FOLLOWING THE FUNDAMENTALS

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

THE HANDOFF

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During 2022 and 2023, our quarterly updates often centered around our concerns that the US economy was on the cusp of a potential recession. In our 2024-Q2 update, titled “Send it in Jerome!”, we discussed that the historically high levels of government deficit spending and high levels of immigration had lowered the odds of a recession in our view due to those factors artificially supporting the US economy. While we felt better about the economy in the near term during that 2024 update, we didn’t believe that high levels of government spending and immigration could sustain the economy in perpetuity.

It has been 18 months since that 2024-Q2 update and many changes have taken place. In our view, one of the biggest changes has been the new administration attempting to transition from a government led economy to one that sustains itself through private sector growth. With football season underway, the obvious way to view this transition is as a handoff from the Government to the private sector. In this quarter’s update, we discuss how the handoff is going so far, and what we will be watching to help us determine if the handoff will be successful.

IN THIS ISSUE WE'RE COVERING

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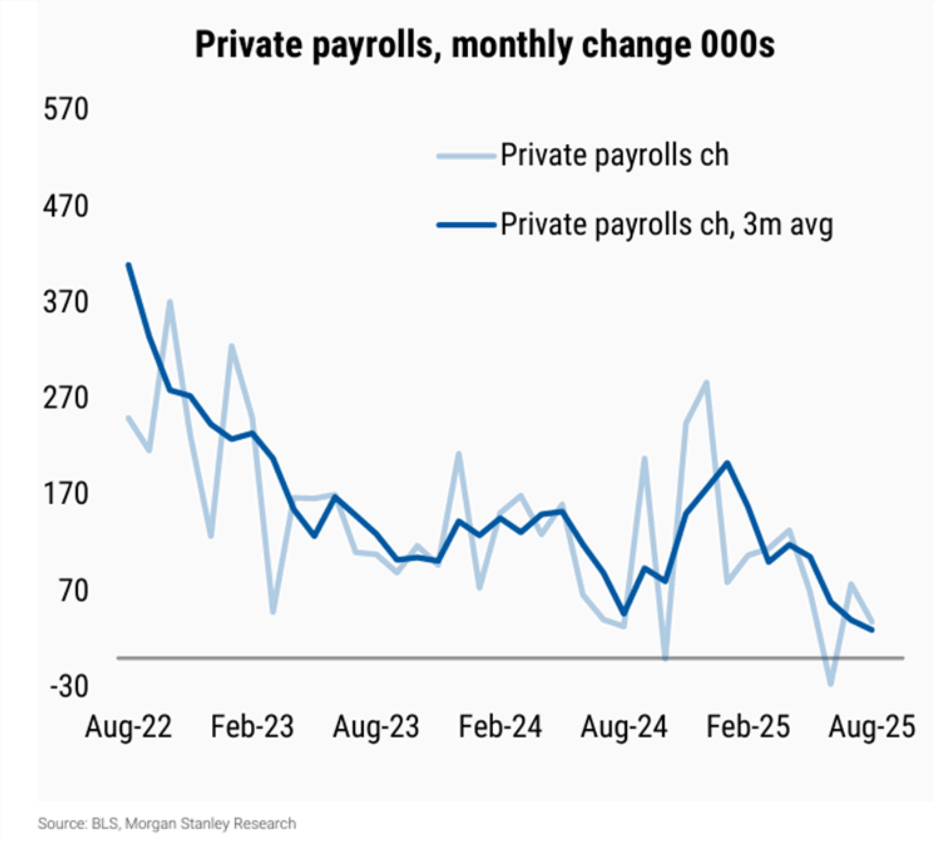
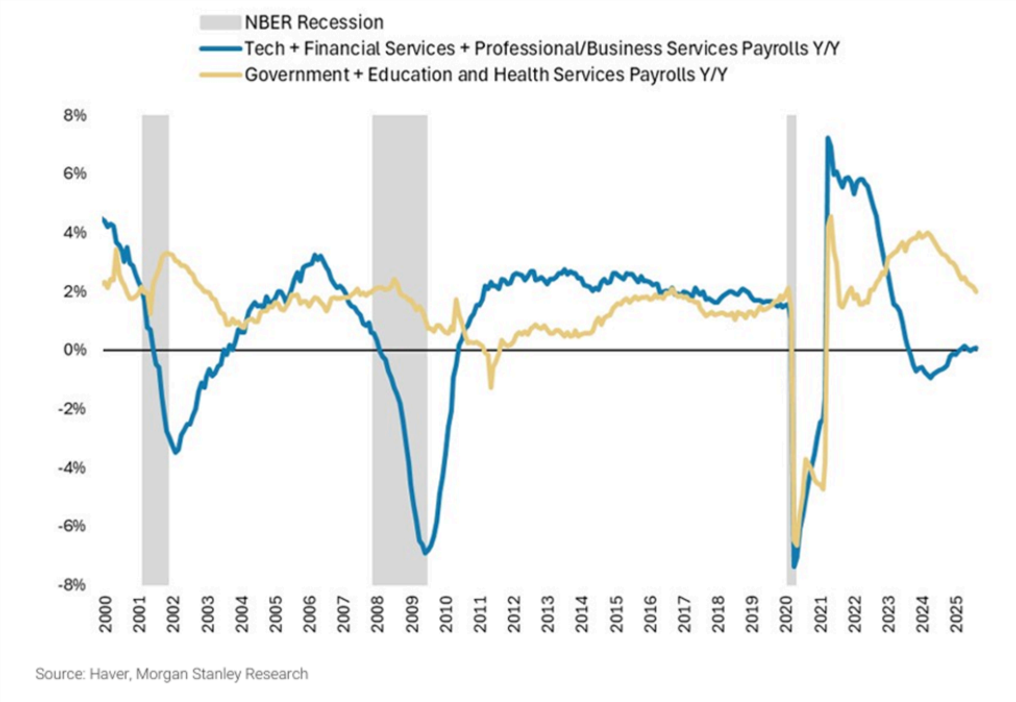
THE GOVERNMENT ECONOMY

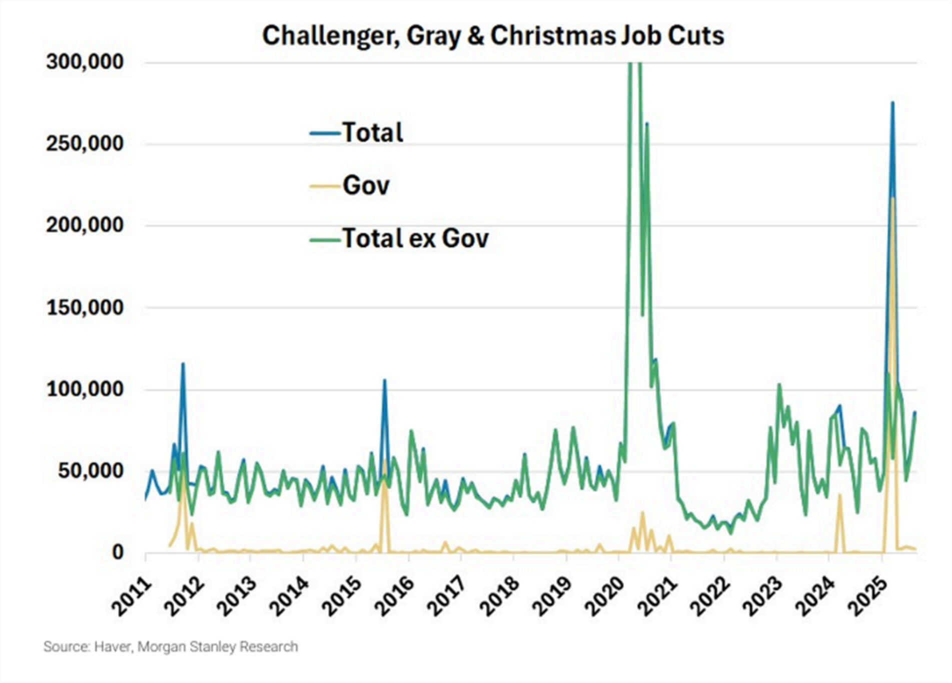
When we were expressing our worry during our quarterly updates in 2022 and 2023, one of the few data points that continued to ease our concern regarding the economy, was that we were still experiencing job growth. As seen in the chart below, even though job growth was slowing, the Bureau of Labor Statistics was continually reporting positive job growth throughout that period.



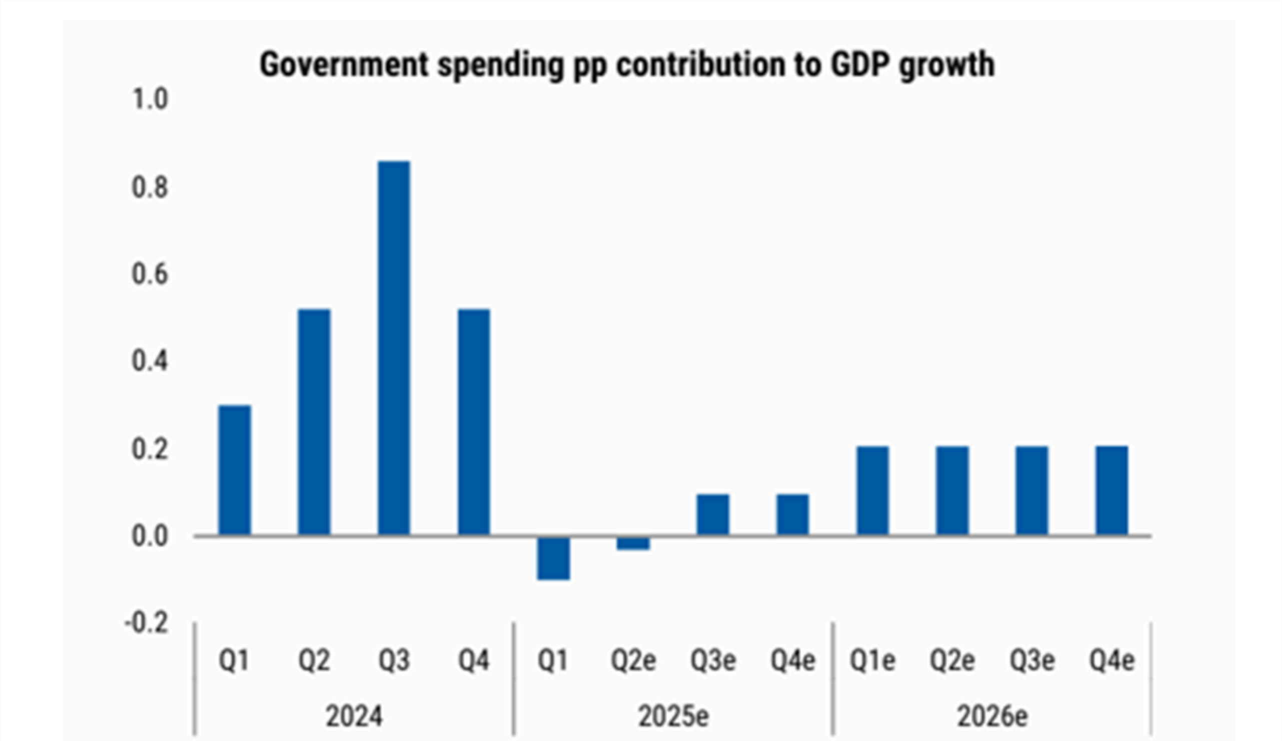
As the monthly job reports from the Bureau of Labor Statistics have been revised and updated, it has become clear that the majority of the job growth the past few years has come directly from the government, or sectors connected to the government like education and health care services. As seen in the chart below, private job growth has been flat or negative the past few years while the growth in government related jobs has accounted for all the job growth we have seen. (Chart on page 3)



Knowing that government hiring had been supporting the jobs market for the past few years, one of our biggest concerns heading into 2025 was how large of an impact the Department of Government Efficiency, or DOGE, would have on the economy if it followed through on the administration's campaign promise to significantly cut the government workforce. It didn't take long for the cuts to start taking place and within the first 3-6 months of 2025, government layoffs reached levels that have not been seen in the past 15 years.



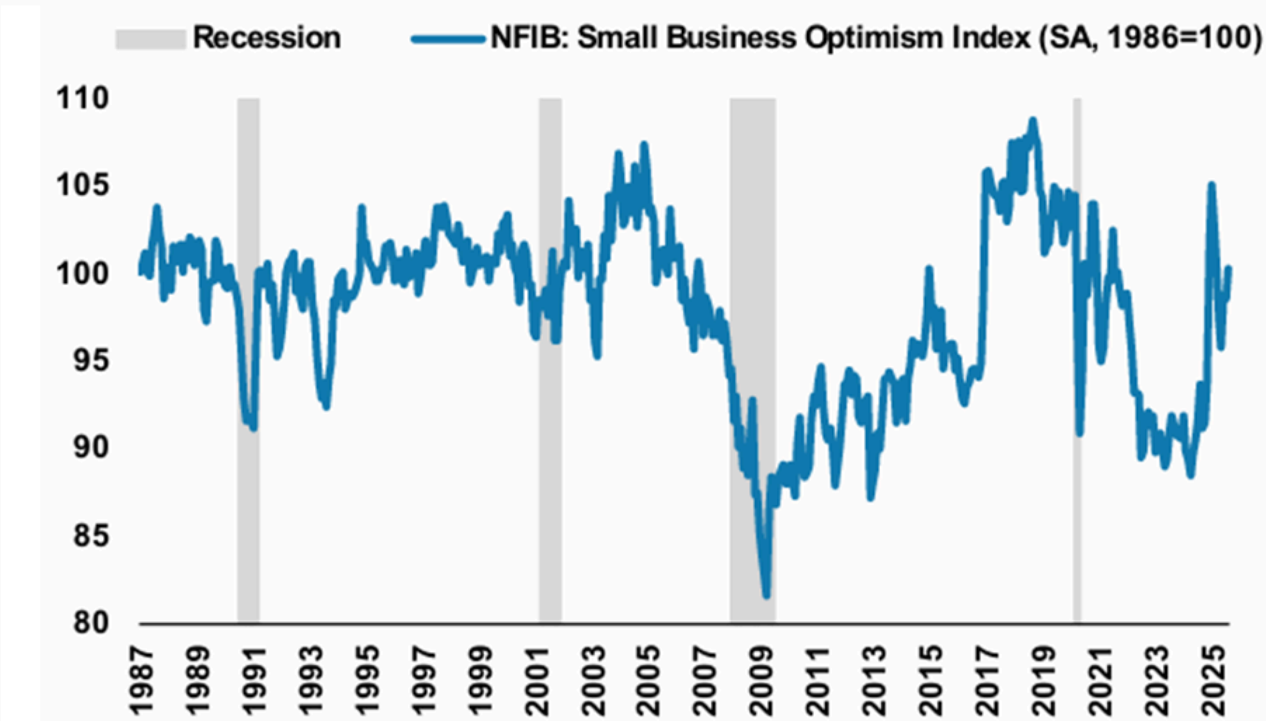
On top of the government job cuts, the DOGE team was also focused on cutting what they deemed to be waste throughout the government. As job and department cuts started to add up, the lack of government spending in the economy started to become a drag on economic growth compared to the previous years. As seen below, government spending had a negative impact on economic growth in the 1st half of 2025. However, post the tariff announcements on Liberation Day, the DOGE headlines reached a tipping point, and the administration has pivoted back to growth in government spending.



Source: BEA, Morgan Stanley Research Forecasts

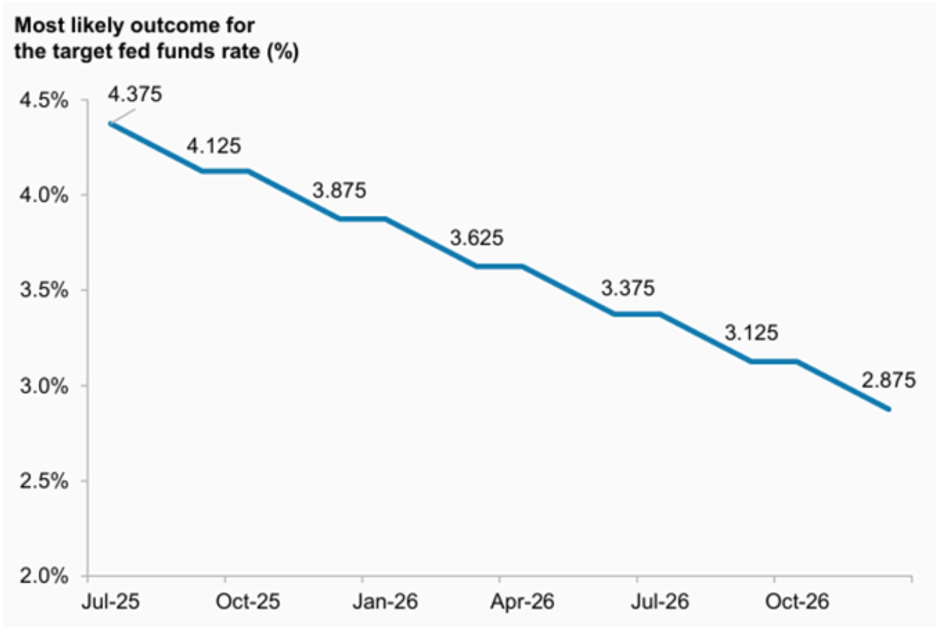
THE HANDOFF

As seen in the previous chart, while government spending is not expected to be drag on economic growth going forward, Morgan Stanley expects government spending to account for much less growth than it has in the government led economy of the past few years. For the economy to avoid a recession, we believe private sector growth is going to need to increase to make up for the void left from less government spending. As seen below, the handoff is off to a solid start as the NFIB Small Business Optimism Index has risen off of the depressed levels of 2022-2023.



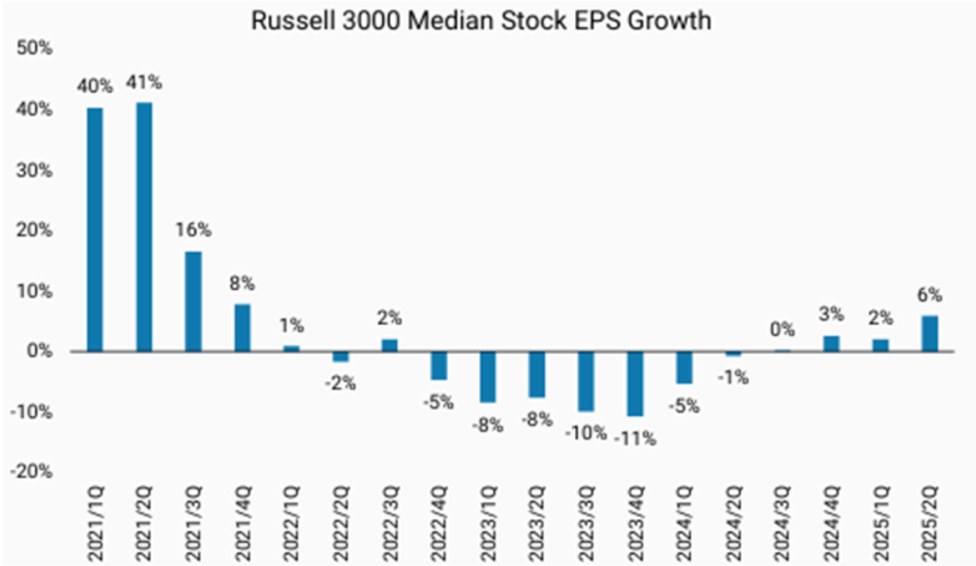
Note: As the latest period (calendar 3Q) is not complete, the bar is an intra-quarter data point. Data as of 8/20/2025. Source: AlphaSense, Haver Analytics, Morgan Stanley Economic Research, Census Bureau, Bureau of Labor Statistics; Note: Searches are inclusive of synonyms. Universe is US public companies with market caps >$1B, excluding Financials.

We believe that part of this optimism is due to the expectations that the Federal Reserve is going to continue lowering interest rates over the next 12-15 months. As we covered in our previous update, “The Haves vs the Have-Nots”, higher interest rates disproportionately affect small companies compared to larger companies as smaller companies generally need to finance their growth through loans and do not have the cash to fund expansion. Morgan Stanley research expects the Federal Reserve to lower interest rates to between 2.75%-3.00% by the end of 2026 which we believe is another positive for a potential handoff to the private sector. (Chart on page 6)



Source: Morgan Stanley Research forecasts

In addition to small business optimism increasing, we have also started to see empirical data that provides evidence that the handoff is taking place. Over the past few years we have discussed that much of the S&P 500's growth can be attributed to just a few mega-cap stocks that make up a significant portion of the index. During 2022 and 2023, the average stock struggled to grow their earnings and showed negative or flat earnings during that period. However, we have started to see that change and the median stock in the Russell 3000 (made up of large and small cap stocks) has now gone positive and experienced earnings growth of 6% in the 2nd quarter.



Source: Compustat, Morgan Stanley Research.

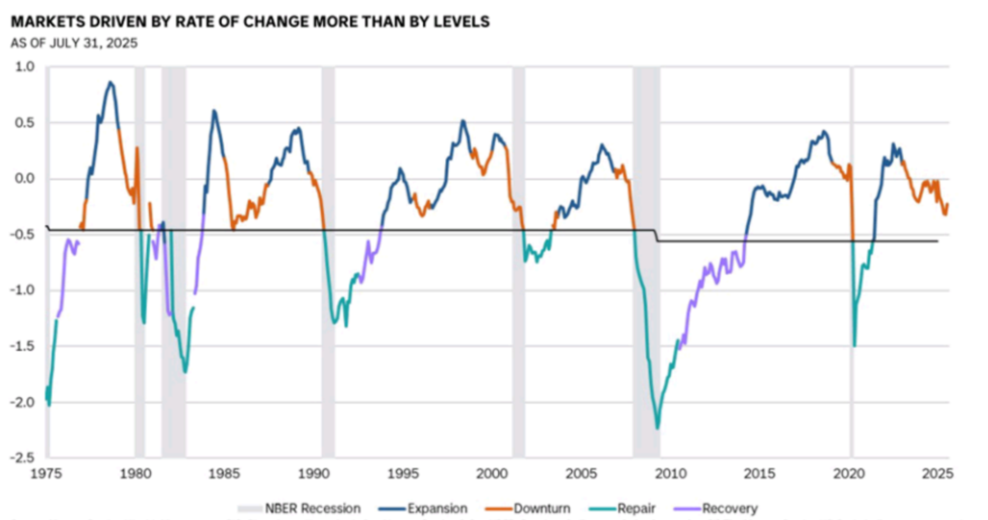
CONCLUSION

Over the past 24-36 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 elevated levels of government spending and immigration flows. While immigration flows have been cut significantly, the cuts in government spending have reversed and become spending increases.

We believe the increase in government policy clarity and the expectations of lower interest rates has led to a rebound in consumer and business sentiment. In our view, this has reduced the odds of an economic recession in the next 6-12 months and led to a widening out of growth expectations from the mega-cap stocks that have led the past few years.

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, as seen in the chart below, the Morgan Stanley Cycle Indicator is still registering as in a “downturn” and we will be watching the data closely to make sure the handoff to the private sector continues to be successful and doesn’t result in a fumble.

Morgan Stanley Cycle Indicator for US Economy[1]



Source: Morgan Stanley Wealth Management GIO, Bloomberg, Haver Analytics, Morgan Stanley & Co., NBER. Grey bars indicate periods of recession. (1) The Morgan Stanley US Cycle Indicator measures the deviation from historical norms for macro factors including employment, credit conditions, corporate behavior and the yield curve. The repair phase occurs due to the time lag between when these factors are beginning to improve and when they turn positive. The Morgan Stanley US Cycle Indicator was revised as of December 31, 2018, by MS & Co. Research.

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The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks. An investment cannot be made directly in a market index.

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