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WEALTH MANAGEMENT

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The 2nd quarter of 2025 brought positive total returns for most equity markets around the globe. Stock markets climbed the proverbial wall of worry with eight of 11 US sectors posted gains here in the US. Volatility surged early during the quarter due to new US tariffs aimed at reshaping global trade and escalating tensions with China. However, a 90-day tariff pause announced on April 9th triggered a strong market recovery that continued through the quarter. A double-digit, "risk-on" rally pulled year-to-date (YTD) returns into positive territory for the broader US stock market. The 2nd quarter was the first time since 1938 that the S&P 500 index was both up and down at least 10% in a single quarter. This has happened only 3 other times in history, all of which happened during the Great Depression years of 1931, 1933, and 1937[i]. From a promising start to the year for prudent investing, the pendulum has swung back, for now, to a "risk-on" environment. Meanwhile, our Federal Reserve maintained a wait-and-see stance and opted to keep interest rates unchanged during the quarter, as inflationary trade and fiscal policies could potentially offset cooling inflation data.

The Artificial Intelligence (AI) theme, a significant driver of recent growth-stock returns, continues to rest on questionable fundamentals, with significant expenses set against currently insufficient customer revenues. Nevertheless, our team believes many AI-related companies have exorbitant market valuations. Beyond massive capital expenditures, AI companies are now engaging in an arms race for talent, paying as much as *nine-figure contracts* to *individual employees*[ii] and investing billions in pre-product companies. Amongst the euphoria, a tech giant company published a recent study that shed a sobering light on the AI optimism, and anecdotes continue to surface about disappointing customer experiences and elusive cost savings. At today's levels, many AI-growth stocks demand fundamental perfection to justify such lofty valuations.

In May, rating agency Moody's downgraded the United States' credit rating from Aaa to Aa1. The downgrade marks the first time the agency has ever downgraded the US credit rating, and is a reflection of the coming potential troubles as a result of our country's inability to address ever-rising debts and deficits. The move means that all three major credit rating agencies, including Standard & Poor's and Fitch Ratings, have now downgraded the US from each of their highest possible ratings[iii].

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In spite of this, stock investors looked past the downgrade and pushed domestic stocks higher during the 2nd quarter. The S&P 500 and Nasdaq led US stock markets with quarterly gains of +10.9% and +18.0%, bringing their YTD gains to positive +6.2% and +5.9%, respectively. The least growth-oriented of the major US stock benchmarks, the Dow Jones Industrial Average (i.e., the Dow), gained +5.5% during quarter for a YTD gain of +4.6%[iv].

Outside the US, overseas markets continued to do well, allowing them to maintain their outperformance lead. The MSCI EAFE Index, which measures stocks in developed economies such as Japan, the UK, France, and Switzerland, was up +11.8% bringing its gain for the year up to +19.5%. The MSCI Emerging Markets Index, measuring stocks in still-developing economies such as China, India, and Brazil, grew +12.0% for a gain of +15.3% YTD[v]. This strong outperformance by international markets has been fueled by the weakest US dollar (relative to other global currencies) since 1973[vi].

Although there's been much debate about the direction of interest rates, bond markets remained mostly steady, providing investors and their portfolios a source of foundational consistency. The Bloomberg US Aggregate Index, the benchmark for taxable bonds, added to their 1st quarter gains with a return of +1.2%, bringing up their YTD gains up to a respectable +4.0%. The interest rate on the closely-watched US Treasury 10-year bond remained essentially unchanged at 4.24%[vii].

Outside of traditional stock and bond markets, commodity markets, as measured by the Bloomberg Commodity Index, gave back some of their 1st quarter gains by shedding -3.1% but still maintained a positive gain of +5.5% for the 1st of the year[viii]. The price of oil dipped to finish at $65.11/bbl. Gold bullion continued to shine, however, hitting $3,303/oz, resulting in a quarterly gain of +6% and a YTD gain of +26%[ix].

The combination of investor complacency in an environment with trade wars, out-of-control US government spending, enormous deficits and debts, funding risks in a period of financial tightening, heightened inflation threats, an economy on the verge of a potential recession, deteriorating faith in "US exceptionalism," a declining US dollar, risk of monetary debasement and a "massively overvalued stock market" (per billionaire investor extraordinaire Paul Singer[x]) is about as toxic a brew as we could imagine. Not only are investors extraordinarily complacent, the recovery rally since April 7th has encouraged them to return to taking enormous risks.

Chart 4: S&P reversed $10tn market cap loss, with $5tn Mag7 gain
Top 10 companies as % of S&P 500 market cap

Source: BofA Global Investment Strategy, Bloomberg

Worse yet, investors are also pouring into all sorts of garbage stocks, grossly overpriced high-flying tech stocks and cryptocurrencies. Interest in Special Purpose Acquisition Companies, or SPACs – blank-check IPO shortcut vehicles that rose to prominence during the pandemic and ended up being abysmal investment failures – has returned. Meanwhile, the Goldman Sachs Non-Profitable Tech Index, which tracks a basket of (you guessed it) technology companies that have no earnings and make no money, is up over +60% higher in just the past three months since the beginning of April.

Source: Goldman Sachs, Bloomberg

Given the stock market's fundamental disconnect between today's prices (fantasyland) and the economic realities of all-time high valuations set against an unusually wide range of potentially adverse outcomes, any attempt to make sense of this environment reminds us of a Mark Twain quote: "The more you explain it, the more I don't understand it." Perhaps in the current short-term focused investing (gambling) world, the time lag between cause and potential effect has led to a false sense of security. An important but little discussed stock market influence that has significantly contributed to the current environment where many stocks' valuations have seemingly become disconnected from their reasonable business value is what is referred to as "passive flow." With monthly investments in retirement funds reaching as much as $20 billion directed towards the S&P 500[xi], enormous amounts of investors' money flows into the largest individual components (i.e., the Mag 7 tech stocks which now comprise over a 30% weighting of the index), without any regard to those stocks' valuation or underlying financial results. For now, all is well, and it's back to "risk-on."

Our team, however, is still focused on identifying, quantifying, and managing the ever increasing risks that many seem to be conveniently ignoring. We are of the belief that the passive, mostly-growth US portfolios of the past 15 years will be challenged ahead and apt to give way to one that is actively managed, multi-asset, global and value oriented – where potentially the strongest and most appropriate opportunities are sourced from a bigger and much deeper ocean.

Please do not hesitate to reach out to us with any questions about any of these topics, or how they may pertain to your portfolio and financial plan. We are always available to help address any concerns you may have. And as always, our team appreciates and highly values the confidence you have placed in us.

All the best,

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i "Beyond the News" by MFS Investment Management and Bespoke, July 8, 2025
ii "Meta Pouched Apple's Pang with Pay Package Over $200 Million" Bloomberg, July 9, 2025
iii "Moody's Cuts America's Pristine Credit Rating" by Davide Barbuscia of Reuters, May 17, 2025
iv All domestic equity index returns courtesy of Morgan Stanley Capital Markets Research
v All international equity index returns courtesy of Morgan Stanley Capital Markets Research
vi "US Dollar Off to Worst Start in 50 Years" by Max Zahn of ABC News, July 2, 2025
vii All fixed income index returns courtesy of Morgan Stanley Capital Markets Research
viii Commodity index returns courtesy of Morgan Stanley Capital Markets Research
ix JP Morgan Guide to the Markets, 3Q2025
x ""Stock markets today are just about as risky as I have ever seen': Paul Singer" by Joseph Adinolfi of MarketWatch
xi "From Diversification to Distortion" by Worldwide Asset Management

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A basis point is defined as one hundredth of one percent (1%), used chiefly in expressing differences of interest rates.

An investment cannot be made directly in a market index. For index and indicator definitions referenced in this report please visit the following: https://www.morganstanley.com/wealth-investmentsolutions/wmir-defnitions

Investing in commodities entails significant risks. Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

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