Q3 2025

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Markets continued to reach new highs in the third quarter thanks to better earnings, clarity on the path for Fed rate cuts, and healthy financial conditions. Following peak uncertainty and concern around tariffs on Liberation Day, we believe the market is now focused on a more positive rate of change and a rebounding earnings backdrop. Companies, for the most part, have handled higher import tariffs better than expected through cost controls, supply chain changes and pricing strategies. Any negative policy impacts have been more concentrated in certain sectors rather than the broader market. A softer US dollar, range-bound crude oil prices, and Artificial Intelligence ("AI") enabled efficiency gains have also been tailwinds that we expect to continue. For its part, the Fed cut rates by 25bps in response to slowing growth and a weaking job market. It also added an additional rate cut to this dot plot, bringing its forecast to three cuts for this year. It is clear that the Fed is now more concerned with the potential for a greater slowdown and is more willing to tolerate the risk of higher inflation. What prompted the Fed to cut rates by 50 bps in the fall of last year was the pickup in unemployment as an increase in immigration caused the supply of labor to outpace the demand for it. This time around, we expect unemployment to remain contained as deportations have reduced the labor pool. However, we do expect the labor data to come in weaker than expected due to weaker government jobs data. The lagging data may not show negative payroll growth until early November when the government employees affected by DOGE in February/March file for unemployment. Currently, these former employees have been receiving severance through September.[1] Higher tariff-driven costs are expected to increase as we head into year-end. We expect these to be one time price increases before any potential demand destruction forces prices to come back down in response. However, in the near term, any increase in inflation that outpaces expectations, regardless of whether it is temporary or not, is likely to be met with negative price action in the markets. We would be buyers of any potential pullback this may cause.

Current Thoughts

- We believe the upcoming Fed cutting cycle, a weaker USD, and AI adoption support a bullish narrative for the equity market over the longer term.
- We remain positive on the potential for a continued pickup in productivity as more companies start to reap the benefits of AI (artificial intelligence).
- We expect to see the pick-up in M&A and IPO activity to continue as the cost of capital falls.
- We expect to see a moderate economic slowdown in growth from tariffs.
- We expect price dispersion to remain elevated across companies and sectors.
- We see positive tailwinds for international equities due to a weaker dollar and increased fiscal stimulus.
- While small caps may continue to see a near-term rally as the Fed cuts rates, we remain cautious longer term due to their lower quality amidst a slowing economy.
- We expect a temporary tariff related pickup in prices and inflation in Q4, which can potentially catalyze the next near-term pullback.
- We would be buyers of any potential pullback.
- We see the lack of euphoria in the markets as a positive contrarian signal given that earnings fundamentals remain strong.
- While we expect the labor market to weaken as DOGE layoffs flow through the data, we see unemployment risks as contained as a low hiring rate is accompanied by a low firing rate thanks to a smaller labor pool.
- We view structured products and alternative investments as options to mitigate risk and diversify portfolios for eligible investors, where appropriate.

1 US Equity Strategy; Weekly Warm-Up; 9/22/25

An Un-Loved Rally

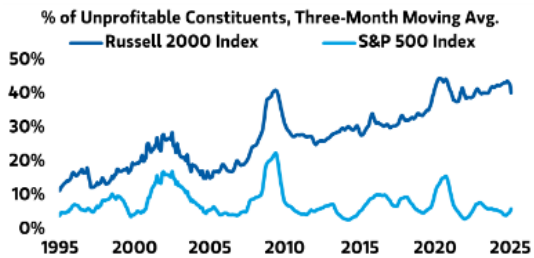
The economy and markets have been telling diverging stories. Macroeconomic data has started to weaken while the S&P 500 has posted new all-time highs, driven largely by robust consumer spending, significant corporate technology investments (especially in AI), and favorable tax policies. We continue to reiterate that the market is not the economy. The economy is slowing, as expected. However, companies have delivered much stronger earnings growth than expected as well. According to FactSet, 81% of S&P 500 companies have beaten analyst expectations in Q2 earnings, beating the ten-year average of 75%. Total Q2 earnings growth came in at 12% with 6.4% revenue growth. Both of these figures have easily beaten estimates.[2] Despite these positive results, sentiment is still somewhat pessimistic. According to the latest AAII Investor Sentiment Survey, investors' sentiment over the next 6 months is 41.7% bullish, 16% Neutral and 42.4% bearish.[3]. Bearish sentiment is well above its historical average of 31% while bullish sentiment is significantly below its norm of 38%.[4] What has contributed to this resilience? So far, the year over year change in revenues continues to outpace the year over year change in costs by nearly two percentage points, even after tariffs have been implemented.[4] Analysts, who became overly pessimistic after Liberation Day have now been forced to upwardly revise their estimates. In fact, we have seen a historic 35% re-acceleration in earnings revisions breadth over the last three months. The earnings growth of the median stock in the Russell 3000 is now positive at 6% after a long period of negative and stagnant growth.[1] What are the risks? Many US companies, especially those with strong profit margins and robust earnings, initially absorbed the rising costs associated with tariffs rather than immediately passing them on to consumers. Analysts expect the full impact of the recent historically high tariffs to be felt more substantially in late 2025 and 2026 as some firms are starting to pass more of the costs to consumers as they find it more difficult to absorb them. As we have mentioned earlier, weaker demand from higher prices could eventually push inflation back down if prices fall lower. We expect consumer spending to slow but remain positive as this occurs. We have cited the strength of the consumer, even during periods of economic hardship. This is largely in part to the healthy nature of the consumer's balance sheet. Consumers have seen their wealth increase over the years, thanks to strong financial asset performance and higher home equity values. The younger cohort, which comprises a smaller portion of aggregate spending, remains most vulnerable, as finding jobs has become more difficult and home affordability is still challenged by constrained supply. Overall, spending is expected to remain healthy as long as we do not see a massive pickup in layoffs, which is not our base case.

Many companies have cited different methods of tariff mitigations. Some have looked for alternative supply chains while others have gained market share and volume growth by absorbing costs, while others have used automation and AI to cut costs elsewhere within their businesses. While tariffs remain an overhang for certain pockets, it's important to note that they do not impact every company and sector equally, much in the same way that benefits from the One Big Beautiful Bill (OBBBA) do not broadly benefit every company and sector equally. When examining the S&P 500 Index, the number of companies that benefit from the Trump administration's pro-growth policies greatly exceed the number of companies impacted negatively by tariffs. Said differently, the industries that are more impacted by tariffs comprise a much smaller weight in the index than the industries that benefit from deregulation and increased cash flow generation from being able to expense R&D and bonus depreciation upfront.[5] This explains why Consumer Discretionary as a whole has underperformed the broader market this year. Again, different companies within the sector have seen high performance dispersion due to their different degrees of pricing power, brand loyalty, cost cutting efforts, automation, etc. In fact, those that have benefited from utilizing AI for inventory management, supply chain automation, demand planning/forecasting, and customer care/service have fared far better than expected. Sectors such as industrials have stronger pricing power in general due to their essential nature and should continue to see policy-driven tailwinds from near-shoring and domestic AI investment that can sufficiently offset any increased material costs they may face. In a similar fashion, semiconductors have outperformed despite negative policy impacts, as benefits from the AI theme have outweighed the policy risks. Many have cited high visibility into future earnings from strong orders from data centers.

We believe that AI has the potential to unlock new sources of growth, productivity and innovation across sectors. AI's economic value creation can come from cost cutting (lower headcount, lower costs to perform a wide variety of tasks by deploying AI) and new revenue and margin generation (freeing employees to spend more time on higher-value-added activities that could both increase revenue and enhance margins). According to Morgan Stanley's analysis, many sectors have potential savings (pretax, net of indicative implementation costs) that exceed 50% of consensus estimated 2026 pretax earnings. However, the full benefits are likely to be seen over the long term. We compare this to past historical events such as when profits benefited from an investment cycle underpinning internet and PC adoption. Lastly, it is worth nothing that the impacts of these technological advancements have been disinflationary over the longer term.[6] Media outlets have claimed that companies have poured billions into AI without seeing it pay off yet, raising fears of a bubble. However, it long-horizon transformation should not be met with short-horizon expectations. Like earlier technologies such as electrification, railroads, and the internet, AI follows a "J-curve." The early years demand large investments in data, infrastructure, and talent while producing modest returns. However, the benefits tend to compound once the systems are fully integrated.[7]

2 FactSet Earnings Insights; 9/19/25
3 Charles Schwab Weekly Trader's Outlook; 9/15/25
4 Applied Equity Team – September 2025
5 US Public Policy x Thematic Alpha; Explaining Equities Resilience to Policy Risks; 8/20/25
6 On the Markets; September 2025
7 AI's Payoff Problem Is Not About Technology. It's About Time Horizons; Jessica Pollock – September 2025

Small cap companies have seen their valuations drop over the last several years due to their greater sensitivity to higher interest rates following the Federal Reserve's hiking cycle. While a Fed cutting cycle can work in their favor, we believe that improving fundamentals, such as positive earnings revisions or a more supportive macroeconomic environment, may also be necessary in order for small-cap outperformance to prove sustainable. So far, the proportion of companies without earnings in the Russell 2000 index remains high at around 41%. During the COVID-19 pandemic, the percentage of non-profitable small-cap companies surged, concentrated in industries like renewables energy, pharmaceuticals and electric vehicles.[8] We view small caps as a short-term trade versus a long-term hold.



Source: Bloomberg, Morgan Stanley Wealth Management GIC. Data as of August 31, 2025.

International Markets

A weaker dollar has benefited the earnings growth of both US multinational companies as well as international companies. Over the last decade, a strong dollar has dampened international returns. The Trump administration has been laser focused on increasing exports and has heavily relied on a weaker dollar in order to do so. This bodes well for international markets. So far, the winners in international markets have been domestic companies with low dollar exposure as well as value-oriented sectors that have benefitted from increased spending on infrastructure, defense spending and the energy transition. One of the most notable outperformers has been European banks, which are finally benefitting from positive yields and improved profitability. We continue to like having a core style preference in order to benefit from this theme while still having exposure to high quality blue chips in the growth space including semiconductors that are supporting the buildout of generative AI, top tier streaming and e-commerce companies, as well as luxury goods producers with strong pricing power. We are positive on the self-help stories occurring overseas and well as tailwinds from dollar weakness. With regards to Asia, we continue to like companies that benefit from their essential roles within the AI supply chain.

Fixed Income & Rates

The Fed sees downside risks to employment. However, Chair Powell acknowledged that while the demand for workers has come down sharply, the lack of available workers is helping to prevent layoffs. This explains why the FOMC's unemployment forecast moved down despite Powell's more cautious tone. While the FOMC marked up its core inflation forecast for 2026 to 2.6% from 2.4%, this reflects Powel's view that there will be a one-time goods price increase.[9] Meanwhile, sticky inflation components continue to soften, especially housing, which may help the Fed look past tariff related inflation when cutting rates. We believe inflation risks will continue to diminish once we move beyond the initial hit of higher tariffs. Furthermore, as past technological advancements have turned out to have deflationary effects, we believe that AI has the potential to keep inflation at bay in the long run.

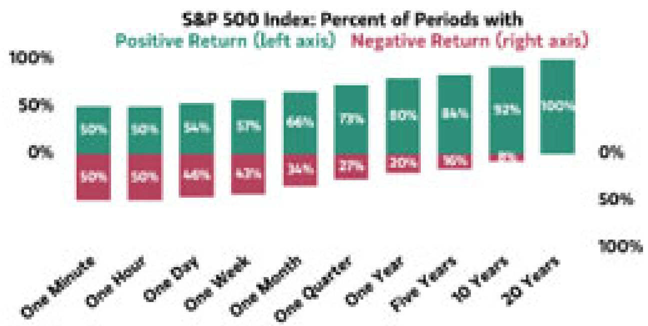
We do not believe Powell's decision has been a result of political pressures and expect the Fed to remain data dependent. While President Trump has repeatedly criticized the Fed for not cutting rates sooner, the real threat is the volatility that taking legal actions against a sitting Fed chair can present in the future if these actions continue. The run-up in gold that followed Lisa Cook's firing shows that the Fed's independence is not something the market takes lightly. We believe the Fed must continue its long-held mandate to set policy based purely on the goals of maximum employment and price stability. With that said, risks remain that the new Fed make-up following the end of Chair Powell's term may appear politized to the market, putting the Fed's credibility at stake. In the near term, the Fed continues to play a balancing act between maintain labor market stability while not allowing inflation to run too hot for too long. This is why we remain balanced within our fixed income allocation, although we have moved up duration. Most notably, we have overweighted multisector fixed income exposure, which has the ability to invest in both currencies and international and emerging market bonds. With US credit spreads at historically tight levels, we prefer a flexible fixed income mandate. We still believe it is prudent to maintain some exposure to shorter duration fixed income as well in order to hedge against temporary pickups in inflation. We do encourage investors who are overweight ultrashort fixed income or cash alternatives to be mindful of reinvestment risk.

Outlook

To sum up, while we remain optimistic on both equities and fixed income, we do expect volatility to pick up as tariffs flow through earnings and government shutdown risks remain. Given that the market's rally has been met with such doubt and skepticism despite strong fundamentals, we would be buyers of any pullbacks. The steep sell-off that we've seen on Liberation Day has de-risked the forward-looking results to a large degree, in our opinion. Given the high degree of concentration in the market to the Magnificent Seven, we encourage investors with high allocations to that cohort to seek diversification. We see opportunities across other areas of the market that have not yet participated to the same degree including asset managers that can benefit from lower yields and a pickup in M&A and IPO activity or medical devices that have sold off on citing higher costs despite their essential nature. We expect to see efficiency gains from deregulation and further improvements in productivity from companies and employees utilizing AI. The quick snap-back in markets aligns with our previous call that 2025 will likely be a year of two halves, with the administration starting off with tariffs before implementing pro-growth

8 Topics in Portfolio Construction September 16, 2025
9 KKR Flash Macro Update Henry McVey; September 2025

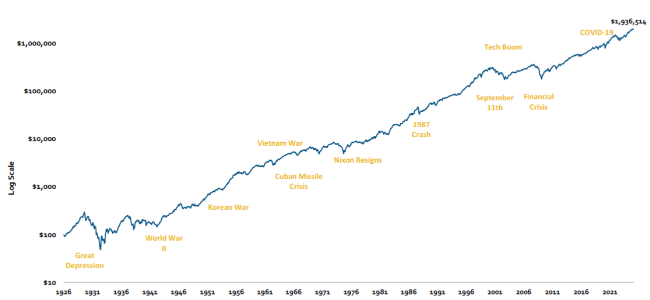
policies. We remind investors that it is prudent to keep emotions contained as markets usually recover quickly from corrections and have grown dramatically over time, even though intense geopolitical and economic turmoil. We encourage investors to stay aligned with their long-term investment plan and lean on periodic rebalancing and disciplined contributions rather than reacting to stomach-churning market action.



Source: Morgan Stanley Wealth Management GIC. Data as of August 31, 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



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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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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

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2024 Forbes Best-In-State Wealth Management Teams
Source: Forbes.com (Jan 2024) 2024 Forbes Best-In-State Wealth Management Teams ranking awarded in 2024. This ranking was determined based on an evaluation process conducted by SHOOK Research LLC (the research company) in partnership with Forbes (the publisher) for the period from 3/31/22–3/31/23. Neither Morgan Stanley Smith Barney LLC nor its Financial Advisors or Private Wealth Advisors paid a fee to SHOOK Research LLC, for placement on its rankings. This ranking is based on in-person and telephone due diligence meetings to evaluate each Financial Advisor qualitatively, a major component of a ranking algorithm that includes client retention, industry experience, review of compliance records, firm nominations, and quantitative criteria, including assets under management and revenue generated for their firms. Investment performance is not a criterion. Rankings are based on the opinions of SHOOK Research LLC, and may not be representative of any one client's experience; investors must carefully choose the right Financial Advisor or team for their own situation and perform their own due diligence. This ranking is not indicative of the Financial Advisor's future performance. Morgan Stanley Smith Barney LLC is not affiliated with SHOOK Research LLC or Forbes. For more information, see www.SHOOKresearch.com.

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2024 Forbes America's Top Wealth Management Teams
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