



Capital Markets Commentary – May 2025

If only it were that easy. Trade imbalances and less than fair (sometimes downright predatory) trade practices have vexed the US from the very beginning. Today, given our outsized share of global GDP, you'd think owning the bully pulpit would be enough. However, the problem is that the global economy is infinitely more interdependent than it was in the 50's, 60's, or 70's. Today, the global economy is a closely integrated ecosystem where even an apex species relies upon the contribution of seemingly minor players to survive and thrive.

Furthermore, our financial markets rely on this interdependence, and to be blunt about it, US financial markets like it just fine when global businesses and markets depend on us to be the responsible adult....steady, reliable, and predictable. We imagine, that on April 2nd, when the administration announced the largest tariffs imposed in over a century, that the world's dependence upon our leadership would necessarily force tariffed countries to rapidly capitulate. Not an entirely unreasonable assumption, but that's not what happened. We didn't get capitulation. What we got instead was a war and that's when things got ugly. When that war quickly began to hammer the dollar and US Treasury markets, two things that almost always go up, not down, during periods of global instability, the administration was forced to hit pause. We'll talk about why the dollar and the Treasury might have headed the wrong direction and why that scared markets silly in a moment, but first, let's look at the numbers for April.

You'd be forgiven for thinking that returns this month would be a train wreck. Dramatic and at times traumatic as the month was, indices were not much worse for the wear. The NASDAQ actually managed to pull off a teeny gain of 0.9%, and the S&P lost just 0.7%. The Dow, where the components tend to be more tariff sensitive, closed down 3.1% - down, but far from tragic. Europe, on the other hand, did very well indeed. The broader Eurozone STOXX 50 gained 3.9% and the German DAX ended the month up 6.6%. Returns in Asia were mixed, as one might expect. Whereas the Japanese Nikkei 225 added 6.3% in April, China's Shenzhen lost 4.5% while the Hang Seng lost 3.7%.ⁱ

Bonds as measured by the US ten-year Treasury, were wilder still. The ten-year started April at a yield of 4.15%, then the yield plunged to a low of 3.8% following the tariff announcement. But then things quickly went sideways. Yields began to rise sharply on April 7th, and continued surging through the 11th, when the benchmark bond hit 4.6%.ⁱⁱ Let's talk about why that might have happened and why it made markets nervous (heck, not going to lie...it made us nervous, too).

The US Treasury, and the dollar, are the Swiss army knives of the global economy. The Treasury is not just a way for the US to finance operations or for Treasury bond buyers to generate income. Treasuries can be bought by foreign companies who plan on making purchases or investments in the US. They can be bought by foreign governments who may want to redeem them for dollars with which to buy other currencies, particularly their own. Treasuries can also be held by people, institutions, and investment vehicles to hedge risk. These hedges can be more complex than a post-graduate physics class at M.I.T., but the strategy mostly boils down to the fact that when things get dicey in the economy, and equity markets stumble, the value of safer stuff like Treasuries is *supposed* to rise. The increasing value of that Treasury position can serve to offset some of your losses in stocks. And yet, in the aftermath of the tariff announcement, while many, if not most, analysts were projecting increased odds for recession and stocks were, day after day, heading alarmingly lower, Treasury (and dollar) prices were not rising....they were falling. On April 4th, the ten-year Treasury was yielding 3.88%. Just one week later, it kissed 4.6%. What broke?

There are a few reasons Treasury prices might have been falling, none of them good:

- The market may have feared that tariffs would cause a spike in inflation and with it, rising interest rates. When interest rates rise, bond prices fall, so traders could have been trying to unload Treasury positions before the bottom fell out.
- Investors (very large ones) could have been facing margin calls and selling Treasuries in order to raise cash to meet those calls.
- Foreign governments and companies could have been dumping Treasuries and dollars to pressure the US (kind of a conspiracy theory, but it's out there so we mention it), or more likely because they were suddenly less inclined to make investments in US businesses or dollar-denominated securities, or,
- Investors world-wide may have begun to wonder if the Treasury's safe-haven status might be in jeopardy.

Any or all of these things could have been true at the same time, but the result was that the bond market was falling at a time when it should have been rising. At Graystone Charleston, we've been around the block a bunch of times and in our experience, while downdrafts in equity markets can be alarming, downdrafts in debt markets can be downright dangerous. On the morning of April 9th, as Treasury yields continued to fall, to be perfectly honest, we were concerned. Apparently, and thankfully, so was the administration. Early that afternoon, the announcement came that most of the tariffs would be paused for 90 days. Equity markets exploded upwards with joy, posting the highest point gain and the 3rd highest percentage gain in index history.ⁱⁱⁱ Bonds prices rose, too, but not by much. Equity markets tend to be emotional things, but bond markets are more likely to take a more circumspect approach. Equity markets are happy to assume something good will happen. Bond markets want proof.

Plus, bond markets may still have been getting a strong whiff of inflation. Tariffs, after all, hadn't been cancelled, only "suspended," and the tariff on China had been raised to 145%. The 10% across-the-board tariffs left in place for the rest of our trading partners were still much larger than investors had anticipated. Markets had baked in broad tariffs in the neighborhood of 2.5%^{iv} so the reduced tariffs were still four times larger than the 2.5%, folks had planned for. Nevertheless, the partial rollback was enough to stabilize the Treasury market.

Then, just when we thought the situation couldn't get more chaotic, it did. If the US is viewed as the responsible adult of global markets, the US Federal Reserve is viewed as the responsible adult of the American financial system. The Fed is designed to be an independent body, not beholden to the whims and desires of politicians. To insulate the board from political pressure, the Board Chair is appointed to a four-year term, removable only for cause. The rule is intended to allow the Board room to make decisions they feel are in the best interest of the financial system, even if those decisions are not politically expedient. Jay Powell was appointed by President Trump in 2018 and

retained by Biden in 2022. His current term will not expire until May 2026, but on Monday, April 21st, the President launched a series of broadsides against Powell on social media. The S&P promptly tanked. Luckily, the White House did an about face, assuring investors that no attempt would be made to remove the Fed Chair. This assurance was, thankfully, enough to nip that round of selling in the bud.

So where does this leave us? While we hope that the worst of the volatility is behind us, these tariffs are so new that we're not yet seeing the impact bubble up through the hard data with the exception of a mildly negative GDP print for the first quarter. Nevertheless, we believe those impacts will soon become evident. We can expect to see, at least temporarily, a spike in inflation and a pronounced drop in spending not only because folks may be more circumspect about opening their wallets, but also because there may be less stuff to buy. According to a spokesman for the Port of Los Angeles, arriving cargo will be down 35% by next week, adding "essentially all shipments out of China for major retailers and manufacturers have ceased." This could in turn lead to softening employment. Apollo Global Management estimates that we could begin to see empty shelves within four to eight weeks.

Even if tariffs were reversed tomorrow, it'll take time for manufacturing and ship lading to come back on-line. Then, there's transit time. It takes a heavily loaded container ship about three weeks to travel from Hong Kong to LA,^v so all in, we're talking about five weeks to two months, maybe more, before inventories reappear on store shelves. Global trade can't restart, though, until some sort of rapprochement is reached. That could happen tomorrow, or it could take months; and the longer it takes, the harder it's going to be on the economy and US markets.

So what does this mean for markets going forward? Alas, while we have decades of experience in trying to anticipate how economic Policy A should result in Outcome B, what happens next is not a market question but a political one. Since the question is political and without precedent, we aren't even going to venture a guess as to what happens next. CEO's apparently feel the same way with some companies either issuing two versions of their earnings guidance, each dependent upon how long tariffs last, or suspending guidance all together.

But there is good news. Although consumer confidence is at record lows, CEO confidence is declining, and we're seeing the sharpest decline in the earnings outlook since 2020^{vi}.....wait, this is the good news? It is! Look, April was a rough month and commentary on the Street is very, very dark, and yet, year-to-date the S&P is down just 4.9%. For the trailing twelve months, the S&P is still *up* 12.1%. Despite the heavy mood, we're holding up pretty darn well.

Regular readers of this letter will know that we've been preaching caution for months now, and positioning for a correction. No, we did not see this coming. We did not guess that the *reduced* tariff menu would be of a magnitude four times greater than markets had baked in. But, based on valuations alone, we've adopted an increasingly defensive posture. We do believe we're appropriately positioned to mitigate downside capture, but we warn you that markets may remain volatile and perhaps range-bound for the foreseeable future. While we can speculate as to what some of the knock-on effects will be, we can't possibly anticipate them all. None of this is normal. If we were tempted to feel inadequate *because* we don't know what's going to happen, we can be consoled by the fact that nobody else knows, either, and anyone who claims they do know is lying.

It bears repeating: Trailing 12-month returns are still solid despite the whirlwind that was April. If you spent a single long night last month staring at the ceiling, we need to talk. Now. It's been a very long time since markets were this challenging. When they seem to do nothing but go up, it can be easy to assume more risk than we should. If you lost any sleep in April, let us help you sleep better in May.

Should you have specific questions or concerns, please never hesitate to call. We always look forward to hearing from you.

ⁱ Source: Morgan Stanley Wealth Management GIO, Bloomberg, FactSet

ⁱⁱ Source: Morgan Stanley Wealth Management GIO, Bloomberg, FactSet

ⁱⁱⁱ Source: msn.com/en-us/money/markets

^{iv} Source: Morgan Stanley Wealth Management GIC

^v Source: searates.com/distance-time/

^{vi} Source: Federal Reserve Bank of Philadelphia, Macrobond, Apollo Chief Economist

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. Interest on municipal bonds is generally exempt from federal income tax, however some bonds may be subject to the alternative minimum tax, accrued market discount taxes and / or capital gains taxes.

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.

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.

NOT FDIC INSURED / MAY LOSE VALUE / NOT BANK GUARANTEED / NOT A BANK DEPOSIT / NOT INSURED BY ANY GOVERNMENT AGENCY

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.

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

This communication contains links to third party websites that are not affiliated with Morgan Stanley. These links are provided only as a convenience. The inclusion of any link is not and does not imply an affiliation, sponsorship, endorsement, approval, investigation, verification or monitoring by Morgan Stanley of any information contained in any third-party website. In no event shall Morgan Stanley be responsible for the information contained on that site or your use of or inability to use such site. Furthermore, no information contained in the site constitutes a recommendation by Morgan Stanley to buy, sell, or hold any security, financial product, particular account or instrument discussed therein. You should also be aware that the terms and conditions of such site and the site's privacy policy may be different from those applicable to your use of any Morgan Stanley website.

Investing in fixed income securities involves interest rate risk, credit risk, and inflation risk. Interest rate risk is the possibility that bond prices will decrease because of an interest rate increase. When interest rates rise, bond prices, and the values of fixed income securities generally fall. Credit risk is the risk that a company will not be able to pay its debts, including the interest on its bonds. Inflation risk is the possibility that the interest paid on an investment in bonds will be lower than the inflation rate, decreasing purchasing power.

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.