INVESTMENT PERSPECTIVES

FEBRUARY 2025

Key Takeaways —

- The case for U.S. exceptionalism.
- 4 key issues facing fixed income.
- What do the groundhog and the stock market have in common?

S&P 500 INDEX EXCEPTIONALISM

Mark Luschini, Chief Investment Strategist

Many have held a longstanding belief in American exceptionalism. Proponents of that view hold that the United States has a differentiated and distinguished position in the world. Similarly, many investors have come to believe that the U.S. stock market, commonly proxied by the S&P 500 Index, is exceptional, given its stellar performance over the past decade-plus when compared to the rest of the world. To be sure, the U.S. equity market has produced attractive returns over much longer periods of time, as have many other foreign stock markets.

However, an increasingly common refrain today is when, if ever, is the demonstrably superior performance that we have seen since 2013 versus the rest of the world going to end? Catalyzing that question is not only the rich valuation hosted by the S&P 500 index at about 22 times 12-month forward estimates of earnings, but also the widening disparity in valuations between the U.S. equity market and its foreign bourse counterparts.

We will start by reviewing just how good the returns have been for the U.S. equity market. Over the last 11 years ending December 31, 2024, the S&P 500 index (SPX) generated an annualized total return (price plus dividends) of around 13%. Meanwhile, the MSCI World ex USA Index (an equity index comprised of almost all developed market countries outside the U.S.) returned about 5% per year. It is easy to question, if one succumbed to the cognitive bias of recency, why any investor today would consider owning non-U.S. equities, at least in any sizable proportion of a portfolio. Arguably, there is a sound rationale for the S&P 500's outperformance. Companies in the U.S. have produced steadily rising and faster growth in revenues and earnings, had higher profit margins, and post-Great Financial Crisis better economic growth than most.

However, if one were to harken back to the 14-year period between December 31, 1999, and December 31, 2013, one observes that non-U.S. developed market equities outperformed their U.S. brethren. During that stretch, foreign equities delivered a cumulative total return of roughly 70%, while the SPX produced a 64% gain. The annualized difference in total return is somewhat negligible at 3.6% for the SPX versus 3.9% for the MSCI World ex USA., respectively. Still, it illustrates a lengthy stretch where the SPX was not quite "exceptional." In fact, there have been multiple periods, albeit fleeting, during the last 11 years of SPX dominance where foreign equities have outperformed. Unfortunately for investors teased by the tenuous gains that seemed to occur cyclically almost every other year and usually lasted just three to six months, they proved to be false dawns.

Where do we stand today? At face value, it seems pessimism toward foreign stocks is pervasive and priced in. Even after accounting for sectoral biases, where the U.S. equity market is dominated by iconic tech and tech-related companies when compared to most other developed markets that tend to have a large industrial and financial services weighting, the case can be made that non-U.S. equities trade at a rare discount to their U.S. counterparts. At the index level, the delta in the Price-to-Earnings (P/E) ratio of 8.6 represents a nearly 40% haircut for non-U.S. valuations, which is the deepest in the past quarter century and something that only narrowly existed before 2014.

Since then, it has not only expanded but widened in the past three years at an accelerating rate. This valuation gap alone offers a compelling margin of safety that's not as present in the U.S., given the SPX's lofty valuation. But is that enough?

One could surmise the current picture in foreign markets is bleak; therefore, the inexpensiveness is warranted. After all, economic activity is tepid at best, demographics are not working in favor of many developed economies, political dysfunction is rife in Europe, and geopolitical tensions could seemingly surge with the wrong turn of a phrase.

Yet markets do not move on today's news but rather on what is anticipated multiple quarters ahead. Furthermore, it is often just the anticipation of news that is less bad rather than unambiguously good that moves stock prices. On that, it is worth noting that the MSCI World ex USA Index is outperforming the SPX so far this year.

Obviously, this development is embryonic, and history tells us that this move may pass quickly; however, some economic green shoots have emerged recently, particularly in Europe, giving reason to think this may persist. A sustained decline in the Dollar against its foreign currency crosses would help to cement our interest in raising the capital allocation to non-U.S. equities, which we laid out in our Outlook 2025 publication. While we postulated that it could occur later this year, it may already be blossoming. Stay tuned. ■

4 KEY ISSUES FOR 2025

Guy LeBas, Chief Fixed Income Strategist

As an annual follow-up to our Year in Review issue of Investment Perspectives, this second issue of 2025 highlights four themes that will shape bond markets and broader financial conditions.

In 2024, we focused on productivity gains, policymakers' personal risk aversion, CTA-driven market trends, and private credit expansion. Some of these played a major role, while others had a smaller impact. The AI-driven productivity boom clearly lifted economic growth, a trend likely to continue. Policymakers, particularly Fed Chair Powell, exhibited noticeable risk aversion and resisted aggressive rate cuts to guard against inflation risks. Private credit expanded to become a market force, but the sector remains a sideshow to the broader bond markets. And finally, CTAs reinforced momentum trades in fixed-income markets, leading to periods of trending interest rates throughout 2024.

For 2025, we focus on **policy-driven inflation risk, corporate profit growth, mean-reverting interest rates, and the maturation of private credit** as key drivers of financial markets.

Table 1: Key Themes

Key Themes for 2024	Key Themes for 2025
Productivity Gains	Upside Inflation Risk from Policy
Policymaker Risk Aversion	Corporate Profit Growth
CTA	CTAs Get Chopped Up
Private Credit	Private Credit Matures

Source: Janney ISG

Upside Inflation Risk from Policy

Inflation trended lower in 2024, but new risks could push it higher in the back half of 2025—or at least create a risk of higher longer-term inflation. Instead of a traditional demand-driven rise, **tariffs and immigration restrictions** could increase costs. Higher import duties raise prices for manufacturers, while tighter immigration policies restrict the labor supply, fueling wage pressures. Non-productive wage gains tend to lead to higher inflation in the intermediate to longer term. If inflation moves higher, the Fed may keep rates elevated longer than expected, forcing markets to adjust. While not our base case, the risks do skew in that direction.

Corporate Profit Growth

After years of resilient earnings, 2025 will test whether companies can maintain profit momentum. The good news is that most forecasts have corporate earnings growing healthily in aggregate for the coming year, and early indications from 4Q earnings reports seem to reinforce those forecasts. Even so, margins face pressure from rising labor costs, input prices, and borrowing expenses. Some industries—especially those leveraging AI and automation—may sustain strong earnings, while others with weak pricing power could struggle. Since the former tend to be larger profit drivers of the broad market indices, the aggregate profit numbers will probably look a good bit better than the equal-weighted ones.

Mean-Reverting Interest Rates

After exhibiting periods of 8- to 12-week trends in 2024 (higher in 1Q, lower in 2Q - 3Q, and higher again in 4Q), we anticipate that interest rates will fluctuate in a narrower range in 2025. One reason for the trending markets last year was the prominence of Commodity Trading Advisors, or CTAs. CTAs are essentially rules-based hedge funds that mostly exacerbate momentum trades. While the sector was quite successful in 2024, we anticipate the capital will be less productive in 2025, leading to more choppy but narrower trading ranges. Longer-term macro themes like tariff risks could prove more powerful than this mean-reversion trading theme, but absent such macro shifts, we expect longer-term rates to oscillate around the mid-4% area.

Maturation of Private Credit

Private credit has grown into a $1.6 trillion market, reshaping corporate lending. In 2024, the sector expanded to include a wider range of borrowers and investors. Investors have poured capital into this space, allowing highly leveraged companies to refinance without major stress. In 2025, we expect private credit to represent the bulk of expansion in credit writ large, likely surpassing the high-yield bond market in size. While we were skeptical about the sector in its early stages, as private credit matures, it will maintain a more significant place in investor allocations. Still, liquidity and credit risks are significant, and we are watching for any signs of weaker underwriting and excess risk-taking in the sector.

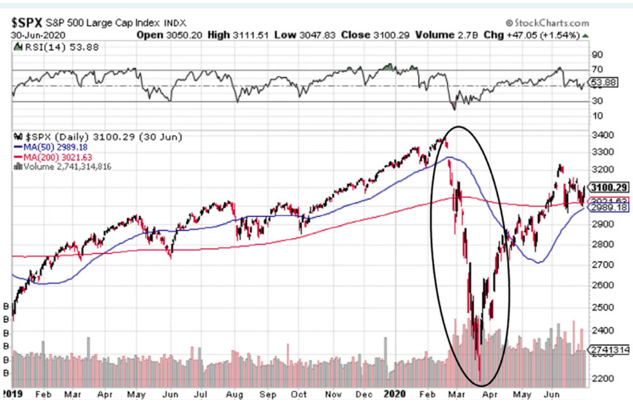
A TREND IS NOT ALWAYS YOUR FRIEND

Gregory M. Drahuschak, Market Strategist

Punxsutawney Phil cast a cold shadow on prospects for a quick end to winter as his February 2, 2025, appearance on Gobbler's Knob suggested winter's chill will be with us for six more weeks. Phil is an American institution that led the governor of Pennsylvania to name him the "official state meteorologist" last year. Phil's meteorological acumen, however, has been mediocre at best, as history shows that he has been correct only slightly more than a third of the time. In a tongue-and-cheek context, coming as Groundhog Day does in February, the context might extend Phil's warnings of a chilly environment to the stock market.

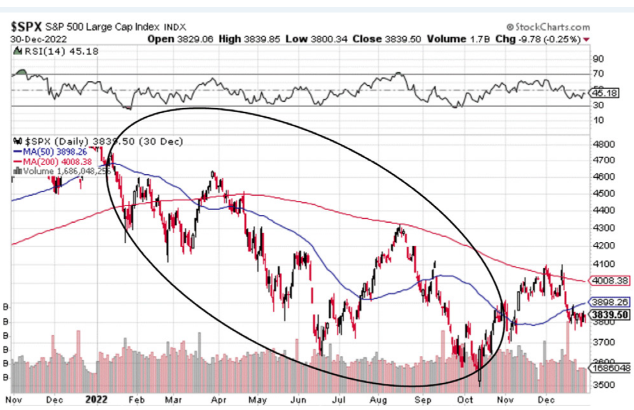
Of the 137 years when Phil ventured from his burrow to offer a weather prediction, he suggested an early spring only 20 times. In 2000, Phil predicted an extended winter. That year, the stock market suffered through a severe cold spell, and from February 24 through March 23, the S&P 500 index dropped 34%.

Chart 1: S&P 500 Large Cap Index



Source: Stockcharts.com; Janney Investment Strategy Group

Chart 2: S&P 500 Large Cap Index

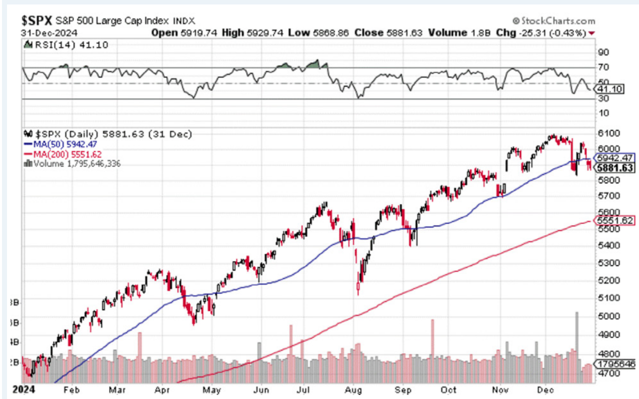


Source: Stockcharts.com; Janney Investment Strategy Group

Twenty-two years later, Phil forecasted that winter would be with us longer. That year, the stock market had a cold start as the S&P 500 peaked on January 3 and then fell 27.55% by October.

The S&P 500 did not follow Phil's 2024 icy expectations. China's Shanghai Composite Index dropped 26.3% ahead of the Chinese New Year last year, but the S&P 500 spent last year heading sharply higher.

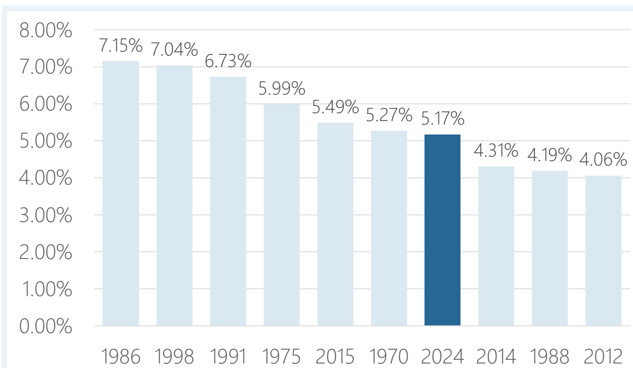
Chart 3: S&P 500 Large Cap Index



Source: Stockcharts.com; Janney Investment Strategy Group

Meteorological predictions—Phil's or anyone else's—likely will have nothing to do with what the stock market does this month or in 2025.

Chart 4: 10 Best S&P 500 February Results



Source: Thomson Financial Janney Investent Strategy Group

Often, February is a productive but choppy month for stocks. February is one of only three months (February, August, and September) that, on average since 1950, have ended lower. However, in the previous 75 years, the S&P ended higher 42 times in February. Last year, the fifth-best February result was produced, and the S&P 500 ended the month up 5.17%. The worst February was the recession-induced 10.99% loss. Five of the 11 worst S&P 500 February losses happened from 2008 to 2020.

Earnings report season will be an important part of the market this month as investors examine how most major companies fared in the final quarter of 2024. These reports, however, will be viewed as old news, with attention rapidly shifting to guidance from companies about the current quarter and potentially the full year.

Famed market technician Marty Zweig is credited with applying a physics principle to the stock market. He noted that a trend remains in force until broken, which he used as a key technical consideration.

The market this month will be looking for a positive break from the current mediocre earnings expectations trend.

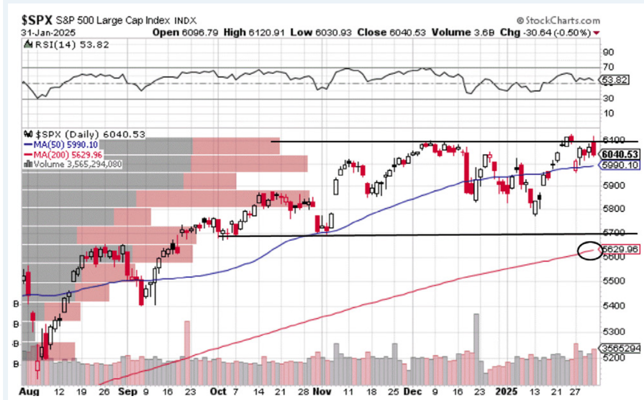
Chart 5: 2025 S&P 500 Earnings Estmate

Source: CFRA-Standard & Poor's; Janney Investment Strategy Group

Turning earnings expectations higher could hinge on guidance offered by reporting companies during earnings season. As of January, only 25 S&P 500 companies offered first-quarter earnings guidance, with 13 positive and 12 negative. With the heavy slate of earnings releases still ahead, more firms will join this list.

Since October 2024, the Dollar Index was up as much as 10% early in January before pulling back modestly by the end of the month. With 30-40% of S&P 500 revenues coming from foreign operations, the path of the dollar could be a notable headwind holding back overseas earnings. The market also will closely monitor how tariffs might impact business overseas. Nonetheless, earnings expectations remain positive. According to FactSet, S&P 500 earnings are expected to be up 10.1%, with double-digit growth leading to a 14.3% full-year earnings gain.

Chart 6: S&P 500 Large Cap Index



Source: Stockcharts.com; Janney Investment Strategy Group

Although the S&P 500 set a new high late last month, it did so without the upside thrust often associated with new highs. However, as the accompanying chart suggests, sufficient technical support exists to keep interim bouts of weakness well contained—a prediction we think should beat Punxsutawney Phil's weather record.

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