Eleon Capital Management Ltd.

- MARKET OUTLOOK -

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Economic Outlook Commentary

The topic of tariffs currently dominates the concerns of most investors. Many agree that tariffs ultimately represent a cost borne by businesses and customers. However, the ultimate outcome is far more complex, as second -, third-, and subsequent-order effects remain unclear and largely unknown. Questions abound: Will businesses or consumers shoulder the cost? How will demand be affected? Are tariffs inflationary, and if so, will the impact be a one-time occurrence or span multiple periods? What will the effect on supply chains be? If trading partners impose reciprocal tariffs, will equilibrium be maintained, albeit at higher prices? Will an inward economic focus stifle growth opportunities? Can local manufacturers eventually acquire the necessary skills to produce goods at lower costs and of acceptable quality? How might tariffs influence national wealth per capita? If one country benefits disproportionately at another's expense, will the "winner" still have markets to trade with? Could nationalism drive demand? How can the U.S. achieve a trade surplus by consuming less while expecting its trade partners to consume more? How will tariffs affect the U.S. dollar's status as a reserve currency? What if U.S. trade partners increase cooperation among themselves, trading more internally? How will this impact the U.S.'s current account and budget deficits? Lastly, how might trade wars affect foreign willingness to hold U.S. debt?

While these questions are critical, their answers remain largely unknowable.

How to Respond

Macro Level Perspective: It is essential to recognise that complex adaptive systems—such as stock markets and economies—are inherently interdependent. Small changes in one variable can create significant and, at times, unpredictable ripple effects throughout the system. Given the sheer range of outcomes with inaccurate probabilities, attempting to estimate them offers little utility for investors. It suffices to understand that, over time, even irrational events tend to "work out," especially within systems supported by adaptable and resourceful participants.

Micro Level Observations: The likelihood of businesses experiencing compressed operating margins and lower growth prospects has increased. After years of above-average margins and growth, a reversion to the mean appears likely. Businesses with strong management teams and competitive advantages through their business models or product offerings—are better positioned to navigate these unprecedented times. For instance, despite substantial subsidies to incentivise local production, challenges persist, as evidenced by Intel's struggles to manufacture locally in the U.S.

Resilience can often be found in companies with durable advantages, decent returns on capital, and capable management teams skilled in capital allocation.

Valuation Insights

Mohnish Pabrai recently noted that,: "The odds that the S&P 500 delivers over 5% per annum for the next 10–15 years? Approximates ZERO." He explained that an investor expecting to earn 10% annually by investing in Nvidia, for instance, would require its current free cash flow of approximately $60 billion to grow to $400 billion—an outcome he deems nearly impossible. This underscores the importance of sound valuation in setting future return expectations.1.

Assuming an investor's' hurdle rate is 10% per annum and that a business does not reinvest its normalised earnings, the price-to-earnings (P/E) multiple becomes a function of the expected growth rate of normalised earnings:

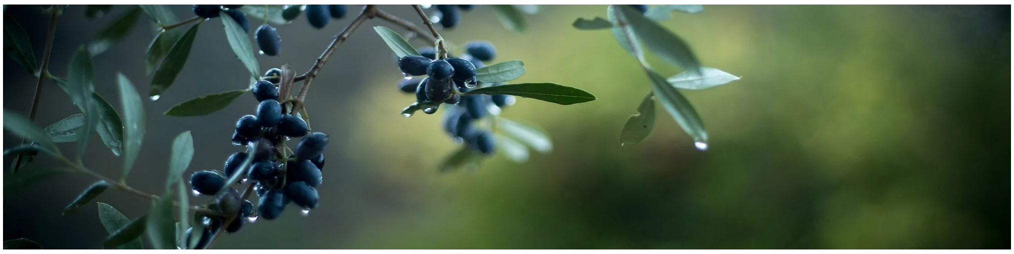
At a -5% growth rate, the P/E multiple would be ~6.

At 0% growth, the P/E would be ~10.

At a 5% growth rate, the P/E would be ~21.

If management can reinvest earnings above their opportunity cost, the P/E multiple could rise, depending on factors such as reinvestment magnitude, *return spread, cash flow timing, and reinvestment certainty.*

For an investor targeting a 10% return in the broader U.S. equity market, the S&P 500, with its current P/E of ~25, would require aggregate normalised earnings to grow faster than 5% and/or a significant portion of retained earnings to be reinvested at above the opportunity cost—with no margin of safety. Considering that tariffs are likely to act as a cost to businesses, they may suppress demand due to price increases, and make margin and growth reversion more probable, it is expected that S&P 500 returns will fall short of 10% in the foreseeable future.



Strong Roots, Sustainable Growth

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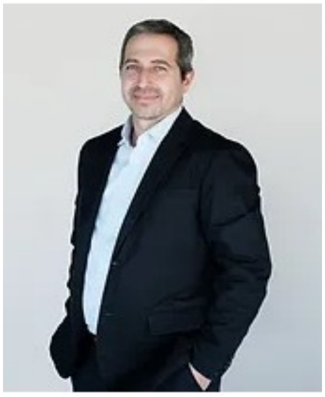
1 Arch. Makarios III Avenue
Office 801, Lakatameia,
2324,Nicosia, Cyprus



Panagiotis Ververis,
Portfolio Manager,
Eleon Capital Management

Phone: +357 22 021 634
Fax: +357 22 021 635
Email: info@eleoncapital.com
Website: www.eleoncapital.com

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