# Q2 2025


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The second quarter has been quite the rollercoaster ride. After falling into bear market territory post Liberation Day, the S&P 500 index has essentially roundtripped right back to reach new all-time highs. This has been driven by several factors that all have one common theme – the belief that the worst-case scenario has been averted. The first major catalyst has been the de-escalation of trade tensions. In particular, a reduction in the headline tariff rate on China to 30% from 145% significantly reduces the risks of a recession and has helped alleviate consumer and corporate confidence. Most recently, The U.S. and China have confirmed details of a trade framework that seeks to allow rare earth exports from China while the U.S. eases technology export restrictions. Second, earnings turned out to be better than feared while earnings revisions breadth continues to improve. Fears of an escalating war between Israel and Iran have also receded as a ceasefire agreement has been temporarily reached, reducing the risk of a major oil supply shock. Positive sentiment over the potential for a more diplomatic outcome led to a growth-oriented rally that helped push the Nasdaq 100 index to new record highs. Lastly, macroeconomic data has been mixed. A recent downward revision for 1Q U.S. GDP growth has reignited hopes for Fed rate cuts in 2025. Lastly, the labor market remains resilient despite previous concerns about the impact of tariffs, deportations and Federal government cuts. Wage gains have been healthy with the most recent year-over-year hourly earnings for private nonfarm payrolls increasing 3.9% over the past year.[1] The unemployment rate has remained steady at 4.2%[2] For its part, the Federal Reserve has kept rates unchanged. Its median number of expected cuts for 2025 remains at two, and Chair Powell appeared to take a "wait and see" approach to adjusting the policy rate. Going forward, we see several unresolved risks as well as opportunities ahead which we will discuss.

**Current Thoughts**

- While peak policy uncertainty may be behind us, risks remain until all major trade deals are finalized.
- We expect to see a moderate slowdown in growth from tariffs.
- Inflation may go up before it falls again as prices will likely need to readjust if demand falls sufficiently.
- Markets will seek clarity on the finalized bill that Congress passes.
- We believe rates will stay range bound unless growth slows more meaningfully and rate cuts resume.
- We expect any potential geopolitical risk event to have a minimal impact on markets aside from short term volatility.
- We expect to see more growth-positive policies in the second half of the year including de-regulation and tax incentives.
- We expect to see positive earnings revisions breadth continuing as a weaker dollar benefits multinationals.
- We remain positive on the potential for a continued pickup in productivity as more companies start to reap the benefits of AI (artificial intelligence).
- Given the quick shifts in market leadership, it is prudent to stay diversified across style boxes, sectors, regions, and asset classes.
- As markets have already priced in both peak optimism and pessimism in the 1H2025, we believe that, absent of a shock, it will shift its focus to a more positive earnings backdrop in 2026.
- We view structured products and alternative investments as options to mitigate risk and diversify portfolios for eligible investors, where appropriate.

1 Economic Policy Institute Nominal Wage Tracker; May 31, 2025.
2 US Equity Strategy – Weekly Warm-up; June 9, 2025.

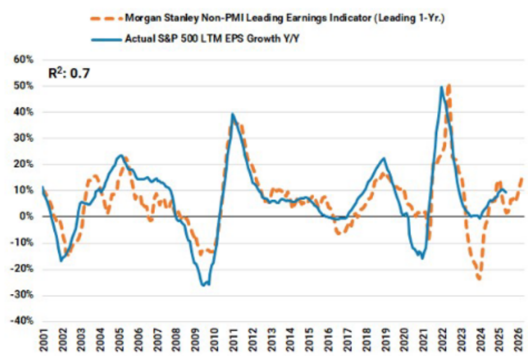
**Tariffs**

The extremely high starting levels for tariffs announced by President Trump on Liberation Day resulted in an equally extreme sell-off in markets and prompted economists and media outlets to immediately start forecasting a recession. Goldman Sachs' prime brokerage data showed that hedge funds sold the most global equities in the history of the data set since 2010. Other banks increased their probability of a global recession to as high as 60%. The S&P 500 fell more than -18% from its February highs while 40% of all NYSE stocks had traded to a new one-year low.[3] Given that the average stock in the S&P 500 Index already endured a 30% drawdown this year, there was an overwhelming amount of bad news already priced into stocks.[4] Effective US tariffs ultimately saw a major reduction from initial levels, catalyzing the complete reversal of all Liberation Day losses and reducing recession risks. Uncertainty is likely to remain an overhang as 90-day reprieves need to turn into more durable deals as key deadlines approach. The most recent deal with China has provided markets with much relief as rare earth minerals are essential in things ranging from electronics and technology devices to fighter jets utilized for national security.

Given the sharp snap-back we've seen, any disappointments in final trade deals with our other trading partners including the EU, Canada and Mexico may be met by a larger retracement in stocks. According to Morgan Stanley Economists, the average effective tariff rate, around 13%, will stay in place as trade negotiations persist. This assumption incorporates the 10% across-the-board tariff on imports, tariffs on steel, aluminum and autos and exemptions that comply with the United States Mexico-Canada Agreement (USMCA). They also assume that potential forthcoming tariffs on pharmaceuticals, chips and copper, among other items, will be roughly offset by exemptions achieved through bilateral negotiations and a reduction in tariffs on non-USMCA-compliant goods.[4] These tariff-induced gains in goods prices will likely cause inflation to temporarily rise. However, this is likely to be short lived as the demand decline that will then likely follow will ultimately force prices back down in order to meet it. We expect macro data and earnings for durable goods such as autos, electronics and technology hardware to be weaker in the near-term if we get a pay-back in demand following the higher amount of purchasing that was done to get ahead of the tariffs. The market impact from this is likely to be more muted given the excessive pessimism that was already embedded into some of these areas. In fact, we have already seen the market shift its focus back towards secular growth themes with greater near-term visibility. Knowing that growth is likely to slow, the market has once again embraced stocks showing the strongest earnings growth. This has helped the Nasdaq 100 index recover its losses and hit new all-time highs. Several AI related stocks also reported strong earnings despite previous export restrictions to China. This shows the resiliency of these companies given the essential nature and superior quality of their products.

While media outlets have highlighted the U.S. dollar's sharp pullback, they have not mentioned how this is a major tailwind for multinational companies' earnings growth and earnings revisions. When revisions breadth is accelerating in a V-shaped manner from an extreme low, equity markets typically remain supported and potential pullbacks tend to be more contained.[2] Earnings revisions bottomed at -25% in mid-April and is now at -9%. The dollar is currently down about 11% from the January highs, and our FX strategists see an additional 7% downside by the middle of next year.[5] Another catalyst that we see in the second half of the year is positive operating leverage. Morgan Stanley's Non-PMI Leading Earnings Model is projecting mid-teens EPS (earnings per share) growth by 1H26 even if growth slows below trend. This means that costs for the majority of the market cap of the S&P 500 are actually decelerating, while the demand-related indicators are stabilizing. If this continues to play out, especially in the context of lower oil prices and a weaker dollar, earnings growth can potentially surprise to the upside. Financial services in particular are likely to see an improvement in profitability as capital reserve requirements relax and payments on deposits fall once the Fed cuts rates. Now, with a little more clarity on tariffs and the economy, there has been some unlocking in deal making and capital markets activity. We believe that AI can also improve margins and labor productivity for more companies going forward. As the cost of inference, which is the process of running live data through a trained AI model to reach a decision or solve a task, has fallen, a larger set of companies can begin to start leveraging it to improve productivity and profitability. AI capex growth has already slowed following elevated levels in 2024. This essentially means that certain companies can start to see higher returns on their investments, resulting in gross margins that are more supported.

**Exhibit 1:** Our Non-PMI Leading Earnings Indicator Is Pointing to a Clear Inflection Higher in EPS Growth...




Note: Non-PMI LEI components are Philadelphia Fed economic activity, Creighton U. business confidence, Chicago Fed supplier deliveries, Atlanta Fed wage tracker (inverse signal), NFIB small bus. most important problem inflation (inverse signal), and Brave-Butters-Kelley cycle component of monthly GDP. Source: Bloomberg, FactSet, Haver, Morgan Stanley Research

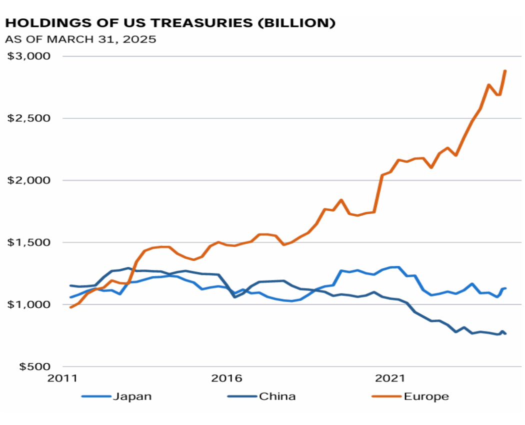
Tariff headwinds are likely to be modest assuming current tariff rates stay in place and are largely concentrated in a few areas of the S&P 500 that have lower market cap and net income percentage index weights (less than ~15% according to MS & Co.).[6] This includes certain cohorts within Consumer Discretionary and companies with limited pricing power as an offset. Overall, earnings for US equities at large should remain supported by a positive rate of change in operating leverage, dollar weakness, and broader realization of AI-driven

3 Applied Equity Team - May 2025.
4 On the Markets – June 2025.
5 Weekly Warm-Up; June 16, 2025.
6 Weekly Warmup; June 23, 2025.

efficiency gains. We believe the market will eventually start to refocus on 2026, where we expect to see stronger EPS growth and lower rates.

### The Fed & Rates

The Fed has been on hold since December as it waits to see what impact tariffs will ultimately have on inflation. If the later proves to be temporary and growth starts to slow, we believe the market will have more visibility on the path for rate cuts. While the Fed has been less dovish in its rhetoric, it did slow the pace of its balance sheet roll off, better known as quantitative tightening early. As tariffs will take time to flow through the system, we could see more rate cuts in 2026 and potentially none in 2025, regardless of the current dot plot. Weaker demand from higher prices could eventually push inflation back down if prices fall lower. This should give the Fed confidence that it can start cutting rates without reigniting inflation. In this scenario, we prefer a barbell approach to fixed income positioning in order to prepare for both higher short-term inflation and slowing growth. We continue to like credit which has remained well behaved despite concerns over debts and deficits. Corporations, for the most part, have been more prudent with their balance sheets post-COVID. Bank capital requirements may be loosened to allow banks to raise Treasury holdings by as much as 1.5% of assets without impacting capital charges. This is important, as US Treasury issuance is poised to accelerate when the debt ceiling is raised this summer, with more than a third of issuance scheduled for the front end. Proposed legislation on stablecoins, frequently backed by US hard currency collateral, could also stimulate short-duration Treasury demand.[4] We expect the steeping of the yield curve to continue as shorter-term rates may come down faster than longer-term rates as a result of the Fed's cutting. This should, at least, partially alleviate some of the concerns regarding the cost of interest on the U.S.'s debt as well as the demand for US debt going forward. It is unrealistic to think that the rest of the world will simply dump their holdings of US treasuries. While China and Japan have held less over the years, Europe has been a net buyer.




Source: Morgan Stanley Wealth Management GIO, Bloomberg.

While it may sound scary to hear that our national debt can be as high as $3.8 trillion over the next 10 years, it is important to keep things in perspective. This actually works out to about $380 billion annually. The last time our national debt went up by less than $300B in a single year was September 30, 2001. If GDP grows at 2.5% per annum, GDP is likely to exceed the uptick in our national debt over the next 10 years.[7]

### Geopolitical Risks

The biggest risk for equities as it pertains to the recent conflict in the Middle East would be that oil prices rise significantly. As oil is an input cost for a large part of our economy, this would pose a threat to the business cycle. History suggests that such a rise in oil would need to be in the range of +75% on a year-over-year basis ($120+/bbl). As we are currently nowhere near these levels, it would take a sustained supply disruption in the Strait of Hormuz in order to drive oil prices significantly higher. So far, large number of vessels continue to travel via the Strait of Hormuz.[8] While geopolitical uncertainty is certainly unnerving, it is important to note that the market has looked past prior tensions and risk events. Markets have been resilient and recovered relatively quickly from declines associated with geopolitical events. Such historical instances include September 11th and Afghanistan, Iraq's invasion of Kuwait, Russia's invasion of Ukraine and many more, including the COVID-19 pandemic.

### Market Rotations

While the first half of the year saw an overwhelming shift to defensives over cyclicals, value over growth and International over U.S. equities, we have seen much of that reverse in the second half of the year. As we mentioned, strong results from AI chipmakers and enthusiasm over the de-escalation of both trade tensions and geopolitical conflicts caused growth stocks and cyclicals to retake their lead after a massive correction.


Source: Morgan Stanley Wealth Management GIO, Bloomberg.

As earnings revisions breadth has broadened for both, we believe the market is searching for growth leaders as it begins to digest that growth will likely become scarcer. As we expect tariffs to produce both winners and losers, we continue to prefer services over goods, which are less tariff exposed, including financial services, media streaming and software services, including cybersecurity. We remain optimistic on AI

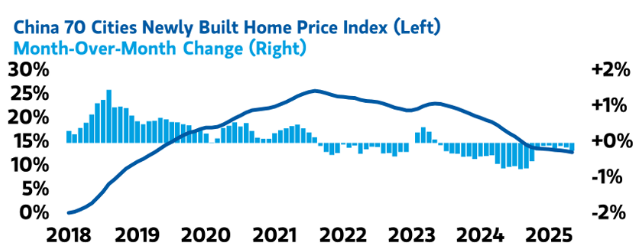
7 Kevin Griffin, MSWM Capital Markets Rates and MBS Commentary; June 5, 2025.
8 The Oil Manual - Martijn Rats; June 16, 2025.

beneficiaries and see opportunities across both the value and growth spectrum, which supports our advocacy for a balanced approach between the two. We see capital goods stocks and infrastructure as beneficiaries from the reshoring theme. We expect that the potential passage of tax cuts and deregulation can serve as a catalyst for banks and assets managers, which have sold off meaningfully in the first half of the year. A less restrictive regulatory environment, along with better opportunities for lending and higher net interest margins, should continue to support the fundamental outlook for the space going forward.

International equities have recently lagged after a strong start to the year. Europe has seen a near term pullback due to the possibility of being cut off from Iran's oil supply after already trying to ween off of Russia's. While the degree of outperformance of International over U.S. equities may be more muted in the second half of the year, we still see positive tailwinds. Europe is now committed to increasing defense and infrastructure spending, which is a major shift. NATO partners have also committed to increasing spending by 5%. While a stronger Euro weighs on certain European equities, we believe Europe can still benefit from fiscal policy and lower rates. While capital flows into the U.S. are likely to remain positive, we believe capital may also make its way back to Europe and the rest of the world as they benefit from "self-help."

China has also seen a major rebound from depressed levels thanks to excitement around generative AI capabilities. We view investing in China as more of a trade than a high conviction fundamental call. While China has enacted fiscal stimulus to boost consumer demand, Chinese consumers are reluctant to spend given their wealth is still tied up to a weak property market.

**China's New-Home Prices Have Fallen for 24 Consecutive Months**



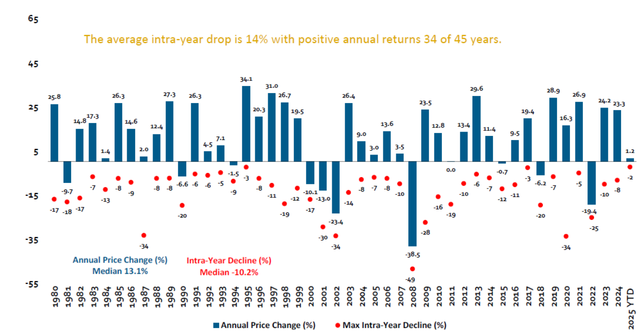

China is also likely to face headwinds if exports disappoint given their massive inventory glut. Despite President Xi Jinping's new embrace of China's technology sector, we still recall a time when he almost destroyed it with crackdowns and restrictions. Given the high degree of uncertainty surrounding China, we look to active International managers to access potential exposure.

**Outlook**

Looking towards the second half of this year and into 2026, tariff uncertainty remains, but we see the administration pivoting to the more growth-positive part of its policy agenda. There is slightly more clarity on the fiscal path, as both chambers of Congress have aligned on a strategy to extend the expiring 2017 Tax Cuts and Jobs Act (TCJA) and implement more tax cuts, which will likely be largely offset by savings found elsewhere. We expect to see efficiency gains from deregulation and further improvements in productivity from companies and employees utilizing AI (artificial intelligence). We believe tariff-induced gains in goods prices will cause inflation to rise temporarily before falling back towards the Fed's target. We see the Federal Reserve on hold this year, with back-loaded rate cuts in 2026. The quick snap-back in markets aligns with our previous call that 2025 will likely be a year of two halves. We remind investors that pullbacks are normal and should be expected. Recent dollar weakness could improve earnings growth for multinationals going forward. The market may start to price in a decline in rates before it actually occurs, which should benefit bonds. Over the last 15 years, we have experienced four different growth scares, none of which led to a recession.[9] We remind investors that it is prudent to keep emotions contained as markets usually recover quickly from corrections and have grown dramatically over time, even though intense geopolitical and economic turmoil.

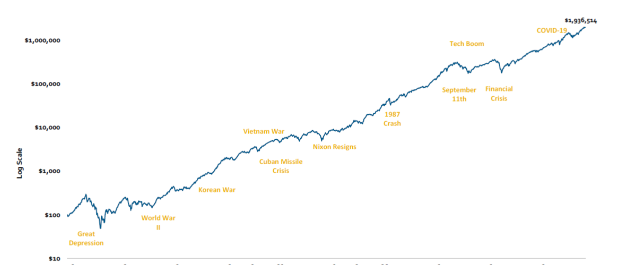
**Markets Rarely Finished the Year at Their Sharpest Intra-Year Lows**

S&P 500 Annual Price Change and Intra-Year Declines
Data through February 28, 2025




**Over the Long Term, S&P 500 Has Grown Despite Negative Events**

S&P 500: Growth of $100
Monthly data: January 31, 1926 – February 28, 2025




Source: FactSet, Ibbotson, Calculated by Morgan Stanley Wealth Management GIC using data provided by Morningstar. (c) 2023 Morningstar, Inc. All rights reserved. Used with permission. This information contained herein: (i) is proprietary to Morningstar and/or its content providers; (ii) may not be copied or distributed; and (iii) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information.
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Source: Bloomberg, FactSet, Morgan Stanley Wealth Management GIO. Intra-year declines are defined as the peak-to-trough decline during the year based on closing price return.
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9 JP Morgan Market Insights- Alan Wynne; March 14, 2025.

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An investment in Structured Investments is subject to significant risks and may not be appropriate for all investors. These risks can include, but are not limited, to: fluctuations in the price, level or yield of underlying asset(s), interest rates, currency values and credit quality; substantial loss of principal; limits on participation in appreciation of underlying asset(s); limited liquidity; credit risk of the issuer; and, conflicts of interest.

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Foreign currencies may have significant price movements, even within the same day, and any currency held in an account may lose value against other currencies. Foreign currency exchanges depend on the relative values of two different currencies and are therefore subject to the risk of fluctuations caused by a variety of economic and political factors in each of the two relevant countries, as well as global pressures. These risks include national debt levels, trade deficits and balance of payments, domestic and foreign interest rates and inflation, global, regional or national political and economic events, monetary policies of governments and possible government intervention in the currency markets, or other markets.

The interest rate on a floating-rate security may be lower than that of a fixed-rate security of the same maturity. The reference rate could be an index or an interest rate. There can be no assurance that the reference rate will increase. The interest rate is subject to change and the projected yield to maturity at purchase may or may not be realized due to changes in the reference rate. Some floating rate securities specify rate minimums (floors) and maximums (caps). Some floating-rate securities may be subject to call risk.

Duration, the most commonly used measure of bond risk, quantifies the effect of changes in interest rates on the price of a bond or bond portfolio. The longer the duration, the more sensitive the bond or portfolio would be to changes in interest rates. Generally, if interest rates rise, bond prices fall and vice versa. Longer-term bonds carry a longer or higher duration than shorter-term bonds; as such, they would be affected by changing interest rates for a greater period of time if interest rates were to increase. Consequently, the price of a long-term bond would drop significantly as compared to the price of a short-term bond.

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The companies identified within are shown for illustrative purposes only and should not be deemed a recommendation to purchase or sell the companies mentioned.

Equity securities may fluctuate in response to news on companies, industries, market conditions and the general economic environment. Companies cannot assure or guarantee a certain rate of return or dividend yield; they can increase, decrease or totally eliminate their dividends without notice.

Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies.

**Small- and mid-capitalization companies** may lack the financial resources, product diversification and competitive strengths of larger companies. In addition, the securities of small- and mid-capitalization companies may not trade as readily as, and be subject to higher volatility than, those of larger, more established companies.

Growth investing does not guarantee a profit or eliminate risk. The stocks of these companies can have relatively high valuations. Because of these high valuations, an investment in a growth stock can be riskier than an investment in a company with more modest growth expectations.

Value investing does not guarantee a profit or eliminate risk. Not all companies whose stocks are considered to be value stocks are able to turn their business around or successfully employ corrective strategies which would result in stock prices that do not rise as initially expected.

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Indices are unmanaged. An investor cannot invest directly in an index.

For index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

Interest on municipal bonds is generally exempt from federal income tax. However, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax-exemption applies if securities are issued within one's state of residence and, local tax-exemption typically applies if securities are issued within one's city of residence. The tax-exempt status of municipal securities may be changed by legislative process, which could affect their value and marketability.

Bonds are affected by a number of risks, including fluctuations in interest rates, credit risk and prepayment risk. In general, as prevailing interest rates rise, fixed income securities prices will fall. Bonds face credit risk if a decline in an issuer's credit rating, or creditworthiness, causes a bond's price to decline. Finally, bonds can be subject to prepayment risk. When interest rates fall, an issuer may choose to borrow money at a lower interest rate, while paying off its previously issued bonds. As a consequence, underlying bonds will lose the interest payments from the investment and will be forced to reinvest in a market where prevailing interest rates are lower than when the initial investment was made. NOTE: High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues.

Real estate investments are subject to special risks, including interest rate and property value fluctuations, as well as risks related to general and economic conditions.

Risks of private real estate include: illiquidity; a long-term investment horizon with a limited or nonexistent secondary market; lack of transparency; volatility (risk of loss); and leverage.

Investors should carefully consider the investment objectives and risks as well as charges and expenses of a mutual fund before investing. To obtain a prospectus, contact your Financial Advisor or visit the fund company's website. The prospectus contains this and other important information about the mutual fund. Read the prospectus carefully before investing.

Treasury and Government Money Market: You could lose money by investing in the Fund. Although the Fund seeks to preserve your investment at $1.00 per share, it cannot guarantee it will do so. An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Fund's sponsor has no legal obligation to provide financial support to the Fund, and you should not expect that the sponsor will provide financial support to the Fund at any time.

You could lose money by investing in a Money Market Fund. Because the share price of the Fund will fluctuate, when you sell your shares they may be worth more or less than what you originally paid for them. The Fund may impose a fee upon sale of your shares or may temporarily suspend your ability to sell shares if the Fund's liquidity falls below required minimums because of market conditions or other factors. An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Fund's sponsor has no legal obligation to provide financial support to the Fund, and you should not expect that the sponsor will provide financial support to the Fund at any time.

Asset Allocation, Diversification and Rebalancing do not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy.

CDs are insured by the FDIC, an independent agency of the U.S. Government, up to a maximum of $250,000 (including principal and accrued interest) for all deposits held in the same insurable capacity (e.g. individual account, joint account, IRA etc.) per CD depository. Investors are responsible for monitoring the total amount held with each CD depository. All deposits at a single depository held in the same insurable capacity will be aggregated for the purposes of the applicable FDIC insurance limit, including deposits (such as bank accounts) maintained directly with the depository and CDs of the depository. For more information visit the FDIC website at www.fdic.gov.

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