Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

The Great Disconnect

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AUTHOR

BRUNO PAULSON
Managing Director

The second quarter was dramatic. It started with a sharp market fall in early April in the wake of the "Liberation Day" tariff announcement but the recalibration of tariff policy in the wake of the market turbulence helped fuel a very powerful rally, taking equity indices to all-time highs and turning a 10%+ drop in the MSCI World Index by April 8th into an 11% rise for the second quarter, the strongest quarter since the 2020 recovery from the COVID low.

While an element of the recovery does seem justified given the improvement in the environment since early April, the current euphoric atmosphere, with stretched valuations and record retail inflows, does seem tough to justify given the modest growth outlook and multiple sources of uncertainty. Indeed, we see a sharp disconnect between the state of the markets and the state of the real world.

The economic outlook has improved from the trough of early April. While growth expectations have slowed this year, with the Bloomberg consensus now for 1.5% U.S. real GDP growth in 2025 as against around 2% earlier in the year, this is a far cry from the Wall Street base case of a U.S. recession in the immediate aftermath of the "Liberation Day" tariff announcement. Equally, while inflation remains sticky and above the 2% Fed (U.S. Federal Reserve) target, we have yet to see a tariff induced acceleration.

The more positive take is that the "Taco trade"—a concept introduced by the media which implies that the Trump administration tends to back down with respect to policies that hit markets hard—has paid off so far and may well continue to work. The "Taco trade" talk has mainly been around tariffs following the step back on the "reciprocal" tariffs on April 9th, with the introduction of the 90-day pause.

The "Taco adjustments" go rather wider than just the trade arena. Business fears have also eased around immigration, or rather the repatriation of illegal immigrants in the U.S., with recent administration talk of more tolerance for un-documented workers, particularly in the farming sector. In addition, the rhetoric around deficit reduction, powered by a supposed massive DOGE[1]-driven cut in spending, which threatened to create a demand headwind in the U.S., has faded away, with the final version of the "One Big Beautiful Bill" set to increase the U.S. national debt by a

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further $3 trillion over the next decade, according to the Congressional Budget Office. This should provide an expansionary boost to the economy in 2026, mitigating the contractionary effect of the tariffs.

The less positive take is that significant political headwinds still remain for the economy and markets, as the negative economic impacts of the recent policy changes have yet to fully take effect. The existing arrangements imply a 15% effective tariff rate overall,[2] up from 2.5%, acting as both an effective tax on consumers and an inflationary shock, even before any further tariff rises as the 90-day pause expires. The full effects of these existing tariffs on consumer prices may well not have come through yet. Equally, the growth in the U.S. labour market is set to slow sharply, with Barclays expecting only 0.1% growth in 2026 and 2027 as against the 1%+ level that the U.S. economy is used to, given both ageing populations and minimal net immigration, which threatens both aggregate demand and corporate margins. More broadly, general policy uncertainty still remains very elevated, not least around the expiry of the 90-day pause, with implications for both consumer and business confidence.

Outside the administration, there have been two further boosts to markets since early April. One is that hyper-scaler capex forecasts have continued to rise despite the DeepSeek shock earlier in the year as the tech giants still expect massive demand for compute. The other is the decline of the dollar, with the ICE Dollar Index down over 10%[3] year to date (YTD). This helps overall revenues and earnings in dollar terms, given that other currencies make up half of MSCI World revenue and even 40% of the revenue earned by S&P500 companies.

While some of the tail risks of April seem to have faded, the overall outlook suggests an environment of only ordinary growth, with the U.S. slated to grow at just 1.5% in 2025 and 2026, below levels expected at the start of the year, with the European Union slower still at around 1%. There is also unusually high uncertainty around this unexciting outlook, given both raised geopolitical tensions and the unstable U.S. policy environment, leading to economists giving an elevated 38% chance of a U.S. recession in the next 12 months. Although the worst fears of early April have not been realised, it is hard to argue that the environment is better than it was at the start of the year.

By contrast, markets seem to be priced for a very different world, seemingly disconnected from the actual economies. Equity valuations look distinctly elevated versus history. The MSCI World Index is on close to 20x forward earnings, with the S&P500 Index at 22x. These extended multiples are on forward earnings that are meant to grow double-digit on the back of margins improving further from record highs. All this is at a time when U.S. earnings are actually falling, with the S&P500 expectations for 2025 and 2026 both down around 4% YTD, even measured in the fast-depreciating dollar. The fixed income markets also seem pretty cheerful, with the ICE BofA BBB US Corporate Spread Index down at 110bps,[4] close to the all-time lows achieved at the start of the year.

There is plenty of further evidence that markets are boisterous, euphoric or frothy, depending on your preferred adjective, beyond the extended overall valuations. Barclay's Equity Euphoria Indicator has bounced back through 10%, rivalling the levels of the dot-com boom and 2021's meme frenzy, perhaps unsurprisingly given that retail investors added a record $155 billion into equities in the first half of the year.[5] Looking at the drivers of the equity market advance, over half of the MSCI World's double-digit second quarter gain was concentrated in only two of the 25 industry groups, semiconductors and software & services, with 85% coming from just five groups, adding in the cyclical media & entertainment, banking and capital goods elements.

To summarise, our view is that the best estimate for the real-world outlook is mediocre, with a great deal of uncertainty. By contrast, markets seem to be pricing in a higher-growth scenario with a high level of certainty. There is plenty of evidence of euphoric behaviour by retail investors, who will now feel even more justified in buying every dip. Given this level of market optimism, it is unsurprising that Q2 was not a great environment for high quality companies with low operational and financial leverage which are likely to be robust in tough times. After all the market seems to be discounting any possibility of tough times. However, if our view of the great disconnect between markets and reality is close to being correct, high quality companies are likely to get a chance to show their mettle.

Source for data cited unless otherwise stated: FactSet

[1] U.S. Department of Government Efficiency

[2] The Budget Lab at Yale, as of June 17, 2025

[3] Bloomberg DXY Index

[4] The Federal Reserve Bank of St Louis

[5] Financial Times, VandaTrack

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