MARKET SIGHT *LINES*

Putting Bear Case Scenarios in Focus: Investment Ideas for Times of Trouble

By Michael O'Keeffe, *Chief Investment Officer*

In our report Outlook 2025: ***Gravitational Shifts*** (report, video, webinar), we presented a more positive "bull case" scenario and a more negative "bear case" scenario, each influenced by the challenges and opportunities stemming from the power shift in Washington. Given the changes in U.S. policies and practices, some clients are optimistic about the markets, while others are concerned about the risk of economic and market troubles that these changes may trigger. We guide clients to be diversified across and within asset classes, and such an approach helps mitigate bear scenario risks. In this week's Sight|Lines, we share possible paths for our bear case scenario and some investment themes to reinforce and deepen diversification that may be helpful should one of these paths unfold.

THE TAKEAWAY: A MORE COMMON ECONOMIC DOWNTURN IS POSSIBLE, BUT WE BELIEVE THE CHANCES OF MORE SEVERE TROUBLES ARE REMOTE

We've defined five bear case paths along with corresponding investment ideas. In summary:

- Erratic shifts in government policy, poor communication, or policy errors can cause an *Erosion of Animal Spirits* and could lead to an equity market correction or a bear market.
- Foreign policy shifts, including tariffs and assertive trade policies, may unintentionally trigger a *Global Recession* and a correction or bear market.
- While inflation typically declines during a recession, persistent inflation during economic troubles could create *Sustained Stagflation* and lead to a more severe bear market.
- We've discussed the unsustainable *U.S. Fiscal Trajectory and Debt Mismanagement*, and if this trouble persists or worsens, the U.S. dollar's reserve currency status and investor confidence in U.S. debt could be at risk. This creates the risk of an economic depression and a very severe bear market. However, we see the chances of this being less than 3%.
- Some feel the new administration's actions may push the nation to the precipice of a *Constitutional Crisis*. Uncertainty, conflicts within the government, or even civil unrest could disrupt our economy and markets, risking a severe recession or depression and a deep bear market. We see the chances of this scenario as having a less than 1% chance of occurring.

IN-DEPTH: WHILE WE SEE A MORE COMMON ECONOMIC DOWNTURN AS POSSIBLE, WE BELIEVE THE CHANCES OF OUR MORE SEVERE SCENARIOS AS QUITE REMOTE

We've outlined five possible paths for our bear case scenario, listing them here with the most likely and least impactful to the least likely and most impactful. Going deeper:

- An *Erosion of Animal Spirits* can be caused by erratic shifts in or poor communication about government policy, or policy errors may trigger an equity market correction or a bear market:
  - We assign a 15% probability to this scenario.
  - Investment Considerations: Traditional asset allocation and hedged equity strategies.
- U.S. economy forecasts for this year are positive, but unintended impacts of foreign policy shifts, including tariffs and assertive trade policy, may trigger a *Global Recession* and a correction or bear market:
  - We assign a 15% probability to this scenario.
  - Investment Considerations: Traditional asset allocation and hedged equity strategies.
- During a recession, inflation normally falls. But if we have a recession while inflation persists, we risk *Sustained Stagflation*, which could well lead to a more severe bear market:
  - We believe the chances of this scenario unfolding to be less than 5%.
  - Investment Considerations: Treasury inflation-protected securities (TIPS), floating rate bonds, and real assets.
- We've discussed the challenges of our unsustainable deficits and debt. If this continues, the *U.S. Fiscal Trajectory and Debt Mismanagement* could put at risk the U.S. dollar's reserve currency status, as well as investor confidence in U.S. debt. This could lead to an economic depression and very severe bear market:
  - We believe the chances of this scenario unfolding to be less than 3%.
  - Investment Considerations: Non-dollar safe-haven currencies, high-quality short corporates, floating rate bonds, mutual funds or ETFs with exposure to precious metals or hard assets, and infrastructure investments.
- The new administration has taken bold actions, with a number being challenged in the courts. Some feel we are on the precipice of *Constitutional Crisis*. Conflicts within the government, or even civil unrest, amplifies uncertainty and could disrupt or economy and markets. If these troubles deepen, we could find ourselves in a severe recession (or depression) and a deep bear market:
  - We believe the chances of this scenario unfolding to be less than 1%.
  - Investment Considerations: Non-dollar safe-haven currencies, high-quality short corporates, floating rate bonds, mutual funds or ETFs with exposure to precious metals or other hard assets, and infrastructure investments.

CONCLUSION

In Outlook 2025: *Gravitational Shifts* (report, video, webinar) we present both a positive "bull case" and a negative "bear case" scenario, influenced by the evolving dynamics in Washington. While some of our clients are optimistic about the market outlook, others are concerned about potential risks. Although we view the chances of more severe bear case scenario paths as quite remote, it is prudent to consider investment ideas that may help.

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Alternative Investments – Alternative investments, including hedge funds, involve a high degree of risk and often engage in leveraging and other speculative investment practices that may increase the risk of investment loss. Alternative investments are not subject to the same regulatory requirements as more traditional investments and often charge high fees, which may erode performance. For instance, alternative investments can be highly illiquid due to restrictions on transfer, lockup periods, and lack of a secondary trading market and are not required to provide periodic pricing or valuation information to investors. These investments may involve complex tax structures and delays in distributing tax information. Regulations limit alternative investments to investors who satisfy eligibility requirements, such as satisfying the Accredited Investor or Qualified Purchaser requirements, and are only appropriate for investors who have the capacity to absorb a loss of some or all of their investment. Detailed information regarding the risks associated with alternative investments can be found in the private placement memorandum or offering material, which investors should read and understand before investing in any alternative investment.

Asset allocation and Diversification – Asset allocation and diversification do not ensure a profit and may not protect against loss.

Bonds – When investing in bonds and interest rate-sensitive securities, it is important to note that as interest rates rise, prices will fall.

Commodities and Futures – The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.

Hedged Equity Strategies – Hedged equity strategies involve purchasing equity in some form, as an underlying investment, and then securing a hedge to potentially offset losses connected to market risk or a security that combines these features. There is no guarantee that any such investment objective will be met, and hedged equity strategies are not suitable for all investors. Hedged equity strategies may be complex, volatile, and subject to the loss of principal. Depending on the security selected, fees and risks vary. Investors may experience different risks, such as structuring risk, liquidity risk, and interest rate risk, to name a few. Investors should carefully review the prospectus or offering material and fully understand the risks of any hedged equity strategy before investing.

International and Emerging Markets Investing – There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries.

Mutual Funds and ETFs – When investing in mutual funds and exchange traded funds (ETFs), the investment return and principal value of funds will fluctuate, and an investor's shares, when redeemed, may be worth more or less than their original cost. ETFs trade throughout the day like a stock and may trade for less than their net asset value.

Real Estate – When investing in real estate, property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies or investments.

Sector-Based Investments – Due to their narrow focus, sector-based investments typically exhibit greater volatility.

Small Company Investments – Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies.

Structured Investments – Structured investments can be an integral part of a well-diversified portfolio and an important complement to traditional investments. Recommendations of structured investments are subject to alignment of the client's investing needs with the specific features offered and the client's ability and willingness to bear the liquidity and issuer-default risks that may be associated with a particular investment. Structured investments are complex and may not be suitable for all investors.

Index Descriptions and Disclosure

The Standard & Poor's 500 index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The DJIA was invented by Charles Dow back in 1896. The MSCI EAFE index (Europe, Australasia, and the Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. VIX is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options. Indices are unmanaged, do not reflect fees or expenses, and you cannot invest directly in an index.

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