decline in the S&P 500 of more than 10%. This was a pretty unusual two-day move. Going back to 1945, there were only a couple of instances of similar declines. This is right up there with one of the bigger declines that we've seen in the equity markets over a two-day period.

The same is true in the high yield market. High yield spreads blew out almost a full percentage point. Again, we have to go back to periods of tremendous stress - the COVID shutdown, global financial crisis, 9-11 - where we saw a similar kind of move in the markets.

The cost of insuring against a default in U.S. Treasuries has actually gone up. Now, these numbers are still pretty small, meaning the likelihood is very, very little. But it gives you a sense of what the market is thinking about the risk of sovereign defaults. Relative to Germany, Australia, and the UK, the U.S. is now seen as having a higher risk of defaulting. Again, the risk is very small, but it's just a sign that markets are reflecting the higher risks of investing in the United States now.

Regardless of what actually may happen with tariff policy - and there's obviously some uncertainty around that - earlier this week on April 9th, the president announced that he was going to delay the implementation of some of the tariffs, and the market saw a huge move upward. To put this in perspective, the more than 9% gain that we saw on April 9th was one of the biggest we've ever seen in history.

Interestingly, the other big gains all occurred during periods of tremendous economic stress, mostly in the early 1930s during the Great Depression, but also during the 2008 financial crisis and the COVID months. The column on the far right side shows you the maximum drawdown of the market over the subsequent six months following a huge increase in a single day. You can see that the markets generally continued to decline after the one-day bounce.

This is not a prediction that markets are going to continue to decline. The conditions of the Great Depression were very different than what we have today, so I would not put a lot of credence in these numbers, but it does suggest caution. The markets could very well continue to look for a bottom here following this big one-day spike.

Regardless of whether the tariff policy is implemented fully or partially or delayed or somehow modified, the level of uncertainty has increased dramatically. This index of economic uncertainty headlines, put together by three academic researchers going back 40 years, shows that this past week has seen the highest level of economic uncertainty ever in the last 40 years - even more than the COVID months when the global economy was shut down, and certainly more than previous periods like the global financial crisis, the war in Ukraine, or the 9/11 attacks.

If you think that this has been a period of heightened uncertainty, you're absolutely right. There's good academic research that shows greater economic uncertainty leads to lower economic activity. That makes sense - businesses and households tend to pull back, cut discretionary spending, and have a little bit more caution. That lower spending tends to lead to lower economic activity.

I'll come back to that in a moment, but first I want to talk about bananas. We love bananas. The average American consumes about 30 pounds of bananas per person per year. That's for every man, woman, and child in America. We love bananas - and why not? They're delicious, they're nutritious, they're great.

The problem is that we don't grow a lot of bananas in the United States. There are about 100 banana farmers in Hawaii and a handful in Florida and scattered around, but we simply cannot produce enough bananas to satisfy the 30 pounds per person per year that we want to consume.

It turns out that there's a small, poor country in South America called Ecuador that happens to be really good at growing bananas. In fact, they're very proud of their bananas, as they should be - so proud that they put it on a stamp. I don't know if you can read the fine print, but it says "Ecuador: País del Banano" -

Country of bananas. They're very proud of their bananas, and rightfully so.

We want to consume a lot of bananas. Ecuador grows a lot of bananas. And so we buy bananas from Ecuador. They give us bananas, we give them dollars. They want dollars because it turns out that we're really good at making a lot of things in America, but we're especially good at making dollars.

The reason is that we have the world reserve currency. Dollars are the world's reserve currency, meaning that all transactions around the world take place in dollars, meaning every country has to have dollars in order to transact. And we're very good at making dollars. No one can tell us how many dollars to make or when to make them. We get to decide that.

Ecuador needs dollars. We need bananas. And so we exchange - we give them dollars, they give us bananas. They take those dollars and put them back into our banks where we pay them a low rate of interest. We pay them an uncompetitive rate of interest because we can - because they have to have dollars. They can't have other currencies; they have to have their reserves in dollars in order to transact. That's what a world reserve currency means. It is an extraordinary privilege that we have, some would say an exorbitant privilege, owning the world's reserve currency.

So we get to pay a low rate of interest as they recycle those dollars back into our banks, and we get to consume as many bananas as we like. This seems like a pretty fair trade.

The problem, however, is that we run a trade deficit with Ecuador because we are buying bananas and they're not buying anything from us. Part of it is because they're a very poor country and can't really afford to buy things from us. But we run a trade deficit with Ecuador.

In no way does that mean that Ecuador is taking advantage of the United States, or abusing, or raping, or looting the United States. Not at all. We get bananas that we love. They get dollars that they need. Everyone's better off. That's why free trade is the one free lunch in economics. Everyone is better off.

In fact, every one of you runs a trade deficit with every other person that you interact with. I run a trade deficit with my barber every month. I give him money, he cuts my hair, but he doesn't buy anything back from me. He just gets my money. I get a haircut, which is great, but he's not buying anything from me. I'm running a trade deficit with my barber.

I run a trade deficit with my auto mechanic, with my gardener, with my grocer. I run a trade deficit with my children. I give them money, and I get nothing but love back. They're not buying anything from me. I run a trade deficit, a big trade deficit, with my children. They're very expensive.

I'm going a little bananas here. Apologies. This is all to say that running a trade deficit is not at all a sign of economic weakness. In fact, it is a sign of a functioning, healthy, productive economic system.

At Angeles, all of our clients run a trade deficit with us. They pay us for investment services, and all of you have a trade deficit with Angeles because we're not buying stuff back from you. Now, part of it is the fact that most of our clients are endowments and foundations and pension funds and families, and you're not really selling us anything or don't have anything to sell us. But nonetheless, you run a trade deficit with us. All of this is just sort of a silly way of suggesting that the fact that there is a trade deficit with a particular party or country or person is not a sign of economic weakness or a problem or a concern. It's again the sign of a well-functioning economy. And again, free trade is the one free lunch in economics.

The president's tariff proposals are extraordinary. The graph on the left-hand side shows you that if fully implemented, tariffs would represent about 2% of GDP. The infamous Smoot-Hawley tariffs of 1932 raised tariffs to a little over a half a percent of GDP. We've never had tariffs this high. It would represent effectively an enormous tax hike, and you see that on the graph on the right-hand side that shows tax hikes over the last 85 years or so. This would be a very, very big one.

Now, the market thinks that these tariffs will be brought down - that they will not be fully implemented as proposed, that they will be negotiated down, delayed, postponed, or modified in some way, and this impact will not be as draconian as we see here. That may very well be.

Regardless, though, of where the tariffs fall out, the uncertainty that's been created around them and their potential rise certainly means that the risks of a recession have gone up. Three months ago when I did my last webinar, I said that the odds of a recession in 2025 in the US were zero - not going to happen, the economy is too strong. I was wrong. The odds of a recession have gone up materially.

I'm still not sure that we will actually see a contraction in the economy because the economy is starting from a very strong base. Just two data points to give you a sense of just how strong the economy is: household net worth to GDP and corporate profits to GDP. These graphs over the last 50 years are near record highs. The private sector - households and corporations - are in very, very strong shape.

I could also have shown you information on the labor force. 150 million people are currently employed in the US, the most ever. Wages are up, profits are up. The economy is starting from a very strong position, so any diminution in economic activity can be pretty well handled by an economy that is starting from a strong position.

There are signs, however, that the economy is weakening a bit, even regardless of tariffs. I could show you a lot of data on housing, on manufacturing. This is credit card delinquencies over the past 12 years or so. You can see that they are rising, particularly among young people and lower income people. These are just some signals of maybe some leaks in the boat that don't necessarily mean a full-fledged recession but are signs of concern as we see the economy slow.

I want to leave you with this graph. This is a semi-log scale of the S&P 500 over the last 35 years. You can see that there have been numerous periods of substantial decline in the market. Currently, the S&P has fallen about 15% from its high. This is normal. This is what we can expect, and this is how markets function.

When we see higher uncertainty, when we see the prospects of a slowing economy and lower profits, the markets react. They adjust. Prices come down, valuations come down. And over time, companies will adapt to the new environment. Even though we may see this period of profit slowdown and price decline, companies find a way to adjust and resume profit growth, and markets resume their upward move.

Owning equities is the only way to accrete wealth over time - public equities, private equities, whatever it may be. It's the only way that wealth can grow over a long period of time, not in a quarter or a year, but over a longer period. This is a normally functioning market. Adjustments have been made, and we may not have seen the bottom for sure, but this is how things really ought to work. And we have to own equities for the long term.

So we need a bigger boat, partly because we need more ballast. Volatility is increasing, the risks of recession are going up, profits are likely to come down. But there is strength in the economy, and it's not clear to me that we actually will have a recession given how strong a position we are starting from. But a reminder: the markets have already largely adjusted, or at least partially adjusted, with a 15% decline in equities and blowout in credit spreads.

There could very well be more on the downside to come - that probably makes some sense. I'm not sure we've seen a bottom in the short term. But I think investors should not lose track of the bigger picture, and that we do have to own equities for long-term growth. Having a little bit more liquidity to take advantage of the volatility - to be able to buy when we see sharp declines and sell when there's a sharp increase, to be able to rebalance our portfolios - may be more critical today than ever before in this period of heightened volatility.

Lastly, to diversify portfolios. And this is really what I mean by "going to need a bigger boat." Those of you who've worked with us for the last decade or so know that our equity portfolios have been very narrowly crafted. We've had a big overweight to large U.S. Tech companies. Those have been the companies driving profit growth, and our portfolios have reflected that.

But I think going forward, it makes more sense for investors to have a more diversified portfolio where investments are spread across different geographies and different sectors, more broadly based to help reduce volatility and give us better returns - better risk-adjusted returns. A more diversified portfolio is really what I mean by a bigger boat.

And with that, I think I will leave it there and look forward to your questions. I appreciate very much the opportunity to speak with you.

Q&A Session

Q: There's been a good deal of focus on the bond market. What's it telling us? And where does the Fed go and how does the Fed react?

A: It is a bit of a surprise to many people that the bond market has reacted so poorly to the decline in the equity markets. Typically, we expect bonds to provide a hedge to declines in equities, so when equities fall, bond prices go up. That's not what we've seen here.

I think there are a couple of factors going on that suggest perhaps why bonds have not been a particularly good hedge to equities in the last week or so. Partly, I think this could just be an overall reduction - sort of a technical explanation of an unwinding of the basis trade where investors use treasuries as a hedge. As positions get sold, those hedges unwind and treasuries get sold. That could be part of it.

We've seen a huge decline in the value of the dollar. Part of that is an expression of concern about the viability of the US as truly a safe haven for foreign assets. That unwinding of the dollar means losses for people who have other currencies. There could be investors selling treasuries in order to buy German bunds or other foreign currencies, reflective of this risk away from the US and looking elsewhere for safe haven investments.

I think the last couple of days, the inflation data have been generally pretty positive, but inflation is still well above Fed targets. And Jay Powell has said the Fed is very likely to be cautious in moving monetary policy until it sees how things shake out - where the tariff policy moves, and exactly what happens to economic activity and inflation. As long as inflation remains elevated, I think the Fed will be very cautious in reducing interest rates.

The market expects the Fed to cut rates pretty substantially this year, at least 100 basis points. My sense is it will probably be a little bit less than that, again, unless we do have a full-blown recession and we see a big spike down in inflation. At the moment, I think the Fed will be cautious, meaning interest rates are not likely to move substantially from here until we see a big drop in inflation.

These are very unusual times in the bond market and treasuries, and I think it speaks to the need for investors to think about diversifying portfolios not just into traditional hedges, which may or may not work, but well beyond that - in terms of equities going outside the US, thinking about the value of currencies, other opportunities, and other bond markets perhaps than just the US market.

Q: What about the proposed tax cuts potentially offsetting the impact of tariffs?

A: I introduced the notion of a tariff as being a tax hike, which effectively it is. It's paid by consumers and businesses in some ratio depending on how much of the price increases get passed along to consumers. Tax hikes slow economic activity; tax cuts boost economic activity. So for sure, if we do have tax cuts coming, that could be a possible offset to tariffs.

What I would caution, though, is a couple of things that make actual tax cuts more difficult to implement. First, a lot of what's being talked about is merely an extension of the tax regime that was put in place ten years ago. If that simply gets extended, that's not a tax cut - that's just an extension of where we are today, or the avoidance of a tax hike should an agreement not be able to be reached. It's a positive development for the economy in the short run, but not necessarily an actual tax cut offsetting whatever tariffs may be imposed.

The second factor is that we are continuing to run massive deficits - $2 trillion budget deficits. Firing tens of thousands of government workers is not really going to make a big dent in that. We need much more substantial cuts in spending to be able to put a dent in that. Given these very large deficits, there's a number of politicians that will be reluctant to have a big tax cut.

In theory, yes, a big tax cut could somewhat offset the economic impact of hiking tariffs, but I think the flexibility we have to implement a big tax cut is somewhat constrained.

Q: With higher volatility, how relevant are benchmarks?

A: I think the relevance of benchmarks in the short term has been diminishing over time as we've been increasing the allocations to private investments - public benchmarks have less and less value in measuring short-term relative performance. In periods of high volatility, they're especially irrelevant for short-term performance.

I'd try to make the case of not looking and focusing or obsessing over short-term relative performance in a period of higher volatility. And again, as we've increased our private allocations in portfolios, it just becomes a lot less relevant. What matters for investors is not really relative performance, but absolute performance and our ability to achieve your goals - your goals of liquidity, your goals of capital preservation, your goals of long-term wealth accretion. That's really what matters and not whether we're above or below a benchmark in the very short term.

Q: Do you think equities will underperform in the near term given the slower economic activity?

A: There have been long periods of time where equities have not performed well. You think of the 1970s in real terms - nominal terms they did fine, but in real inflation-adjusted terms, they had negative returns. The period of the 2000s also saw negative returns in equities.

With the caveat that, of course, no one knows for sure, I still think that there is enough innovation and adaptability in our economic system to be able to continue to generate high returns for investors in equities. There are some amazing companies doing amazing things that will make our lives better, and investors will be rewarded for investing in equities.

It's impossible to predict what will happen in the very short term, but I'm confident over the long term that we will adapt and get through whatever short-term challenges and volatilities we have. I don't think investors ought to abandon equities because it may be a rough few months or even a rough year or so.

I think we have to stick to the long-term plan of owning equities to accrete wealth. And again, just a reminder: we've already seen a 15% decline. We could see a bigger decline from here, but there's already been an adjustment in equities. I really don't think this is a time to abandon that long-term strategy.

The other thing is, it's really impossible to get timing correctly, and investors are much better served with a long-term strategic plan, rebalancing to those plans as we take advantage of the volatility in markets. I also argued for diversifying portfolios - I think that makes a lot of sense as well, beyond what we've seen in the last decade.

Q: What about the dollar possibly losing its status as the world reserve currency?

A: This has enormous implications, and I do think that there are long-term moves away from the dollar, partly because various administrations have effectively weaponized the dollar, cutting countries off from access to the dollar system, making it less relevant and less attractive as a world reserve currency.

That said, there's really no prospect for another world reserve currency to replace the US dollar. The euro, which represents a very large economic block, simply does not have the internal integrity to provide that function. The Chinese renminbi, from the second largest economy in the world, is really not freely convertible and faces all the capital constraints and controls currently in place.

This will be a very long process - decades - where world central banks will look to diversify their holdings of reserves. We're already seeing some of that at the margin, but this is very, very marginal.

The implications of this accelerating would be terrible for the US. It truly is an enormous advantage to control the world's reserve currency, and anything that diminishes that advantage will be harmful over time. What it means is we get to service our debt at a lower cost of interest than we otherwise would because countries have to own and have deposits in dollars in order to transact, which means we don't have to pay a competitive rate.

The impact is very significant, and the advantage is very significant in having the world's reserve currency. I don't see that changing overnight, but over the very long term, should we continue down this path, perhaps there might be another currency that replaces the dollar, but I don't see that happening at all in the short term or even in my lifetime.

This is a very long process, but we should be appreciative of the fact that having the world's reserve currency is an enormous privilege that confers tremendous advantages to the United States.

Q: How do you see M&A activity and particularly how this affects private equity in the near term?

A: The higher levels of uncertainty in the economy will slow activity in M&A. It will mean the public markets are less open, less attractive to exits in private equity, and activity will slow. Higher economic uncertainty leads to less economic activity, including M&A opportunities.

That said, at some point, as we sort of reach the bottom and we see valuations become very attractive, companies that are in strong positions will absolutely look to take advantage of the lower valuations and acquire companies for a lot cheaper than they could have before. That's when the cycle turns and we begin to see an increase in M&A activity. Markets begin to open up, a bottom is found, and as valuations become more attractive, we see more activity.

I don't think we're quite there yet. We could be a few months away from that. But again, there's already been an adjustment in valuations, and at some point, the slowdown in M&A activity and IPOs reverses, and we start to see activity pick back up again.

Hard to know exactly when that will be, but that's the cycle that has always played out, and we should expect it going forward.

Q: Are you planning any material changes in equity allocation between US and non-US, and public and private markets?

A: We've already made some pretty significant adjustments. Our equity portfolios have been very heavily weighted to US large cap, essentially growth or tech companies, as the drivers of profits and returns in markets for the last 15 years or so.

We've already adjusted and taken the very large overweights that we've had in the US and large tech companies and created a much more diversified portfolio across sectors and across geographies - a much more balanced portfolio going forward. I suspect that will continue, at least in the near term, partly as a function of a weaker dollar, which makes non-US or non-dollar assets more valuable to dollar investors.

Part of it is I think there is some greater ability and willingness on the part of certain regions - Europe for one, China perhaps another - to engage in more fiscal stimulus for their economies. So on a relative basis, we might see better relative growth performance in those areas combined with a weaker dollar, which perhaps might make those areas more attractive to dollar investors.

It's impossible to know how long that will last or how long this view will hold. But my sense is given the volatility we see across all asset classes - equities, bonds, currencies, real assets, commodities - we are likely to just hold a much more diversified portfolio, and I think we'll be better served by doing so in the future because I really don't see this level of uncertainty and volatility coming down anytime soon.

With respect to private investments, one of the ironies is that as exits become more difficult and fundraising becomes more difficult, and big institutional investors have been overcommitted to private equities, the opportunities we are seeing in our private equity portfolios have actually gotten better. We're seeing higher quality, better expected return opportunities in private markets than we have in the past. So those that have cash to deploy will be well served with better opportunities. We remain fully committed to our program in private investing for sure, and I think we'll likely be able to generate very attractive returns for investors over the long term.

Thank you all very much for your time.

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