KAR | Kayne Anderson Rudnick Investment Management

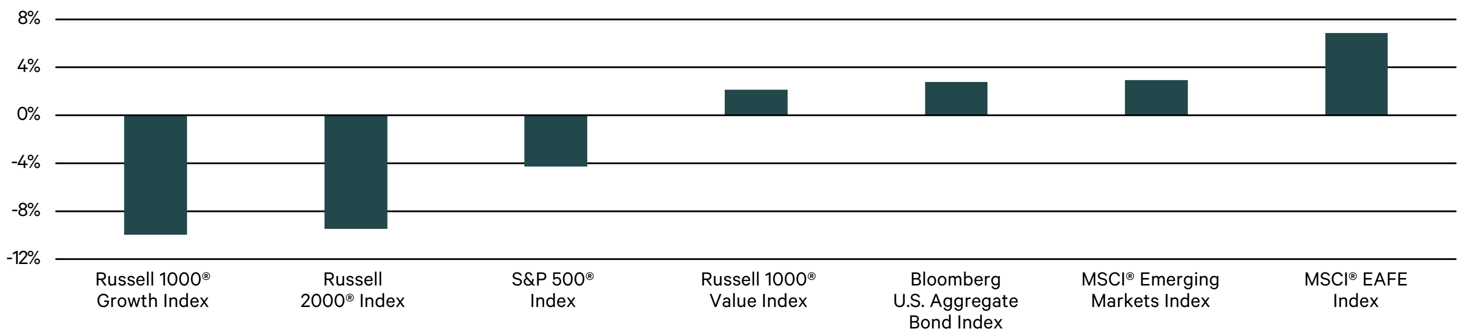
Market Review Commentary

1Q 2025

Market Review

The first quarter of 2025 proved to be a volatile ride with the U.S. stock market hitting new record highs to begin the quarter, followed by sharp declines precipitated by President Trump's tariff announcements. International markets fared much better than the U.S., marking the strongest outperformance by international stocks during the first quarter of a calendar year dating back to 1987. Fixed income also performed well, as investors sought safety amid the heightened uncertainty in equity markets.

FIGURE 1: FIRST QUARTER 2025 INDEX PERFORMANCE



Data presented is for the three months ending March 31, 2025. Data is obtained from FactSet and is assumed to be reliable. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment. Please see the end of this commentary for additional information regarding the indexes. ***Past performance is no guarantee of future results.***

In this commentary, we focus on five questions we believe are top of mind for investors.

1. What are our thoughts on tariffs?

Over the past six weeks, tariff malaise has erased $5.8 trillion in U.S. stock market value. While many worried how the incoming administration's position on the widespread use of tariffs would fare, few would have guessed the magnitude of the impact on equity markets.

For now, the Trump administration appears prepared to stomach the economic impact of the tariffs in hopes of spurring domestic production and consumption by turning away from international trade. It is unclear how an electorate that blamed President Biden for persistently higher prices will respond to a near-term increase in costs across a broad swath of goods.

In thinking about tariffs, we see three channels of impact. First is the impact on domestic consumption. We would characterize a tariff as a tax on consumption. All else equal, that means tariffs should reduce consumer demand, producing a headwind for an economy that is two-thirds driven by consumer spending. Second, and an offset to

reduced consumer spending would be a lower trade deficit. While positive, the scale of this is small compared to the likely impact on demand.

The third and perhaps most troubling impact of tariffs is the headwind of uncertainty. This affects both consumers and perhaps more profoundly, business investment. While the Trump administration was forthright in its intentions to impose tariffs, the scale has been much larger than expected and the implementation has been uneven in its execution.

For many companies, this has created significant uncertainty in making future investments for growth. We have great confidence in most companies' ability to adapt to changing market conditions. But without clarity and at least some degree of policy stability, the best course of action is inaction for most companies. And that can do long-term damage. We are seeing early signs of this in the survey data for both consumers and business leaders. Many feel the lack of clarity makes it hard to allocate capital and create a long-term strategy.

Investors have reacted to all these questions with broad-based selling, moving away from the strategies that had worked so well most recently. This includes a deep sell-off in the "Magnificent 7" stocks, but also renewed interest in international markets, with European equities in particular moving up strongly. We have not seen this large of a divergence in performance between the S&P 500 and European stocks since the 1980s.

In terms of how tariffs have impacted our approach to investing at KAR, the answer is "not very much." Given the level of uncertainty and degree of market malaise, it would be foolish to try to perfectly position a portfolio for a specific outcome. There are simply too many diverging and conflicting possibilities to try to predict that any of them will occur with any reasonable accuracy.

We could make an argument that because small caps are less dependent on exports to foreign markets, they could outperform. But small caps can be more economically sensitive, and if a trade war leads to a U.S. recession, they may be challenged. In our view, the better strategy is, of course, diversification, but with a focus on quality. This is not the time for needless speculation.

We continue to be confident that investing in quality companies that have demonstrated an ability to nurture and protect their competitive advantage in adapting to a wide range of market outcomes serves our clients best. After being challenged to match index performance last year due to the strong rotation into AI stocks, the majority of our strategies are demonstrating the typical downside protection that we are known for. While we will gladly take this as an opportunity to establish or expand positions in companies that may have been out of reach due to excessive valuations, for the most part we continue to stay the course and focus on individual company fundamentals.

2. How are tariffs likely to impact interest rates?

In the span of 12 months, we have seen short-term interest rates decline meaningfully, while longer-term rates have increased slightly. We think this reflects concern about the near-term outlook, as well as broader fears that U.S. deficits will pressure our ability to borrow at favorable rates over the long term. For the most part, the bond market has been calmer than equity markets this quarter.

The outstanding question is how will tariffs impact inflation and how, in turn, will that impact the Federal Reserve's rate-setting actions. In his prepared comments, Fed Chair Jerome Powell used the word "uncertainty" 11 times. Much like corporate boards, the Fed has been pushed into a holding pattern until there is more clarity on 1) the Trump administration's overall policy, and 2) the impacts of tariffs on prices and consumption.

While tariffs are traditionally a one-time price increase or tax, a global trade war would have a long-lasting impact on overall price levels. This could lead to more persistent pressure on wage levels, and changes there could be self-reinforcing, leading to more prolonged inflation. We note that this would be happening while immigration is expected to be materially curtailed, adding further upward pressure to labor costs.

The Fed is well aware of these forces, but they also know the cure for high prices can sometimes be high prices. Meaning, pushing demand lower in the U.S. would reduce overall economic activity, which could eventually lead to a cooling in prices. The Fed is likely very concerned about the risk of stagflation, where growth stagnates, *and* prices still increase.

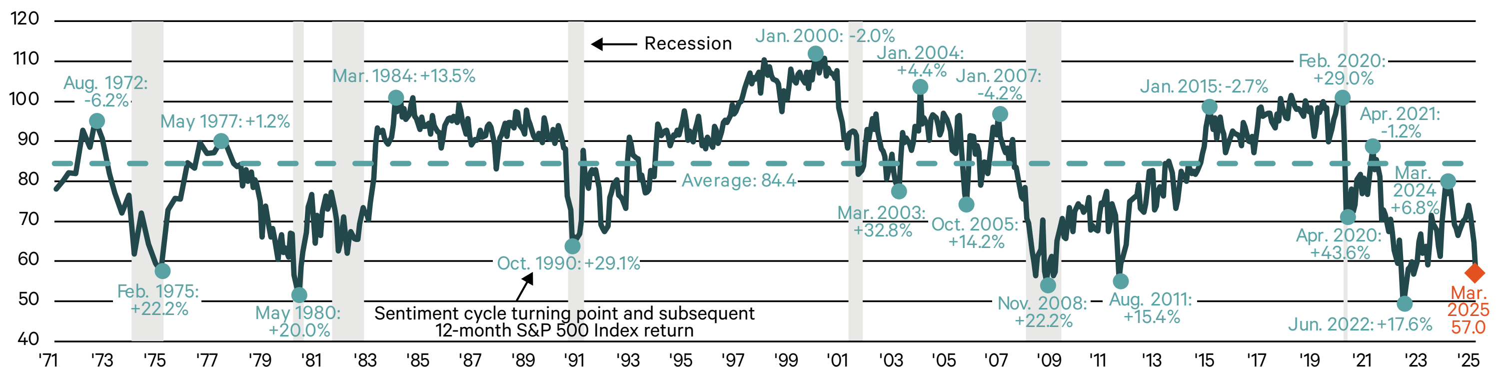
We would not advocate for positioning based on the expectation that interest rates will be cut in the near-term. It is likely the Fed will want to see concrete data on how tariffs and uncertainty and policy changes are impacting the real economy, which will take some time. Therefore, we would not expect a material decline in short-term rates, meaning that borrowing costs for companies with high levels of variable rate debt are unlikely to come down meaningfully, at least in the near term.

3. What is our view on the U.S. consumer at this point?

Looking at recent survey data, it appears the U.S. consumer is feeling far more negative than just a few months ago. The widely tracked University of Michigan Consumer Sentiment Index is at the lowest point since the global financial crisis, with the exception of the outbreak of COVID-19 and August 2011 (when the S&P 500 fell 6.7% in a single day, the European sovereign debt crisis was raging, and S&P downgraded its credit rating for the U.S.).

FIGURE 2: CONSUMER CONFIDENCE AND THE STOCK MARKET

Consumer Sentiment Index and Subsequent 12-Month S&P 500 Index Returns



Data presented is as of March 31, 2025 and is obtained from FactSet, Standard & Poor's, University of Michigan and J.P. Morgan Asset Management and is assumed to be reliable. Peak is defined as the highest index value before a series of lower lows, while a trough is defined as the lowest index value before a series of higher highs. Subsequent 12-month S&P 500 returns are price returns only starting from the end of the month and excluding dividends. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and it is not available for direct investment. Please see the end of this commentary for additional information regarding the index. ***Past performance is no guarantee of future results.***

Business confidence has also declined. The Institute for Supply Management's (ISM's) Purchasing Manager's Index for the manufacturing sector in March shows new orders and backlogs contracting, along with production and employment. Supplier deliveries slowed from last month, raw materials inventories grew, as did customers' inventories, while prices increased, exports contracted, and imports grew (perhaps in anticipation of tariffs to be imposed in April).

Usually, we would caution against reading too much into "soft" survey data as we have often seen periods of low consumer confidence that conflicts with strong consumer spending. But it is a clue into the consumer mindset.

Many feel exhausted by higher prices, most notably grocery prices, which have not seen any material relief in terms of inflation. The prospect of paying even higher prices to pursue an abstract goal of American exceptionalism may feel less

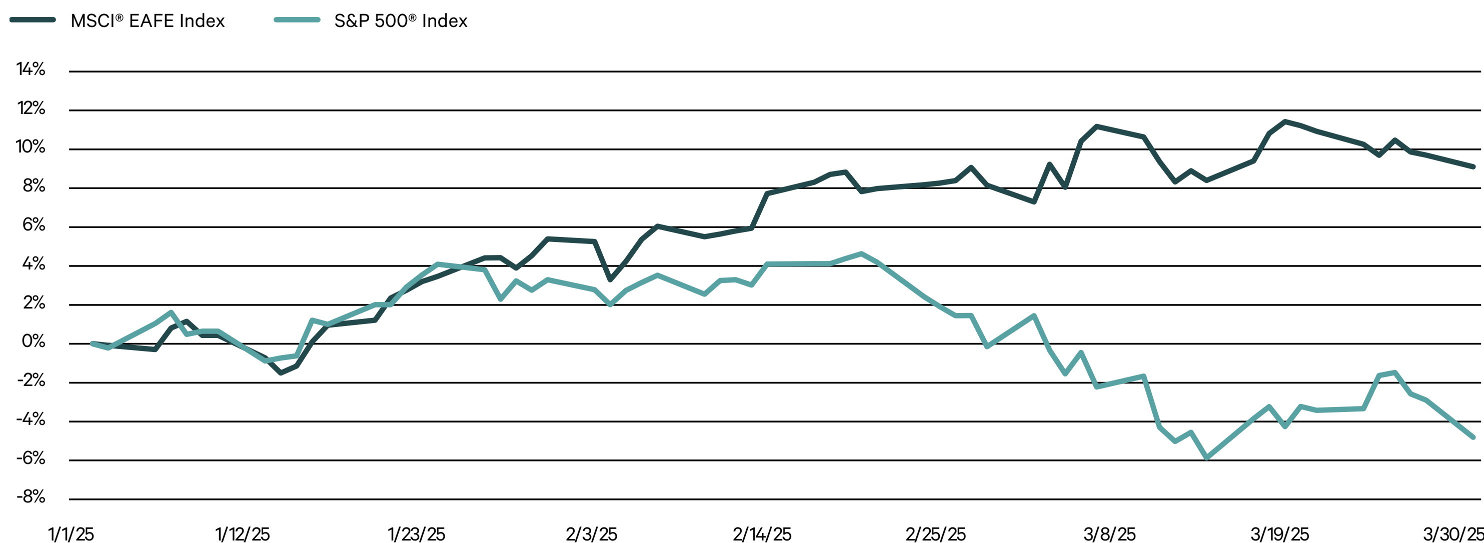
compelling than it did last November. Comments from President Trump and Treasury Secretary Bessent that near-term pain should be expected is perhaps not the salve consumers need right now.

That said, very few have ever struck it rich betting against the U.S. consumer. They have been the backbone of the decade-plus economic expansion we have enjoyed. With employment still quite strong, we do think consumer spending should remain intact, although with perhaps more deterioration for those at lower income levels. We think every consumer in every income bracket is fatigued by the evaporation of value they have experienced while shopping over the last few years. We think this favors any consumer brand or company that focuses on offering good deals or value.

4. What are the investment opportunities abroad?

As Americans, it is sometimes difficult for us to recognize how actions in the U.S. affect markets abroad. While the U.S. accounts for only 5% of the global population, we consume 30% of what is produced globally. Thirty percent is a lot, but it doesn't dictate how markets abroad behave. Nor does it explain the recent strong outperformance of international markets relative to the U.S.

FIGURE 3: OUTPERFORMANCE OF INTERNATIONAL MARKETS RELATIVE TO THE U.S.
MSCI® EAFE Index vs. S&P 500® Index



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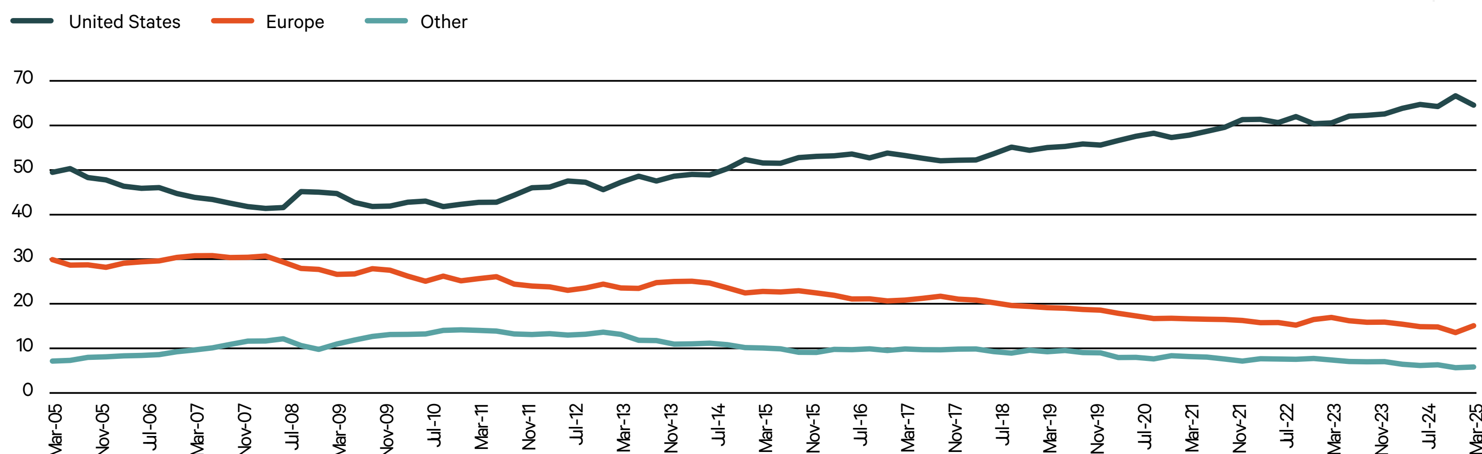
We think several factors have been driving the divergence in U.S. equity market performance versus the rest of the world. First, valuations. At the beginning of the year, U.S. equity markets were near the top of their valuation ranges historically, with a price/earnings multiple for the S&P 500 of roughly 30 at the end of 2024, compared to about 15.3 for the MSCI EAFE Index.

Since the start of the pandemic, we had seen money flowing continuously into U.S. markets—that spigot reversed in the first quarter of 2025. It is challenging to estimate how much U.S. equities benefited from this flow of international capital but if we look at the value of the U.S. stock market value relative to the rest of the world, it's easy to see it is quite extreme compared to the percent of the world's GDP the U.S. represents.

FIGURE 4: GROWTH IN MARKET CAP WEIGHTING OF MSCI ACWI® INDEX



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Some of this flow of capital has been normalized over the last few months as investors have become a bit wary of investing new money in U.S. equities, but other factors are at play. The normal pattern of European austerity and American expansion has reversed. Europe recognizes it has been chronically underinvesting in its military and has stepped up plans to expand defense spending materially. And this is not just a "re-arming story" – European banks, telecommunications stocks, and insurance are also outperforming, with the least expensive stocks making the biggest moves higher. Meanwhile, the U.S. is trying to constrain government spending to get the deficit under control.

Outside Europe and the U.S., we have seen the Chinese government stepping up to try to mitigate the impact of U.S. tariffs on its economy and to increase local consumption spending. If successful, this could benefit other Asian economies that trade with China, providing some relief from tariffs that will likely hurt their exports to the U.S.

As with tariffs in the U.S., we think that attempting to predict global outcomes is a fool's errand. A far better strategy is to seek global diversification with quality companies. For example, just over 10% of small cap companies in Europe have negative earnings, compared to roughly 40% in the U.S. Our international team continues to see quality companies abroad that are underpriced relative to their U.S. peers, using a bottom-up focus that is allowing these portfolios to add quality diversification in these turbulent times.

5. What are our updated thoughts on AI?

We continue to be intrigued by the potential Artificial Intelligence offers, albeit with a certain amount of skepticism in the near-term. While we believe AI will fundamentally change the nature of work, how we communicate, and how we learn, we are decidedly not futurists. It is easy to see how disruptive the technology could be to many domains, and how profoundly it could change research and analytics, health care, and insurance.

But we believe we are still in the early experimental stages of the technology. What also concerns us is how technology companies will monetize the massive investments they are making in AI. Not all disruptive technologies lead to outsized riches for the inventors or early adopters. Aviation is a great example. So is ecommerce.

Julie Biel, CFA
Chief Market Strategist

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Think of online retail. As companies sought to expand their online presences and ability for consumers to shop online, every retailer believed there would be huge incremental sales from "omni-channel" strategies. They invested billions in technology, new warehouses, robotics, website designers, and so on.

And they were right, to an extent. Incremental sales from omnichannel shoppers were a bit higher. But so were returns. Returns skyrocketed as it got easier and easier for consumers to ship their purchases back on the retailer's dime. Returns in retail kill both margins and efficiency. This huge investment in omnichannel has permanently lowered margins and returns on capital, and shoppers now have sky-high expectations for price transparency, free shipping, and free returns.

While we do not think early adopters or vendors of AI chatbots and other tools will fare as retailers did, we do think the online shopping story serves as a cautionary tale that not all disruption is good for the leaders of disruption. And we believe it is still too early to predict who the outsized winners will be.

In a recent commentary, we noted that AI appears to favor the very largest companies with access to mountains of cheap capital and data. DeepSeek certainly proved us wrong. The advent of a technology that was nearly as good as the leading models for a fraction of the cost threw the entire thesis of pursuing scale above all else into the trash. It is normal in technology transitions to have these periods of infinite hype and infinite doom. AI will be no different and perhaps even more extreme in its movements.

With that said, we are seeing early signs of generative AI adoption in the workplace, particularly for technology companies. Many are now able to use AI to write new software code, replacing low-level programmers. Others are using more advanced analytics for customer service or data optimization. We expect these to be the early beneficiaries of the technology, meaning better efficiency and scaling opportunities through automation. What is less clear to us is how companies will generate enough new revenues or new cost savings to justify the tens of billions already invested in AI (data centers, chips, servers, etc.), with even more planned going forward. As a result of that uncertainty, we continue to avoid making investments solely on the basis of a company's AI potential; instead, for now we see it as a nice benefit if all goes well.

As always, we thank you for your continued trust and confidence in these turbulent times.

Large-capitalization stocks are represented by the S&P 500® Index which is a market capitalization weighted index which includes 500 of the largest companies in leading industries of the U.S. economy. Growth stocks are represented by the Russell 1000® Growth Index which is a market capitalization-weighted index of growth-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. Value stocks are represented by the Russell 1000® Value Index which is a market capitalization-weighted index of value-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. Small-capitalization stocks are represented by the Russell 2000® Index which is a market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The MSCI® EAFE Index is a free float-adjusted market capitalization index that measures developed foreign market equity performance, excluding the U.S. and Canada. Emerging markets are represented by the MSCI® Emerging Markets (EM) Index which is a free float-adjusted market capitalization index tracking the equity performance of global emerging markets. The MSCI AC World Index (net) is a free float-adjusted market capitalization-weighted index that measures equity performance of developed and emerging markets. The index is calculated on a total return basis with net dividends reinvested. The Bloomberg U.S. Aggregate Bond Index is a market value weighted index that tracks the daily price, coupon, pay downs and total return performance of fixed-rate, publicly placed, dollar-denominated and non-convertible investment grade debt issues with at least $250 million par amount outstanding with at least one year to final maturity. Performance is calculated on a total return basis with dividends reinvested. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment. This report is based on the assumptions and analysis made and believed to be reasonable by Advisor. However, no assurance can be given that Advisor's opinions or expectations will be correct. This report is intended for informational purposes only and should not be considered a recommendation or solicitation to purchase securities. Kayne Anderson Rudnick has chosen to include the securities in this commentary based upon objective criteria. It should not be deemed as a recommendation to purchase the securities mentioned, and it should not be assumed that securities recommended in the future will be profitable. ***Past performance is no guarantee of future results.***

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