

FOLLOWING THE FUNDAMENTALS

2ND QUARTER 2025: ISSUE 34

A Quarterly Market Update from The Volrath Castle Group at Morgan Stanley

NOT SO FAST MY FRIEND!

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In last quarter's update, Are the Have-Nots Thawing Out, we covered the historic rise the NFIB Small Business Survey experienced immediately after the US election in November. The first month after the election, the Small Business survey experienced the largest one month increase since the survey began being published monthly in 1986. We wrote, that if small business sentiment were to continue to improve the way it improved after the election in 2016, we would likely become more constructive on the economy and the stock market.

Since last quarter's update, the new administration has taken over and much of their focus has been on reducing government spending, reducing immigration flows, and implementing tariffs causing an abrupt reverse of the positive sentiment that immediately followed the election. Seeing this abrupt change in investor sentiment, my mind immediately went to Lee Corso from ESPN's College Gameday as he challenges his guests with his famous line, "Not so fast my friend"! In this quarter's update, we will cover how sentiment has reacted to the new administration's actions and the impact it's had on the S&P 500.

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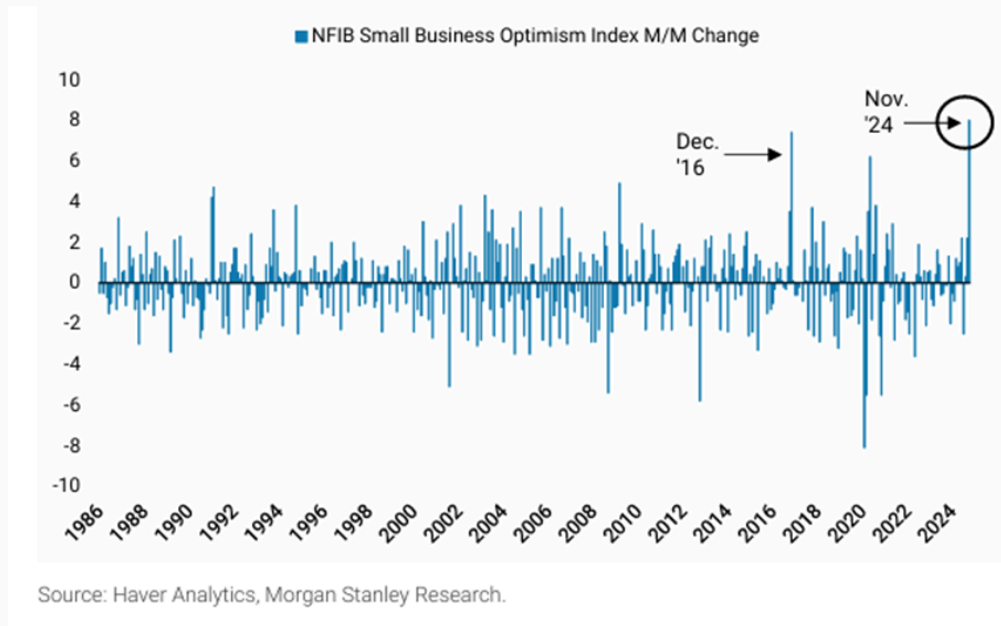
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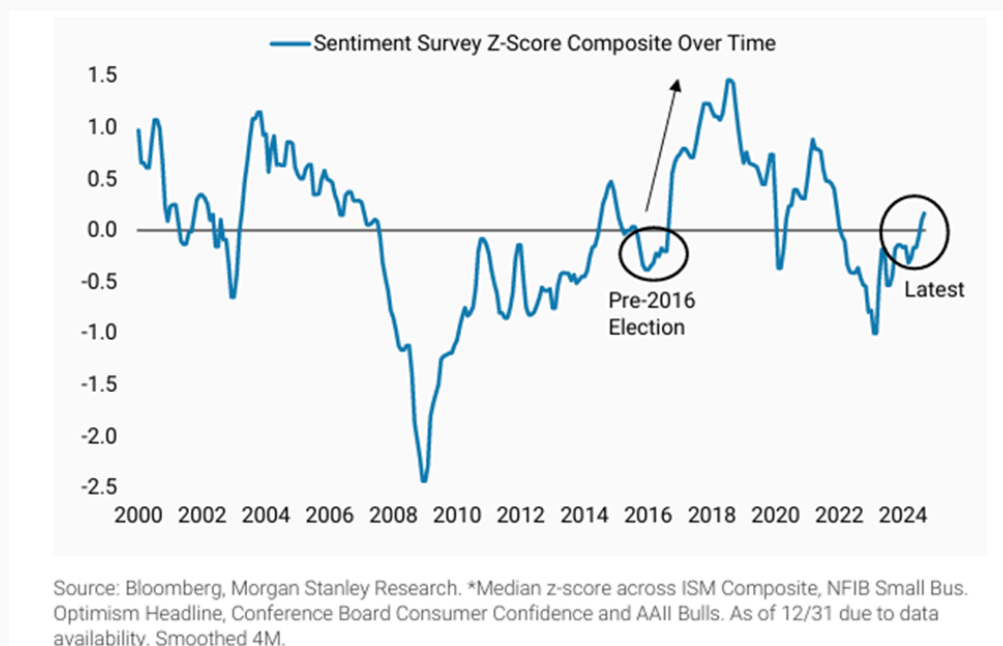
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POST ELECTION OPTIMISM

As mentioned in the introduction, the NFIB Small Business Survey jumped 8-points in the month immediately following the November election. This rise was the largest one-month increase the index has seen in the nearly 40 years that the survey has been conducted. Outside of a recession, the only time we have seen that large of a one-month move was in December of 2016, which also coincided right after an election in the US.

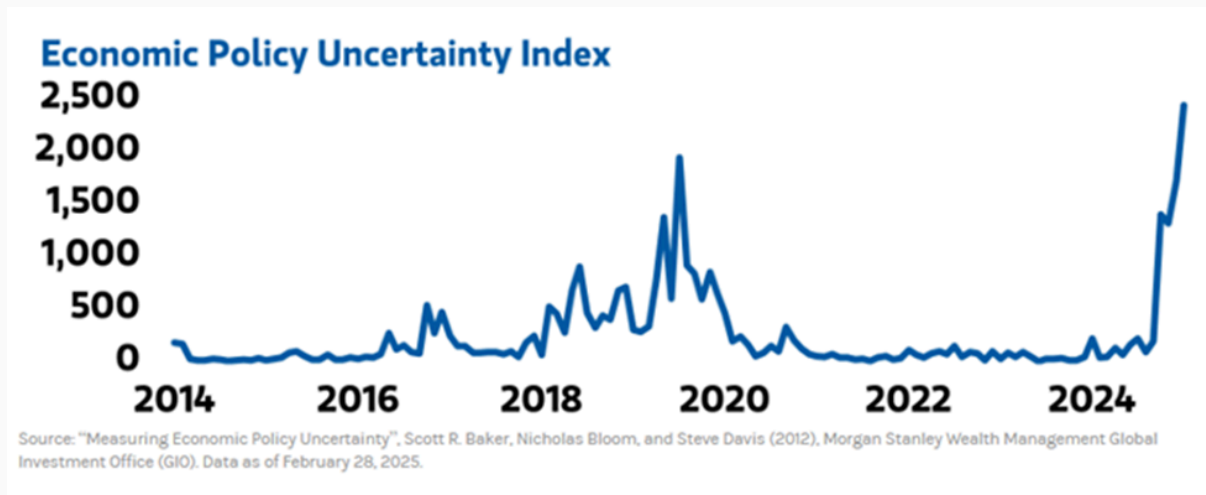


In addition to the NFIB Small Business Survey, we track a Sentiment Survey Composite that is published by Morgan Stanley that combines a group of sentiment indicators alongside the NFIB survey. This broader composite, seen below, confirms that through 12/31/2024 a broad swath of sentiment indicators had improved significantly after the November election.

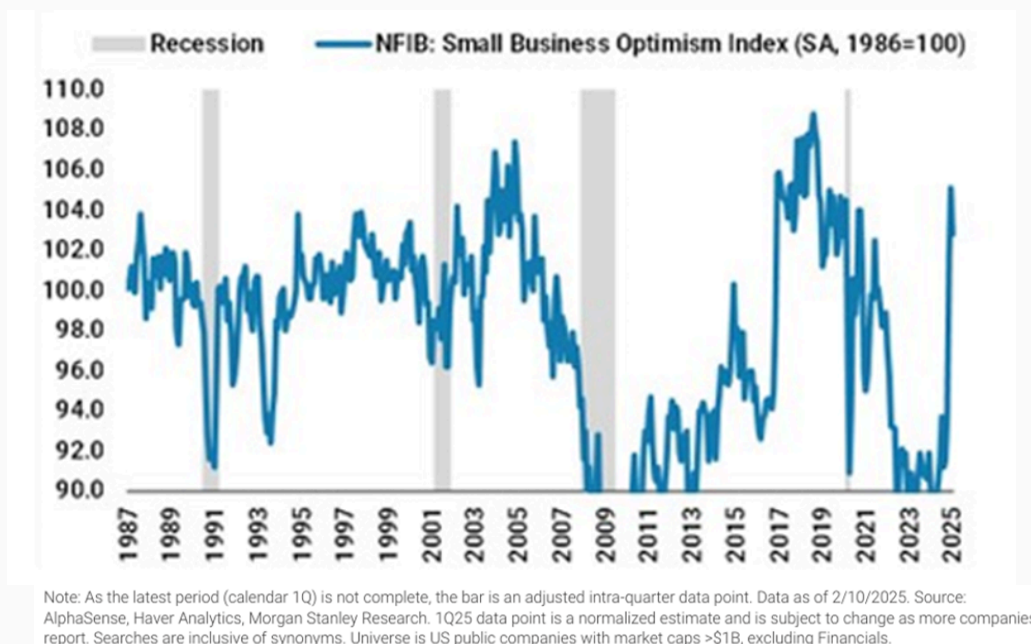


NOT SO FAST MY FRIEND!

As mentioned in the introduction, the new administration has been making major changes in policy over the first few months in office. Specifically, we believe the administration's focus on reducing government spending and tariffs have led to policy uncertainty for investors. As seen below, changes in policy have led to a significant rise in the Economic Policy Uncertainty Index.



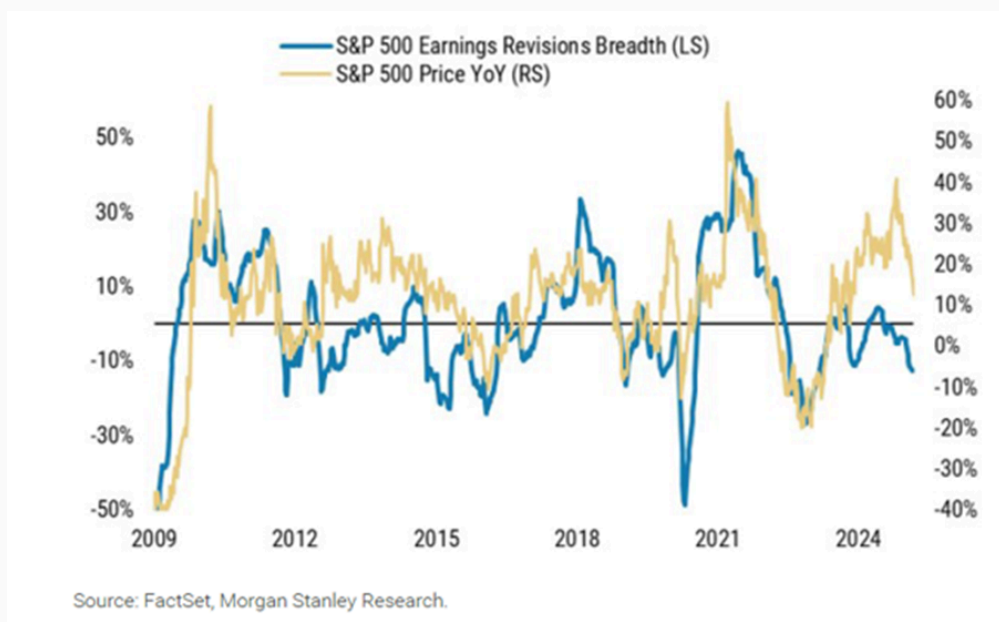
We believe this economic uncertainty is also affecting the confidence of small business owners. While still elevated from the historic spike after the election, the NFIB Small Business Survey has declined in consecutive months after the initial election bump from 105.1 in December to 100.7 in February.



Along with the small business sentiment starting to weaken, large companies are also starting to question their confidence due to the lack of policy clarity. As seen below, the CEO Business Confidence Survey has also started to turn down in the past few months.



As CEO and small business confidence has started to weaken, the S&P 500 has started to see earnings revisions turn negative. While we are currently in a seasonal period that tends to generate negative earnings revisions, we believe that the lack of economic policy certainty has exaggerated the move lower that was already in place. We believe the negative earnings revisions breadth seen below in the S&P 500 is the main culprit in the downward pressure on the S&P 500 the past few months.

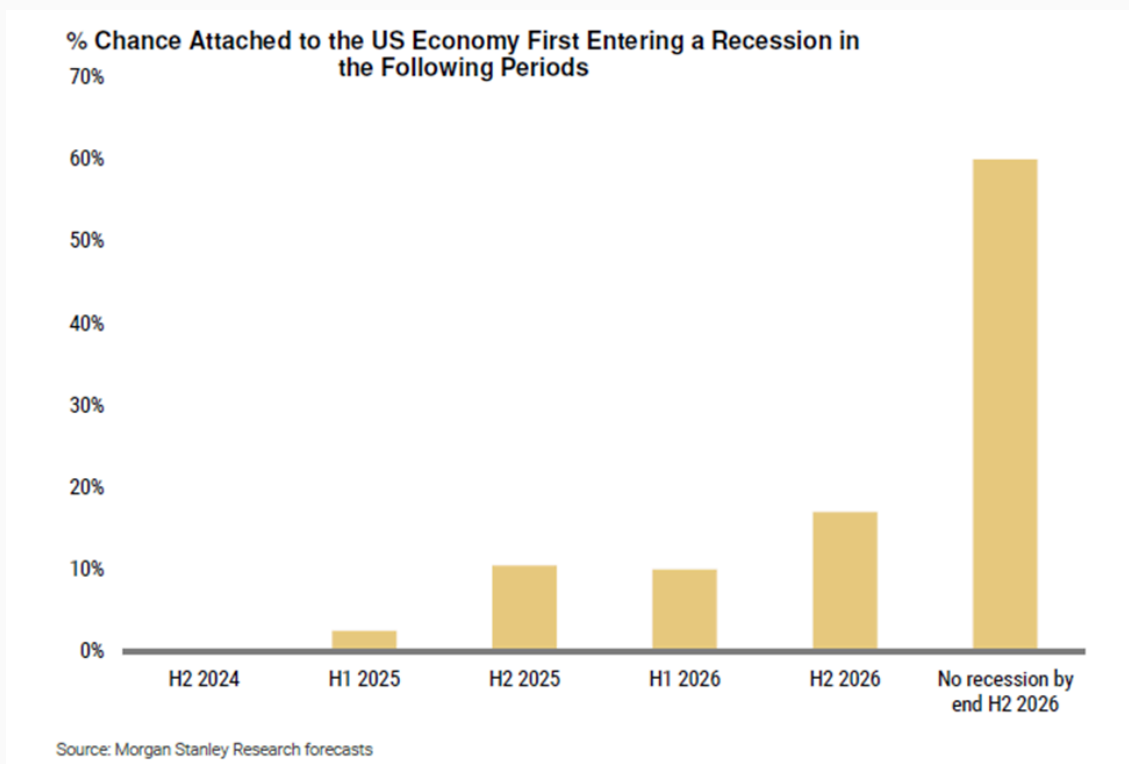


CONCLUSION

Over the past 12-18 months, we expressed concern that the economic expansion the US was experiencing was due to the historically high levels of deficit spending by the government and the large increase in net immigration. Since inauguration day in January, a major focus of the new administration has been reducing the elevated levels of government spending and immigration flows. We believe that these changes in policy and lack of clarity on tariff implementation have led to elevated levels of economic uncertainty that have led investor and business leader confidence to start to weaken.

While weakening sentiment levels are concerning and something we will monitor closely, Morgan Stanley economists do not believe there is a material chance that the US will enter an economic recession in the next 6-12 months. As seen in the chart below, Morgan Stanley economists believe there is a 60% chance that the economy will not have entered a recession by the end of 2026.

Along with our economists at Morgan Stanley, our team does not believe that an economic recession in the US is imminent and without a recession, we do not believe S&P 500 earnings will degrade enough to push the index into a bear market in the next 6-12 months. However, inputs into our thinking are changing quickly and we will be watching the data closely to determine if we are experiencing a “Not So Fast My Friend” moment with the economic expansion.



JOIN OUR WEBINAR

Enjoy this content? We'll be hosting our quarterly webinar on Tuesday April 15th at 6:00PM CST. We won't ask you to turn your camera on, but you'll be able to see us! Your name will also be hidden for complete client confidentiality.

Email allie.girardin@morganstanley.com for the Invitation and Registration Link.

Like to plan ahead? Here's the schedule for the remaining 2025 Following the Fundamentals Webinars: July 15th and October 21st. Additional information and times to follow.

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