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Investment Management

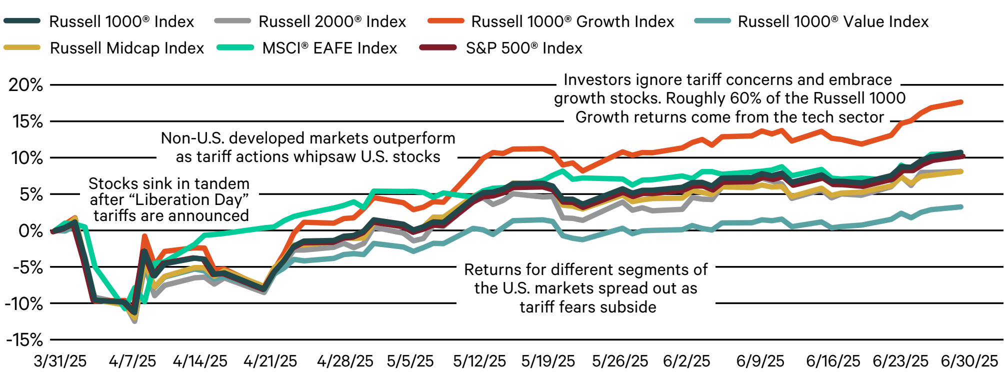
Market Review Commentary

2Q 2025

Market Review

Broad market indices delivered a serious case of whiplash over the second quarter of 2025, losing over 10% in the early part of April, recovering from those losses by early May, then surging to new highs at the end of June. We doubt any predictions from the beginning of the quarter would reflect how things actually evolved (a great example of why we do not make predictions).

FIGURE 1: 2Q INDEX RETURNS



	April 1 - April 30, 2025	Q2 2025
S&P 500® Index	(0.68%)	10.94%
Russell 1000® Index	(0.60%)	11.11%
Russell 1000® Growth Index	1.77%	17.84%
Russell 1000® Value Index	(3.05%)	3.79%
Russell Midcap Index	(1.03%)	8.53%
Russell 2000® Index	(2.31%)	8.50%
MSCI® EAFE Index	4.58%	11.78%

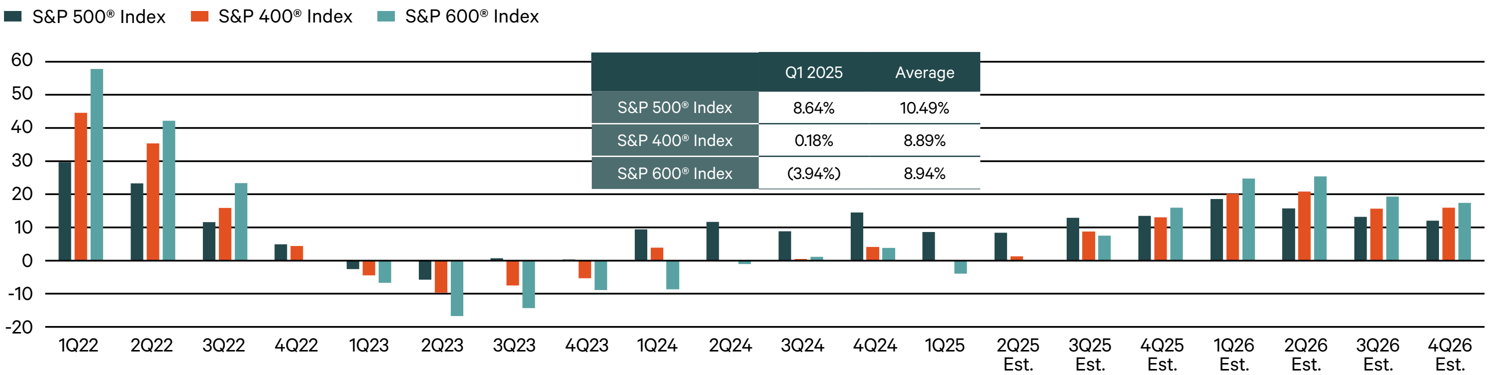
Data presented is for the three months ending June 30, 2025. Data is obtained from FactSet and is assumed to be reliable. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment. Please see the end of this commentary for additional information regarding the indexes.
Past performance is no guarantee of future results.

In this commentary, we answer some questions our clients have been asking about the markets and our views on the current outlook, including the macroeconomic uncertainties that are driving many conversations.

1. What are earnings growth estimates for small, mid, and large cap stocks?

Small cap earnings growth continues to be weaker than those of larger peers, although we believe that is expected to change later this year and into 2026. Earnings for the S&P 600 Index (the index of profitable small cap companies) declined nearly 4% in the first quarter of 2025. Mid cap earnings, as measured by the S&P 400 Index, were flat, while S&P 500 earnings grew nearly 9%. Earnings for the so-called Magnificent 7 stocks grew 29% in the period, pushing up the average for the S&P 500 materially.

FIGURE 2: EARNINGS GROWTH ESTIMATES FOR SMALL, MID AND LARGE CAP STOCKS



	Q1 2025	Average
S&P 500® Index	8.64%	10.49%
S&P 400® Index	0.18%	8.89%
S&P 600® Index	(3.94%)	8.94%

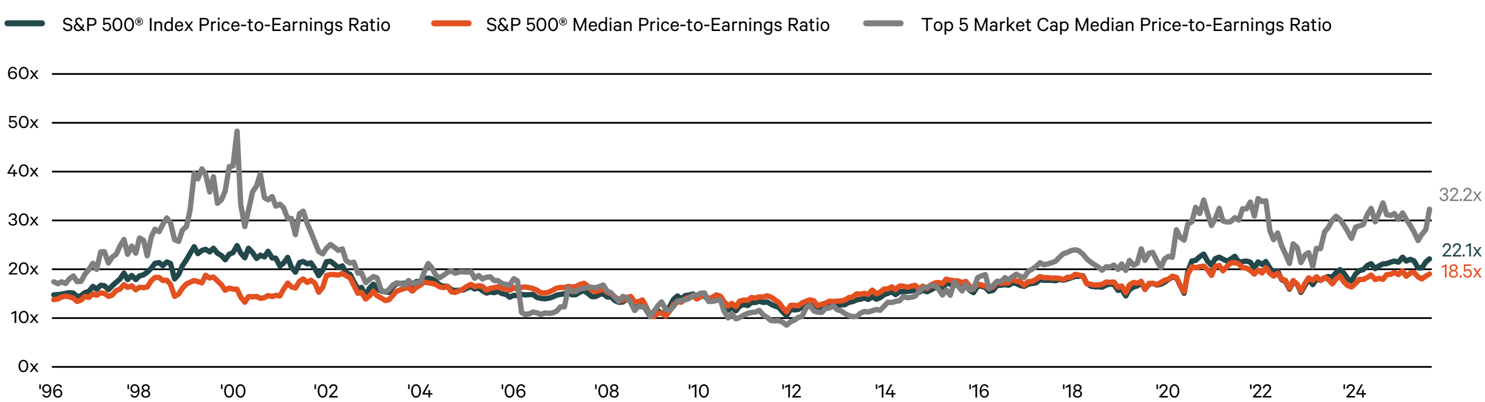
Data presented is as of July 2, 2025, is obtained from Strategas and Bloomberg and is assumed to be reliable. Please see the end of this commentary for additional information regarding the indices ***Past performance is no guarantee of future results.***

Some of this reflects the mix of businesses in each index. Regional banks, real estate, and energy stocks are more heavily represented in the small cap indices, while technology has a much larger weight in the S&P 500 (roughly 3x greater than in the Russell 2000 Index).

2. Where are valuations for small, mid, and large cap stocks compared to February before most of the tariff angst hit? Are these justified by earnings growth and macroeconomic conditions?

At the peak of tariff terror (the low point for the market), we saw equity valuations normalize, particularly those of expensive technology shares. At that time, valuations ranged from fair to attractive, particularly for small cap stocks. As investors gained confidence that cooler heads would prevail in the tariff wars, we saw valuations bounce back materially. This is particularly true for the largest companies in the S&P 500 (i.e., the big tech firms leading the surge).

FIGURE 3: S&P 500® INDEX MEDIAN PRICE-TO-EARNINGS RATIO VS. TOP 5 WEIGHTS
Next 12 Months



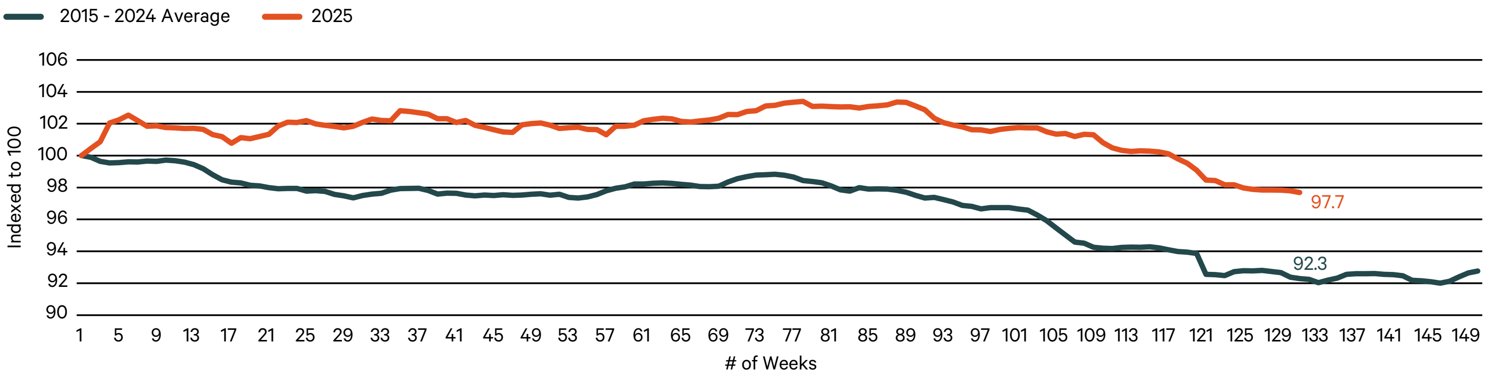
Data is as of June 30, 2025. Data, is obtained from Strategas and Factset and is assumed to be reliable. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment. Please see the end of this commentary for additional information regarding the index. ***Past performance is no guarantee of future results.***

Looking at earnings expectations for Big Tech, we believe it makes sense for investors to continue to focus on stocks with strong secular growth. That said, just because it makes sense does not mean that growth is assured.

Even excluding the Magnificent 7, valuations are on the high side relative to history. With so much uncertainty both at home and abroad, it is hard to gauge whether higher valuations are likely to be justified with strong earnings growth.

Earnings estimates have been sliding as the year has progressed, which is not unusual. But this does put more pressure on expectations for the end of 2025 and into 2026.

FIGURE 4: S&P 500® CALENDAR YEAR EPS ESTIMATE PROGRESSION



Data is as of June 30, 2025. Data, is obtained from Strategas and Factset and is assumed to be reliable. The index is unmanaged, its 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 index. ***Past performance is no guarantee of future results.***

It is also possible that investor expectations for interest rate cuts support higher equity market valuations. We would caution though that the Fed's stance currently is that the economy is on solid enough footing that it does not need to cut rates. Should that change, and the Fed were forced to cut rates, that probably would not be positive for equity valuations overall.

3. Would lower interest rates help to bolster the performance of small cap stocks?

We do not expect lower interest rates to be the only key to boosting small cap stock performance. As 90% of long-term stock returns are driven by earnings growth, the recent weakness in small cap stock performance can largely be explained by softer earnings.

Some of that weakness can be attributed to the fact that smaller companies typically borrow at a variable rate, mostly through bank loans. This has resulted in higher interest costs as short-term rates have remained elevated. So, in a sense, lower interest rates could support small cap earnings growth.

Still, that would be far less meaningful than an improvement in demand and margins. Many investors are concerned that the more economically sensitive small cap companies could be hurt by any macro weakness unleashed by tariffs. How high the "final" tariffs will ultimately be and how they will affect demand and margins, is far from clear.

In our view, not all small caps are created equal and many higher-quality small companies have shown earnings growth comparable to that of their larger cap peers. And, importantly, often at better valuations as well.

4. There seems to be little sign of tariffs in data thus far. Will we actually see a tariff impact in economic data? If so, when?

Investors and market watchers have been searching high and low for ways in which tariffs are impacting the hard economic data. We know that consumer and business confidence (soft data points) took an immediate nose-dive in the early, chaotic days after tariffs were announced. Some of those metrics have even recovered a bit from record lows. But evidence in the hard data has been thin.

We think this makes sense. We know anecdotally that many companies front-loaded orders across their supply chains so they could take delivery of goods before tariffs went into effect. Others postponed deliveries, particularly for goods from China, expecting lower tariffs eventually. Volumes at the Port of Los Angeles have been volatile, reflecting this uncertainty and the opportunistic changes in shipments made to avoid higher tariffs. With supply chains so in flux, it's hard to tell what true underlying demand is versus stockpiling.

The real question is who will pay for these tariffs. The Trump Administration claims that other countries (the exporters) will pay for them; if not, companies in the U.S. are being pressured to eat the costs. Many fear that consumers will be the ones who end up paying most of the bill, leading to higher inflation and sustained higher interest rates as a result.

Right now, tariff costs are not likely to be borne by foreign firms. When the first Trump administration placed tariffs on China, we actually did see exporters shouldering more of that burden and the yuan weakened in the face of those levies. This time around it is the U.S. dollar that has depreciated, so it is hard to argue that foreign entities are shouldering the cost.

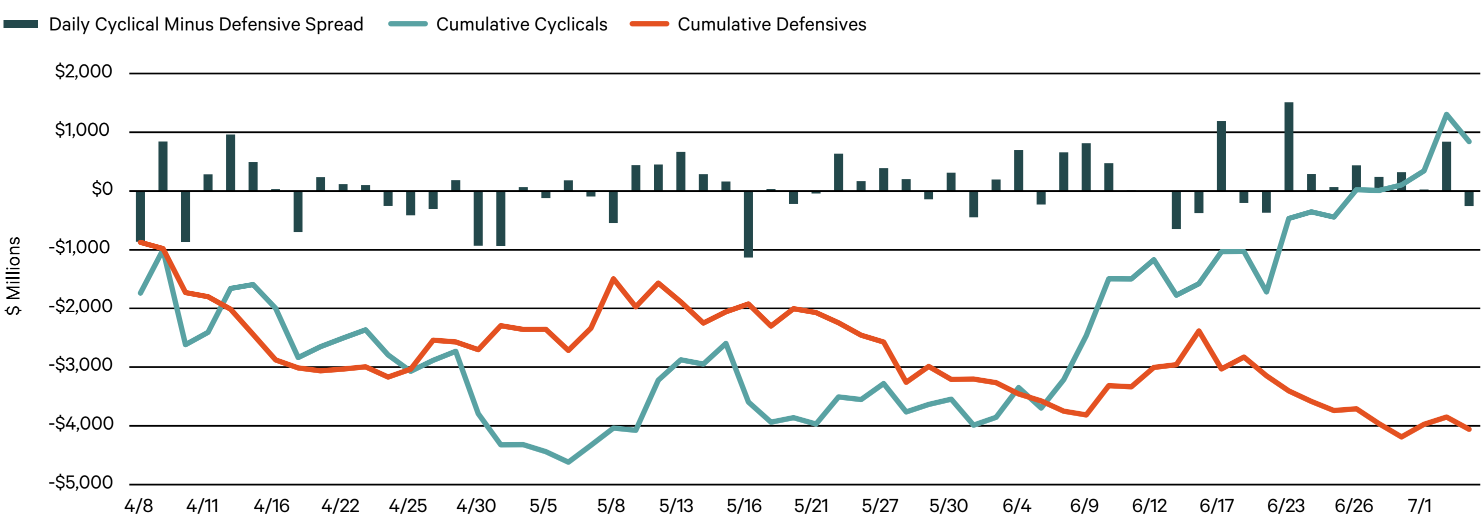
For now, inflation in the U.S. has been higher than the Fed's stated goal of 2%, but it has not moved materially higher since the tariffs were implemented in March and April. Thus, it appears that either higher costs will be passed on to consumers or U.S. companies will accept lower margins in the interim, or a combination of both. We will gain a much better understanding of the impact when companies begin to report second quarter earnings later this month.

Our concern is that pricing power has been exhausted in many industries on the back of prolonged higher inflation. If that's the case, margins could be structurally weaker. Typically, strong margins support strong equity markets, and with valuations on the high side there could be some downside risk if those margins drift materially lower.

5. Are defensive sectors gaining traction amid macro-level uncertainty?

Despite the surge in uncertainty across markets, you might be surprised to learn that cyclicals remain more popular than defensive stocks, all else being equal.

FIGURE 5: CYCLICAL VS. DEFENSIVE SECTOR FLOWS SINCE APRIL 8TH LOW



Data presented is as of July 3, 2025. Data is obtained from Strategas and is assumed to be reliable. ***Past performance is no guarantee of future results.***

The relative weight of defensive stocks as a percentage of the overall market (the S&P 500) has been in a prolonged descent over the last 30 years. It's interesting to note that utilities are typically considered to be defensive, and despite a substantial run in utility stocks on the hopes of AI-driven demand for electricity, this hasn't halted the relative weakness in defensive stocks as a group.

FIGURE 6: SUM OF S&P 500® INDEX DEFENSIVE SECTOR WEIGHTS
Consumer Staples, Energy, Health Care and Utilities

Data presented is as of July 4, 2025. Data is obtained from Strategas and is assumed to be reliable. ***Past performance is no guarantee of future results.***

Our takeaway is that investors appear to be choosing higher growth over greater certainty of earnings. But this 35-year decline is worth considering in terms of the market's relative posture, where the stance is clearly on the front foot. We believe this is why the market swooned so dramatically following the tariff announcements. Investors are positioned for good news and good growth, and any threat to that creates wholesale movements away from risk assets.

6. Are companies still holding off on capital spending in light of general uncertainty?

The unsatisfying answer to this question is, "it depends on the company." The biggest driver of growth in capital expenditures recently has been spending on AI data centers. Capital expenditures in that arena appear to be very much intact, as investors are showing patience for the fruits of that spending to materialize. There is some risk to the concentration of spend in capital expenditures, but at least for the near-term, we expect that growth to remain robust.

Outside the technology sector we see a more mixed picture. In the last week of June, the Richmond Federal Reserve released results from a CFO survey that showed concern for tariffs and their impact on costs and prices. This flowed through to their expectations for capital expenditures. Firms that reported concerns around tariffs were materially more likely to postpone, scale down, or indefinitely delay their plans for capital expenditures. Firms not concerned by tariffs were much more likely to have unchanged capital expenditure plans.

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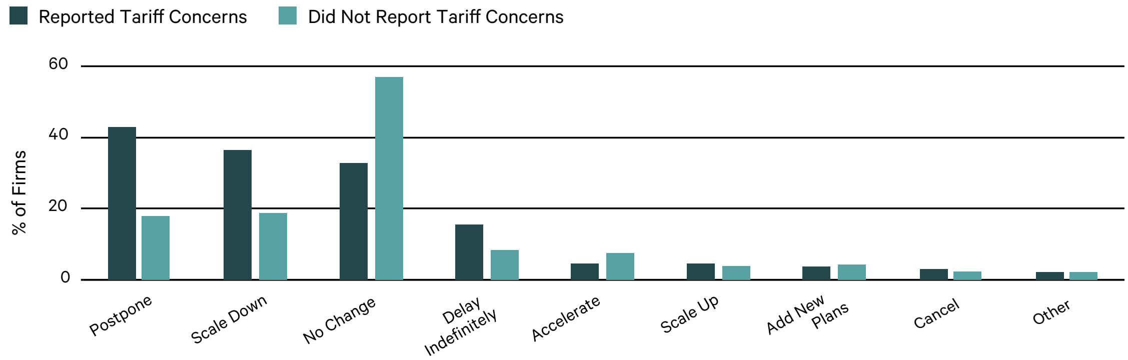
FIGURE 7: HAS ADDITIONAL TARIFF UNCERTAINTY LED YOUR FIRM TO DO ANY OF THE FOLLOWING?



Data presented is from May 19, 2025 - June 6, 2025. Data is from the CFO Survey and is obtained from Duke University, FRB Richmond and FRB Atlanta and is assumed to be reliable. Note: Percentages do not sum to 100 because respondents could report more than one action.
https://www.richmondfed.org/research/national_economy/cfo_survey/data_and_results/2025/20250625_data_and_results

It's important to note that nearly 65% of survey respondents had postponed, scaled down, or indefinitely delayed their capital expenditure plans. We would caution that this is based on plans, not actual results. Second quarter earnings will, once again, provide more concrete evidence of changes to capital expenditure plans in light of announced tariffs.

Outside of capital expenditure actions, the survey also asked CFOs what actions companies are planning in response to new tariffs. Fewer than 5% of respondents plan to move production to the U.S., despite this being a central goal of the tariffs.

FIGURE 8: HAS ADDITIONAL TARIFF UNCERTAINTY LED YOUR FIRM TO DO ANY OF THE FOLLOWING?

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https://www.richmondfed.org/research/national_economy/cfo_survey/data_and_results/2025/20250625_data_and_results

As always, we remain focused on the fundamentals of the high-quality businesses in which we invest and we thank you for your continued trust and confidence.

The S&P 500® Index is a market capitalization weighted index which includes 500 of the largest companies in leading industries of the U.S. economy. The Russell 1000® Index is a free float-adjusted market capitalization-weighted index of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The Russell 1000® Growth Index which is a free float-adjusted 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. All companies that have a weight greater than 4.5% in aggregate are no more than 45% of the Index and no individual company has a weight greater than 22.5% of the Index. The Russell 1000® Value Index which is a free float-adjusted 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. All companies that have a weight greater than 4.5% in aggregate are no more than 45% of the Index and no individual company has a weight greater than 22.5% of the Index. Small-capitalization stocks are represented by the Russell 2000® Index which is a free float-adjusted market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The Russell Midcap® Index is a free float-adjusted market capitalization-weighted index of medium-capitalization stocks of U.S. companies. The index is calculated on a total return basis with dividends reinvested. All companies that have a weight greater than 4.5% in aggregate are no more than 45% of the Index and no individual company has a weight greater than 22.5% of the Index. 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. The S&P Mid Cap 400® provides investors with a benchmark for mid-sized companies. The index, which is distinct from the large-cap S&P 500®, is designed to measure the performance of 400 mid-sized companies, reflecting the distinctive risk and return characteristics of this market segment. The S&P SmallCap 600® seeks to measure the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable. 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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