

FOLLOWING THE FUNDAMENTALS

3RD QUARTER 2025: ISSUE 35

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

GAME ON?!?!

BY AARON CASTLE, *Financial Advisor & Portfolio Manager*

With the school year over and the summer season upon us, I'm getting to watch and interact with my children much more than during the school year. Recently, while watching them ride their bikes in our cul-de-sac, a memory emerged from my childhood of a friend of mine who had a basketball hoop positioned on the road at the end of the cul-de-sac they lived on. We would play basketball in the road and were always reminded that we needed to stop playing and get out of the way when a car was approaching. Similar to the scene from the Wayne's World movie, when a car was approaching, we would yell "Car!" and scurry out of the road then scream, "Game On!" and resume playing after the danger had passed.

The past 2-3 quarters have felt similar to that scene as sentiment has experienced wild swings reacting to headlines in the news. We have covered these swings in our previous two updates titled, "Are the Have-Nots Thawing Out" and "Not So Fast My Friend". In this update, we take another bite of the apple and attempt to determine if the recent rebound in sentiment will lead to a "Game On!" environment for the stock market.

IN THIS ISSUE WE'RE COVERING

Business & Consumer
Sentiment P.2

Government Spending & the US
Dollar P. 3

Game On?!?! P. 4

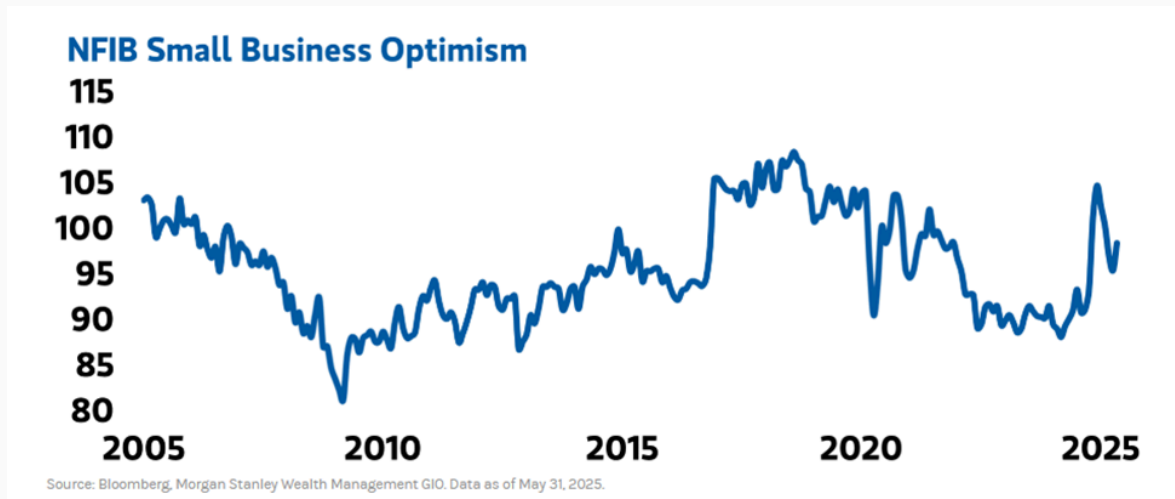
Conclusion P.5

Webinar Information P.5

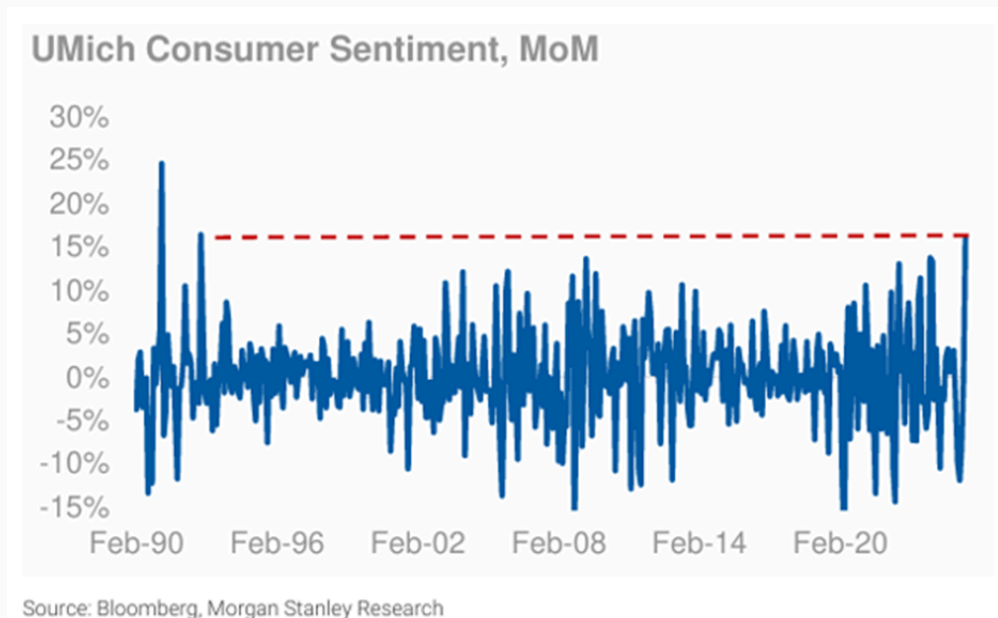
4300 E. 53rd Street
Suite 300
Davenport, IA 52807
563-344-4327

BUSINESS & CONSUMER SENTIMENT

In the past two updates we have emphasized the NFIB Small Business Optimism survey as we believe it is an accurate indicator of how the average small business feels about the current and future state of the economy. We highlighted that immediately following the US Presidential election, this indicator saw the largest one month increase in the history of the survey. However, after the tariff announcements, the survey quickly reversed course and sentiment turned negative. As seen below, as tariff rhetoric has cooled, sentiment is starting to improve once again.

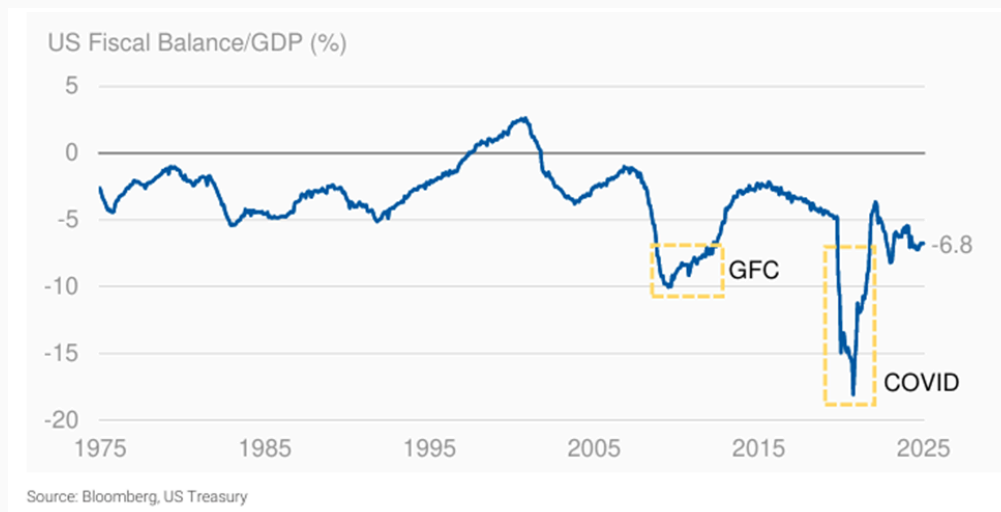


In addition to the small business survey, we have also tracked consumer sentiment the past two updates. The University of Michigan Consumer Sentiment survey has also seen wild swings since the election. This past month, the survey saw the largest positive increase in consumer sentiment seen in over 30 years.



GOVERNMENT SPENDING & THE US DOLLAR

While we believe much of the swing in sentiment was driven by tariff rhetoric, we also believe the efforts from the Department of Government Efficiency, or DOGE, was also having an impact on sentiment. With government employees being let go and government contracts being cancelled, we believe sentiment suffered as many across the country were not sure where the cuts would stop and what the ripple affects would be. However, recent discussion in Washington DC has focused more on deficit expansion as opposed to spending cuts. Based on the most recent reports, the US is on pace to have a 6.8% deficit ratio to GDP.



As the focus in Washington DC has turned from massive cuts in spending, to potential spending expansion, the value of the US Dollar has started to decline when compared to a basket of currencies from around the world. The current level is equal to the value of the US Dollar seen at the end of 2021 before the Federal Reserve embarked on the historically aggressive rate hiking cycle that occurred in 2022 and 2023.

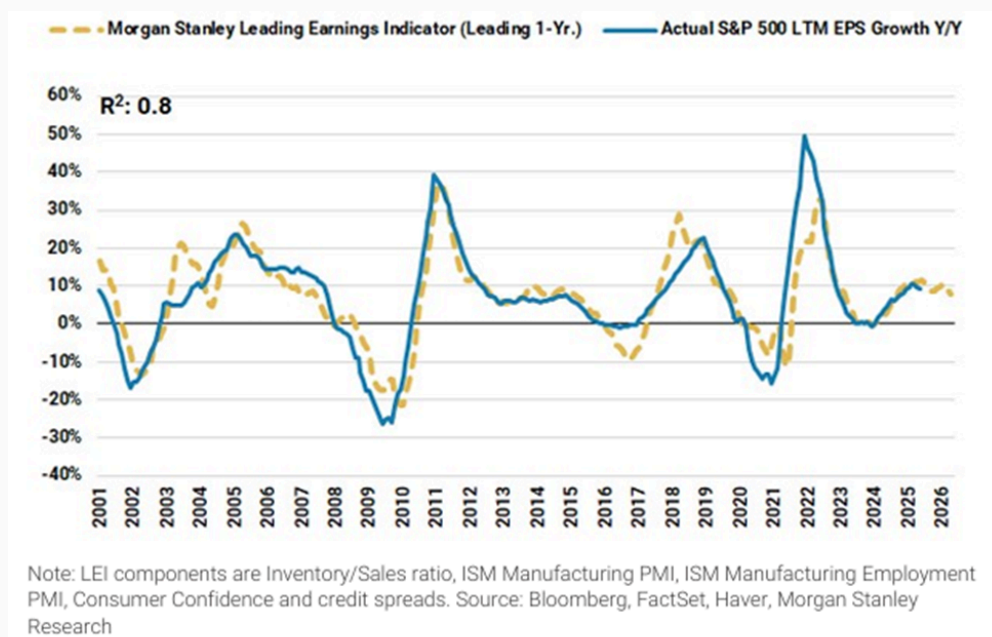


GAME ON?!?

We believe additional government spending and the weakening of the US Dollar are two of many factors setting up as a potential tailwind for S&P 500 earnings. Many companies in the S&P 500 are multi-national companies and incur a portion of their revenues from other countries and currencies around the world. Historically, when the US Dollar is weakening year over year, it has led to positive earnings revision breadth from companies in the S&P 500.



In addition to the government spending expansion and a weakening US Dollar, the Morgan Stanley Leading Earnings Indicator, an indicator that measures multiple leading indicators, is also predicting solid earnings growth from the S&P 500. This indicator is predicting high single-digit or low double-digit growth in S&P 500 earnings over the next 12 months.

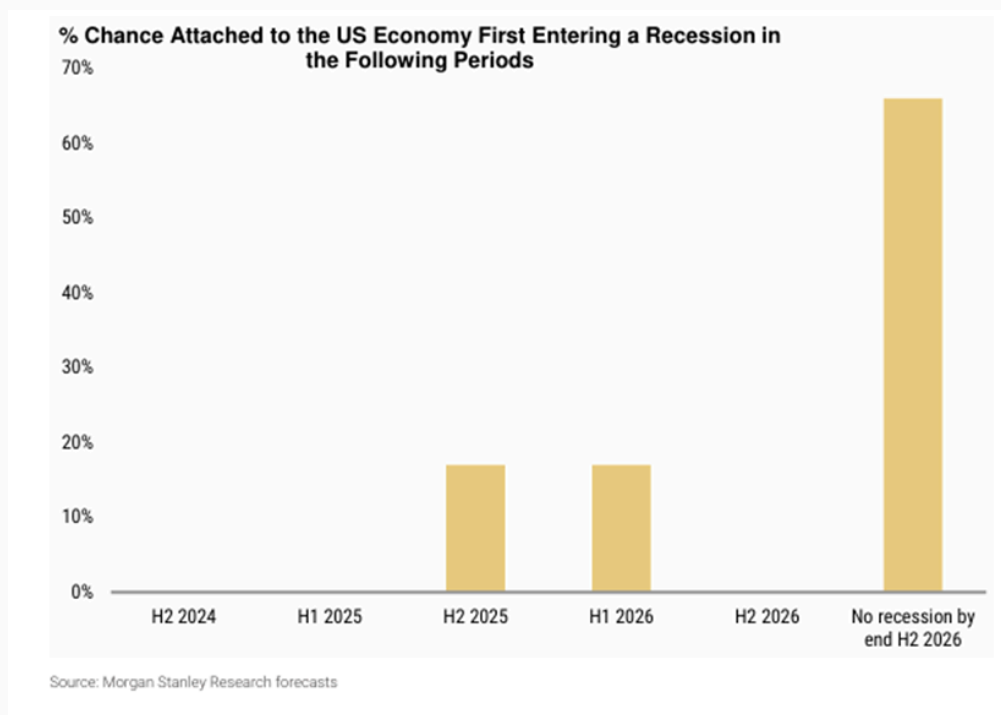


CONCLUSION

Over the past 12-18 months, we expressed concern that the economic expansion the US was experiencing was largely 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 high levels of government spending and immigration flows. While immigration flows have been cut significantly, the cuts in government spending look like they may become spending increases. We believe the lack of focus on government spending cuts and more clarity with the tariff situation has led to a rebound in consumer and business sentiment.

With consumer and business sentiment starting to rebound and more clarity on government policy, Morgan Stanley economists do not believe that the US likely to enter an economic recession in the next 6-12 months. As seen in the chart below, Morgan Stanley economists believe there is a 65%-70% 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. If the economy holds steady, we believe the previously discussed factors along with increased productivity and efficiency from the use of artificial intelligence can lead to earnings growth and price appreciation in the S&P 500. However, inputs into our thinking are changing quickly and we will be watching the data closely to determine if the game is in a delay or if it's Game On!



JOIN OUR WEBINAR

Enjoy this content? We'll be hosting our quarterly webinar on Tuesday July 22nd 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: October 21st. Additional information and times to follow.

DISCLAIMERS

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>

This material contains forward looking statements and there can be no guarantees they will come to pass. The information and statistical data contained herein have been obtained from sources believed to be reliable but in no way are guaranteed by Morgan Stanley as to accuracy or completeness. There is no guarantee that any investments mentioned will be in each client's portfolio.

The views expressed herein are those of the author and do not necessarily reflect the views of Morgan Stanley Wealth Management or its affiliates. All opinions are subject to change without notice. Neither the information provided nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. Past performance is no guarantee of future results.

This material has been prepared for informational purposes only. It does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. Morgan Stanley Smith Barney LLC ("Morgan Stanley") recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a Morgan Stanley Financial Advisor. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. Past performance is no guarantee of future results.

Information contained herein has been obtained from sources considered to be reliable, but we do not guarantee their accuracy or completeness.

Morgan Stanley Smith Barney LLC. Member SIPC.
CRC 4598532 06/25