

Policy as a Catalyst for Market Divergence

In our annual letter last December, we introduced the concept of a *policy-driven market regime*, one in which government action plays a far more significant role in shaping asset price trends than in the past. Six months later, we are even more confident in this perspective. We believe that two forces, **government policy** and **artificial intelligence**, are emerging as the dominant drivers of the macroeconomic landscape, influencing corporate earnings potential and, by extension, stock prices.

Initially, we highlighted three critical policy trends: (i) deregulation, (ii) reshoring, and (iii) heightened scrutiny of government spending. Since then, we've added a fourth, and arguably the most consequential to date: tariffs. Tariffs came to the forefront in April, initially triggering a sharp market selloff, which was followed by a strong rebound as implementation was delayed and early data showed limited immediate impact on inflation and consumer spending. Yet the scale of current and proposed tariffs is striking: today, nearly 100% of U.S. imports are subject to some form of duty, with the average effective rate nearing 18%—up from just 2.3% last year and reaching levels not seen since the 1930s. Recent trade agreements with the EU and Japan have reduced uncertainty, but the base tariff rate remains around 15%—still high enough to disrupt global supply chains. Industry-specific tariffs in sectors such as steel, copper, semiconductors, pharmaceuticals, and automobiles are likely to exceed that baseline.

We have long believed that this administration views tariffs not merely as a negotiating tactic, but as an end in themselves, reflecting the belief that access to the U.S. market and military protection should come at a cost, with tariff revenue funding domestic policy priorities. A policy shift of this magnitude is bound to reshape trade patterns and the cost structure of imported goods. The critical question is not **if** there will be an impact—but **where**: who will bear the costs, and who stands to benefit?

We assess tariff risk through two primary lenses: **(i) Macroeconomic Impact**—will tariffs fuel inflation, constrain consumer spending, or compel the Federal Reserve to maintain elevated interest rates? —and **(ii) Company-Level Impact**—which businesses are positioned to benefit or suffer under this new regime? On the macroeconomic front, we believe the second half of the year, particularly the fourth quarter, will offer more definitive insights. The muted response thus far may be misleading, as the effects of significant policy shifts often take several quarters to materialize. Companies tend to delay operational adjustments until there is greater policy clarity and typically rely on pre-tariff inventories before passing on higher costs. While traditional economic models suggest that tariffs of this scale are inflationary and a drag on growth, such frameworks may have limited relevance today given the absence of recent historical precedent and the influence of multiple overlapping factors, including pro-growth legislation, ongoing deregulation, and substantial investment in artificial intelligence and energy infrastructure.

However, at the company level, the implications are already clearer. For example, domestic retailers whose business models rely on sourcing inexpensive overseas goods face existential challenges. Similarly, foreign brands dependent on the U.S. consumer but lacking domestic manufacturing presence are increasingly

vulnerable. In contrast, U.S. producers of strategic commodities and products, and exporters poised to benefit from adjusted trade flows (e.g., Boeing, LNG exporters etc.) are well-positioned to outperform.

Tariffs are only one aspect of how policy is creating market winners and losers. Consider these recent developments:

- **Crypto Regulation:** The GENIUS Act brings regulatory clarity and consumer protections to the \$220 billion U.S. stablecoin market, setting the stage for mainstream adoption. Two additional bills—the Digital Asset Market Clarity Act and the Anti-CBDC Surveillance State Act—have passed the House and await Senate action. If enacted, they would reduce legal risk for exchanges, funds, and custodians, accelerating the growth of decentralized payment systems. Reflecting this shift, the total crypto market cap has climbed from \$2.4 trillion in October 2024 to \$4 trillion today.
- **Energy and Capital-Intensive Industries:** Title IV of the newly passed H.R.1—dubbed the “One Big Beautiful Bill” by Republicans—supports fossil fuels by easing fuel economy standards, slowing the EV transition, and cutting climate research funding. Conversely, it eliminates green infrastructure funds earmarked under the CHIPS Act and withholds federal support for EV and battery innovation. At the same time, it accelerates full expensing for capital investments, allowing businesses to immediately deduct the cost of qualifying assets. This change boosts after-tax cash flows and is likely to spur M&A and faster reinvestment in domestic heavy industry.
- **Alternative Asset Managers:** According to the Wall Street Journal, a forthcoming executive order will expand access to private market investments for U.S. retirement plans. This is a long-sought win for private equity firms, granting access to the vast pool of retirement savings currently beyond their reach. For traditional asset managers, however, this could dilute revenue and intensify competition from more sophisticated private-market players.

These examples underscore a broader point: we are firmly in a regime where government policy is the key catalyst for market divergence. More than ever, investment decisions must incorporate a policy-driven framework, prioritizing alignment with emerging government priorities and avoiding exposure to assets that, while optically attractive, are structurally disadvantaged by the current policy landscape.

Agentic AI and the Do-It-For-Me Economy

In a recent memo to employees, Amazon’s CEO Andy Jassy stated: “We have strong conviction that AI agents will change how we all work and live. Think of agents as software systems that use AI to perform tasks on behalf of users or other systems. Agents let you tell them what you want (often in natural language) and do things like scour the web (and various data sources) and summarize results, engage in deep research, write code, find anomalies, highlight interesting insights, translate language and code into other variants, and automate a lot of tasks that consume our time. There will be billions of these agents, across every company and in every imaginable field. There will also be agents that routinely do things for you outside of work, from shopping to travel to daily chores and tasks. Many of these agents have yet to be built, but make no mistake, they’re coming, and coming fast.”

Agentic AI is set to evolve rapidly—largely because it offers the most compelling path to monetization in the AI ecosystem. While major AI companies have explored various business models, agent-based systems present a more tangible and measurable value proposition. A recent report by Bank of America estimated that global knowledge worker wages across seven major functions—sales, marketing, customer support, finance, human resources, IT, and operations—total \$18.6 trillion annually. If AI agents automate just 10% of that work, it could unlock \$1.9 trillion in economic value.

As we have noted in previous letters, AI is not just another wave of innovation—it is a foundational shift. Both corporations and investors must recalibrate their strategic frameworks. Every business model now faces some degree of disruption. Although somewhat reductive, our current view is that AI represents a tremendous cost-side opportunity—and an equally substantial revenue-side risk. On the cost side, virtually all knowledge work, defined as work involving the acquisition, creation, analysis, or application of information, can now be done faster, more effectively, and at a fraction of the cost. This includes domains such as finance, legal, marketing analytics, software development, and back-office processing. Even industries requiring physical presence or manual labor will feel the ripple effects, as AI reshapes support operations, yielding major efficiency gains. Companies that apply AI intelligently stand to capture several points of operating margin, all else being equal. The revenue side, however, presents significant challenges. The ability to perform high-quality work at minimal cost lowers the barrier to entry for new competitors and enables incumbents to undercut each other on pricing. The startup cost for AI-native businesses is low, often relying on off-the-shelf models or repackaged capabilities built atop existing large language models. In some cases, there is outright replacement risk. We are particularly focused on software and software-adjacent services—sectors that form a core component of the \$5 trillion global IT spending base. AI agents can be understood as a fundamentally new kind of software: more dynamic, goal-oriented, and self-adjusting than traditional programs. While traditional software follows static instructions, AI agents represent a shift toward software that adapts, learns, and acts autonomously in changing environments.

Much like policy, artificial intelligence is now a primary source of market divergence. Near-term winners include: i) companies aligned with the AI infrastructure buildout (e.g., Nvidia, CoreWeave, Oracle, and power providers to data centers), ii) foundational model developers (largely private firms like OpenAI, X.AI, and Anthropic), and iii) category leaders that successfully deploy AI to reduce costs and expand margins. Conversely, the losers are likely to be firms in sectors with high replacement risk or those in competitive knowledge-work industries where pricing power and value propositions are eroding steadily.

The Case for Currency Diversification

The U.S. dollar has notably depreciated in the first half of the year, with the Dollar Index falling 10.7%. This follows a prolonged period of strength dating back to the aftermath of the 2009 credit crisis. While we typically refrain from making short-term currency forecasts, we believe movements in the dollar merit close attention in the months and years ahead. Several key macroeconomic risks—the unsustainable trajectory of government debt, the evolving global trade order, technological disruption in payment systems, and shifts in

global currency reserves—all converge on the dollar, making it a potential early barometer of broader financial stress.

After years of maintaining a bullish stance on the U.S. dollar, we now see merit in some degree of currency diversification, particularly for portfolios with foreign currency liabilities. By most economic measures, the dollar appears overvalued. Yet valuation alone is a weak anchor in currency markets, where no underlying cash flows, such as interest or dividends, exist to provide a stabilizing force. Still, the dollar's current decline must be considered against the backdrop of its prolonged outperformance, a reality any foreign tourist visiting the U.S. in recent years could confirm. That extended period of strength now creates the conditions for potential mean reversion.

Several factors support the case for a softer dollar:

1. *Reserve Diversification*

The pace of foreign reserve accumulation by central banks, a dominant force over the past two decades, has slowed meaningfully. Reserves serve multiple purposes, including managing exchange rate volatility and recycling current account surpluses, with the dollar historically representing the bulk of these holdings. However, reserve levels relative to GDP and global trade have been declining, suggesting diminished need for dollar-denominated reserves. Against the backdrop of shifting trade alliances and rising geopolitical frictions, foreign central banks may seek to diversify away from the dollar. Even modest diversification at the margin could have outsized implications for currency flows.

2. *Fading Rate Advantage*

Interest rate differentials are one of the most consistent drivers of currency movements. When a country's rates decline relative to those of its peers, its currency tends to weaken. Currently, U.S. interest rates remain elevated relative to global counterparts—but that spread appears unsustainable. Should the Fed begin cutting rates sharply over the next 12 months, combined with the prospect of a new, ultra-dovish Fed chair appointed by President Trump, would weigh heavily on the dollar.

3. *Trade Policy Dynamics*

Ongoing trade negotiations between the U.S. and its key partners are likely to spotlight America's persistent trade deficits. In this context, foreign currency appreciation may be viewed as a partial mechanism to address these imbalances. Moreover, countries that previously intervened to suppress their currency values will face increased scrutiny and may find it politically or diplomatically untenable to continue doing so. As such, the dollar's decline could become the "path of least resistance".

To manage this risk, investors should consider diversifying into stable foreign currencies (such as the euro, yen, and Swiss franc), commodities (like gold and copper), and American Depositary Receipts (ADRs) of high-quality foreign companies. A shift toward renewed dollar strength could be driven by two key developments: a resurgence of non-inflationary economic momentum in the U.S.—potentially spurred by the

administration's push for a capital expenditure (capex) boom—or a sovereign debt crisis abroad, with countries like France appearing particularly vulnerable.

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