The month of May produced extraordinary returns for US equity investors – the S&P 500 posted its best May return since 1990, up 6.2 percent. The rally extended down the capitalization spectrum with the Russell Mid-Cap and Russell 2000 gaining 5.7 and 5.3 percent respectively. Growth outperformed value for the month with the Russell 1000 Growth gaining 8.8 percent and the Russell 1000 Value gaining 3.5 percent. International stocks also had a good month with the MSCI All-Cap World Ex-US gaining 4.7 percent. Bonds did not fair as well: the Bloomberg Aggregate Bond Index fell 0.7 percent for the month as rates rose on the back of a US debt downgrade by Moody's.

But May's US equity market dominance opposed the clear trend so far this year – the best returns in 2025 have come from simply investing in non-US dollar-denominated assets. Dollar weakness has buoyed the returns of foreign stocks, foreign bonds, gold, silver, and cryptocurrency. Year-to-date through May 31st, the S&P 500 gained only 1.1 percent for the year and the Dow Jones Industrial Average only 0.1 percent. The Bloomberg Aggregate Bond Index gained 2.4 percent. On the other hand, international market returns have been robust. Through the first 5 months, the MSCI EAFE gained 17.3 percent and the MSCI Emerging Markets Index 8.9 percent. Foreign treasury bonds as measured by the Bloomberg Global Ex-US Dollar Aggregate Bond index gained 7.7 percent. Gold and silver gained 24.5 percent and 13.0 percent respectively.

So what happens next in a year that has already seen a bear market and the start of a new bull in its first 5 months? Morgan Stanley's Global Investment Committee released its mid-year outlooks at the end of May and summarized its key points as follows:

For its Investment Outlook:

1. Equities and high-quality fixed income should provide reasonable returns as the global economy slows but avoids a recession.
2. Investors should favor U.S. assets over the rest of the world with the S&P 500 climbing to 6,500 by the middle of 2026 and government bonds offering attractive returns as the Fed cuts rates in the first half of next year.
3. The U.S. dollar should continue weakening benefiting other safe-haven currencies including the euro, yen and Swiss franc.
4. Oil is expected to tip into oversupply in late 2025, pushing prices lower, and investors should underweight commodities.

For the Economic Outlook:

1. Global growth is set to weaken to an average annual rate of 2.9% this year (or 2.5% in the fourth quarter), as U.S. deceleration weighs on the rest of the world.
2. Inflation is likely to slow in most countries, except in the U.S., where tariffs may increase consumer prices to a peak in the third quarter.
3. Central banks could react to lower growth and inflation with rate cuts, except for the U.S., where rates are likely to remain steady until March 2026.
4. Governments in the U.S, Europe and China may spend more to stimulate growth, increasing their deficits.

Overall, our team does not take much issue with the bullets above. Diversified portfolio returns have been good so far and we are optimistic about the remainder of the year just like Morgan Stanley. An astute reader of these lists might note that bullets two and three in the investment outlook are inherently contradictory as evidenced by the YTD contrast in foreign and domestic stock returns listed above. A similar contradiction could be observed between falling oil prices and accelerating inflation. Our team's view differs from Morgan Stanley only with regard to these two issues. We think that rate cuts likely resume this fall rather than next spring, possibly improving bond returns as we end the year. We also think dollar weakness is a feature, not a bug, of the Trump administration's economic plan (the administration wants to shrink trade deficits which is best accomplished by a weaker dollar which makes imports of foreign goods and services relatively more costly to US consumers and US exports relatively less costly to foreign buyers). We would not be surprised to see continued outperformance of non-dollar assets not just in 2025 but for the next 3 or 4 years.

The second quarter GDP number will likely be robust. The Fed's GPD Now estimate is about 3.8 percent. Why? For the same reason the first quarter was negative. As companies increased inventory to front run tariffs, the inventory build made the first quarter number quite low. The second quarter GDP number will likely reflect the opposite effect as companies drew upon that inventory these past couple months and waited to reorder new goods until the muddy waters of the tariff chaos cleared a bit. Both the poor first quarter and the robust second quarter are a bit of a mirage and should be regarded as outliers not indicative of a general trend.

Despite all the talk, inflation the last three months will likely be the lowest since before Covid – the official March and April CPI numbers were negative 0.1 percent and positive 0.2 percent respectively. The Cleveland Fed's Inflation Nowcast number for May is only 0.13 percent – so inflation from March first through the end of May, was something on the order of 0.23 percent for the entire 3 months – about 40-50% of the Federal Reserve's target of 0.5 percent per quarter (This was written over the weekend of June 7-8 and the actual number for CPI came out this morning right before we were cleared to publish at 0.1 percent for May. June Nowcast remains at 0.24 percent.) As we indicated last month in our note, we do expect the CPI numbers to accelerate a bit in June, July and August as the impact of the tariffs become realized – but we see that more as a one-time price shock/tax increase than what an economist means when they use the word "inflation." The economist's definition would be better linguistically formulated as a prolonged series of price increases that compound over time rather than simply as a price increase. Therefore, we think inflation expectations may actually continue to fall over the course of the summer. It's also true that the magnitude of the tariffs waned significantly in late April and May as Trump walked back/suspended many of the reciprocal tariffs and courts voided others. In other words, there may not be as much tariff-related "inflation" this summer as was once feared. The inflation Nowcast number for June is currently 0.24 percent on June the 9th – which would annualize at something on the order of 3%, and would still be a lower number the November, December, or January inflation prints – the three months preceding Trump's tariff and immigration policy shifts.

Morgan Stanley's Chief Economist, Michael T. Gapen, wrote in this month's On the Markets, "we think the average effective tariff rate, at 13%, will stay in place as trade negotiations persist. This assumption incorporates the 10% across-the-board tariff on imports; additional levies that bring the total tariff rate on China to 40%; tariffs on steel, aluminum and autos; and exemptions for trade that complies with the United States-Mexico-Canada Agreement (USMCA). We 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. While down from the level observed on April 2, the effective tariff rate in our revised midyear baseline outlook is much higher than the 8%–9% we assumed in our year-ahead outlook."

Lastly, we want to highlight an excellent piece by Richard Bernstein Advisors from May 29th that compares the attractiveness of quality international stocks relative to US stocks from a fundamental perspective. His point has nothing to do with dollar weakness but is also quite valid: the expected growth rate and dividend yield of quality international stocks make those securities among the most desirable on a relative valuation basis.

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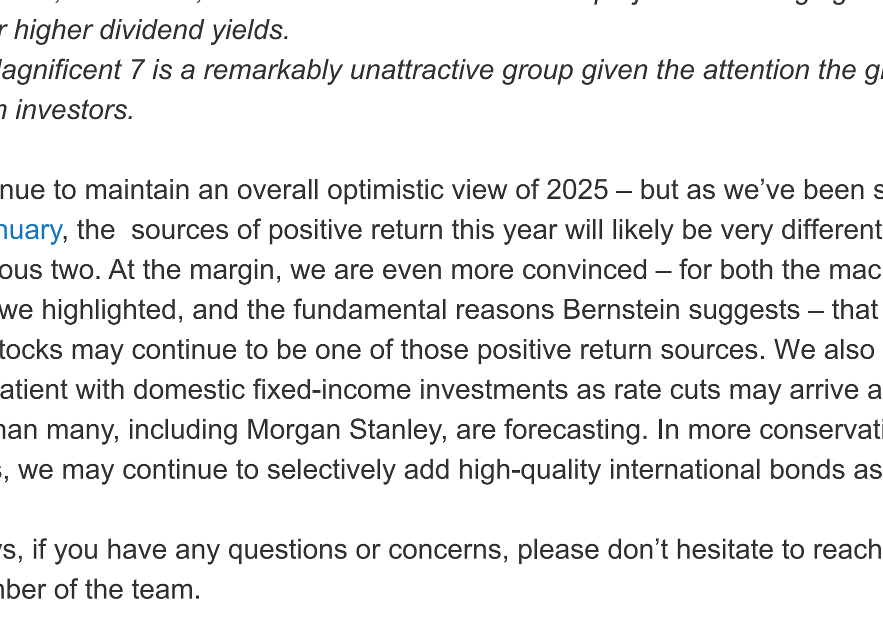

Source: Richard Bernstein Advisors LLC, MSCI, S&P Global, Bloomberg Finance L.P. Green shading denotes an OW position and Red denotes an UW position in our strategies. NTM = Next Twelve Months. Sectors are the S&P 500® GICS Sectors. For Index descriptors, see "Index Descriptions" at end of document.

As Bernstein notes:

There are several important points embedded in the chart:

1. The most attractive segment of those presented is International Quality. It is the most northeast of the groups because it has the highest projected earnings growth rate and the 4th highest dividend yield.
2. There are several groups that offer competitive expected returns to the Magnificent 7's. Materials, Financials, and Industrials all have similar projected earnings growth but also offer higher dividend yields.
3. The Magnificent 7 is a remarkably unattractive group given the attention the group gets from investors.

We continue to maintain an overall optimistic view of 2025 – but as we've been saying since January, the sources of positive return this year will likely be very different than the previous two. At the margin, we are even more convinced – for both the macro reasons we highlighted, and the fundamental reasons Bernstein suggests – that foreign stocks may continue to be one of those positive return sources. We also plan remain patient with domestic fixed-income investments as rate cuts may arrive a little sooner than many, including Morgan Stanley, are forecasting. In more conservative accounts, we may continue to selectively add high-quality international bonds as well.

As always, if you have any questions or concerns, please don't hesitate to reach out to any member of the team.