Graystone Consulting
A business of Morgan Stanley

**Capital Markets Commentary – March 2025**

We're not going to lie. Conjuring topics for this month's letter has been tough. Should we talk about tariffs? Well, we don't know any more about tariffs than we knew last month. Interest rates? It's hard to formulate an outlook on rates until we get more clarity on tariffs. Earnings? Until we understand where rates might go and where tariffs might land, we can't really get much of a grasp on the outlook for earnings, either. So what can we do? We can look to history for a guide. It wasn't that long ago, 2018 and 2019, that we found ourselves in a similar position so this month, we'll take a trip down memory lane and review what's similar this go-round, and what's different, but first, let's look at the numbers for February.

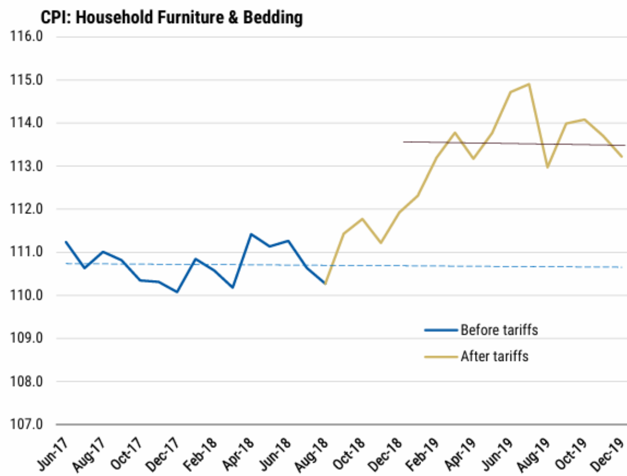
A rally on the last trading day wasn't enough to pull US indices out of losing territory for the month. The tech-heavy NASDAQ took the brunt of the selling, closing February in the red by 3.9% with the S&P 500 and Dow down 1.3% and 1.4% respectively. Europe, on the other hand, closed wholly to the good with the German DAX, UK FTSE, and the Eurozone STOXX 50 all up in excess of 3%. Asia turned in mixed results with Japan's Nikkei 225 losing 3.3% while Hong Kong's Hang Seng gained a whopping 13.6%.[i] Bonds, as measured by the US ten-year Treasury, gained in price and lost yield. The benchmark bond closed January at a yield of 4.57% then ran up a bit in early February, only to drift steadily lower going into month's end. By the time trading closed on the 28th, the yield had dropped all the way down to 4.23%,[ii] perhaps reflecting jitters over what tariffs might mean for growth. So, with the housekeeping out of the way, let's dive in.

The proposed 25% tariffs on imports from Mexico and Canada were postponed. Then, as we were going "to press" with this letter, the administration announced these tariffs will indeed go live on March 4th. Nonetheless, as of this writing, the only new tariff actually implemented thus far is the 10% levy on all imports from China. A 25% tariff on steel and aluminum is *scheduled* to go into effect on March 12th. Since China is thus far the only country actually paying new tariffs, let's start there.[iii] In 2023, the US imported around $427 billion in goods.[iv] Let's assume that the value of 2025 imports would be roughly the same. If that's the case, then the tariff would generate around $42.7 billion in revenue, an unknown portion of which is likely to be passed along to the consumer. The 1st Trump administration imposed similar tariffs on what was then $380 billion in Chinese imports, and these tariffs were largely kept in place by the subsequent Biden administration.[v]

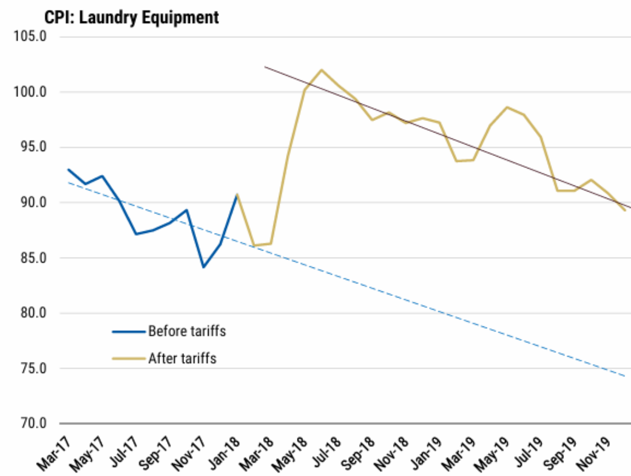
China retaliated, of course, hitting US exports to China like soybeans, sorghum, medical equipment, and agricultural machinery. Between mid-2018 and the end of 2019, US agricultural exports to China dropped by 76% which in turn prompted the US to backstop American farmers to the tune of $28 billion.[vi] The point is that trade wars can have tentacles. We hit them then they hit us. Governments do pick up revenue, but then sometimes have to pay that

revenue back out in order to shore up affected industries. At least a portion of the levy is almost always passed along to the consumer. This is not to say that tariffs won't have their desired effect - they may well be a riotous success – but even in victory, they can be costly. We also acknowledge that many will not unreasonably deem those costs to be justified if they ultimately lead to increased US manufacturing output. It's just impossible to know how costly, and who will pay that cost, until the things are actually in place.

So, we don't yet know what new tariffs will cost the economy, if anything, but let's look at what impact they may have had last go around. This also isn't easy math as taxes are not included in the Producer Price Index and tariffs are considered to be a tax. Nonetheless, research conducted by Mary Amiti of the New York Fed in 2019[vii] and Pablo Fajgelbaum, PhD of UCLA in 2022 suggests that producer prices increased by the amount of the tariffs within months. In other words, tariffs were ultimately passed along to the consumer in their entirety.[viii]




Source: BLS, Morgan Stanley Research



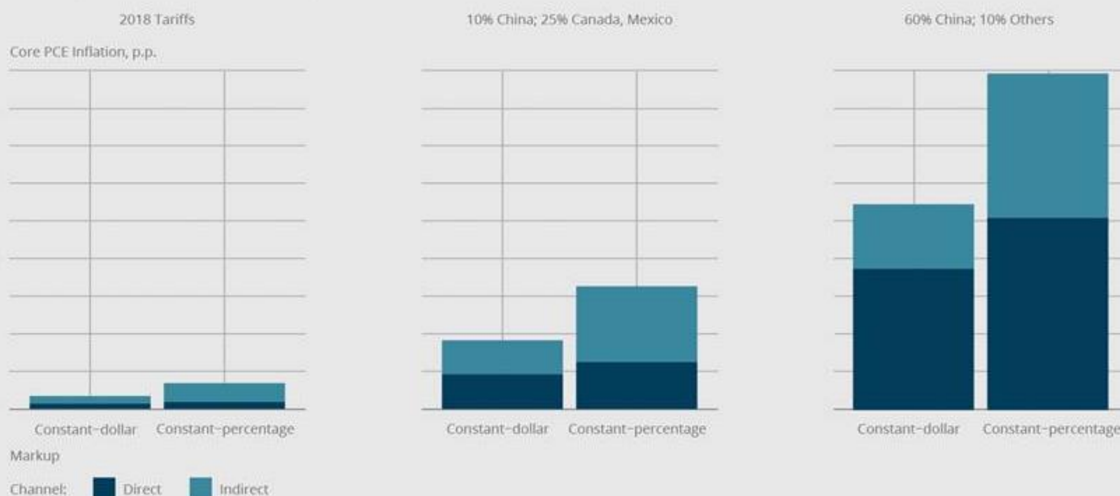

Source: BLS, Morgan Stanley Research

Prices rose, but did US manufacturers add workers? The US has been in the tariff business since the Tariff Act of 1789 was signed by George Washington on July 31st of that year, so this situation is far from novel. That first tariff was levied to, among other things, support the development of American manufacturing, and this has usually been the purported rationale behind most tariffs since. Did it work? Two charts below illustrate tariffs collected by the US since 1948 and US manufacturing employment since 1948. These charts should not suggest to you that tariffs have utterly failed in that mission. We just cannot know with any precision the extent to which tariffs have helped us retain some jobs that may have been otherwise lost to automation and offshoring.

The 2018-2019 tariffs were targeted, imposed on things like washing machines, solar panels, steel and aluminum. We have no reason to believe that any tariffs imposed this time around will not also end up being targeted, even though the administration's current posture is that they'll be all-encompassing. The potential impacts on inflation vary widely from minimal, if they resemble 2018, to substantial if applied as now advertised. The chart below attempts to predict that range of potential impacts.

## Figure 4: Contribution of 2018 Tariffs and 2025 Tariff Scenarios to PCE Inflation

Holding the rest of the economy constant




*Note(s): We compute the Core PCE contribution of 2018 tariffs using import tariff increases and targeted product-country categories from Fajgelbaum et al. (2019) weighted by the PCE contribution of each product. The country-product contributions refer to 2017 data. We compute the two scenarios for 2025 using our PCE contribution shares and assuming (1) a 25 percent tariff increase on all imports from Canada and Mexico and a 10 percent additional tariff on all imports from China and (2) a 60 percent tariff increase on all imports from China and a 10 percent increase on all other imports.*

*Source(s): US Bureau of Economic Analysis, US Census Bureau, Fajgelbaum et al. (2019), and authors' calculations.*

Federal Reserve Bank of Boston

In 2018, prices shocked to the upside, but leveled off fairly quickly and do not seem to have contributed meaningfully to inflation. That's not to say there weren't impacts. An auto manufacturer, for example, shuttered factories in Ohio, Maryland and Michigan citing steel tariffs as a cause[ix], and it's a similar impact we need to consider this time around. The American Automobile Labeling Act of 1994 restricts the definition of an "American Made" vehicle to one that has 55% or more of it's components originating in the US or Canada. Ergo, as much as 44% of an "American Made" car is assembled using foreign parts.[x] The same can be said of many widgets otherwise advertised as domestic.

Long story short: We can expect tariffs to goose inflation, which is one reason why we expect the Federal Reserve to delay additional cuts to the Fed funds rate at least until June and perhaps for the balance of the year. If tariffs are short and targeted, we would expect the pick-up in inflation to also be brief, with minimal impacts to the consumer. Longer tariffs more broadly applied could incrementally change that calculus. We just don't know which way its going to go. As Fed Chair Jay Powell opined in comments following the Fed's December meeting:

> "It's kind of common sense thinking that when the path is uncertain, you go a little bit slower. It's not unlike driving on a foggy night or walking into a dark room full of furniture; you just slow down."
>
> Jerome Powell, December 18, 2024

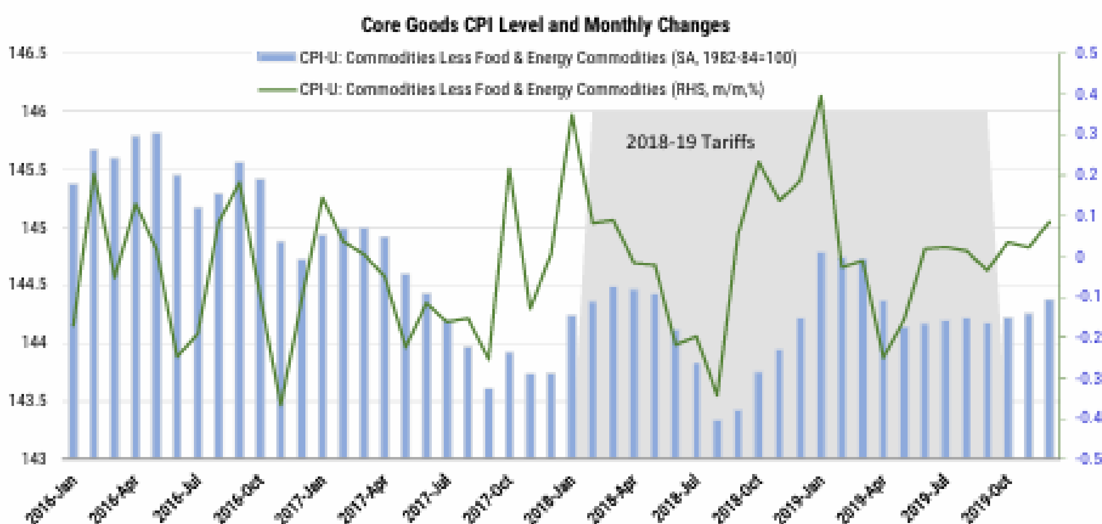
Let's say that tariffs do succeed in forcing domestic manufacturers to repatriate jobs to the US. The American manufacturing worker is the highest paid in the world, earning on average $28.50 per hour. The same worker in South Korea earns the equivalent of $9.08 per hour.[xi] The more American made stuff that goes into a product, the more it will cost. Morgan Stanley estimates that inflation as measured by the Personal Consumption Index (PCE) will increase by 0.6% and that overall inflation will increase as much as 1.1% putting the Fed's 2% target further out of reach. The firm also estimates that consumer spending will contract by as much as 2%. Larry Kudlow, the director of the National Economic Council during the first Trump term, was quoted as saying, "At least for now, the economic signals are flashing slower growth and higher inflation. Not good."

In economics, Newton's 3rd law of physics also applies: For every action there's an equal and opposite reaction. Lower interest rates, for example, mean that more Americans may be able to afford a mortgage loan. On the other hand, cheap mortgage rates can also drive up the price of housing thus making homes unaffordable regardless of the interest rate charged. In the same vein, increasing the percentage of goods that qualify as "made in America" can employ more Americans, but can also greatly increase the cost of those goods for other Americans. It isn't always a win-win.

Our base case, perhaps overly hopeful, is that tariffs will ultimately be targeted and of brief duration as the alternative, broad and long, would seem to be both politically and economically inexpedient. Nonetheless, the best advice we have is to hope for the best, but plan for the worst. Assess your tolerance for risk and talk to us about whether or not your positioning accurately reflects that tolerance. If that means leaving some upside on the table in the event that tariffs are a non-event, it seems to us a reasonable price to pay.

As always, should you have specific questions or concerns, we hope you'll never hesitate to ask. We always look forward to hearing from you.

**Exhibit 11:** While the pass-through of tariffs into the inflation rate of core goods CPI was relatively small, the sectoral effects were more persistent.




Source: BLS, Morgan Stanley Research

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 report 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 the investments mentioned will be in each client's portfolio.

Morgan Stanley Wealth Management has no obligation to notify you when information in this presentation changes.

International investing may not be appropriate for every investor and is subject to additional risks, including currency fluctuations, political factors, withholding, lack of liquidity, and the absence of adequate financial information, and exchange and control restrictions impacting foreign issuers. These risks may be magnified in emerging markets.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Equity securities may fluctuate in response to news on companies, industries, market conditions and the general economic environment. Companies cannot assure or guarantee a certain rate of return or dividend yield; they can increase, decrease or totally eliminate their dividends without notice.

Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies.

**Small- and mid-capitalization companies** may lack the financial resources, product diversification and competitive strengths of larger companies. In addition, the securities of small- and mid-capitalization companies may not trade as readily as, and be subject to higher volatility than, those of larger, more established companies.

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.

Value investing does not guarantee a profit or eliminate risk. Not all companies whose stocks are considered to be value stocks are able to turn their business around or successfully employ corrective strategies which would result in stock prices that do not rise as initially expected.

Rebalancing does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy.

Growth investing does not guarantee a profit or eliminate risk. The stocks of these companies can have relatively high valuations. Because of these high valuations, an investment in a growth stock can be more risky than an investment in a company with more modest growth expectations.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

The indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. For index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

This material is disseminated in the United States of America by Morgan Stanley Smith Barney LLC.

Morgan Stanley Smith Barney research, or any portion thereof, may not be reprinted, sold or redistributed without the written consent of Morgan Stanley Smith Barney.

Investments and services offered through Morgan Stanley Smith Barney LLC. Member SIPC. Graystone Consulting, a business of Morgan Stanley.

Morgan Stanley Smith Barney LLC ("Morgan Stanley"), its affiliates and Morgan Stanley Financial Advisors or Private Wealth Advisors do not provide tax or legal advice. Individuals should consult their tax advisor for matters involving taxation and tax planning and their attorney for matters involving trusts, estate planning, charitable giving, philanthropic planning or other legal matters.

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.

The NASDAQ Composite Index is a broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market. An investment cannot be made directly in a market index.

Morgan Stanley Smith Barney LLC is a registered Broker/Dealer, Member SIPC, and not a bank. Where appropriate, Morgan Stanley Smith Barney LLC has entered into arrangements with banks and other third parties to assist in offering certain banking related products and services.

The investments listed may not be appropriate for all investors. Morgan Stanley Smith Barney LLC recommends that investors independently evaluate particular investments and encourages investors to seek the advice of a financial advisor. The appropriateness of a particular investment will depend upon and investor's individual circumstances and objectives.

CRC 4285722 03/2025

---

[i] Source: Blomberg, FactSet, Morgan Stanley Wealth Management GIO
[ii] Source: Thompson Reuters
[iii] Source: US Trade Representative, ustr.gov
[iv] Source: US Census Bureau - https://www.census.gov/foreign-trade/balance/c5700.html

[v] Source: https://taxfoundation.org
[vi] Source: USDA, Agricultural Exports and Retaliatory Trade Actions, Applied Economic Perspectives and Policy 2021
[vii] Source: Federal Reserve Bank of New York
[viii] Source: "The Economic Impacts of the US-China Trade War," with Amit Khandelwal. Annual Review of Economics, vol. 14 (2022).
[ix] Source: nytimes.com/2018/11/26/business/general-motors-cutbacks.html

[x] Source: eCFR.gov Part 583, Automobile Parts Content Labeling
[xi] Source: https://tradingeconomics.com>southkorea