

Alley Company Quarterly Letter **Easing Uncertainty and Strong Fundamentals**

July 15, 2025

Our first quarter letter was written right on the heels of so-called “Liberation Day.” We highlighted the elevated level of uncertainty in the marketplace caused by tariff turmoil. Despite the related weakness in consumer sentiment, we cautioned investors *against* becoming too defensive or making knee-jerk changes to their established long-term investment plans.

Fast forward just 90 days and the stock market has experienced a sharp recovery – this is based, in part, on an easing level of uncertainty with tariff negotiations progressing. Additionally, the U.S. economy continues to be in a strong position, spending on the development and adoption of artificial intelligence (AI) is booming, and corporate earnings are growing.

While volatility and market corrections will certainly lie ahead, it appears that the market is set to experience a lower level of uncertainty than contemplated earlier this year. Two key variables, inflation and corporate profit margins, have been feared to be negatively impacted by tariffs. But as outlined below, the data for each is yet to show such effects.

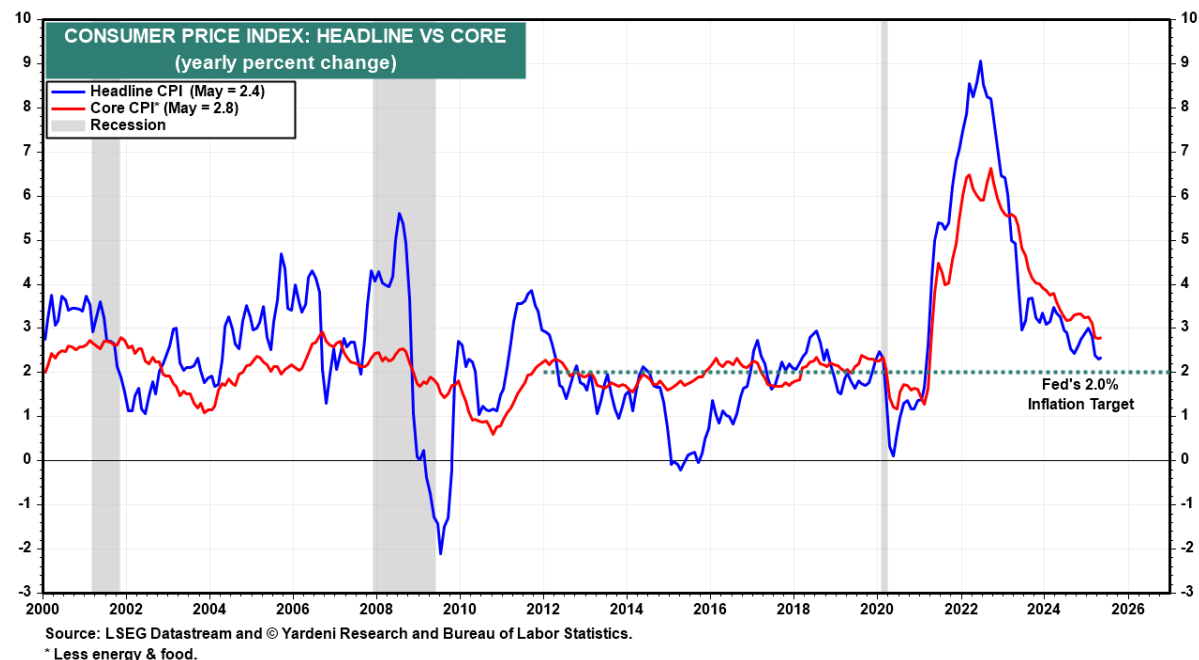
Consumer Price Index (CPI)

CPI measures prices paid by consumers for a market basket of goods and services (i.e., the rate of inflation). Consumers want predictable prices and the Federal Reserve works to accommodate that by targeting a moderate and stable inflation rate of 2 percent.

Exhibit 1 below depicts how the “Core” (which excludes the index’s more volatile food and energy components) CPI has been relatively well contained for the past 25 years. It only spiked in the aftermath of the COVID pandemic where stimulus was abundant and supply chains were abnormally disrupted.

For the past two years, inflation has been reverting toward the Fed’s long-term target. Recent tariff turmoil has threatened to break this progress, but these fears of inflationary pressure have yet to materially show up in the macro data. This is partly owed to a potentially permanent postponement of drastically elevated tariff levels initially proposed.

Exhibit 1: Inflation a Key Variable

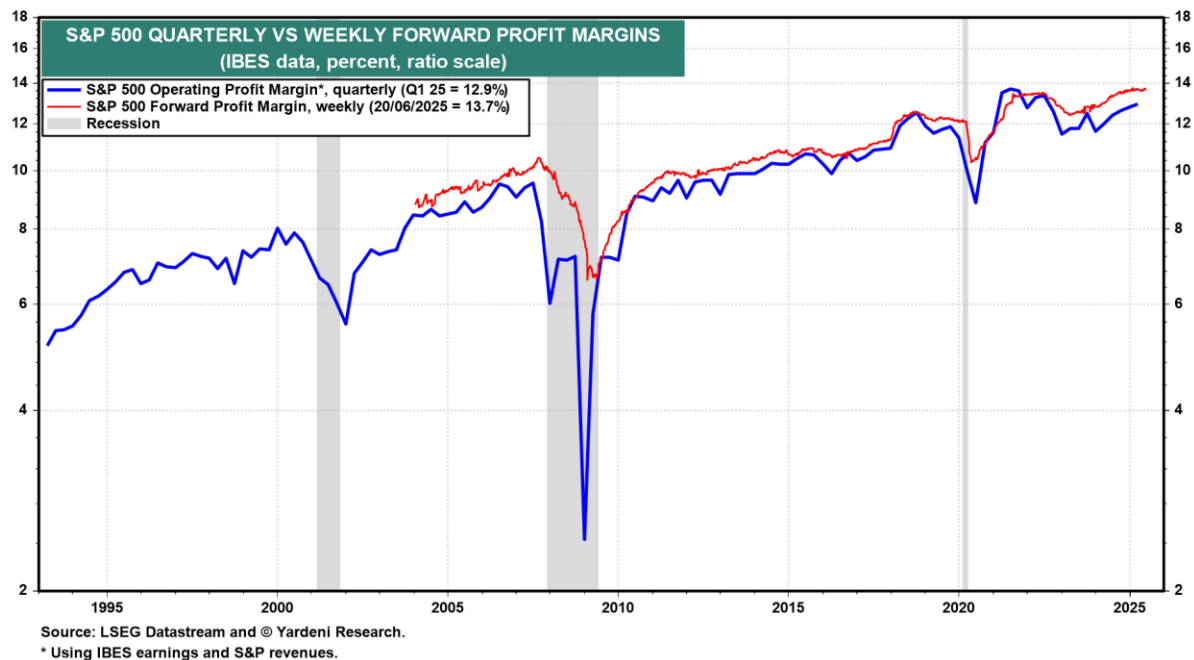


Corporate Profit Margins

As Exhibit 2 below illustrates, corporate profits as a percentage of revenues (i.e., profit margins) have been drifting higher over the past three decades with only short-term interruptions caused by recessionary periods.

Because tariffs are implemented as a tax on the company that imports goods, it has been feared that corporate profit margins in the U.S. could take a hit. While this impact could still be ahead, it should be noted that many U.S. companies are not big importers and astute management teams will continue to mitigate the impact through adjusting supply chains, passing on price increases, and increasing productivity. (For reference, according to Yardeni Research, a 10 percent across-the-board tariff on all goods imported in the U.S. is estimated to total \$400 billion over a 12-month period.)

Exhibit 2: Strong Corporate Profitability



Strong Fundamentals in the Banking Sector

The Federal Reserve conducts “stress tests” annually among the largest banks in the U.S. to ensure they are sufficiently capitalized and able to lend to households and businesses even in a severe recession scenario. The recent June 2025 results indicate that each of the 22 banks tested are well positioned to handle hypothetical stressful conditions.

Post results, Morgan Stanley estimated that “excess” capital at large banks rose by 26 percent. This added capital flexibility should allow management teams to support client activity through loan growth *and* return capital to shareholders through dividends and share repurchases.

Strong Fundamentals in the Technology Sector

The development and adoption of AI is in the midst of a full-fledged “revolution” as evidenced by the capital spending plans of major technology companies such as Amazon, Alphabet, Meta Platforms, and Microsoft, among others.

While direct beneficiaries of AI may ebb and flow over time, the broader benefits to the economy and corporate America may be seen through higher levels of labor productivity (output per hour worked), which could manifest itself in stronger gross domestic product and corporate earnings growth.

Conclusion

Uncertainty was elevated in the wake of “Liberation Day” tariff announcements, but progress has been made with trading partners and broad readings of inflation and corporate profit margins have been resilient. Key sectors of the economy are also on strong footing and the outlook is for continued corporate earnings growth.

“A ten percent correction is around any corner” is a mantra that investors should embrace – meaning that the market can experience a pullback at any point in time! Investors should also structure their asset allocation among stocks, bonds, and cash according to their risk tolerance and time horizon. Whatever one’s asset allocation, our investment philosophy within equities continues to focus on owning a diversified portfolio of high-quality businesses that have the potential to beat inflation over time and produce attractive risk-adjusted investment returns.

The Alley Company Quarterly Letter discusses general developments, financial events in the news and investment principles. It is provided for information purposes only. It does not provide investment advice and is not an offer to sell a security or a solicitation of an offer, or a recommendation, to buy a security. The statements and opinions contained herein are solely those of Alley Company and are based upon sources and data believed to be accurate and reliable. Additional information regarding Alley Company can be found by accessing the SEC’s website at www.adviserinfo.sec.gov.