

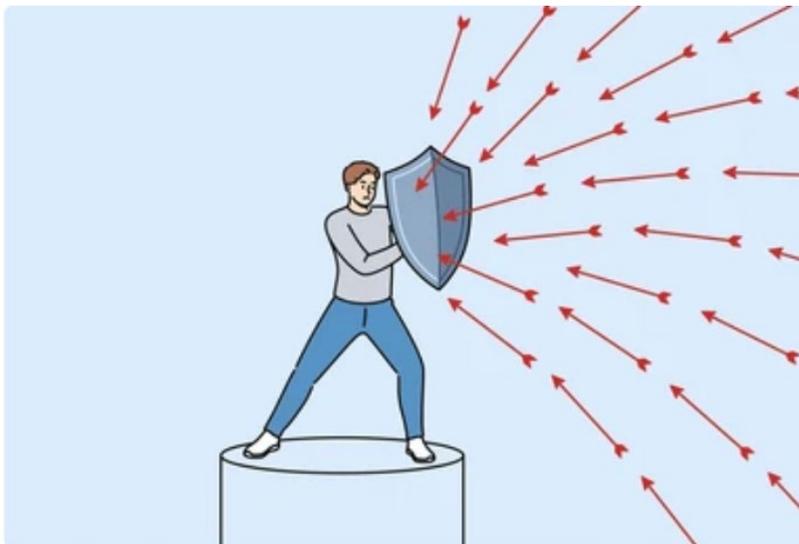


**CROFT** FINANCIAL GROUP

MACRO-ECONOMIC RESEARCH

# The Epstein Deflection

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## MID 2025 OUTLOOK

Cue the music as we pay homage to the Eagle's classic Hotel California. Where the 'dark desert highway' leads to a shimmering light cascading on an economic labyrinth that could be heaven or hell!

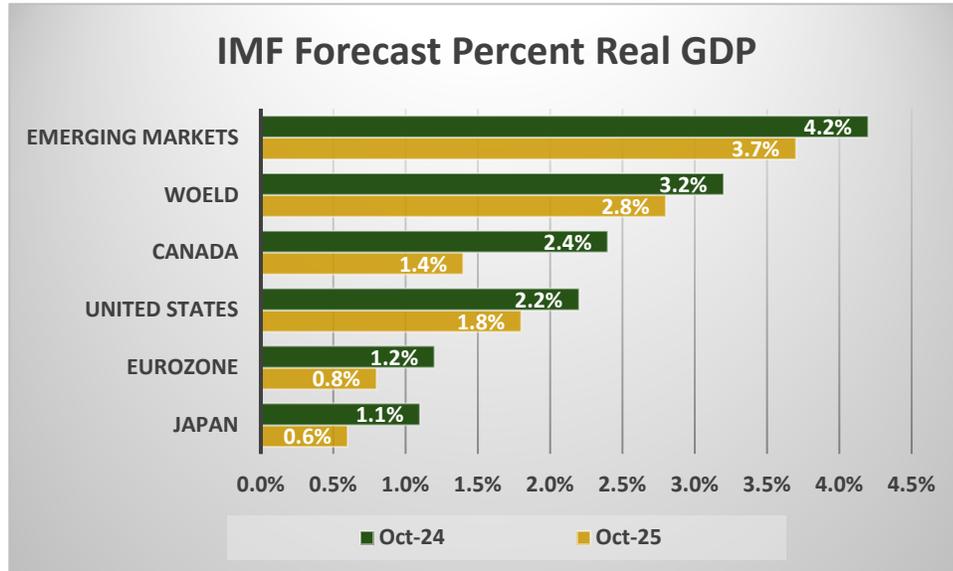
Enter the Tiffany-twisted consumer and her pretty, pretty boys dancing in the courtyard. In our own twisted way of thinking, we see economic datapoints dancing in the sweet summer sweat, some data to remember, some data to forget.

Then we come face to face with Captain Trump's fantasy filled tariff policy and giant tax and spend bill. The fantasy is that all good things come to those who wait but the Captain can't bring me my wine because "we haven't had that spirit here since nineteen sixty-nine."

Welcome to our Mid-2025 Economic Outlook where the phrase "moderate growth" is somehow both comforting and suspicious. And to provide some perspective, we will attempt to explain why your pocketbook looks at the grocery bill and thinks it is attending a high-end spa.

While there are many ways to describe world economies over the last six months, the most common theme is uncertainty. Disjointed trade policy, slowing growth and rising inflation are self-inflicted wounds. Lack of clarity has caused many companies to stop issuing forward guidance while at the same time, delaying capital expenditures and reducing headcounts.

Growth projections are declining as the International Monetary Fund (IMF) has issued downward revisions for the U.S., Canada, Europe, Japan and many emerging markets. According to the White House trade negotiations involving the U.S., Canada, Europe and China are moving forward... albeit at a pace that will not likely meet Trump's self-imposed August 1<sup>st</sup> deadline.



Most companies are retrenching because management has no certainty about where tariff rates will settle. In Trump world, trade deficits imply that the US is being treated unfairly. He wants a bigger piece of the trade pie. Unfortunately, that view flies in the face of economics 101.

Trump's vision is predicated on the view that the size of the pie is fixed. Economic theory posits the value of growing the pie. The underlying principle is that it is better to have a smaller piece of a bigger pie than a bigger piece of a smaller pie. The risk with Trump's position is that it could push world economies into a recession even if the tariff rates are ultimately lowered. Either way, it will have an impact.

Corporate management has taken the position that uncertainty is an economic data point that must be considered in much the same as we look at hard data like employment, consumer spending and business investment.

The impact on the economy is slower growth, the impact on financial markets is increased volatility. As for the market impact, markets fell sharply on Liberation Day followed by powerful rallies premised on the all too familiar pattern that maybe Trump is right.

By the end of May, the S&P 500 Index had recovered nearly all the post-Liberation Day losses as Trump extended his initial July deadline to August 1<sup>st</sup> so that his trade negotiators

could sign ninety deals in ninety days. To this point, the tally is zero deals save for a framework to engage in ongoing discussions with the UK and Vietnam.

Having said that, the data suggests that we probably reached the highest level of uncertainty when Trump released his tariff strategy on April 2<sup>nd</sup>. The Volatility index – the markets fear gauge - peaked during the first week of April (see chart). If we get some encouraging progress, it could result in a smoother ride in the second half of the year.



## Global Repositioning

According to Capital Economics, “the world is changing in ways we haven’t seen in decades. This global realignment - politically, militarily, economically - is disruptive and likely to remain so until a new order takes shape.”

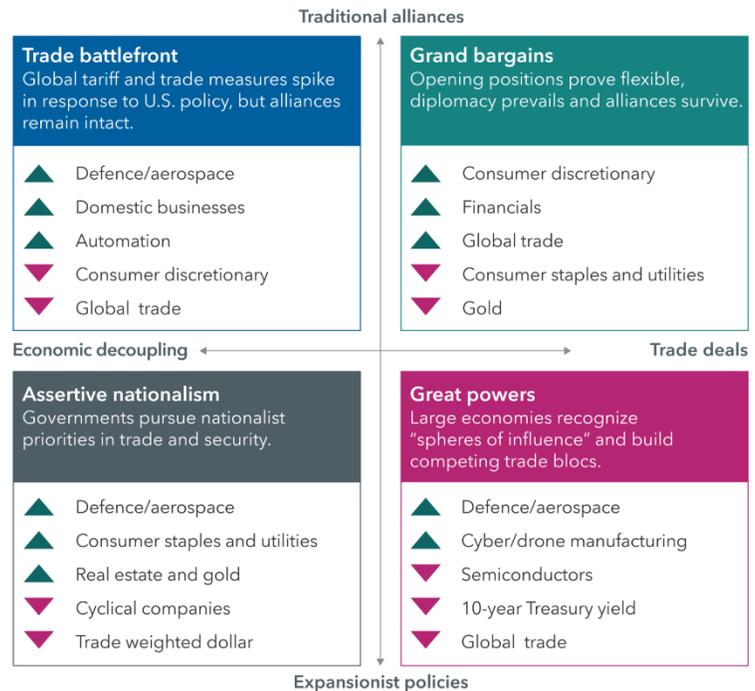
While that may be a good outcome, one thing is clear; the integrated supply chains that are the economic foundation we have relied upon for several decades, will look very different under Trump’s Presidency. Gaming potential outcomes requires economists to apply probabilities to a range of scenarios to generate an investment thesis that offers the best risk-adjusted outcome. Easier said than done!

There are four large-scale scenarios that could play out in coming years. If we enter a global trade war that shifts political alliances, it will negatively impact inflation and lower growth prospects. The so-called stagflation outcome.

If, on the other hand, new trade deals are signed quickly, it could spark a major rally. Given that US stocks are at new highs, one could argue that a series of completed trade deals is the most likely outcome envisioned by market participants. Either that, or traders have been caught up in another bout of irrational exuberance.

To add meat to this skeleton we looked at the four global realignment scenarios posited by Capital Economics with the attendant impact each would have on specific sectors of the economy.

The vertical axis illustrates a potential geopolitical shift toward traditional alliances (with an arrow pointing up) or expansionist policies (with an arrow pointing down), while the horizontal axis indicates a potential shift toward economic decoupling (with an arrow pointing left) or trade deals (with an arrow pointing right).



Pinpointing the underlying thesis is easy... it comes down to whether the Trump Administration can wrap up a series of deals in a short timeline. That's a tall order given that no deals have been finalized despite four months of intense bargaining. For good reason!

These are complex deals that must deliver win-win economic benefits (something that is foreign to Trump's view of negotiation) all within the context of meeting political imperatives.



## How will Central Banks manage any fallout?

Global central banks – notably the US Federal Reserve (FED) and the European Central Bank (ECB) – must thread a very small hole in a very small needle. Despite what Trump espouses, Americans understand that tariffs are a corporate tax that has the greatest impact on small business. Those taxes will be paid in the form of higher prices which could stifle demand and slow growth.

What percentage of the tariff is ultimately passed through to the end consumer will determine to what extent it will impact inflation. Recent data from the US Bureau of Labor Statistics has provided some evidence that inflation is starting to bite. The last two CPI reports showed a slight uptick in prices. Both reports were much better than the market was anticipating. Still, US inflation is hovering between 2.5% to 3% on an annualized basis, which is well above the FED's 2% target.

More disconcerting is that on closer examination, the cost of services, entertainment, domestic travel and gas prices held steady. However, prices for goods that were subject to tariffs such as groceries, clothing and manufactured goods rose.

The pre-buying and stockpiling that took place before the tariffs took effect likely explains why the inflation data has remained tepid. However, the FED is well within its mandate to stay the course until they examine a couple of additional data points.

The ECB has already begun cutting rates, because the European Union has had greater price stability, and is less prone to future inflationary spikes because it did not engage in the tariff whirlwind that has shocked American business.

Despite the potential for a bad outcome, we think the FED will deliver two rate cuts before year-end. Whether that has the desired impact on longer term rates – which are more sensitive to inflation data – remains to be seen.

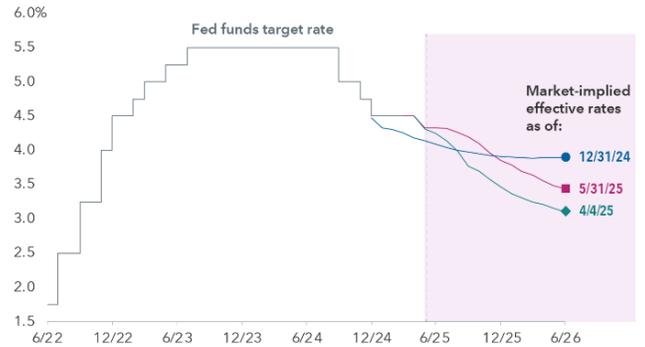
The accompanying chart illustrates the change in the Fed funds rate from June of 2022 through December 2024, and three projections of what the monthly effective federal funds rate could be based on futures pricing, extending through June 2026. Think of this chart as a picture of the so-called dot-plots based on the interest rate outlook for the Federal Open

Market Committee (FOMC). This data series shows a rate path that is more sanguine than the original dot-plots before the tariff tsunami.

We think a slowing economy with strong employment will likely limit any aggressive action from the FED. Assuming the labor markets don't have any outsized setbacks the FED can remain on the sidelines. That we could see a couple of rate cuts by the end of 2025 would represent a dovish turn but not a panic-induced change in outlook.

The U.S. Federal Reserve is expected to loosen monetary policy this summer

Federal Funds rate actual vs. market implied (%)



Sources: Capital Group, Bloomberg Index Services Ltd., U.S. Federal Reserve. Fed funds target rate reflects the upper bound of the Federal Open Markets Committee's (FOMC) target range for overnight lending among U.S. banks. As of May 31, 2025.

### Can we avoid a recession?

There is only a small risk that the US economy will slip into a recession. At least through the next three to four quarters. The bulk of economic data points to further growth through year-end. Then there is the meteoric rise in the US stock market since the April lows which indicates that investors are not expecting an immediate tariff-induced downturn.

As noted above, if the end game is a Trump induced global trade war, then the probability of a mild recession rises. But, as with all self-inflicted wounds, stepping back from the abyss will dramatically reduce the odds of a recession. Unfortunately, the end game rests on the personality of a President who sees tariffs as a critical piece of his economic puzzle.

Still, if Trump can close some trade deals that spawn a more stable environment, business leaders may start to invest in capital projects which would dial back any concerns about a recession. Otherwise, it may be difficult to convince businesses and consumers to move forward with confidence.

### THE WEAKENING GREENBACK

As of mid-2025, the US dollar has dropped over 12% against a basket of currencies that

matter (see chart of Dollar Index), More striking, the fallout in 2025 represents the sharpest decline in over 50 years.



Economists have posited several reasons for the dollar's decline. Slowing US growth, stubborn inflation and ever-changing trade policies top the list. And in many ways these factors are interrelated.

Trump's erratic trade policies that focused on countries where the US had a trade deficit likely caused the initial decline. That is not surprising because the currency market is the first to feel the initial impact of major policy shifts.

In this case, US companies imported excess supply to front-run tariffs causing the trade deficit to widen, which by extension, increases demand for foreign currencies. Since currency markets are circular in nature and a zero-sum game (what is good for one country is bad for another), increasing demand for foreign currencies reduces demand for the domestic currency which leads to currency depreciation. That said, this is likely a short-term phenomenon that will stabilize once the markets have clarity on the end game for tariffs.

When we reach the tariff end game, we will have a better understanding about how this policy shift will impact US inflation and growth which will have a more lasting impact on the trajectory of the US dollar.

The inflation / growth components are most worrisome for the FED which is why the Federal Open Market Committee (FOMC) has been reluctant to cut interest rates. If excess tariffs cause inflation to rise (something we have seen in the last two monthly reports from the US Department of Labor) in an environment where growth is slowing, the result is stagflation. That scenario limits any policy moves the FED has in its playbook. Raising rates to combat inflation will slow economic activity while lowering rates to stimulate activity will lead to higher prices. A classic catch-22!

There is also concern about the mountain of US debt. The tax and spend bill that was signed into law on July 4<sup>th</sup>, will add between US \$3 trillion and US \$8 trillion in new debt depending on which side of the political spectrum the numbers are being calculated. That is on top of the current US \$31.5 trillion in debt which eventually – no matter what additional debt numbers you choose to believe - will make interest payments on the debt the largest single expense in the US Treasury. The US debt and deficits summons up Thelma and Louise's exit scene over Dead Horse Point.

Concerns about the US debt level is likely why we have seen a surge in gold prices, strengthening foreign currencies, and increased investment in international equity markets. It also draws into question whether the US dollar will continue to be the world's reserve currency.

Leading this charge is BRICs (Brazil, Russia, India and China) which has been amassing their gold reserves in the hope they can compete with the US dollar as the world's reserve currency. This is a longer-term strategy that will not likely displace the US dollar for at least ten years. But, if the fragmented US trade policy continues to act like a leaf blowing in the wind, it could become a serious threat. Should the US dollar lose its reserve status it will have major implications for US debt levels.

That was likely why Trump threatened Brazil with the imposition of a 50% tariff. Brazil is a country with which the US has a trade surplus. The unhinged position that the tariff threat was related to the former President Jair Bolsonaro's legal woes is simply a Trump deflection. It also provides Trump with the authority to issue the proclamation by claiming it is in the national interest of the US.

## THE POWELL/EPSTEIN DEFLECTION

On July 16<sup>th</sup> Trump met with twelve Republican politicians where he revealed a draft letter that purported to fire Jerome Powell. Some of the Republicans cobbled together press briefings and demonstrating their unfettered loyalty, began telling journalists that Trump was about to fire US Federal Reserve Chairman Jerome Powell. Financial markets fell on the news only to recover the next day when Trump stated the obvious that it was "highly unlikely," he would fire the FED Chair. Fact is he has no authority to do so.



This was a classic example of how traders can benefit from the Trump TACO (Trump Always Chickens Out) trade. This is useful information for aggressive traders because we suspect there will be several opportunities over the next few weeks as Trump ramps up his deflection campaign to turn attention away from his reluctance to release the Jeffrey Epstein files.

The Epstein files have painted Trump into a corner. For his MAGA base it is the government swamp – i.e., lack of transparency - that Trump campaigned against. And it does not matter if the files have any incriminating evidence. If he is hiding the files to protect some of those in his inner circle, then in the eyes of his base, he becomes the swamp. If he releases the files and there is nothing new, he lied on the campaign trail by inciting conspiracy theories about Democrat pedophiles living on Epstein's' remote island home as a base of operation. Either way Trump loses!

Since Trump is not one to back down, this will remain a blotch on his Presidency, and he will continue to apply the same deflection tools that he learned from his mentor Roy Cohn. The draft letter was a recent example, much like his threat to revoke Rosi O'Donnell's citizenship (he has no authority to do that either), the release of his medical records that show he was diagnosed with venous insufficiency, a common condition in older adults where blood pools in the veins of the legs due to weakened valves. When was the last time we saw any medical condition related to President Trump?

That was followed by his campaign to change the name of the Washinton Commanders and Cleveland Guardians. How about suggesting that the Justice Department arrest Barrack Obama based on Tulsi Gabbard's collusion delusion. Trump likely has a team of people looking for deflections that he will hand out like candy from a Pez dispenser. It is a simple strategy; look over there... throw the press a bone and they will chase it like a dog chasing a car.

One of the more interesting deflections was the Democrat conspiracy hoax where Democrats were pushing the Epstein story to get back at the President. For some reason, conspiracies that involve Democrats continue to play well with part of his base. Albeit the percentage of his base who are buying those conspiracy theories is beginning to dwindle.



Look for more of the same with new deflections each day. Some of the deflections will involve outlandish tariff threats which will impact markets negatively and when rescinded, positively. If you are a trader, read “Trump’s TACO Trade” and follow the bouncing ball. If you are a long-term investor recognize that this is an arrow in Trump’s media manipulating quiver. More importantly, this is his game with his rules... don’t fall for it!

## THE TRUMP TACO TRADE

The term TACO was coined by Robert Armstrong a freelance columnist with the Financial Times and publisher of the newsletter “Unhedged.” Since Armstrong’s TACO reference first surfaced in his Financial Times column, it went viral and has become a popular short-term trade among individual and institutional investors.

The TACO trade refers to a recurring cycle where Trump threatens something outlandish (usually a tariff threat) with a specific date. Markets fall on the news; Trump delays or waters down the measures; and markets bounce back as investors follow the pattern.

The trend began on April 2<sup>nd</sup> (the so-called Liberation Day) when Trump announced sweeping new tariffs on all trading partners... friend or foe. Trump unveiled a cardboard menu, using grade two arithmetic, that shocked the financial markets by instituting a series of price hikes aimed at major trading partners that had a trade surplus with the US. In Trump’s warped sense of economics, US trade deficits meant that other countries were effectively taking advantage of America’s benevolence.

The global equity markets fell sharply including an 8% drop in Hong Kong’s Hang Seng index and a 9% plunge in Tokyo’s Nikkei 225. US equity markets, as measured by the S&P 500 Index, shed 760 points (representing a 13.4% decline) between April 2<sup>nd</sup> and April 8<sup>th</sup>.

Trump paused the tariffs seven days later to prevent a collapse in the US Treasury market. He told reporters that he would allow a 90-day window to negotiate trade deals and his staff enthusiastically implied that Americans would see ninety deals in ninety days! So far, Trump has signed, count’em... zero deals!

Still, two things became evident. First, the equity markets began to recover as traders began to see that Trump’s bombastic rhetoric was cannon fodder and secondly, it



reinforced the position that the financial markets are one of the few guardrails on this Presidency.

Trump is not fond of the TACO acronym as witnessed by his response when asked about it by a reporter for the New York Times. According to Trump he never chickens out but rather sees his approach as a high stakes' negotiation tactic. He went on to scold the reporter adding, "That's a nasty question." It was what followed that provided financial assurance for TACO trade enthusiasts as Trump implied that his art-of-the-deal strategy is to start with a 'ridiculously high number' and then negotiate down.

China is a case study in how well the art-of-the-deal approach works in the real world. As the US and China engaged in a tit-for-tat escalation of tariff rates, it became clear that the 'ridiculously high number' effectively amounted to a trade embargo. When Trump eventually pulled back on the 'ridiculously high tariffs,' it transitioned the TACO trade from folklore to a viable trade that could profit from this Administrations principal negotiating strategy. Analysts now believe that these recurring pullbacks have become so consistent that traders now price them into market forecasts, leading to sharp rebounds after Trump softens his stance.

The idea is to buy after Trump issues a statement about new tariffs because historically, Trump reverses course within a short period of time and the markets rebound. Which is to say, Trump is a bad poker player who will go all in on a pair of excellent hole cards only to fold before the flop.

For economists and investors, the "TACO Trade" is more than a meme. On a global level, it reflects an underlying instability in trade governance and a lack of policy clarity from the White House. From a negotiating standpoint, the TACO metaphor is Trump's unmistakable "tell" and knowing that, will make it difficult to successfully close new trade deals before his August 1<sup>st</sup> deadline. Which most likely will lead to another version of Taco Tuesday.

## BUYING INTO CONCENTRATION RISK

We have been witnessing a growing trend towards exchange traded funds (ETFs) that hold a concentrated basket of securities rather than a portfolio of securities that are properly diversified. It is not a surprising development since most of the financial industry is driven



by trend-following marketing departments rather than academically supported investment metrics.

Concentrated ETFs fit the style of retail investors seeking short term lottery style returns. The shorter the timeline, the better. Buying an ETF that manages a small basket of hot stocks – or just one stock – is more exciting than holding a passive index fund that owns every stock in the market. It is also a lot riskier.

The change is palpable. In the late nineties about 85% of stock-index funds were weighted by capitalization, where larger companies carried greater weight, in much the same way as they do in the S&P 500 Index or the S&P TSX 60 Index. By the end of 2024, only 40% of index funds were capitalization weighted. The typical index fund held 503 stocks in 1998, by the end of May 2025, the number had declined to 123 stocks.

The downsizing strategy is expanding as big investment houses are marketing a slew of new concentrated ETFs holding fewer stocks. In some cases building an ETF strategy around a single stock.

It is a strange twist from a couple of perspectives. Obviously, investors are taking more risk, but more concerning is that many do not fully understand just how much extra risk is associated in a non-diversified portfolio. Ironically, concentrated ETFs are multiplying at a time when many investors worry about the tech-heavy (i.e. magnificent seven stocks) concentration in broad based indexes like the S&P 500.

You can't dispute the mountain of academic research that supports the value proposition of proper diversification. Simply stated; attaching an ETF wrapper around a small basket of stocks doesn't make it safe.

It can also distort the investor's returns relative to market trends. The smaller the collection, the farther away from the overall market you move, leading to more extreme returns both up and down.

Historically, between 1985 and 2024, the average stock suffered at a point in time a maximum drawdown of 81%. More than half of those stocks never fully recovered. The fallout can be decimating for an investor's financial plan.



## What's driving the wave towards concentration?

Simply stated, fund managers want to earn higher fees. Whereas passive index funds charge 10 basis points or less to track a broad-based index like the S&P 500. Managers can earn 20 to 30 times that amount by managing a concentrated fund even if it is designed to track a specific index or small basket of stocks. And this is appealing to investors who want the rush that comes from chasing higher returns with greater risk.

Based on data from the Wall Street Journal (WSJ), we now have ETFs that capture the returns of heating, ventilation and air-conditioning stocks; own convertible bonds issued by companies that hold bitcoin in their corporate treasury; use borrowed money to buy already leveraged loans; follow an index of small-to-midsize uranium stocks; track the future cost of transporting crude oil by sea; and replicate the performance of Icelandic stocks.

The ultimate in concentration risk is leveraged single-stock ETFs. They typically seek to double or triple the daily performance of only one stock. (A few aim to amplify the opposite of its return each day.)

When magnificent seven funds rolled out in 2022, they jacked up the returns with positions in Apple, Microsoft or Tesla. More recently, in the search for outsized returns, investment houses have gone down the capitalization scale towards smaller more volatile stocks with a good story.

According to the WSJ, recently launched ETFs seek to double the daily returns of such tiny, hyper-risky stocks as electric-aircraft maker Archer Aviation, computing provider D-Wave Quantum, nuclear-power developer Oklo, voice-recognition company SoundHound AI and lending platform Upstart Holdings. Among this list of single-company ETFs investors have been exposed to gains of 226% and losses of 26%.

So far, this risk-based strategy constitutes less than 0.2% of total ETF assets. But their average daily trading volume has more than doubled in the past year, to nearly US \$9 billion.



We believe there are simply too many horror stories to justify exposing clients to these risks. We note for example; ETFs linked to the performance of cannabis stocks that lost more than 90% of their value between 2019 and 2023. ETFs following solar-stock indexes have fallen more than 70% at least three times. Index funds that use such factors as equal weighting (tilting toward smaller stocks) or momentum (rapid price appreciation) have suffered deeper drops than the overall market.

Nevertheless, money keeps pouring into quirkier index funds. Last year, US \$132 billion went into non-market-capitalization-weighted index funds, according to Morningstar. Another US \$25 billion flowed in during the first five months of 2025.

When you buy a narrowly focused ETF, you're making an active bet on the direction of a particular market or asset which by any definition is speculative. Unlike many other pleasures, speculation isn't illegal, immoral or even fattening. It can be educational, engaging and just plain fun...as long as the profits last!