



UNIFIED INVESTMENT MANAGEMENT
Q2 2025 MARKET UPDATE
TARIFFS ON-MARKETS DOWN, TARIFFS OFF-MARKETS UP

As I write this update on July 2nd, the S&P 500 is making new all-time highs. Yet just three months ago, markets were in turmoil as substantial tariffs were announced. Given that equity markets should be forward-looking indicators of future earnings, it wasn't a surprise that markets quickly dropped 15%* following the higher than anticipated initial tariffs. Tariffs can depress earnings if companies absorb the increased cost instead of passing them on to the end consumer. It also wasn't surprising when stocks reacted positively to the subsequent delays/reductions in tariffs. However, what has been surprising (pleasantly so) is how quickly stocks rebounded back to new highs given the continued uncertainty around the economic/inflationary impact of tariffs and high equity valuations. We have three theories on why stocks are doing so well in this uncertain environment: 1) short term stock movements are more based on sentiment/momentum than valuation 2) Q1 earnings continued to surprise to the upside and the outlook for the second half of 2025 has improved with the likelihood of tariff reductions 3) the spending and tax bill (aka, "the big, beautiful bill") is positive for short-term economic growth, which in turn is good for stocks.

History has shown that starting valuations are a good predictor of future returns over longer periods (5 to 10+ years)***. However, markets can go through shorter periods where valuations are meaningless, and stocks move on sentiment and momentum. This is the type of market we are currently in. It is estimated that up to 80% of daily stock volume is driven by quantitative strategies (computers buying and selling stocks based on an algorithm). Since quantitative strategies often rely heavily on market sentiment and new economic data, any news/tweets on tariffs (positive or negative) can have a major impact on the direction of stock prices. And once stocks start moving in one direction, they usually continue to do so (momentum) until sentiment shifts in the opposite direction. This is exactly what we saw with the vacillating tariff news in Q2.

Meanwhile, better than expected Q1 earnings reports and mixed Q2 economic data were likely a tailwind for stocks. Another potential tailwind was the fiscal implications of the "big, beautiful" bill that was moving through Congress. Without getting into the specifics of the bill, any bill that increases government spending and cuts taxes should result in a near-term economic boost, which is positive for the economy, corporate earnings, and stock

prices. Ultimately, the country is on an unsustainable fiscal path and this bill only exacerbates that problem with higher future deficits and government debt. The true costs of this bill will likely be paid for by higher future inflation. While Congress may eventually be forced to make cuts to entitlement spending and increase taxes, we believe that they will choose to print money (inflationary) first. Given the likelihood of higher future inflation, we would look to own companies that have strong pricing power, low debt levels, and/or own hard assets or natural resources. We would avoid highly commoditized businesses, highly indebted businesses, and long-term bonds.

Here's What Happened in Q2:

- Inflation readings were stable in the quarter with the latest year-over-year readings on core CPI and core PCE (fed's preferred gauge) of 2.8% and 2.7% respectively*, both above the Fed's stated target of 2%. While inflation continues to generally head lower, the Fed is hesitant to cut rates until they better understand the impact of tariffs. Therefore, the Fed maintained short term rates at 4.5%* throughout the quarter, with current forecasts of only two rate cuts* for the remainder of 2025.
- Yields on the 10-year Treasury bond initially moved lower to 4.0% as the market feared the tariffs could be recessionary. As those fears subsided with tariff revisions, long rates moved back up to 4.6% by late May and traded in a narrow range for the remainder of the quarter. Yields ended the quarter relatively unchanged at 4.2%.
- The S&P 500 ended up 10.9% in Q2 after an initial drop of over 10% in early April*.
- Growth stocks outperformed value stocks, up 17.8% versus 3.9% respectively, as mega-cap tech stocks led the recovery off the lows*.
- International stocks outperformed US stocks in the quarter and smaller stocks underperformed larger stocks*.

Index Returns (indices listed in footnotes)

	<u>US large-cap</u>	<u>US mid-cap</u>	<u>US small-cap</u>	<u>Developed International</u>	<u>Emerging Mkts.</u>	<u>Agg Bonds</u>
Q2 2025	10.9%	6.7%	8.5%	11.8%	12.0%	1.2%
YTD 2025	6.2%	0.2%	(-1.8%)	19.5%	15.3%	4.0%

How the Markets Look Now & What's Ahead:

- The S&P 500 continues to trade at a higher valuation than historical averages. Based on trailing 12 month estimates of \$240** in earnings per share for the index through Q2, the trailing price/earnings (P/E) ratio would be 25.9 (higher P/E= stocks are more

expensive). This compares to a 34-year median of 19.2*. Based on our 2025 estimate of \$265 per share, the market's forward P/E of 23.4 compares to a 34-year median of 17.1*. The large-cap stock benchmark is clearly expensive. Yet, the S&P indices for mid and small cap stocks are trading in-line or at a discount to historical valuations and appear relatively cheap.

- There continues to be a record \$2.9T in retail money market funds *. This represents a lot of liquidity that could eventually flow into stocks, even if a significant portion is likely earmarked as a fixed income alternative.
- As a proxy for flows into the US stock market, we watch flows into and out of US equity Exchange Traded Funds (ETFs), specifically monthly flows. We are still seeing strong flows into US stock ETFs as evidenced by \$45 billion* over the previous month or **\$540B** annualized. This annualized number is below the \$658B* over the last year, but above the \$450B* average over the last 3 years, a sign that inflows might be slowing but are still very positive.
- We still expect the yield on the 10-year Treasury to remain at or above 4.0% (currently 4.4%) unless there is fear of an economic slowdown.

Investment Considerations:

- Since elevated stock valuations=higher risk of below average long-term (5 year+) returns.***, we believe a more defensive allocation is still warranted. Within one's risk allocation (stocks), we suggest some tech exposure, but also exposure to unloved value stocks, small and mid-cap stocks.
- There are still good values outside mega-cap tech, particularly in healthcare and energy. The new tax and spending bill also presents opportunities.
- In fixed income, we would avoid long-term bonds due to the risk of long rates moving higher and stick to short-term and intermediate term (3-7 years) bonds.
- Other major risks beyond elevated valuations include: selling in the bond markets sends the 10- year Treasury yield above 5%; corporate earnings growth disappointing; and the ever present global and domestic geopolitical risks. The biggest long-term risk is out of control government debt and spending.

Disclosures

* Data from Bloomberg, **Data from S&P, ***Data from JP Morgan, ****Data from WSJ. All valuation data and estimates are only relevant as of 1/08/25 and are subject to change and revisions. The large-cap index is S&P 500, mid-cap index is S&P 400, small-cap index is Russell 2000, developed international index is the MSCI EAFE, emerging markets index is the MSCI EM, and the bond index is Bloomberg US Agg.

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